LINDA LINGLE
GOVERNOR

JAMES R. AIONA, JR.
LT. GOVERNOR

KURT KAWAFUCHI
DIRECTOR OF TAXATION

SANDRA L. YAHIRO
DEPUTY DIRECTOR

STATE OF HAWAII
DEPARTMENT OF TAXATION
P.O. BOX 259
HONOLULU, HAWAII 96809

PHONE NO: (808) 587-1577
FAX NO: (808) 587-1584

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DEPARTMENT OF TAXATION ANNOUNCEMENT NO. 2006-06

RE: Act 124, Session Laws of Hawaii 2006, Relating to Conformity of the Hawaii Income Tax Law to the Internal Revenue Code (Act 124)

On May 24, 2006, the Governor signed H.B. No. 2412, H.D.1, S.D.1, C.D.1 into law as Act 124. Act 124 amends Hawaii's income tax law to conform to certain federal income tax law changes.

Section 235-2.5(c) of the Hawaii Revised Statutes (HRS) mandates that the Department of Taxation submit to each regular session of the Legislature a bill to conform to the changes in the Internal Revenue Code (IRC). The adoption of the amendments to the IRC sections assures continued State conformity with federal income tax law and minimizes taxpayers' burdens in complying with Hawaii's income tax law.

Reviewed were the federal income tax law changes resulting from the following federal acts:

1. An Act to amend the Internal Revenue Code of 1986 to extend the Leaking Underground Storage Tank Trust Fund financing rate. (P. L. No. 109-006; March 31, 2005);
2. The Act to Provide for Proper Tax Treatment of Certain Disaster Mitigation Payments of 2005 (P. L. No. 109-007; April 15, 2005);
3. The Energy Policy Act of 2005 (P. L. No. 109-58; August 8, 2005);
4. The Safe, Accountable, Flexible, Efficient Transportation Equity Act: A Legacy for Users of 2005 (P. L. No. 109-59; August 10, 2005);
5. The Katrina Emergency Tax Relief Act of 2005 (P. L. No. 109-73; September 23, 2005);
6. The Gulf Opportunity Zone Act of 2005 (P. L. No. 109-135; December 21, 2005); and
7. The Mental Health Parity Act (P. L. No. 109-151, December 30, 2005).

PART I. Section 235-2.3, HRS – Conformance to the Federal Internal Revenue Code; General Application

A. <u>In General</u>

Section 1 of Act 124 amends section 235-2.3 of the HRS to conform the Hawaii Income Tax Law to the operative IRC sections of subtitle A, chapter 1, amended as of December 31, 2005. Generally, subtitle A, chapter 1, refers to the IRC sections 1 through 1400T.

B. Non-Conformity to IRC Section 1400O

Section 235-2.3 of the HRS is amended to decouple from section 1400O of the IRC. The Gulf Opportunity Zone Act temporarily expands the Hope and Lifetime Learning credits for students attending an eligible education institution located in the Gulf Opportunity Zone. In addition, for Gulf Zone students, Hope and Lifetime Learning credit qualified tuition and related expenses include section 529(e)(3) qualified higher education expenses. Hawaii does not conform to the Hope and Lifetime Learning credits contained in section 25A of the IRC.

C. Non-Conformity to IRC Section 1400P

Section 235-2.3 of the HRS is amended to decouple from section 1400P of the IRC. Section 1400P provides an exclusion from income for the employee and a credit to the employer for housing provided by certain employers to certain employees in the Gulf Opportunity Zone.

D. Non-Conformity to IRC Section 1400R

Section 235-2.3 of the HRS is amended to decouple from section 1400R of the IRC. The 2005 Gulf Opportunity Zone Act provides an employee retention credit for employers affected by Hurricane Katrina, Hurricane Rita and Hurricane Wilma, *i.e.*, an income tax credit to eligible employers in an amount equal to 40% of the qualified wages for each eligible employee. The employment relief credits allowed by section 1400R are authorized under section 38 of the IRC, which is not operative for the purposes of section 235-2.3 of the HRS.

E. Non-Conformity to IRC Section 1400T

Section 235-2.3 of the HRS is amended to decouple from section 1400T of the IRC. The Gulf Opportunity Zone Act makes changes to the qualified mortgage bond rules for financing provided before Jan. 1, 2011, for owner-occupied residences in the Gulf Opportunity Zone, the Rita Gulf Opportunity Zone, or the Wilma Gulf Opportunity Zone.

PART II. Section 235-2.45, HRS – Operation of Certain Internal Revenue Code Provisions; Sections 641 to 7518

A. In General

Section 2 of Act 124 amends section 235-2.45 of the HRS to clarify the application of sections 1400N and 1400S of the IRC.

B. IRC Section 1400N

Section 235-2.45(g) decouples from certain subsections of 1400N of the IRC. Hawaii will conform to the subsections of 1400N that provide additional allocations of low-income housing credit dollar amount in the Gulf Opportunity Zone; the election to expense 50% of demolition and debris removal costs paid or incurred in the Gulf Opportunity Zone; the election to expense qualified environmental remediation costs for sites in the Gulf Opportunity Zone; an increase in

the limitation under section 194(b)(1)(B) for "qualified timber property"; net operating loss incurred by small timber producers before January 1, 2007, attributable to the Gulf Opportunity Zone are allowed a five-year carryback; an election for taxpayers to treat certain casualty losses to public utility property caused by Hurricane Katrina as a specified liability loss eligible for the 10-year net operating loss carryback period; a special five-year carryback period for net operating loss to the extent of certain amounts related to Hurricane Katrina or the Gulf Opportunity Zone; and an election for taxpayers to deduct Gulf Opportunity Zone public utility property loss from Hurricane Katrina in the fifth tax year before the year of loss.

C. IRC Section 1400S

Section 235-2.45(h) decouples from certain subsections of 1400S of the IRC. Hawaii will conform to the subsections of 1400S that provide temporary suspension of the percentage limitations on charitable deductions for certain cash contributions made after Aug. 27, 2005 and before Jan. 1, 2006 to certain charities; the amount allowed as a charitable contribution deduction is not treated as an itemized deduction for purposes of the overall limitation on itemized deductions to the extent it does not exceed the "qualified contributions" paid during the tax year; the removal of the two limitations on personal casualty and theft losses (the "$100-per-casualty floor" and the "10%-of-AGI threshold") for losses related to Hurricane Katrina, Hurricane Rita, and Hurricane Wilma. Hawaii will not conform to subsection (d) of 1400S with respect to the special rule for determining earned income.

PART III. Brief Description of the Federal Acts that Passed in 2005 that Amended the Internal Revenue Code

A. An Act to Amend the Internal Revenue Code of 1986 to Extend the Leaking Underground Storage Tank Trust Fund Financing Rate

Paragraph (3) of section 4081(d), IRC is amended by extending the applicable date from April 1, 2005 to October 1, 2005.

Hawaii does not conform to section 4081 of the IRC.

B. The Act to Provide for Proper Tax Treatment of Certain Disaster Mitigation Payments of 2005

a. This Act amends section 139 of the IRC (relating to disaster relief payments) by adding subsection (g), which excludes from gross income any qualified disaster mitigation payments.

Hawaii has conformed to the disaster relief payments income exclusion under section 139 of the IRC and conforms to this amendment.

b. Section 1033 of the IRC (relating to involuntary conversions) is amended by re-designating subsection (k) as subsection (l) and adding a new subsection (k), which treats sales or exchanges under the Robert T. Stafford Disaster Relief and Emergency

Assistance Act or the National Flood Insurance Act as involuntary conversions for the purposes of this section.

Hawaii has conformed to the involuntary conversions provisions under section 1033 of the IRC and conforms to this amendment.

C. The Energy Policy Act of 2005

The following highlights some of the provisions of this Act:

a. This Act provides for expensing of 50% of the cost of certain capacity-increasing refinery investments, generally effective for property placed in service after August 8, 2005 and before 2012. The original use of the property must begin with the taxpayer.

Hawaii has conformed to this new deduction provision under section 179C of the IRC.

b. This Act provides a new deduction for energy efficient commercial buildings meeting a 50% energy reduction standard. The deduction (generally $1.80 per square foot, but 60 cents per square foot in some cases) is effective for property placed in service after December 31, 2005 and before January 1, 2008.

Hawaii has conformed to this new deduction provision under section 179D of the IRC.

c. This Act provides tax credits for the following: the construction of new energy efficient homes; fuel produced from non-conventional sources; coke and coke gas from qualified facilities; a new 10% personal tax credit for energy efficient improvements to existing homes; the purchase of hybrid, fuel cell, advanced lean burn diesel and other alternative power vehicles; investments in clean coal facilities producing electricity; certain gasification projects; qualifying advanced nuclear power facilities; a small agri-biodiesel producer credit for the biodiesel fuels credit; the purchase of fuel cell power plants; the small ethanol producer credit to producers with annual production capacity of 60 million gallons and clean renewable energy bonds income tax credit

Hawaii does not conform to the tax credits allowed under the relevant IRC sections.

d. The Act provides tax incentives such as an elective five-year carryback of net operating losses for certain electric companies; a two-year writeoff of geological and geophysical expenses; a 84-month amortization for the cost of power-plant air pollution controls; a seven-year recovery period for natural gas gathering; a 15-year writeoff for certain assets used in the transmission of electricity for sale and related land improvements and natural gas distribution lines; expensing of 50% of the cost of certain capacity-increasing refinery investments.

Hawaii has conformed to these amendments.

e. The Act modifies depreciation recapture rules to treat disposition of multiple amortizable intangibles in a single transaction as if all the intangibles were a single asset.

Hawaii has conformed to this amendment.

D. The Safe, Accountable, Flexible, Efficient Transportation Equity Act: A Legacy for Users of 2005

The amended IRC sections under this Act are not operative for the purposes of sections 235-2.3, 235-2.4 and 235-2.45 of the HRS.

E. The Katrina Emergency Tax Relief Act of 2005

This Act includes a number of tax incentives to encourage rebuilding of the areas ravaged by Hurricane Katrina. For the most part, this Act made law changes that did not amend the Internal Revenue Code. Many of the Katrina Emergency Tax Relief Act of 2005 provisions, though technically repealed, were codified and expanded to apply to Hurricanes Rita and Wilma by the Gulf Opportunity Zone Act of 2005. Key provisions of the 2005 Katrina Emergency Tax Relief Act that were not repealed or modified by the Gulf Opportunity Zone Act of 2005 include exclusion from income of discharge of debt related to Katrina; work opportunity tax credit; extension of replacement period for Katrina-related involuntary conversions; new limited exemption for housing Katrina victims; increase in charitable standard mileage rate for Katrina relief; temporary enhanced charitable deduction for contributions of food inventories; and temporary enhanced charitable deduction for C corporation contributions of book inventories. Hawaii has conformed to these provisions, to the extent that Hawaii conforms to the IRC provisions amended.

F. The Gulf Opportunity Zone Act of 2005

This Act contains many technical corrections to a number of earlier laws. These corrections include section 199, domestic production activities deduction rules; section 409A rules for nonqualified deferred compensation; section 965 dividends repatriation rules; the S corporation rules relating to the election to treat family members as one shareholder; the tax shelter rules; rules relating to expensing of certain film and television production costs; rules relating to reforestation costs; rules relating to the definition of nonqualified preferred stock; rules relating to the state and local sales tax itemized deduction and the alternative minimum tax; rules relating to the sale of a principal residence following a section 1031 exchange; rules relating to donee reporting of donations of motor vehicles, boats and airplanes; rules relating to the limit on the employer deduction for certain entertainment expenses; and rules relating to the uniform definition of a child in the Working Families Tax Relief Act of 2004. Hawaii has conformed to those amendments, to the extent Hawaii conforms to the IRC section amended.

The 2005 Gulf Opportunity Zone Act establishes a Gulf Opportunity Zone, which is defined as the portions of the Hurricane Katrina, Hurricane Rita and Hurricane Wilma disaster areas that have been designated by the President to warrant individual or individual and public assistance under the Stafford Act because of Hurricanes Katrina, Rita and Wilma. The 2005

Katrina Relief Act provided a package of income tax relief provisions to help victims of Hurricane Katrina, and did so for the most part through changes that did not amend the Internal Revenue Code. The 2005 Gulf Opportunity Zone Act extends the 2005 Katrina Relief Act income tax relief measures to Hurricanes Rita and Wilma as well. Technically, it does so by repealing the relevant 2005 Katrina Relief Act provisions as of the 2005 Gulf Opportunity Zone Act's December 21, 2005 effective date and incorporating them into broader 2005 Gulf Opportunity Zone Act provisions that amend the Internal Revenue Code to benefit victims of Hurricanes Katrina, Rita and Wilma.

Sections 1400N through 1400T, the major relief provisions, were discussed previously.

G. The Mental Health Parity Act

The 2005 Mental Health Parity Act includes a single provision, section 9812 of the IRC, that extends the federal excise tax for failure to comply with the mental health parity requirements an additional year through December 31, 2006. Section 9812 of the IRC is not under subtitle A, chapter 1. Therefore, Hawaii law does not conform to this provision.

PART IV. Effective Date

Act 124 shall apply to taxable years beginning after December 31, 2005; provided that section 235-2.4(h) of the HRS, shall apply to contributions made between August 28, 2005, to December 31, 2005.

For further information, please contact the Rules Office at (808) 587-1577.



KURT KAWAFUCHI
Director of Taxation