LINDA LINGLE
GOVERNOR

JAMES R. AIONA, JR.
LT. GOVERNOR

KURT KAWAFUCHI
DIRECTOR OF TAXATION

MARIE C. LADERTA
DEPUTY DIRECTOR

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

PHONE NO: (808) 587-1510
FAX NO: (808) 587-1560

August 3, 2005

DEPARTMENT OF TAXATION ANNOUNCEMENT NO. 2005-12

RE: Act 60, Session Laws of Hawaii 2005, Relating to Conformity of the Hawaii Income Tax Law to the Internal Revenue Code (Act 60)

On May 19, 2005, the Governor signed S.B. No. 834, S.D. 2, H.D. 1, into law as Act 60. Act 60 amends Hawaii's income tax law to conform to certain federal income tax law changes.

Hawaii Revised Statutes (HRS) § 235-2.5(c) mandates that the Department of Taxation (Department) 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 and the provisions of Public Law 109-001 assure continued State conformity with the federal income tax law and minimize 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. The Pension Funding Equity Act of 2004 (P. L. No. 108-218, April 10, 2004);

2. The Working Families Tax Relief Act of 2004 (P. L. No. 108-311; October 4, 2004);

3. The American Jobs Creation Act of 2004 (P. L. No. 108-357, October 22, 2004);

4. An Act to accelerate the income tax benefits for charitable cash contributions for the relief of victims of the Indian Ocean tsunami (P.L. No. 109-001, January 7, 2005); and

5. Sec. 201. Disclosure of tax information in terrorism and national security investigations (P.L. 107-134, January 23, 2002).

PART I. HRS § 235-2.3 – Conformance to the IRC; General Application

A. In General

Section 2 of Act 60 amends HRS § 235-2.3 to conform the Hawaii Income Tax Law to the operative IRC sections of subtitle A, chapter 1, amended as of December 31, 2004. Generally, subtitle A, chapter 1, refers to IRC §§ 1 through 1400L.

B. <u>Adoption of the Provisions of Public Law 109-001</u>

The provisions of Public Law 109-001, An Act to accelerate the income tax benefits for charitable cash contributions for the relief of victims of the Indian Ocean tsunami, January 7, 2005, are also adopted. Although H.R. 241 (P.L. 109-001) was enacted on January 7, 2005, the purpose of HRS §§ 235-2.5(c) and 235-3 is broad enough to include the provisions of P.L. 109-001 in Act 60.

P.L. 109-001 allows taxpayers to treat qualified charitable cash contributions that were made in January 2005 for the relief of victims in areas affected by the December 26, 2004 Indian Ocean tsunami as if such contributions were made on December 31, 2004, and not in January 2005, for purposes of IRC § 170. Taxpayers who may benefit from the provisions of P.L. 109-001 are (a) individuals who itemize their deductions and (b) other calendar year taxpayers.

To qualify for the accelerated deduction, all four criteria must be met:

- The charitable contribution must be in the form of cash. Marketable securities and other property do NOT qualify for purposes of P.L. 109-001. Charitable contributions made by (a) check are treated as cash contributions and (b) credit card are treated as cash contributions at the time of the credit card charge;
- The charitable cash contribution must be made in January 2005 (after December 31, 2004 and before February 1, 2005);
- The charitable cash contribution must be paid to an eligible charitable organization whose program(s) support relief operations in the Indian Ocean basin (e.g., programs that help to eliminate the burden of shipping goods overseas and stimulate the economic growth by generating more cash flow in the Indian Ocean basin's economies); and
- The charitable cash contribution must be pledged and fully earmarked to aid victims in areas affected by the December 26, 2004 Indian Ocean tsunami, for which a charitable contribution deduction is allowed under IRC § 170. The taxpayer must have records to substantiate that the charitable cash contribution was pledged and fully earmarked to provide the aforementioned aid.

The following contributions do NOT qualify for purposes of P.L. 109-001:

- Charitable contributions to foreign organizations;
- Charitable contributions pledged, earmarked, or used to fund programs that do not solely provide Indian Ocean tsunami-related disaster relief; or
- Non-cash charitable contributions such as marketable securities and other property contributions.

Taxpayers may choose to deduct qualified charitable cash contributions for either (a) the 2004 tax year or (b) the 2005 tax year. Multiple contributions may be treated as separate contributions for purposes of this allocation. However, the qualified charitable cash contribution can only be deducted once. Taxpayers claiming a deduction for the 2004 tax year with respect to the qualified charitable cash contribution shall NOT claim a deduction for the 2005 tax year with respect to the same contribution.

Other than Public Law 109-001, federal income tax law changes enacted during the 2005 calendar year have not been considered for purposes of Act 60 and will be taken into consideration during the 2006 legislative session.

C. Definition of Surviving Spouse and Head-of-Household

HRS § 235-2.3 is amended to clarify that IRC §§ 2(a), 2(b), and 2(c) are adopted solely for the purpose of defining "surviving spouse" and "head-of-household," and determining if a husband and wife are entitled to file a joint Hawaii return for purposes of HRS §§ 235-52, 235-1, and 235-93, respectively.[1]

D. Non-Conformity to IRC § 114

HRS § 235-2.3 is amended to clarify that, although the American Jobs Creation Act of 2004 repealed IRC § 114 (exclusion of extraterritorial income and disallowance of deductions related to such excluded income), Hawaii has NOT adopted the related transitional rule for 2005 and 2006 and grandfather clause with respect to any transaction occurring pursuant to a binding contract.[2]

For Hawaii income tax purposes, a taxpayer who has excluded extraterritorial income and has not deducted expenses related to such excluded income, under the transitional rule or grandfather clause related to the repeal of IRC § 114, on the taxpayer's federal income tax return must adjust the taxpayer's Hawaii adjusted gross income or taxable income (as applicable) for such amounts.[3] See PART V of this Announcement for further information.

E. Non-Conformity to IRC § 179B

HRS § 235-2.3 is amended to decouple from IRC § 179B, deduction for capital costs incurred in complying with environmental protection agency sulfur regulations. IRC § 179B allows small business refiners to immediately deduct as an expense up to 75 percent of the costs paid or incurred for the purpose of complying with the Highway Diesel Fuel Sulfur Control Requirements of the Environmental Protection Agency (EPA). Costs qualifying for the deduction are those costs paid or incurred with respect to any facility of a small business refiner during the period beginning on January 1, 2003, and ending on the earlier of the date that is one year after the date on which the taxpayer must comply with the applicable EPA regulations or December 31, 2009. For IRC § 179B purposes, a small business refiner is a refiner of crude oil who employs not more than 1,500 employees directly in refinery operations and who has had average daily domestic refinery runs for the one-year period ending on December 31, 2002 (average) of less than 205,000 barrels. The deduction is reduced for small business refiners with an average in excess of 155,000 barrels.

For Hawaii income tax purposes, a taxpayer who has deducted such expense under IRC § 179B on the taxpayer's federal income tax return must increase the taxpayer's Hawaii adjusted gross income or taxable income (as applicable) for the amount of such expense. See PART V of this Announcement for further information.

---

[1] HRS § 235-1 defines "head of household" as any individual who qualifies as a head of household under the Internal Revenue Code. HRS § 235-52 defines "surviving spouse" as a surviving spouse as defined in the Internal Revenue Code. HRS § 235-93 allows a husband and wife to file a joint Hawaii income tax return if such husband and wife are considered married for federal tax purposes and are entitled to make a joint federal return for the taxable year. By adopting IRC §§ 2(a), 2(b), and 2(c) definitions of "head of household," "surviving spouse," and "certain married individuals living apart" with respect to an individual being treated as not married at the close of the taxable year, taxpayers have a definite source of reference in connection with HRS §§ 235-1, 235-52, and 235-93.

[2] In prior years, Hawaii has never adopted IRC § 114 and has carved out the adoption of IRC § 114 via HRS § 235-2.3. If IRC § 114 is completely repealed with no transitional rule and grandfather clause, there would be no need to carve out the adoption of IRC § 114 via HRS § 235-2.3. Since the American Jobs Creation Act of 2004 includes a transitional rule for 2005 and 2006 and a grandfather clause for any transaction occurring pursuant to a binding contract and Hawaii has not adopted the transitional rule and grandfather clause, the non-conformity to IRC § 114 via HRS § 235-2.3 is necessary.

[3] For tax treatment , see HRS §§ 235-4 and 235-5 AND HRS chapter 235, Part II, Uniform Division of Income for Tax Purposes.

F. Non-Conformity to IRC § 181

HRS § 235-2.3 is amended to decouple from IRC § 181, treatment of certain qualified film and television productions. IRC § 181 allows taxpayers who have incurred qualified film or television production costs to elect to deduct such costs in the year the costs are incurred in lieu of capitalizing and recovering the costs through depreciation allowances.

For Hawaii income tax purposes, a taxpayer who has deducted such expense under IRC § 181 on the taxpayer's federal income tax return must increase the taxpayer's Hawaii adjusted gross income or taxable income (as applicable) for the amount of such expense. See PART V of this Announcement for further information.

G. Non-Conformity to IRC § 199

HRS § 235-2.3 is amended to decouple from IRC § 199, deduction for U.S. production activities. IRC § 199 replaces the exclusion of extraterritorial income. The IRC § 199 deduction is equal to a portion of a taxpayer's qualified production activities income and applies to a very broad base of taxpayers and activities.

In addition to taxpayers who have primarily exported products and benefited from the exclusion of extraterritorial income, taxpayers whose products are primarily or exclusively consumed in the United States will also benefit from the IRC § 199 deduction.

For IRC § 199 purposes, qualified production activities income means net income (domestic production gross receipts net of expenses) from the following activities:

- U.S. manufacturing;
- Production, including electricity, natural gas and potable water production;
- Growth, including food production, food storage, and food processing;
- Extraction activities;
- U.S. film production;
- U.S. construction activities; and
- U.S. engineering and architectural services

For IRC § 199 purposes, domestic production gross receipts means:

- Income derived from leasing, renting, licensing, selling, exchanging, etc.:
  - Tangible personal property, computer software, and any sound recordings that was manufactured, produced, grown, or extracted by the taxpayer in whole or in significant part within the United States, including food processing and food products if such food products were not prepared and sold at retail at the taxpayer's retail establishment;
  - Qualified film (any motion picture film or videotape, live or delayed television programming) produced by the taxpayer; or
  - Electricity, natural gas, or potable water produced by the taxpayer in the U.S.;
- Income derived from the sale, exchange or other disposition of agricultural products; or
- Gross receipts derived from:
  - Construction activities performed in the United States; or
  - Engineering or architectural services performed in the United States for construction projects in the United States.

For Hawaii income tax purposes, a taxpayer who has deducted such expense under IRC § 199 on the taxpayer's federal income tax return must increase the taxpayer's Hawaii adjusted gross income or taxable income (as applicable) for the amount of such expense. See PART V of this Announcement for further information.

H. Non-Conformity to IRC §§ 1352 - 1359

HRS § 235-2.3 is amended to decouple from Subchapter R, IRC §§ 1352 - 1359, election to determine corporate tax on certain international shipping activities using per ton rate. Subchapter R, IRC §§ 1352 – 1359, allows corporations to elect a "tonnage tax" in lieu of the U.S. corporation income tax on the corporation's taxable income attributable to the corporation's international shipping activities. An electing corporation is subject to tax on "qualifying shipping activities" only at the maximum corporation income tax rate on its "notional shipping income," which is based on the net tonnage of the corporation's vessels.

The election of the alternative tax "tonnage tax" on the taxpayer's federal income tax return is NOT applicable for Hawaii income tax purposes.

I. Non-Conformity to IRC §§ 1400 to 1400L

Hawaii does NOT conform to Subchapters W, X, and Y:

- Subchapter W, IRC §§ 1400 - 1400C (with respect to District of Columbia Enterprise Zone);
- Subchapter X, IRC §§ 1400E - 1400J (with respect to Renewal Communities); and
- Subchapter Y, IRC § 1400L (with respect to New York Liberty Zone Benefits)

A taxpayer who has excluded income, deducted expenses, and claimed credits under IRC §§ 1400 to 1400L on the taxpayer's federal income tax return (a) must increase the taxpayer's Hawaii adjusted gross income or taxable income (as applicable) for the amount of such (i) exclusion of income or (ii) deduction of expense and (b) cannot claim any of the credits under IRC §§ 1400 to 1400L for Hawaii income tax purposes. See PART V of this Announcement for further information.

PART II. HRS § 235-2.4 – Operation of Certain IRC Provisions; IRC §§ 63 - 530

A. In General

Section 3 of Act 60 amends HRS § 235-2.4 to clarify the application of IRC §§ 168(k), 179(b)(1), and 179(b)(2).

B. Non-conformity to IRC § 168(k)

HRS § 235-2.4 is amended to clarify that Hawaii decouples from the changes to IRC § 168(k), accelerated cost recovery system: special allowance for certain property acquired after September 10, 2001 and before January 1, 2005. IRC § 168(k) allows qualifying aircrafts to be eligible for the additional first-year depreciation expense deduction if the qualifying aircrafts are placed in service before January 1, 2006 and provides a special rule in the case of multiple units of property subject to the same lease.

For Hawaii income tax purposes, a taxpayer who has deducted such expense under IRC § 168(k) on the taxpayer's federal income tax return must increase the taxpayer's Hawaii adjusted gross income or taxable income (as applicable) for the amount of such expense. See PART V of this Announcement for further information.

C. <u>Non-conformity to IRC §§ 179(b)(1) and 179(b)(2)</u>

HRS § 235-2.4 is amended to clarify that Hawaii decouples from the changes to IRC §§ 179(b)(1) and 179(b)(2), election to expense certain depreciable business assets. IRC §§ 179(b)(1) and 179(b)(2) has been extended for an additional two years with respect to the increased amounts that a taxpayer may expense ($100,000 indexed for inflation) and other expensing enhancements so that such expensing enhancements continue up to the 2007 tax year.

For Hawaii income tax purposes, the maximum amount that a taxpayer may elect to expense under IRC § 179 is $25,000.[4] Thus, a taxpayer who has deducted such expense, under IRC § 179, in an amount exceeding $25,000 on the taxpayer's federal income tax return must increase the taxpayer's Hawaii adjusted gross income or taxable income (as applicable) for the excess amount. See PART V of this Announcement for further information.

PART III. HRS § 235-2.45 – Operation of Certain IRC Provisions; IRC §§ 641 - 7518

A. <u>In General</u>

Section 4 of Act 60 amends HRS § 235-2.45 to allow the Department to disclose return information to the United States Justice Department or appropriate federal or state law enforcement agency for purposes of (a) investigating terrorist incidents, threats, or activities and (b) analyzing intelligence concerning investigating terrorist incidents, threats, or activities by conforming to IRC §§ 6103(i)(3)(C) and 6103(i)(7).

B. <u>HRS § 235-2.45(h) – IRC §§ 6103(i)(3)(C) and 6103(i)(7)</u>

The Working Families Tax Relief Act of 2004 extends the period of time during which disclosures to law enforcement agencies or intelligence agencies may be made upon written request to December 31, 2005. For conformity purposes, this extension is applicable to disclosures between October 4, 2004 and December 31, 2005.

Return information includes the following information:

- a taxpayer's identity, the nature, source or amount of income, payments, receipts, deductions, exemptions, credits, assets, liabilities, net worth, tax liability, tax withheld, deficiencies, overassessments, or tax payments;
- whether the taxpayer's return was, is being, or will be examined or subject to other investigation or processing;
- any other data, received by, recorded by, prepared by, furnished to, or collected by the Department with respect to a return or with respect to the determination of the existence, or possible existence, of liability (or the amount thereof) of any person for any tax, penalty, interest, fine, forfeiture, or other imposition, or offense; and

---

[4] Hawaii has never adopted the IRC § 179 increased expensing provisions with respect to amounts in excess of $25,000.

For Hawaii income tax purposes, the dollar limitation for IRC § 179 remains at $25,000 for any eligible property placed in service after the 2002 tax year. See the provisions of IRC § 179, amended as of December 31, 2002 (<u>prior to</u> the amendments made by the Jobs and Growth Tax Relief Reconciliation Act of 2003)

- The term "return information" does not include data in a form that cannot be associated with or otherwise identify, directly or indirectly, a particular taxpayer. "Taxpayer return information" means return information which is filed with, or furnished to, the Internal Revenue Service by or on behalf of the taxpayer to whom such return information relates.

If the Department receives a written request meeting certain requirements, it may disclose return information (other than taxpayer return information) to officers and employees of any federal law enforcement agency who are personally and directly engaged in the response to, or investigation of, any terrorist incident, threat, or activity. However, no disclosure shall be made if disclosure would identify a confidential informant or seriously impair a civil or criminal tax investigation.

The written request must be made by the head of any federal law enforcement agency (or his delegate) involved in the response to or investigation of any terrorist incident, threat, or activity and set forth the specific reason or reasons why disclosure may be relevant to a terrorist incident, threat, or activity.

The head of any federal law enforcement agency may disclose return information obtained under such written request to officers and employees of any state or local law enforcement agency provided that such agency is part of a team with the federal law enforcement agency engaged in the response to, or investigation of, a terrorist incident, threat, or activity, and the information is disclosed only to officers and employees who are personally and directly engaged in that response or investigation. The information disclosed to officers and employees of law enforcement agencies shall be used only by them in that response or investigation. Officers and employees, and former officers and employees, of state and local law enforcement agencies shall not disclose any return or return information received under this rule, except as authorized by the IRC.

As a condition of receiving the above tax information, federal and state agencies must establish procedures satisfactory to the Department to safeguard that information and return it or make it undisclosable when they are finished with it.

The Department may disclose returns and taxpayer return information to the Attorney General to the extent necessary for, and solely for use in preparing, an application for ex parte court ordered disclosure initiated by the Department.

PART IV. Brief Description of Select Federal Income Tax Law Changes to which Hawaii Conform

A. The Pension Funding Equity Act of 2004

This Act provides interim relief to companies with pension plans, especially to airline and steel industries who have been adversely affected by the minimum funding requirements for their pension plans by allowing (1) the use of a higher interest rate in calculating the deficit reduction contribution and (2) employers in the airline and steel industries to elect to make reduced additional required contributions to their defined benefit plans.

Hawaii has traditionally conformed to the interest provisions under IRC §§ 404, 412, 415, and 420.

1. For 2004 and 2005 plan years, the amounts of additional pension contributions are reduced, for purposes of the deficit reduction contribution requirements, for persons who are subject to the minimum funding requirement.

2. For 2004 and 2005 plan years, employers in the airline and steel industries are allowed to elect to make reduced alternate deficit contributions.

B. The Working Families Tax Relief Act of 2004

This Act provides a uniform definition of child, extends business tax incentives that expired in 2003, and has made technical corrections to the IRC. Following are highlights of select tax law changes resulting from this Act to which Hawaii conform.

1. Rewrites the definition of a dependent under IRC § 152 to categorize a dependent either as (a) a qualifying child or (b) a qualifying relative. For a qualifying child, the gross income test is eliminated, and the support test is redefined. For a qualifying relative, the relationship, support, and gross income tests must be satisfied. Currently, Hawaii closely follows the federal definition of "child" for net income tax purposes (e.g., determining whether a person is a dependent).

2. Makes permanent the research and development credit under IRC § 41 to which Hawaii conforms with modifications (see HRS § 235-110.91). Conformity to the permanent research and development credit under IRC § 41 assures continued guidance from the federal provisions.

3. Extends the above-the-line deduction for expenses incurred by elementary and secondary schoolteachers for materials used by a teacher in the classroom under IRC § 62 to tax years 2004 and 2005.

4. Eliminates the phase-out for deduction for clean-fuel vehicle property IRC § 179A for tax years 2004 and 2005.

5. Extends the special rule for charitable contributions of computer technology and equipment for educational purposes under IRC § 170 to tax years 2004 and 2005.

6. Extends the election to expense environmental remediation costs under IRC § 198 for such costs incurred in tax years 2004 and 2005.

7. Extends the Archer MSA program under IRC § 220 by allowing taxpayers to establish new accounts through December 31, 2005.

C. The American Jobs Creation Act of 2004

This Act is the most significant reform of U.S. business taxation since the Tax Reform Act of 1986 and affects both business and individuals. Following are highlights of select tax law changes resulting from this Act to which Hawaii conform.

1. Extends the 40/60 percentage of completion/capitalized cost method to naval shipbuilders.

2. Allows taxpayer to make an election to take an itemized deduction for state and local general sales taxes instead of an itemized deduction for state and local income taxes. IRS Publication 600 states that the Hawaii general excise tax will qualify as a "sales tax" for purposes of this federal deduction.

3. Imposes enhanced substantiation requirements for charitable contribution deductions with respect to non-cash contributions of certain tangible personal property, such as motor vehicles, boats, and airplanes, valued at more than $500.

4. Limits the amount of charitable contribution deduction to (a) lesser of the donor's basis in the property or fair market value of the property with respect to non-cash contributions of patents and other intellectual property and (b) the gross proceeds received by the charitable organization with respect to non-cash contributions of certain tangible personal property, such as motor vehicles, boats, and airplanes.

5. Allows “qualified leasehold improvement property” and “qualified restaurant property” to be depreciated over a 15-year recovery period. Previously, such properties were depreciated over a 39-year recovery period.

6. Allows qualified permanent motorsports racetrack complexes to be depreciated over a 7-year recovery period.

7. Increases the maximum number of eligible shareholders in a S-corporation from 75 to 100. Provides an election to allow all family members to be treated as one shareholder in determining the number of shareholders in an S-corporation and clarifies that family members may be treated as one shareholder, for the purpose of determining the number of shareholders, by reason of being a beneficiary of an electing small business trust or qualified subchapter S trust.

8. Treats any suspended loss or deduction with respect to a shareholder’s stock in an S corporation that is transferred to a spouse, or to a former spouse incident to a divorce as incurred by the corporation with respect to the transferee in the subsequent taxable year.

9. Allows a beneficiary of a qualified Subchapter S trust to deduct suspended losses under the at-risk rules and the passive loss rules when the trust disposes of the S corporation stock.

10. Clarifies that, solely for purposes of computing the allowable deduction for property under the income forecast method of depreciation, participations and residuals may be included in the adjusted basis of the property beginning in the year such property is placed in service, but only if such participations and residuals relate to income to be derived from the property before the close of the tenth taxable year following the year the property is placed in service (as defined in IRC § 167(g)(1)(A)). Also clarifies that the income from the property to be taken into account under the income forecast method is the gross income from such property. Grants authority to the Treasury Department to prescribe appropriate adjustments to the basis of property (and the look-back method) to reflect the treatment of participations and residuals under the provision.

11. Excludes from gross income education loan repayments provided under the NHSC Loan Repayment Program and State programs eligible for funds under the Public Health Service Act.

12. Allows up to $10,000 of qualified reforestation expenditures to be deducted in the year paid or incurred (i.e., expensed) and allows qualified reforestation expenditures above $10,000 to be amortized over 84 months.

13. Allows an above-the-line deduction, for any deductible attorney fees and court costs paid by, or on behalf of, the taxpayer in connection with an action involving: a claim of unlawful discrimination; a claim of a violation of subchapter III of chapter 37 of title 31, United States Code; or a claim made under section 1862(b)(3)(A) of the Social Security Act.

14. Extends the benefits of income averaging to fishermen.

15. Extends the applicable period for a taxpayer to replace livestock sold on account of drought, flood, or other weather-related conditions from two years to four years after the close of the first tax year in which any part of the gain on conversion is realized. The extension is only available if a taxpayer establishes that, under the taxpayer's usual business practices, the sale would not have occurred but for drought, flood, or weather-related conditions that resulted in the area being designated as eligible for federal assistance.

16. Excludes gain on the sale, exchange, or other disposition of certain brownfield sites from unrelated business taxable income (UBTI) notwithstanding the rule that property held for sale to customers in the ordinary course of a trade or business is included in UBTI.

17. Provides that outright sales of timber by a landowner will qualify for capital gains treatment in the same manner as sales with a retained interest.

18. Restricts partnership allocations and elections in connection with built-in-loss properties and partnership basis adjustments. This results in (a) built-in-losses taken into account only by the contributing partner; (b) allocations to non-contributing partners by the partnership on the assumption that the basis of the contributed property is its fair market value at the time of contribution; (c) the requirement that the partnership shall make basis adjustments under IRC § 743 upon a transfer of partnership interest if the partnership has a substantial built-in-loss (over $250,000); (d) the requirement that property with a substantial built-in-loss shall be adjusted downward to its fair market value if the contributing partner's partnership interest is transferred or liquidated; and (e) the requirement that the partnership shall make basis adjustments under IRC § 743(b) with respect to certain distributions of partnership property.

19. Precludes partnerships from decreasing the basis of its corporate partner's stock or any person related to its corporate partner in applying the basis allocation rules to a distribution in liquidation of a partner's interest. Any decrease in basis, that absent this preclusion, would have been allocated to the stock is allocated to other partnership assets. If the decrease in basis exceeds the basis of other partnership assets, the gain is recognized by the partnership in the amount of the excess.

20. Clarifies definition of qualified preferred stock for purposes of non-recognition of gain on contributions of property in exchange for stock. This clarification is made to prevent taxpayers from characterizing an instrument as a qualifying preferred stock by including illusory participation rights or other terms.

21. Disallows the exclusion for gain on sale or exchange or a principal residence if the principal residence was acquired in a like-kind exchange in which any gain was not recognized within the prior five years.

22. Modifies the recovery period of certain property leased to a tax-exempt entity to the longer of the property's assigned class life or 125 percent of the lease term; alters the definition of lease term for all property leased to a tax-exempt entity so that the lease term includes all service contracts and other similar arrangements; expands the short-term lease exception for qualified technological equipment to exclude the renewal or extension lease options in determining the 5-year short-term lease exception; and establishes rules to limit deductions associated with leases to tax-exempt entities if the deductions exceed the taxpayer's gross income generated from such leases and if the leases do not satisfy specified criteria.

23. Treats all amounts deferred under a non-qualified deferred compensation plan as gross income if such deferred amounts are not subject to a substantial risk of forfeiture (e.g., if the person's rights to such compensation are conditioned upon the performance of substantial services by any individual).

24. Extends the 15-year recovery period for intangibles to franchises that engage in professional sports and any intangible asset acquired in connection with the acquisition of such franchise including player contracts.

25. Requires partnerships to recognize the cancellation of indebtedness income upon the transfer of a capital or profits interest in the partnership to a creditor in satisfaction of a partnership debt.

26. Denies installment sale treatment with respect to all sales in which the taxpayer receives indebtedness that is readily tradable.

27. Limits the amount of money and property that a distributing corporation can distribute to its creditors without gain recognition to the amount of the basis of the assets contributed to a controlled corporation in a divisive reorganization.

28. Allows for an election to deduct up to $5,000 of start-up expenses or $5,000 of organizational expenses (as applicable) in the taxable year in which the trade or business begins.

29. Treats as a qualifying disposition for purposes of deferral of gain and capital gain treatment, the sale of shares of stock in order to comply with federal conflict of interest requirements.

PART V. Adjustments to Federal Adjusted Gross Income or Taxable Income (as applicable) for Hawaii Income Tax Purposes

Taxpayers who have benefited from the IRC provisions (e.g. certain exclusions of income and deduction of certain expenses and all federal income tax credits) to which Hawaii does not conform:

- Must adjust their federal adjusted gross income or taxable income (as applicable) in determining their Hawaii adjusted gross income or taxable income (as applicable); and

- Shall not claim any federal income tax credit on the Hawaii income tax return. If Hawaii has a credit similar to the federal income tax credit, the Hawaii income tax credit amount is determined under (a) the applicable sections in HRS chapter 235 and (b), if any, the IRC provisions to which the applicable HRS sections reference.

  EXAMPLE:

  A taxpayer purchases equipment in the amount of $60,000 and places it in service during the first quarter of its 2004 taxable year The equipment has a life of five years for tax purposes. Finding that the taxpayer has met the requirements in connection with the IRC §179 expense election, the taxpayer elects to claim an IRC §179 expense for the equipment. The taxpayer has not purchased or placed in service any other tangible personal property during the 2004 tax year and uses MACRS 200% declining balance method and ½ year convention to calculate the depreciation expense deduction.

  For federal income tax purposes, the taxpayer deducts $60,000 as an IRC §179 expense with respect to the equipment placed in service during the 2004 tax year.

  For Hawaii income tax purposes, the maximum amount the taxpayer may deduct as an IRC §179 expense is $25,000.

  The taxpayer must: (a) complete federal Form 4562 for Hawaii income tax purposes reporting $25,000 as the maximum amount of IRC §179 expense and any depreciation expense (e.g., $7,000 depreciation expense attributable to the $60,000 equipment (($60,000 - $25,000) x 20%) for the 2004 tax year; (b) attach the completed federal Form 4562 to the tax return; (c) report the difference of the federal depreciation amount over the Hawaii depreciation amount as an addition to its adjusted gross income or taxable income (e.g., $28,000 ($60,000 federal depreciation amount - $32,000 ($25,000 IRC §179 expense + $7,000 depreciation expense) Hawaii depreciation amount); and (d) attach to the tax return a worksheet showing the computation of the adjustment.

  The corporation must also keep records of the differences in the asset's depreciable basis for federal and Hawaii tax purposes.

PART VI. Application of Effective Date

A. In General

With Act 60, Hawaii conforms the Hawaii Income Tax Law to the operative IRC sections of subtitle A, chapter 1, amended as of December 31, 2004. Although Act 60 is effective, upon enactment, for taxable years beginning after December 31, 2004, the effective date provisions in the below listed acts, for which such amendments are operative for Hawaii income tax purposes, shall apply.

1. The Pension Funding Equity Act of 2004 (P. L. No. 108-218, April 10, 2004);

2. The Working Families Tax Relief Act of 2004 (P. L. No. 108-311; October 4, 2004);

3. The American Jobs Creation Act of 2004 (P. L. No. 108-357, October 22, 2004);

B. Example of application of effective date

Section 307 of the Working Families Tax Relief Act of 2004 has amended IRC § 62(a)(2)(D), adjusted gross income defined: certain expenses of elementary and secondary teachers. This amendment to IRC § 62(a)(2)(D) extends the deduction[5] to 2004 and 2005 and is applicable to expenses paid or incurred in taxable years beginning after December 31, 2003 and before January 1, 2006.

With Act 60, Hawaii has adopted the aforementioned amendment. On or after May 19, 2005 (enactment date), eligible educators may deduct on their 2004 Hawaii income tax returns, up to $250 in qualified expenses, provided that the requirements in IRC §§ 62(a)(2)(D) and 162 have been met. If the eligible educators have, prior to May 19, 2005, filed their 2004 Hawaii individual income tax returns, such educators may amend their 2004 Hawaii individual income tax returns to claim the deduction for the qualified expenses up to $250, provided that the requirements in IRC §§ 62(a)(2)(D) and 162 have been met.

PART VII. Sources of Information

For more information on the 2004 income tax law changes to which Hawaii has conformed and from which Hawaii has decoupled, please refer to the Department's 2005 Digest of Tax Measures, which is anticipated to be published in mid-August 2005.

Current forms and other tax information are available at the Department's website at: www.state.hi.us/tax. If you know which tax form or publication you need, please call the Department's request line at 808-587-7572, or toll-free from the neighbor islands and continental U.S. at 1-800-222-7572. This service is available 24 hours a day, 7 days a week.

KURT KAWAFUCHI
Director of Taxation

HRS Sections Explained: HRS sections 235-2.3 through 235-3.

---

[5] IRC § 62(a)(2)(D) allows an eligible educator to deduct, from gross income, up to $250 in qualified expenses, provided such deduction would have been allowed by section 162 which consist of expenses, paid or incurred by an eligible educator in connection with books, supplies (other than nonathletic supplies for courses of instruction in health or physical education), computer equipment (including related software and services) and other equipment, and supplementary materials used by the eligible educator in the classroom. For more information, please refer to IRS News Release IR 2004-124 dated October 13, 2004 and IR 2002-65 dated May 21, 2005.