

SB464

LINDA LINGLE
GOVERNOR

JAMES R. AIONA, JR.
LT. GOVERNOR



LATE

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

**SENATE COMMITTEE ON WAYS & MEANS
TESTIMONY REGARDING SB 464 SD 1
RELATING TO TAXATION**

TESTIFIER: KURT KAWAFUCHI, DIRECTOR OF TAXATION (OR DESIGNEE)
DATE: MARCH 3, 2009
TIME: 9:30AM
ROOM: 211

This measure amends the renewable energy technologies income tax credit to make the credit refundable for certain taxpayers, allows special allocations of the credit by pass-through entities, and prevents passive activity losses from including depreciable amounts.

The Department of Taxation **supports the intent of incentivizing alternative energy use** in the State; however **opposes sections 1 and 2** of this measure, and, instead of section 3, **prefers the language of Part III of SB 1173 SD1.**

SUPPORT FOR ALTERNATIVE ENERGY—The Department strongly supports the encouragement and implementation of alternative energy systems in Hawaii in order to lessen the State's dependence on alternative energy. As fossil fuel and petroleum prices become more volatile, Hawaii's ability to generate its own energy will make the State more secure and less reliant on others.

PREFER LANGUAGE IN PART III OF SB 1173 SD1—With regard to the renewable energy technologies tax credit, the Department prefers the language in SB 1173 SD1, Part III. The trouble with the approach taken in section 3 of this measure is the unnecessary addition of a separate definition and treatment for solar electric energy systems. Subsections (a) and (g) do not consistently or smoothly work together, which creates confusion. The additional category not only complicates the administration of this measure by requiring the Department to have expertise in the inner workings of these systems rather than focusing on the input (solar or wind) and the output (electricity, useful heat, or fuel) of the system, but it is inconsistent with the subsection (g) election. The nonrefundable and refundable credits identified as available for solar electric systems are not presented as a choice in subsection (a), giving the impression that both may be taken. Subsection (g) suggests that both a nonrefundable and refundable credit are not available, that there is an election to be made; however, because subsections (a) and (g) do not work together, there is confusion as to how the choice is to be made and how the credit amount is to be calculated.

As an alternative, SB 1173 SD1 (Part III) accomplishes the purpose of Section 3 of this measure without the additional, unnecessary administrative difficulties and does not create confusion as to how the credit is calculated. The Department requests that the language in Part III of SB 1173, SD1 replace Section 3 of this measure.

OPPOSITION TO UNBUDGETED REVENUE LOSS— The Department cannot support the amendments to sections 235-2.4(n) (with respect to passive activities) and 235-2.45 (with respect to partnership allocations of the credits) because they are not factored into the budget. The Department must be cognizant of the biennium budget and financial plan. This measure has not been factored into either. Given the forecasted decrease in revenue projections, these amendments would add to the budget shortfall.

UNWORKABLE PASSIVE ACTIVITY LOSS LIMITATION—Hawaii has conformed to the federal tax treatment of passive activity losses, a complex area of tax law instituted to prevent tax sheltering activities. Taxpayers were sheltering taxable income derived from businesses they actively managed by reducing them with losses easily generated from passive activities. These rules limit the ability of a taxpayer to currently deduct from gross income losses incurred as a result of passive activities. Passive activities include business activities in which the taxpayer does not materially participate in, such as most rental real property. Under existing federal and State law, passive activity losses can be used only to offset passive activity gains. Special rules apply to rental real property where the taxpayer actively participates in the rental activities, provided certain income levels are not exceeded. If this exception applies, passive activity losses may generally be used to offset income of up to \$25,000. In the event the passive activity loss exceeds the amount that the taxpayer can currently use, the excess loss is "suspended." The taxpayer will use such losses in a year in which he falls under the limitations or sells the real property from which the loss was generated.

As proposed, this measure would eliminate all depreciation expense that is used in calculating whether an activity has a gain or loss. For example, residential real property is depreciated using a straight line method over 27.5 years. Thus, a building that cost \$275,000 would have depreciation expense of \$10,000 per year in determining the extent of passive activity losses or gains. This measure would strike that amount from determining whether a passive activity loss exists for State tax purposes, as well as depreciation expense from all other property related to the rental real property such as improvements, appliances and furnishings. In other words, the depreciation derived from passive activities could be deducted against all income, not just passive income. The net result for State tax purposes is that there will be a substantial reduction in taxable income because a person's taxable income will be reduced by a depreciation deduction that previously could only be taken if the person had equal passive gains, in not just renewable energy investments, but all passive activity investments, such as real estate.

This measure also decouples state tax law from federal tax law. It should be noted that while the State can eliminate depreciation from determining whether a passive activity loss has occurred for State tax purposes, there would be no effect on the federal tax consequences. For federal tax purposes, depreciation would still be an expense that must be used in calculating whether the passive

activity loss limitation rules apply. In order to accomplish this, the Department would have to generate new forms to track the passive activity losses and whether and when such losses can be used to offset income. This will affect the carryforwards of any losses, such that taxpayers will have to keep track of two different carryforwards: the federal carryforward and the State carryforward. New forms may have to be designed as well. These problems do not currently exist since the passive activity loss limitations are currently the same for both federal and State tax purposes.

REVENUE LOSS—As amended, this measure will result in a revenue loss of approximately \$39.2 million annually.

Solar energy tax credit amounted to \$4.1 million in 2008. It is assumed that making this tax credit refundable for certain taxpayers will increase this amount by 5% or \$0.2 million. Also, it is assumed 4,000 new single-family residential units will be built between now and 2010. The law requires these units to be built with solar energy. At the maximum \$2,250 tax credit per unit, the revenue loss will be about \$9 million.

In addition, the deduction in "activity losses" in Section 469 could amount to \$500 million (our assumption due to lack of hard data) and reduce income tax revenues by \$30 million. ($\$500 \times 6\% = \30).



LATE

TO: Senate Ways and Means Committee
Honorable Senator Donna Kim, Chairman

RE: Testimony in Support of SB464 SD1 SD1 Relating To Taxation.

HEARING: Tuesday, March 3, 2009, 9:30 a.m.

Madam. Chair and members of the Committee:

I appreciate this committee's consideration of SB464 SD1, and welcome this opportunity submit testimony in support of it.

To state the issue briefly, the Hawai'i Renewable Energy Tax Credit is largely unuseable for the reasons discussed in detail below, and therefore fails of its mission to act as an incentive for Hawai'i taxpayers to invest in renewable energy in our State. There are a variety of steps that can be taken by the Legislature to make is useable, some minor and technical, and some more major, such as making it refundable. We urge you to take at least some, and preferably all of these steps by passing SB464 SD1, and thus help our State get away from is \$6 billion per year fossil fuel dependence and at the same time create thousands of "green" jobs and generate more State tax revenue.

My name is Larry Gilbert, and I am the Managing Director and Chief Executive of Sennet Capital LLC. Sennet Capital is a Hawai'i merchant bank that focuses entirely on providing and arranging funding for Hawai'i companies and renewable energy projects. We have become one of the leading experts in Hawai'i in solar project financing, and recently completed one of the largest solar project financings done in Hawai'i when we arranged the financing for Hoku Solar to put solar panels on all of the Neighbor Island airports for the State of Hawai'i Department of Transportation.

During 2008, we attempted to finance nearly \$50 million worth of Hawai'i solar projects. As part of that effort, we spent a great deal of time talking to Hawai'i investors about their interest and ability to use the Hawai'i Renewable Energy Tax Credit contained in HRS 235-12.5. Unfortunately, that effort resulted in zero dollars from Hawai'i investors for solar projects during 2008.

What we found from that experience is that the Hawai'i Renewable Energy Tax Credit is nearly useless to almost all categories of Hawai'i investors, and does not provide them with any meaningful incentive to invest in Hawai'i renewable energy projects. The problem was not a lack of investor interest—their interest in the deals and the returns was very high—it was that without being able to use the Hawai'i Renewable Energy Tax Credit, the returns were insufficient to entice them invest in these projects versus their other alternatives.

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What the Hawai'i investor market tells us from this experience is that the principal problems with the Hawai'i Renewable Energy Tax Credit are:

- 1) The law is unclear about whether, for any type of taxpayer other than major corporations, the Hawai'i Renewable Energy Tax Credit can be used to offset any type of taxable income other than "passive" income. The Federal renewable energy tax credit clearly cannot be used against anything other than passive income, and Hawai'i investors are concerned that the ambiguous nature of the Hawai'i law would result in the same interpretation. Very, very few Hawai'i investors have sufficient taxable passive income to make it worthwhile to invest for the purpose of taking advantage of the tax credit, and when the uncertainty of the existing law is added to this, the result is the most likely type of Hawai'i investor—the high-net-worth individual or successful small or medium-sized business—cannot use the Hawai'i Renewable Energy Tax Credit.
- 2) The Hawai'i Renewable Energy Tax Credit cannot be allocated entirely to Hawai'i investors, as a result of which the Hawai'i tax credits cannot be given entirely to the people who can use them. There is a ready market for investment in the Federal energy tax credit by major mainland corporations seeking to manage their Federal tax bill. But almost none of these companies has any meaningful amount of Hawai'i tax liability. The way in which the other parts of the tax code cause the Hawai'i Renewable Energy Tax Credit to work mean that if these major mainland companies put up half the money, they have to receive half of the Hawai'i tax credits, which are useless to them. In essence, the Hawai'i Renewable Energy Tax Credit does not act as any incentive at all for them to invest. And because the Hawai'i credit cannot be "specially allocated" to even the very few Hawai'i taxpayers that might be able to use it against passive income, the credit goes largely or entirely to waste.
- 3) The Hawai'i Renewable Energy Tax Credit cannot be used by Hawai'i insurance companies against their Hawai'i insurance premium tax liability. Our insurance companies are among the most prolific investors in Hawai'i, and a natural source of capital for renewable energy projects. But again, the Hawai'i Renewable Energy Tax Credit provides no incentive for them to invest in these projects.
- 4) The Hawai'i Renewable Energy Tax Credit can only be used by Hawai'i taxpayers. Other states, such as Oregon, California and (indirectly) New Jersey provide a mechanism for their tax incentives to be converted to cash by investors who cannot use those incentives to offset state income taxes. The amount of investment capital which exists in Hawai'i is relatively limited versus the amount that could be profitably deployed for renewable energy projects here, so cutting off the use of the Hawai'i credit to incentivize these non-Hawai'i investors puts Hawai'i at a disadvantage in terms of attracting capital to finance renewable energy projects.

The Hawai'i market has the potential to immediately attract \$100 million to \$200 million per year in investment capital for renewable energy projects here. These

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projects would generate hundreds if not thousands of jobs, reduce Hawai'i's dependence on imported oil, and protect our environment. Yet of the \$50 million of projects that Sennet Capital could potentially have financed in 2008, zero got financed, principally due to the problems described above with using the Hawai'i tax credit.

SB464 SD1 addresses the flaws in the existing Hawai'i Renewable Energy Tax Credit by (1) making it refundable, (2) removing the restriction on the type of income that it can be used to offset, (3) makes it specially allocatable, and (4) makes it available to Hawai'i's insurance companies.

If Hawai'i is serious about incentivizing investment in renewable energy projects, then making the minor changes to the Hawai'i Renewable Energy Tax Credit which are contained in SB464 SD1 would be a very good way to do so. We strongly support SB464 SD1, and encourage you to pass it out of committee with a favorable recommendation. Hawai'i could be one of the best states in the country for solar projects, and attract tens and hundreds of millions in outside capital to help build them, which in turn provides stimulus to our economy and jobs for our electricians, construction workers and others who install and maintain these projects, as well as put millions of dollars in energy savings into the economy rather than shipping them overseas to buy foreign oil.

Thank you for the opportunity to submit this testimony, and please feel free to contact me if I can be of further assistance.

Larry Gilbert
Managing Director
Sennet Capital LLC
737 Bishop Street, Suite 3170
Honolulu, HI 96813
Tel 808 457-1300
Email: LGilbert@sennetcapital.com



LATE

Hawaii Solar Energy Association
Serving Hawaii Since 1977

March 3, 2009
Room 211
9:30 A.M

Senate
Committee on Ways and Means
SB464 SD1

Mark Duda
President

Testimony in Strong Support

Chair Kim, Vice Chair Tsutsui, and Members of the Committees:

Basis for HSEA's Testimony

HSEA's member companies install the majority of solar systems in the Hawaiian Islands. In this role they work closely not only with prospective purchasers of solar systems but also with financiers and prospective financiers of solar systems. In this position, HSEA is uniquely aware of the financial challenges faced by those who would prefer to consume clean, efficient solar energy. Our testimony is based on this intimate knowledge of the constraints would-be investors face.

HSEA makes the following comments regarding this measure:

As currently written, the Renewable Energy Technologies Income Tax Credit (RETITC) has very limited appeal due to a series of provisions that undermine its ability to serve as a financial incentive to potential investors. SB464 SD1 addresses each of these limitations and in doing so substantially expands the investor base for renewable energy. One of the key beneficiaries of this change will be the State of Hawaii, which is currently unable to benefit from renewable energy systems because investors are not able to monetize the RETITC. Under realistic assumptions the changes proposed in SB 464 SD1 are fiscally positive and result in substantial job creation/retention in a very difficult environment for the construction sector.

SB464 SD1 addresses the current inability to utilize the RETITC by doing the following:

1. Allows tax payers to reduce the 35% non-refundable RETITC by 30% (*i.e.*, reduce it to 24.5%) on a per system basis and have it made refundable.
2. Allows the RETITC credit to be specially allocated within partnerships so that investment partnerships funding 3rd party systems can be more easily assembled.
3. Allows the credit to be used by investors against non-passive income (passive income is basically limited to income from rental property) so as to expand the pool of individual investors that might fund renewable energy.
4. Allows the credit to be taken by insurers against their insurance premium taxes allowing insurance companies to begin funding renewable energy.

5. Makes it possible for low-income people and people with pension income only (*i.e.*, groups that have no tax liability and for whom a non-refundable tax credit is meaningless) to take the credit as refundable instead of non-refundable.

Each of provisions 1-4 individually makes the RETITC a more effective as an incentive and will bring money from outside the state to Hawaii. The bill does not make the credit richer for investors (note that HSEA has earlier this session testified against the need to make the credit richer) but instead expands the class of investors who can use the credit. In doing so it will thereby drive much more capital to renewable energy in Hawaii.

As noted above, the expansion of the investor base for renewable energy systems that will result from SB464 SD1 is fiscally positive. Every dollar given up by the state on a refundable RETITC will yield \$1.48 in combined GET, payroll, and corporate income tax revenues.

In addition, each \$1 million system will generate or preserve 11.3 jobs. At this rate, the PV market, which was roughly \$120 million in 2008, is currently responsible for about 1,356 jobs. At about \$55 million, the solar water heating market is responsible for 621 jobs. These numbers could be far higher if the problems with the RETITC could be addressed.

In conclusion, please note that, although it sounds self-serving, it is nonetheless true that there is virtually nothing the state could do that would have a greater impact on the amount of renewable energy generating equipment installed in Hawaii over the next three years than to pass a form of SB464 SD1. This is the case because the technology involved is proven and available today; and because the distributed nature of the projects means they are far less capital-intensive and thus less exposed to the financial markets than larger scale projects. HSEA strongly supports SB464 SD1 as a policy that is both timely and well-crafted.

About the Hawaii Solar Energy Association

Hawaii Solar Energy Association (HSEA) was founded in 1977 and is comprised of more than 30 installers, distributors, manufacturers and financers of solar energy systems, both hot water and PV, most of which are Hawaii based, owned and operated. The organization's primary goals are: (1) to further solar energy and related arts, sciences and technologies with concern for the ecologic, social and economic fabric of the area; (2) to encourage the widespread utilization of solar equipment as a means of lowering the cost of energy to the American public, to help stabilize our economy, to develop independence from fossil fuel and thereby reduce carbon emissions that contribute to climate change; (3) to establish, foster and advance the usefulness of the members, and their various products and services related to the economic applications of the conversion of solar energy for various useful purposes; and (4) to cooperate in, and contribute toward, the enhancement of widespread understanding of the various applications of solar energy conversion in order to increase their usefulness to society.

LATE

Department of Taxation

Position Summary

Senate Committee on Ways & Means/March 3, 2009

Bill Number	Bill Title "Relating to..."	Position	Comments	Revenue Impact	Methodology
SB 464 SD 1	TAX ADMINISTRATION	Support intent; strong concerns.	<p>*The Department supports the general concept of encouraging alternative energy technologies.</p> <p>*The Department has strong concerns with decoupling from the Internal Revenue Code Sections 469 and 704(b) as generally bad tax policy.</p> <p>*The Department supports the measure to the extent it is budgeted, which includes only the refundability for those with retirement income.</p>	Revenue loss of \$39.2 million annually.	<p>Solar energy tax credit amounted to \$4.1 million in 2008. It is assumed that making this tax credit refundable for certain taxpayers will increase this amount by 5% or \$0.2 million. Also, it is assumed 4,000 new single-family residential units will be built between now and 2010. The law requires these units to be built with solar energy. At the maximum \$2,250 tax credit per unit, the revenue loss will be about \$9 million.</p> <p>In addition, the deduction in "activity losses" in Section 469 could amount to \$500 million (our assumption due to lack of hard data) and reduce income tax revenues by \$30 million. ($\\$500 \times 6\% = \\$30$).</p>
SB 698 SD 1	THE RENTAL MOTOR VEHICLE SURCHARGE TAX	Support	No technical comments.	Indeterminate	Indeterminate due to blank amounts.