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Statement of
RICHARD C. LIM
Director
Department of Business, Economic Development, and Tourism
before the
SENATE COMMITTEE ON WAYS AND MEANS

Friday, February 24, 2012
9:00 A.M.
State Capitol, Conference Room 211

in consideration of
SB 2895, SD1
RELATING TO NEW MARKETS TAX CREDITS

Chair Ige, Vice-Chair Kidani and Committee members:

The Department of Business, Economic Development and Tourism appreciates the overall concept of this bill, but we are concerned about the cost implications generated by this proposal.

This bill does not provide the necessary funding for loan guarantees within the Community Based Economic Development (CBED) Revolving Fund or for staff with the necessary expertise to administer complex financial instruments such as the Federal government's New Market Tax Credits.

Thank you for the opportunity to offer these comments.

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SUBJECT: INCOME, GENERAL EXCISE, New markets tax credit; exempt potable water

BILL NUMBER: SB 2895, SD-1

INTRODUCED BY: Senate Committee on Economic Development and Technology

BRIEF SUMMARY: Adds a new section to HRS chapter 235 to provide that Section 45D (with respect to new markets tax credit) of the Internal Revenue Code (IRC) shall be operative for state income tax purposes.

A taxpayer who holds a qualified equity investment on a credit allowance which occurs during the taxable year may claim a credit equal to the applicable percentage of the amount paid to the qualified community development entity for the investment at its original issue. The applicable percentage shall be the amount in section 45D(a)(2) of the IRC.

Tax credits in excess of a taxpayer's net income tax liability may be used as a credit against the taxpayer's income tax liability in subsequent years until exhausted. All claims for a tax credit under this section shall be filed on or before the end of the twelfth month following the close of the taxable year for which the credit may be claimed. Failure to properly and timely claim the credit shall constitute a waiver of the right to claim the credit. Requires the application for a new markets tax credit to be submitted to the director of taxation on forms prescribed by the director of taxation. The credit may be claimed whether or not the taxpayer claims a federal credit under 45D of the IRC.

The determination of the following shall be made under the designated provisions of the Internal Revenue Code, as amended, as follows: (1) credit allowance date shall be made under section 45D(a)(3); (2) qualified equity investment shall be made under section 45D(b) except that reference to "the Secretary" under section 45D(b)(1) shall be to the director; (3) qualified community development entity shall be made under section 45D(c); (4) qualified low-income community investment shall be made under section 45D(d); (5) low-income community shall be made under section 45D(e); provided that the population tract referenced shall refer to tracts in the state; (6) recapture of credit shall be made under section 45D(g); provided that the tax for the taxable year and five previous taxable years, if applicable, shall be increased under section 45D(g)(1) only with respect to credits that were used to reduce state income tax; and (7) basis reduction shall be made under section 45D(h).

The new markets tax credit shall be operative for HRS chapters 241 and 431. Makes conforming amendments to HRS section 235-2.3.

Amends HRS section 235-2.45(d) to provide that IRC section 704 (with respect to a partner's distributive share) shall be operative for purposes of this chapter; except that section 704(b)(2) shall not apply to allocations of new markets tax credits among partners.

Amends HRS section 235-2.3 to provide that companies that provide potable water under IRC section 501(c) (12) shall not be subject to state income taxation.

Amends HRS section 237-23 (a) to provide that companies that provide potable water under IRC section 501(c) (12) shall not be subject to the general excise tax.

EFFECTIVE DATE: Upon approval

STAFF COMMENTS: On the federal level, the new markets tax credit was adopted as part of the Community Renewal Tax Relief Act of 2000 (P.L. 106-554) to address the lack of capital available to businesses and economic development ventures in low-income communities. The new markets tax credit is provided to individuals or corporations that invest in community development entities working in low-income communities. The credit is equal to 5% of the investment in a qualified community development entity for the first three allowance dates and 6% of the investment for the next four allowance dates with the total amount of credit available equal to 39% of the investment over seven years.

This measure proposes to make the new markets tax credit operable for Hawaii income tax purposes. It should be remembered that Hawaii generally does not adopt any of the credits on the federal level except for the low-income housing tax credit, as Hawaii's income tax rates are not as onerous as those on the federal level.

It should be noted that in recent years investors have shied away from the state low-income housing credits because there are much more generous state income tax credits available to the investor such as the high technology investment tax credit. Adding yet another state credit would merely detract from the low-income housing tax credit. Undoubtedly, affordable housing is one of the priorities for lawmakers. Thus, adopting the new markets tax credit merely dilutes the attractiveness of the low-income housing tax credit. While the new markets tax credit does help to subsidize commercial and retail facilities in a distressed community, given the unbridled use of tax credits to encourage certain business activities, it is questionable whether or not Hawaii's treasury can afford another hit at this time. When and until the legislature decides what is state government's priority, be it affordable housing, high technology development, alternate energy development, or agriculture, the uncontrolled issuance of back door subsidies is beyond the state's financial capacity.

What this proposal does represent is a lack of legislative understanding of what attracts capital investment to a low-income community and what it takes to retain that enterprise in the community. In some ways this proposal is the compliment of what the federal government did with its welfare programs of the 60's, designing model programs based on a particular city or town on the mainland and trying to replicate it throughout the nation. The cookie cutter approach, as many have learned, does not work. Buying into a federal income tax credit program designed to attract capital to a low-income community does not recognize the many unique hurdles that challenge such a venture in Hawaii.

While the proposal picks up the federal definition of low-income community from the new markets tax credit which defines that community as having a poverty rate of at least 20% or a census tract where the median family income does not exceed 80% of the statewide median family income, that definition would probably apply to every census tract in Hawaii save for some in the more affluent communities. Because the cost of living is so high in Hawaii many families are not only two wage earner families, but in many cases both spouses work two or more jobs. As a result, the statewide median family income

is much higher than what would be found on the mainland. In Hawaii, the family of four meeting this criteria of 80% of statewide median family income would qualify if they earned \$79,450, for a two-member family the qualifying income would be \$63,600. These families would hardly be considered in poverty.

Finally, it should be remembered that if this measure is adopted, moneys for the proposed tax credit will, no doubt, come out of the state's general fund and depending on the tax credit, will reduce the amount of available general funds without legislative intervention. These are funds that could be used to fund essential services or in the alternative reduce the tax burden on low and moderate-income families or the overall tax burden that plagues both families and businesses.

If it is the desire of the legislature to provide funding to revitalize economically depressed areas of the state, a direct appropriation would be preferable than adoption of the proposed measure. Better yet, lawmakers may want to look at ways to improve the overall business climate, from streamlining zoning and permitting to a reduction of the general excise tax on business-to-business transactions that will benefit all businesses in Hawaii.

Under current law, IRC 501(c) (12) organizations, while exempt from federal income taxation, are taxable under the state income tax provisions.

This measure proposes to exempt from state income and general excise taxation an IRC 501(c)(12) organization that provides potable water, it would provide preferential tax treatment to a very select group of taxpayers. From the standpoint of equity, such preferential treatment should be granted to all IRC 501(c)(12) organizations with a sunset date of one year to allow the legislature to determine the effects and outcomes of the exemption and whether it should be continued or repealed. At the very least, the department of taxation should be tasked with explaining whether or not such organizations should or should not be recognized as being exempt for state tax purposes. Conversely, instead of hinging the proposed exemption on the reference to the federal Code section, a specific exemption that enumerates the uniqueness of the desired entity to be exempt would help to justify the exemption rather than raising a question about other entities that hold a federal exemption under Code section 501(c)(12).

Like paragraph (12), the other two inoperative paragraphs of section 501(c) appear to be cooperative types of organizations and perhaps this is the original thinking behind making these sections inoperative. In any case, it would appear to be prudent to examine the underlying reasons for making these particular paragraphs inoperative as well as the implications making this paragraph (12) operative and then only for companies providing potable water.

Digested 2/23/12