DAVID Y. IGE
GOVERNOR

THOMAS WILLIAMS
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DEPUTY EXECUTIVE DIRECTOR

STATE OF HAWAII
EMPLOYEES' RETIREMENT SYSTEM

WRITTEN ONLY

TESTIMONY BY THOMAS WILLIAMS
EXECUTIVE DIRECTOR, EMPLOYEES' RETIREMENT SYSTEM
STATE OF HAWAII

TO THE HOUSE COMMITTEE ON FINANCE
ON

HOUSE BILL NO. 629

FEBRUARY 9, 2017, 2:00 P.M
Room 308

RELATING TO TAXATION

Chair Luke, Vice Chair Cullen and Members of the Committee,

H.B. 629 would permit the Employees' Retirement System (ERS) to invest in public-private partnerships to develop construction projects to implement clean energy technology or construction projects to improve the State's water supply with respect to this proposal.

As of the submittal of this testimony, the ERS Board of Trustees has not had the opportunity to review H.B. 629 and therefore has not taken a formal position on this proposal; however, the ERS staff has the following comments and concerns:

- H.B. 629 proposes to amend Section 88-119, Hawaii Revised Statutes, regarding ERS investments, by allowing the ERS to invest in a set of defined public-private partnerships. The amendment may not be necessary as ERS's investment policy already allows for these types of investments; and, in fact, the ERS staff and Board of Trustees encourages investment managers to seek out direct investments in Hawaii

Employees' Retirement System
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infrastructure (particularly “green” infrastructure) projects for inclusion in their portfolio or for the Board’s consideration.

- ERS does not typically invest directly with partners in the construction or management of projects but does so through investment managers with the necessary skills and experience to evaluate, price and monitor such opportunities. In addition, the types of projects listed in the bill are under the authority of specific governmental agencies or departments. Therefore, the language in Sections 1 and 3 regarding certification by the ERS of the non-taxable costs should be amended to allow for certifications to be made by the ERS, its agent or another appropriate government entity. These types of investments, as with all investments, would be subject to our disciplined investment process and have to be evaluated according to the ERS’s usual fiduciary standards.

On behalf of the Board of Trustees and staff of ERS we wish to thank you for the opportunity to testify.

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To: The Honorable Sylvia Luke, Chair
and Members of the House Committee on Finance

Date: Thursday, February 9, 2017
Time: 2:00 P.M.
Place: Conference Room 308, State Capitol

From: Maria E. Zielinski, Director
Department of Taxation

Re: H.B. 629, Relating to Taxation

The Department of Taxation (Department) appreciates the intent of H.B. 629 and provides the following comments for your consideration.

Section 1 of H.B. 629 exempts from the general excise tax (GET) an unspecified percentage of amounts received by a contractor for direct costs incurred by a contractor in a public-private partnership with the Employees' Retirement System (ERS) for construction and operation of a construction project to implement clean energy technology, or a construction project to improve the State's water supply, or a wastewater treatment plant, or a public water system. The exemption is for each year of the anticipated useful life of the project. Section 3 of the measure creates an exclusion from the Hawaii income tax for an unspecified percentage of direct costs incurred by a person for similar purposes, and also for the anticipated useful life of the construction project. Amounts for both exemptions are certified by the ERS. The measure applies to taxable years beginning after December 31, 2016.

First, the Department notes that the income tax exclusion provided in Section 3 is a providing a double-benefit those costs are already deductible as an ordinary and necessary business expenses. This exclusion would allow taxpayers to deduct business expenses from a gross income calculation that already excludes those expenses, giving a double tax benefit for the taxpayer involved in the public-private partnership contemplated by this measure.

Second, on a technical note, although there is a definition of "direct costs" included in the GET exemption in Section 1 of this measure, there is no corresponding definition in the income tax exclusion. Additionally, the process by which the ERS will certify these tax credits is unclear. The Department suggests the following language be added to Section 3 of this measure to clarify the certification process for the exclusion from income tax:

For each taxable year, the employees' retirement system shall issue a certificate to the taxpayer certifying:

(1) That the taxpayer is in a public-private partnership with the employees' retirement system and is entitled to this exclusion from tax;
(2) The amount of direct costs incurred by the taxpayer during the taxable year; and
(3) The amount to be excluded from tax pursuant to this paragraph.

The taxpayer shall file the certificate with the taxpayer's tax return with the department of taxation. Notwithstanding the employees' retirement system's certification authority under this paragraph, the director of taxation may audit and adjust certification to conform to the facts.

For the purposes of this paragraph, "direct costs of construction and operation" has the same meaning as in section 237-__

Finally, the Department requests that the measure be applied to taxable years beginning after December 31, 2017 to allow sufficient time for the necessary form, instruction and computer system modifications necessary for proper implementation. The Department defers to the ERS regarding its ability to certify claims for these exemptions.

Thank you for the opportunity to provide comments

LEGISLATIVE TAX BILL SERVICE

TAX FOUNDATION OF HAWAII

126 Queen Street, Suite 304 Honolulu, Hawaii 96813 Tel. 536-4587

SUBJECT: GENERAL EXCISE, INCOME, USE, Exemptions/Credits for Clean Energy

BILL NUMBER: HB 629

INTRODUCED BY: YAMANE, CULLEN, ITO, KONG, C. LEE, SAIKI, SAY, SOUKI, Choy, Yamashita

EXECUTIVE SUMMARY: Exempts personal income tax income and general excise tax income in an amount up to an unspecified percentage of the costs of construction and operation of projects entered into under a public-private partnership with the ERS to improve water infrastructure or water supply, or to promote clean energy. Authorizes ERS investments in such public-private partnerships. This strategy dodges procurement laws and budgeting, increases risk to ERS assets, and may even be prohibited by ERISA.

BRIEF SUMMARY: Adds a new section to HRS chapter 237 to establish a GET exemption for amounts received by a contractor not more than ___% of the direct costs of construction and operation incurred by a contractor under a public-private partnership with the employees' retirement system to develop a construction project to implement clean energy technology, as that term is defined in section 269-121(b), or a construction project to improve the State's water supply, including projects defined as a water facility under section 167-2 or section 174-2, a wastewater treatment plant under section 340B-1, or a public water system under section 340E-1; provided that the income shall be excluded from gross income for each year of the anticipated useful life of the construction project. Provides for certification by ERS of the creditable amount. Defines "direct costs of construction and operation" as the costs of materials, labor, equipment, and directly involved efforts or expenses for the completion and operation of a construction project, excluding all general overhead costs.

Adds a new paragraph to HRS section 235-7 to establish an income tax exemption for not more than ___% of the direct costs of construction and operation, as described above. Note that unlike the new section in HRS chapter 237, "direct costs of construction and operation" are not defined.

Amends HRS section 88-119 to allow ERS to invest in the public-private partnerships described above.

EFFECTIVE DATE: Upon approval, applies to taxable years beginning after December 31, 2016.

STAFF COMMENTS: Apparently, the proponent of this bill is interested in construction projects that are intended to implement clean energy or improve the State's water supply, such as building water facilities or wastewater treatment plants. Apparently realizing the difficulty of having a state agency procure the projects, the bill proposes throwing tax exclusions at those who would build such projects, and would allow them to enter into a public-private partnership with the Employees' Retirement System and the sizable nest egg it is holding.

Doing that, however, is a perversion of the tax system, the procurement process, and the retirement system. The tax system is supposed to collect revenue for government, not build public works projects. And the money in ERS is to satisfy the obligations the State owes to its retired workers now and in the future. That system is actuarially underfunded right now by billions of dollars. Increasing risk to those assets is not prudent. Indeed, we may even be prohibited by ERISA from gambling with those funds, which is what this bill seems to be doing.

Some technical changes to consider if the Committee still wants to move the bill:

- As written, the exclusions apply independently of each other. Thus, allowing an exclusion "up to 2%," for example, of a $1 million investment in all three places would mean the taxpayer concerned could take a $20,000 net income tax exclusion on top of a $20,000 GET exclusion, for each year of the anticipated useful life of the construction project.
- Income exclusions do not themselves represent revenue loss, but only have value to the extent of other income and tax rate. For example, to a taxpayer making $1 million in net income, a $20,000 exclusion would be worth 8.25% of the excluded amount, or $1,650. To a taxpayer sustaining a large amount of operating losses without other offsetting income, the same exclusion would be worth nothing. If the intent is to apply a fixed dollar incentive, a credit should be considered instead.

Digested 2/6/2017