

# **SB 1169**

Measure Title: RELATING TO THE LOW-INCOME HOUSING TAX CREDIT.

Report Title: Low-income Housing Tax Credit; Hawaii Housing Finance and Development Corporation (\$)

Description: Specifies that certain provisions of the Internal Revenue Code related to at-risk rules and deductions and to passive activity loss do not apply with respect to claims for the state low-income housing tax credit. Appropriates funds to establish one position in the Hawaii Housing Finance and Development Corporation to oversee the Low-Income Housing Tax Credit Program.

Companion: HB1335

Package: None

Current Referral: HOU, WAM

Introducer(s): RUDERMAN, ESPERO, Baker, S. Chang, Galuteria, Harimoto, Inouye, Keith-Agaran, Kidani, Kim, Nishihara, Riviere, Shimabukuro, Taniguchi

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To: The Honorable Will Espero, Chair  
and Members of the Senate Committee on Housing

Date: Thursday, February 9, 2017  
Time: 3:00 P.M.  
Place: Conference Room 225, State Capitol

From: Maria E. Zielinski, Director  
Department of Taxation

Re: S.B. 1169, Relating to the Low Income Housing Tax Credit

The Department of Taxation (Department) appreciates the intent of S.B. 1169 to increase low income housing, but opposes the nonconformity to the Internal Revenue Code (IRC) provisions relating to the at risk and passive activity loss (PAL) limitation rules. The Department otherwise defers to the Hawaii Housing Finance and Development Corporation (HHFDC) on the merits of this bill, and provides the following comments on S.B. 1169 for your consideration.

Among other things, S.B. 1169 provides that at-risk rules and the PAL rules do not apply with respect to claims for the state low-income housing tax credit. The measure is effective on January 1, 2018, and applies to qualified low-income buildings awarded credits beginning after December 31, 2017.

First, the Department notes that it always prefers conformity to the IRC where possible, as this provides clear guidance to both the Department and to taxpayers, since there is substantial guidance issued in the form of rules and regulations issued by the Internal Revenue Service (IRS), as well as court decisions regarding the various sections of the IRC. Conformity greatly minimizes the burden on the Department and taxpayers, thereby assisting compliance with Hawaii's tax law.

Pursuant to the IRC, both the at-risk and PAL rules apply only to:

- Individuals (including partners and S corporation shareholders);
- Estates;
- Trusts (other than grantor trusts);
- Personal service corporations; and
- Closely held corporations.

Currently, losses from activities that exceed the amount the taxpayer has at-risk are disallowed for the current year, but are carried forward until the taxpayer increases the amount that he has at risk at which time the losses up to that amount may be utilized. Similarly, PAL that exceed the income from passive activities are disallowed for the current year, but are carried forward until they may be used against passive income or the interest in the activity has been disposed of. If this measure is adopted, taxpayers would be able to immediately use any losses to offset ordinary income without any limitation.

Congress originally enacted the at-risk provisions as part of the Tax Reform Act of 1976 in order to deter deductions from losses generated by tax shelters. Prior to the enactment, a taxpayer could increase his or her basis in the partnership by utilizing non-recourse loans for which the individual had no true economic risk. This increase in basis allowed the taxpayer to use investment losses to offset ordinary income. Although the IRS attempted to limit this practice, its attempts were only marginally effective until the enactment of IRC Section 465.

Currently, nonrecourse financing is deemed to be at-risk only if the property is acquired by the taxpayer from a non-related person, and the financing is received from a lender in the business of lending (other than the seller of the property) or a government agency. If the at-risk rules are relaxed for the LIHTC, the investor could acquire the property from a related person at a greatly inflated price using nonrecourse liability (such that no individual partner has a liability in the event of default), and yet take virtually unlimited losses in connection with the property.

The at-risk rules prevent a taxpayer from artificially increasing basis through the use of subscription promissory notes (whereby an investor promises to pay an amount in the future) which in fact are never paid. See e.g. Zeluck v. Commissioner, 103 TCM (2012), where the taxpayer contributed \$310,000 to a partnership in 2001 in the form of \$110,000 in cash and a \$200,000 note that matured on December 31, 2009. The taxpayer also guaranteed a note that was issued by the partnership up to an amount equal to the note he contributed, giving him an initial at-risk tax basis of \$310,000 (\$110,000 of cash plus \$200,000 of guaranteed debt). In 2001 and 2002, the taxpayer was allocated losses from the partnership that practically eliminated his at-risk tax basis, and in 2003 the partnership terminated. After the partnership terminated, no attempt was made to enforce payment of the taxpayer's note or the partnership's note on which the taxpayer never made any principal payments and failed to make all interest payments.

The PAL rules were enacted as part of the Tax Reform Act of 1986 to address widespread avoidance of tax through the generation of artificial losses from tax shelters and other trades or business for which the taxpayer did not bear sufficient economic risk. The PAL rules focus on the source and character of losses rather than on the taxpayer's wherewithal to recognize such losses. Broadly speaking, the rules operate to prevent taxpayers from offsetting ordinary income from non-passive activities (i.e., wages or businesses they operate) with losses from passive activities in which the taxpayer does not materially participate, thereby insuring that all taxpayers pay a fair share of taxes on ordinary income. It should also be noted that if the PAL limitation rules are relaxed, a taxpayer will be able to shield their ordinary income and still retain capital gain treatment when the interest in the activity is sold.

The Department notes that with regards to low income housing buildings that are not financed through the use of tax exempt bonds, the LIHTC is already fully subscribed, and no amount of additional incentives can generate additional low income housing using conventional financing. Only projects that are financed with tax exempt bonds are undersubscribed, such that additional inducements may attract additional investors. The Department notes, however, that the LIHTC credit period was shortened 10 to 5 years and it is too early to assess the impact that this change has had on additional projects.

Finally, the Department cautions that it will not be able to accurately and feasibly determine the amount of revenue lost as a result of adopting this measure without a full examination of each partner or member's income tax return. However, if the Committee wishes to advance this measure, the Department notes that it is able to implement this measure with the current effective date.

Thank you for the opportunity to provide comments.

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# TAX FOUNDATION OF HAWAII

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126 Queen Street, Suite 304

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**SUBJECT:** INCOME, Modify Low-Income Housing Credit

**BILL NUMBER:** SB 1169; HB 1335 (Identical)

**INTRODUCED BY:** SB by RUDERMAN, ESPERO, Baker, S. Chang, Galuteria, Harimoto, Inouye, Keith-Agaran, Kidani, Kim, Nishihara, Riviere, Shimabukuro, Taniguchi; HB by HASHEM, BROWER, GATES, YAMASHITA, San Buenaventura

**EXECUTIVE SUMMARY:** Seeks to make the State low-income housing credit more valuable by decoupling from the federal at-risk rules and passive activity loss limitations. As a policy matter, if it is considered desirable to offer incentives to develop such projects, consideration should be given to attacking the root causes of why such projects are prohibitively expensive, such as the permitting process.

**BRIEF SUMMARY:** Amends HRS section 235-110.8 so that the federal at-risk rules under IRC section 42 and the federal passive activity limitations under IRC section 469 do not apply with respect to investments in buildings and projects claiming credit.

**EFFECTIVE DATE:** Upon approval, effective January 1, 2018, and shall apply to qualified low-income buildings awarded credits beginning after December 31, 2017.

**STAFF COMMENTS:** Act 216, SLH 1988, adopted for Hawaii purposes the federal low-income rental housing credit that was part of the Tax Reform Act of 1986. The credit was enacted to offset the repeal of tax shelters and other incentives to build rental housing under prior law, such as accelerated depreciation, capital gains preference, certain tax-exempt bonds, and to specifically target low-income rentals.

While this is just one incentive to encourage developers to build affordable housing, consideration should be given to a number of strategies including the debt financing, partnerships with financial institutions who could then turn around and sell the credits, and the use of federal private activity bonds. Finally, one of the greatest contributors to the cost of housing in Hawaii is the draconian maze of permitting and regulatory processes in order to bring those homes to market. While those regulatory guidelines are to insure the health and safety of the public, streamlining the process would accelerate the time needed to secure those permits thereby reducing the cost of financing. This savings would go a long way toward reducing the final cost of the house to the consumer. For example, for one housing project on Kauai, it took nearly five years to secure the necessary permits to build 14 affordable homes.

Digested 2/7/2017

Testimony by In-State Partners

In Support of SB 1169  
Relating to the Low-Income Housing Tax Credit  
House Committee on Housing  
Thursday, February 9, 2017; 3:00 PM; CR 225

The Honorable Will Espero, Chair and Members of the Committee on Housing

My name is Ryan Brennan, with InState Partners, testifying in strong support of SB 1169 Relating to the Low-Income Housing Tax Credit.

Low-income housing tax projects would not be feasible without the federal and State low-income housing tax credits ("LIHTCs"). The LIHTCs are necessary to subsidize the cost of the projects without which there would not be sufficient incentives for developers to assume the risk of these projects. This is why Hawaii has adopted the federal LIHTCs to be taken against Hawaii taxes. Last year, the Legislature recognized the importance of the LIHTCs by enacting Act 129, which expanded the incentives for Hawaii investors by accelerating the period over which the Hawaii tax credits can be taken from 10 to 5 years, and by matching federal tax credit rate, rather than just 50% of the federal rate.

The purpose of this bill is to build on the incentives provided under Act 129 by decoupling from the at-risk and passive activity loss limitations under federal income tax law. These federal tax limitations only permit large corporations to benefit from the credit, excluding most Hawaii individual and small businesses from participating. This bill therefore expands the investor pool to be more inclusive of the typical Hawaii investor.

Thank you for this opportunity to testify.

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**From:** mailinglist@capitol.hawaii.gov  
**Sent:** Tuesday, February 7, 2017 8:31 AM  
**To:** HOU Testimony  
**Cc:** fromwayne@gmail.com  
**Subject:** \*Submitted testimony for SB1169 on Feb 9, 2017 15:00PM\*

**SB1169**

Submitted on: 2/7/2017

Testimony for HOU on Feb 9, 2017 15:00PM in Conference Room 225

Submitted By	Organization	Testifier Position	Present at Hearing
E. Wayne Johnson	Individual	Support	No

**Comments:**

Please note that testimony submitted less than 24 hours prior to the hearing, improperly identified, or directed to the incorrect office, may not be posted online or distributed to the committee prior to the convening of the public hearing.

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# LATE TESTIMONY

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**From:** mailinglist@capitol.hawaii.gov  
**Sent:** Wednesday, February 8, 2017 5:07 PM  
**To:** HOU Testimony  
**Cc:** annsfreed@gmail.com  
**Subject:** Submitted testimony for SB1169 on Feb 9, 2017 15:00PM

## **SB1169**

Submitted on: 2/8/2017

Testimony for HOU on Feb 9, 2017 15:00PM in Conference Room 225

<b>Submitted By</b>	<b>Organization</b>	<b>Testifier Position</b>	<b>Present at Hearing</b>
Ann S Freed	Individual	Support	No

Comments: Aloha Chair Espero and members, This seems like one good common sense measure to increase access to housing. Mahalo for taking action. Ann S. Freed, Mililani resident

Please note that testimony submitted less than 24 hours prior to the hearing, improperly identified, or directed to the incorrect office, may not be posted online or distributed to the committee prior to the convening of the public hearing.

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