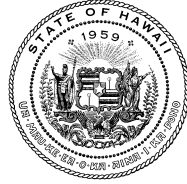


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To: The Honorable Tom Brower, Chair  
and Members of the House Committee on Housing

Date: Tuesday, February 7, 2017

Time: 9:00 A.M.

Place: Conference Room 423, State Capitol

From: Maria E. Zielinski, Director  
Department of Taxation

Re: H.B. 1216, Relating to the Low-Income Housing Investment Tax Credit

The Department of Taxation (Department) appreciates the intent of the measure to increase affordable housing, but opposes this measure due to its excessive generosity and the compliance burdens that it will impose on the Department. The Department otherwise defers to the Hawaii Housing Finance and Development Corporation (HHFDC) on the merits of this bill, and provides the following comments for your consideration.

H.B. 1216 creates a new tax credit for investments made in qualified low-income housing projects or qualified low-income buildings. This credit may be used to offset the income tax under chapter 235, Hawaii Revised Statutes (HRS), or the insurance premiums tax under chapter 431, HRS. The measure is effective upon approval, and applies to investments made after December 31, 2017.

First, the Department notes that this investment tax credit is very similar to the High-Technology Business Investment Tax Credit enacted by Act 221, Session Laws of Hawaii 2000 (QHTB Credit). In fact, this credit is far more generous than the QHTB credit, as it provides a presumption that any tax allocation ratio less than 4 to 1 is presumptively valid, whereas the QHTB credit presumption was for allocations that were 2 to 1 or less. This credit would allow a taxpayer to invest \$100,000 in a qualified project, but generate a \$400,000 State tax credit for use in offsetting income or insurance premium taxes, with virtual impunity. The measure essentially only allows the application of the economic substance doctrine where the credit ratio is more than 4 to 1 and equal to or less than 6 to 1.

As with the QHTB credit, these types of tax credits may lead to substantial abuse and improper claims. The Department expended considerable compliance resources to determine whether taxpayer claims for the credits were proper. Validation of tax credit claims requires review of extremely detailed and technical information, and disputes concerning the credit are not easily resolved. It is not uncommon, for example, that audits and the related appeals to span

several years of extensive and costly litigation.

Second, like the QHTB credit, the Department is concerned with how this credit is heavily front-loaded, with thirty-five per cent of the investment made by the taxpayer in each project (or \$700,000, whichever is less) and twenty-five per cent of the investment made by the taxpayer (or \$500,000, whichever is less) in the second year. Because the investments are made through an entity taxed as a partnership, and because the allocations of the credit only occur through the partnership, an investor who invests \$100,000 in the partnership and is entitled to a 4 to 1 allocation ratio would be entitled to claim \$140,000 in tax credit immediately in the first year. The credit in the first year would be substantially more than the amount invested.

Third, the measure provides absolutely no recapture provisions. This is particularly problematic because of the structure of the credit discussed above. Continuing with the example above, the investor could demand the investment back and fully retain the credits allocated in the first year. This means that the investor would end up with \$100,000 cash returned and a \$140,000 tax credit.

Fourth, the Department notes that with regards to low income housing buildings that are not financed through the use of tax exempt bonds, the Low Income Housing Tax Credit (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, if the Committee wishes to advance this measure, the Department is able to implement this new credit with the current effective date.

Thank you for the opportunity to provide comments.

# TAX FOUNDATION OF HAWAII

126 Queen Street, Suite 304

Honolulu, Hawaii 96813 Tel. 536-4587

SUBJECT: INCOME, FRANCHISE, Low-Income Housing Investment Tax Credit

BILL NUMBER: HB 1216

INTRODUCED BY: CHOY

EXECUTIVE SUMMARY: Enacts a new income tax credit to encourage investment in low-income housing projects. A direct appropriation would be preferable as it would provide some accountability for the taxpayer funds being utilized to support this effort. Meaning, we as taxpayers know what we're getting and we know how much we're paying for it.

BRIEF SUMMARY: Adds a new section to HRS chapter 235 to allow a credit for investment in low-income housing projects, as follows:

- (1) In the taxable year the investment was made, thirty-five per cent of the investment made by the taxpayer in each project or \$700,000, whichever is less;
- (2) In the first taxable year following the year in which the investment was made, twenty-five per cent of the investment made by the taxpayer in each project or \$500,000, whichever is less;
- (3) In the second taxable year following the year in which the investment was made, twenty per cent of the investment made by the taxpayer in each project or \$400,000, whichever is less;
- (4) In the third taxable year following the year in which the investment was made, ten per cent of the investment made by the taxpayer in each project or \$200,000, whichever is less; and
- (5) In the fourth taxable year following the year in which the investment was made, ten per cent of the investment made by the taxpayer in each project or \$200,000, whichever is less.

The credit is nonrefundable, but excess credit may be carried forward to subsequent years until exhausted.

Every claim, including amended claims, for a tax credit 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. Credits not claimed in time will be waived.

Provides that common law principles, including the doctrine of economic substance and business purpose, shall apply to any investment. Provides that the doctrines are presumed to be satisfied if there is an investment tax credit ratio of 4.0 or less; that a taxpayer shall substantiate economic merit and business purpose if the ratio is in excess of 6.0; and the department may review transactions where the ratio is between these benchmarks.

Defines “investment tax credit allocation ratio” as the ratio of the amount of credit that is or is to be received by or allocated to the taxpayer over the life of the investment, over the amount of the taxpayer’s investment.

Contains an unspecified sunset date.

Makes a conforming amendment to chapter 241 making this credit available to franchise taxpayers (banks and other financial institutions).

EFFECTIVE DATE: Upon approval, applies to investments after December 31, 2017.

STAFF COMMENTS: The idea of providing a tax credit to encourage investments may have been acceptable a few years ago when the economy was on a roll and advocates could point to credits like those to encourage the use of or investment in emerging technologies, what lawmakers and administrators have learned in these past few years is that unbridled tax incentives, where there is no accountability or limits on how much in credits can be claimed, are irresponsible as the cost of these credits goes far beyond what was ever intended.

Indeed, the credit as proposed looks suspiciously similar to the high technology business investment credit that sunset in 2011 after causing massive damage to the public fisc.

The bill contemplates certain investors getting allocated multiple times their investment. Some years ago, in Tax Information Release 2007-4, the Department opined that allocations of high technology business investment credit (former HRS section 235-110.9) would be respected if the allocations were 1.5X or less, would be reviewed between 1.5X and 2.0X, and would require substantiation for a ratio of more than 2.0X. The ratios contemplated in the bill are much higher than this.

Instead, lawmakers should consider an appropriation of a specific number of taxpayer dollars. At least lawmakers would have a better idea of what is being funded. A direct appropriation would be preferable to the tax credit as it would: (1) provide some accountability for the taxpayers’ funds being utilized to support this effort; and (2) not be a blank check.

Digested 2/2/2017