TAX FOUNDATION OF HAWAII

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SUBJECT: INCOME, Modify Low-Income Housing Credit

BILL NUMBER: HB 2332, HD-1

INTRODUCED BY: House Committee on Housing

EXECUTIVE SUMMARY: Seeks to make the State low-income housing credit more valuable by decoupling from the federal at-risk rules, installment sale 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.

SYNOPSIS: Amends HRS section 235-110.8 so that the federal at-risk rules under IRC section 42(k), the installment method rules under IRC section 453, the at-risk limitations under IRC section 465, and the passive activity limitations under IRC section 469, do not apply with respect to investments in buildings and projects claiming credit. However, all allocations to partners of their distributive shares of income, loss, and deductions under chapter 235 shall be made in proportion to the partner's allocation of credits.

EFFECTIVE DATE: January 1, 2050; applies to taxable years beginning after December 31, 2018.

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.

On the federal level, the tax credits and losses attributable to such a project are limited by a series of complex rules, including:

At-Risk Rules

For individuals, estates, trusts, and closely held C corporations, deductions of business- or investment-related losses from an activity for a tax year are limited to the amount the taxpayer is at risk. The amount at risk includes: (1) the amount of money and the adjusted basis of property contributed to an activity; (2) amounts borrowed with respect to the activity to the extent the taxpayer is personally liable for repayment or has pledged property, other than property used in the activity, as security for the borrowed amount; and (3) generally, amounts borrowed with respect to the activity of holding real property for which no person is personally liable for repayment (qualified nonrecourse financing). The amount at risk is also increased by the excess of items of income from an activity for the tax year over items of deduction from the activity for the tax year.

Unlike a partner's tax basis, the amount at risk can go negative, although not from recognition of losses. The consequence of a negative at-risk amount is the potential for at-risk recapture, which is the recognition of previously deducted losses as income in a year in which a taxpayer's amount at risk is negative, often as the result of a distribution. Recognition of at-risk recapture increases a partner's amount at risk.

Passive Activity Loss Rules

Passive activity loss rules are a set of IRS rules that prohibit using passive losses to offset earned or ordinary income. Passive activity loss rules prevent investors from using losses incurred from income-producing activities in which they are not materially involved.

Being materially involved with earned or ordinary income-producing activities means the income is active income and may not be reduced by passive losses. Passive losses can be used only to offset passive income.

The key issue with passive activity loss rules is material participation. According to IRS Topic No. 425, "material participation" is involvement in the operation of a trade or business activity on a "regular, continuous, and substantial basis." If the taxpayer does not materially participate in the activity that is producing the passive losses, then those losses can only be matched against passive income. If there is no passive income, then no loss can be deducted. However, rental activities, including real estate rental activities, are considered passive activities even if there is material participation ("real estate professionals" cannot benefit from this exception).

Passive activity losses can only be applied in the current year, and if they exceed passive income they can be carried forward without limitation; they cannot be carried back.

In general, passive activity loss rules are applied at the individual level, but they also extend to virtually all businesses and rental activity in various reporting entities, except C corporations, to deter abusive tax shelters.

Installment Sale

In United States income tax law, an installment sale is generally a "disposition of property where at least 1 loan payment is to be received after the close of the taxable year in which the disposition occurs." The term "installment sale" does not include, however, a "dealer disposition" (as defined in the statute) or, generally, a sale of inventory.

The installment method of accounting provides an exception to the general principles of income recognition by allowing a taxpayer to defer the inclusion of income of amounts that are to be received from the disposition of certain types of property until payment in cash or cash equivalents is received.

The installment method defers the recognition of income when compared with both the cash and accrual methods of accounting. Under the cash method, the taxpayer would recognize the income when it is received, including the entire sum paid in the form of a negotiable note. The deferral advantages of the installment method are the most pronounced when comparing to the accrual method, under which a taxpayer must recognize income as soon as he or she has a right to the income.

Current Proposal

The proposal here is to make these rules inapplicable to investments in low-income housing projects. It is curious why installment sale rules are not to be applied, as they are generally favorable to taxpayers as opposed to the alternative, which would probably be accrual method recognition.

While this bill generally is just one incentive to encourage developers to build affordable housing, consideration should be given to many strategies including 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 required 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.

Digested 2/26/2018