



**STATE OF HAWAII
DEPARTMENT OF TAXATION**

830 PUNCHBOWL STREET, ROOM 221
HONOLULU, HAWAII 96813

<http://tax.hawaii.gov/>
Phone: (808) 587-1540 / Fax: (808) 587-1560
Email: Tax.Directors.Office@hawaii.gov

To: The Honorable Donovan M. Dela Cruz, Chair
and Members of the Senate Committee on Ways and Means

Date: Wednesday, February 28, 2018
Time: 11:00 A.M.
Place: Conference Room 211, State Capitol

From: Linda Chu Takayama, Director
Department of Taxation

Re: S.B. 2402 S.D. 1, Relating to Low Income Housing Tax Credit

The Department supports the intent of S.B. 2402, S.D. 1, defers to the Hawaii Housing Finance and Development Corporation (HHFDC) on the merits of this bill, and provides the following comments for your consideration. S.B. 2402, S.D. 1, does the following:

- Eliminates conformity to the following Internal Revenue Code (IRC) sections such that these provisions do not apply to investments in buildings and projects claiming the credit:
 - Sections 42(k) and 465 - relating to the at-risk rules;
 - Section 453 - relating to the installment method;
 - Section 469 - relating to the passive activity loss (PAL) limitations; and
 - Section 704 - relating to partner's distributive share as it relates to State allocations.
- Is effective on January 1, 2019 and applies to qualified low-income buildings awarded credits after December 31, 2018.
- Is repealed on December 31, 2021 by virtue of section 4 of Act 129, Session Laws of Hawaii 2016, which reenacts this section as it existed prior to the passage of Act 129, Session Laws of Hawaii 2016.

First, the Department notes that it generally 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.

Second, there are two types of at-risk rules that this measure deletes: (1) IRC subsection 42(k), which relates to the credit basis of the building upon which the amount of the credit is

calculated and (2) IRC section 465, which relates to the limit on deductions that can be taken based on an investment in an entity that owns a low income housing building.

Non-conformity to IRC section 42(k) may result in unintended consequences. Under current law, nonrecourse financing is added to the credit basis of the building only if the property was not acquired by the entity from a 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. The amount of the State credit is also set as 50% of the federal credits allocated. Nonconformity to IRC section 42(k) would allow a taxpayer to acquire the property from a related person at an inflated price using nonrecourse liability and increase the basis amount upon which the credit is calculated. To prevent this, the Department suggests that a new subsection (j)(3) be added as follows:

(3) In no event shall the amount of state credits allocated by the corporation for the qualified low income building exceed 50% of the amount of federal credits allocated to such building.

Finally, the Department is able to implement the measure with its current effective date. Thank you for the opportunity to provide comments regarding this measure.



STATE OF HAWAII

DEPARTMENT OF BUSINESS, ECONOMIC DEVELOPMENT AND TOURISM
HAWAII HOUSING FINANCE AND DEVELOPMENT CORPORATION
677 QUEEN STREET, SUITE 300
Honolulu, Hawaii 96813
FAX: (808) 587-0600

IN REPLY REFER TO:

Statement of
Craig K. Hirai
Hawaii Housing Finance and Development Corporation
Before the

SENATE COMMITTEE ON WAYS AND MEANS

February 28, 2018 at 11:00 a.m.
State Capitol, Room 211

In consideration of
S.B. 2402, S.D. 1
RELATING TO THE LOW-INCOME HOUSING TAX CREDIT.

The HHFDC **supports** S.B. 2402, S.D. 1. This bill proposes changes to the State Low-Income Housing Tax Credit (LIHTC) to increase the amount of equity generated by the sale of the LIHTC for affordable rental housing developments. We also have no objections to the Department of Taxation's proposed amendment to this bill.

By eliminating the applicability of the at-risk and passive activity loss limitations to State LIHTC investors, this bill expands the pool of Hawaii taxpayers that can invest in the State LIHTC to any Hawaii taxpayer with Hawaii income tax liability. To increase the production of LIHTC projects, the result will be an increase in the supply of federal and State LIHTC. A federal LIHTC can be sold nationally, but a State LIHTC can only be sold to investors who owe Hawaii taxes. If we do not increase the number of Hawaii taxpayers who can invest in State LIHTCs, there will be an oversupply which will lower the price the existing pool of Hawaii LIHTC investors are willing to pay for a State LIHTC. Any increased pricing for the State LIHTC under this bill will generate more equity that can be spent on affordable rental housing development.

Thank you for the opportunity to provide written comments on this bill.

TAX FOUNDATION OF HAWAII

126 Queen Street, Suite 304

Honolulu, Hawaii 96813 Tel. 536-4587

SUBJECT: INCOME, Modify Low-Income Housing Credit

BILL NUMBER: SB 2402, SD-1

INTRODUCED BY: Senate Committee on Housing

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.

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: This Act shall take effect on January 1, 2019 and shall apply to qualified low-income buildings that receive an allocation of credits 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.

The proposal here is to make these rules inapplicable to investments in low-income housing projects.

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 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.

Testimony by InState Partners

In Support of SB2402 SD1
Relating to the Low-Income Housing Tax Credit
Senate Committee on Ways and Means
Wednesday, February 28, 2018, 11:00AM; CR211

The Honorable Donovan Dela Cruz, Chair and Committee Members:

My name is Rachel Stern, with InState Partners, testifying in support of SB2402 SD1 Relating to the Low-Income Housing Tax Credit.

The purpose of this bill is to build on the incentives provided under Act 129 (2016) 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.

InState Partners strongly supports this measure, and urges this committee to pass this measure out of committee. We also defer to the Hawaii Housing Finance and Development Corporation on the technical issues.

Thank you for this opportunity to testify.