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GOVERNOR



CRAIG K. HIRAI  
EXECUTIVE DIRECTOR

## STATE OF HAWAII

DEPARTMENT OF BUSINESS, ECONOMIC DEVELOPMENT AND TOURISM  
HAWAII HOUSING FINANCE AND DEVELOPMENT CORPORATION  
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IN REPLY REFER TO:

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

### HOUSE COMMITTEE ON FINANCE

April 4, 2018 at 2:30 p.m.  
State Capitol, Room 308

In consideration of  
**S.B. 2402, S.D. 2**  
**RELATING TO THE LOW-INCOME HOUSING TAX CREDIT.**

The HHFDC **supports** S.B. 2402, S.D. 2. 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.

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 testify.



**STATE OF HAWAII**  
**DEPARTMENT OF TAXATION**  
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To: The Honorable Sylvia Luke, Chair  
and Members of the House Committee on Finance

Date: Wednesday, April 4, 2018  
Time: 2:30 P.M.  
Place: Conference Room 308, State Capitol

From: Linda Chu Takayama, Director  
Department of Taxation

Re: S.B. 2402, S.D. 2, Relating to Low Income Housing Tax Credit

The Department supports the intent of S.B. 2402, S.D. 2, defers to the Hawaii Housing Finance and Development Corporation (HHFDC) on the merits of this bill, and provides the following comments for your consideration. A Summary of the key provisions of this measure are as follows:

- 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;
- Has a defective effective date of July 1, 205, but otherwise applies to qualified low-income buildings awarded credits after December 31, 2018.

First, the Department appreciates that the Senate Committee on Ways and Means adopted the Department's recommendation to add a provision to insure adherence to the requirement that the State tax credits allocated to the building do not exceed 50% of the total federal tax credits allocated to the building.

Second, 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.

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

# TAX FOUNDATION OF HAWAII

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SUBJECT: INCOME, Modify Low-Income Housing Credit

BILL NUMBER: SB 2402, SD-2

INTRODUCED BY: Senate Committee on Ways & Means

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: July 1, 2050, and applies to qualified low-income buildings that receive an allocation of credits beginning after December 31, 2018. Amendments made by the bill to section 235-110.8, HRS, will be permanent despite Act 129, SLH 2016.

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.

**SB-2402-SD-2**

Submitted on: 4/2/2018 4:17:31 PM

Testimony for FIN on 4/4/2018 2:30:00 PM

<b>Submitted By</b>	<b>Organization</b>	<b>Testifier Position</b>	<b>Present at Hearing</b>
Ray Kamikawa	InState Partners	Support	Yes

Comments:

Testimony by InState Partners

In Support of SB2402 SD2

Relating to the Low-Income Housing Tax Credit

House Committee on Finance

Wednesday, April 4, 2018, 2:30pm; Conf Rm 308

The Honorable Sylvia Luke, Chair, and Committee Members:

My name is Rachel Stern, with InState Partners, testifying in support of SB2402, SD2 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.

**LATE**

**SB-2402-SD-2**

Submitted on: 4/3/2018 2:11:05 PM

Testimony for FIN on 4/4/2018 2:30:00 PM

<b>Submitted By</b>	<b>Organization</b>	<b>Testifier Position</b>	<b>Present at Hearing</b>
Melodie Aduja	the Oahu County Committee on Legislative Priorities of the Democratic Party of Hawai'i	Support	No

Comments:

**LATE**

**SB-2402-SD-2**

Submitted on: 4/3/2018 6:36:41 PM

Testimony for FIN on 4/4/2018 2:30:00 PM

<b>Submitted By</b>	<b>Organization</b>	<b>Testifier Position</b>	<b>Present at Hearing</b>
George M Clifford	Individual	Support	No

Comments: