

DAVID Y. IGE
GOVERNOR

JOSH GREEN M.D.
LIEUTENANT GOVERNOR



LINDA CHU TAKAYAMA
DIRECTOR

DAMIEN A. ELEFANTE
DEPUTY DIRECTOR

**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 6, 2019
Time: 10:00 A.M.
Place: Conference Room 211, State Capitol

From: Linda Chu Takayama, Director
Department of Taxation

Re: S.B. 855, Relating to Low-Income Housing Tax Credit

The Department supports the intent of this measure, defers to the Hawaii Housing Finance and Development Corporation (HHFDC) on the merits of this bill, and provides the following comments regarding S.B. 855 for your consideration. A summary of the key provisions of this measure as it relates to tax 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 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 upon approval and applies to qualified low-income buildings awarded credits after December 31, 2019.

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 the following be added to subsection (j) as follows:

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.

Thank you for the opportunity to provide comments.



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 6, 2019 at 10:00 a.m.
State Capitol, Room 211

In consideration of
S.B. 855
RELATING TO THE LOW-INCOME HOUSING TAX CREDIT.

The HHFDC supports S.B. 855. 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. It 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.

SB-855

Submitted on: 2/5/2019 9:34:53 AM

Testimony for WAM on 2/6/2019 10:00:00 AM

Submitted By	Organization	Testifier Position	Present at Hearing
Melodie Aduja	Testifying for O`ahu County Committee on Legislative Priorities of the Democratic Party of Hawai`i	Support	No

Comments:

TAX FOUNDATION OF HAWAII

126 Queen Street, Suite 304

Honolulu, Hawaii 96813 Tel. 536-4587

SUBJECT: TAX CREDIT

BILL NUMBER: SB 855; HB 1294 (Identical)

INTRODUCED BY: SB by KEITH-AGARAN, Dela Cruz, Kanuha, Nishihara; HB by SAIKI

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 to a qualified low-income building that receives an allocation of credits after December 31, 2019.

Provides that 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, and that the amount of state credits allocated by the corporation (HHFDC) for the qualified low-income building shall not exceed fifty per cent of the amount of federal credits allocated to the building.

EFFECTIVE DATE: Applies to qualified low-income buildings that receive an allocation of credits beginning after December 31, 2019.

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 several 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 ensure the health and safety of the public, streamlining the process would accelerate the time needed to secure those permits thereby

Re: SB 855
Page 3

reducing the cost of financing. This savings would go a long way toward reducing the final cost of the house to the consumer.

Digested 2/3/2019

Testimony in Support of SB 855 Relating to The Low-income Housing Tax Credit

Chairman and Committee Members,

My name is Rachel Stern, testifying in support of SB 855 Relating to the Low-Income Housing Tax Credit.

Most people in Hawaii cannot afford to live in their homes. Housing is considered “affordable” when a household spends less than 30 percent of their income on shelter and utilities. Households that spend more are considered cost-burdened, and are frequently forced to make difficult financial tradeoffs with other basic necessities. For every 100 low-income families in Hawaii, there are only 29 affordable housing units available¹.

Many working professionals such as teachers, police officers, and construction workers do not earn Hawaii’s housing wage. More than half of all Hawaii renters do not live in affordable housing, while almost 80 percent of the state’s 30,556 extremely low-income households are paying more than half of their income in rent². The “housing wage” needed to afford a two-bedroom apartment at fair market rent (\$1,640/month) is \$31.54, while the average wage of a renter is a mere \$13.86, less than half of what’s needed³. It would take 3.19 firemen, 3.63 school teachers or 5.2 hotel front desk clerks to be able to afford the median-priced home on Oahu⁴. The state housing prices are pushing out the working citizens who contribute to Hawaii, both socially and economically.

The Low Income Housing Tax Credit (LIHTC) provides a strong solution to this affordable housing crisis. The Federal government gives each state Federal low income housing tax credits or “LIHTCs” based on the number of citizens in a state, and to further incentivize the program, the state of Hawaii has created a 50% state match for all federal credits utilized. This is a strong foundation for a program and shows Hawaii is committed to addressing its constituents’ needs.

The Hawaii LIHTC program that currently exists has substantial impact in the state. The numbers in Chart 1 (found on Page 3 of this testimony) are based on the 1,416 housing units created in 2013 and demonstrate the positive impact the construction of the housing units has on local jobs, salaries and tax revenues.

Chart 1 shows that LIHTC is not only a crucial element of combatting the affordable housing crisis, but also creates short and longer term jobs and generates substantial local tax revenue. Unfortunately, LIHTC in Hawaii is not achieving the highest level of impact possible. There are elements of the current statute that make it very difficult to find investors for the LIHTC projects. With a few small changes to the law, Hawaii has the ability to create a thriving and expansive LIHTC program to generate the much needed affordable housing.

¹ The Affordable Rental Housing Gap Persists, National Low Income Housing Coalition, http://nlihc.org/sites/default/files/HS_4-1.pdf

² “ “

³ Hawai‘i’s Affordable Housing Crisis, Hawaii Appleseed Center for Law and Economic Justice, <http://www.hiappleseed.org/affordable-housing-crisis>

⁴ The High Cost of Affordable Housing, Hawaii Business, <http://www.hawaiiibusiness.com/the-high-cost-of-affordable-housing/>

The current statute, HRS §235-110.8, unnecessarily incorporates three very limiting provisions from the Internal Revenue Code, specifically, Section 465 (General At-Risk Rules), Section 42(k) (Credit At-Risk Rules) and Section 469 (Passive Activity Loss Rules (PAL)). Currently, because the state credit is subject to at risk and passive activity loss restrictions, it only attracts a small pool of investors. These are typically C-Corps (mostly insurance companies and big banks) which aren't subject to at risk or passive activity loss restrictions or individuals who have sufficient passive income (a very rare occurrence) to overcome at risk and passive activity loss restrictions. In fact, because the federal tax rules currently encourage small to medium sized banks to organize as Sub-Chapter S Corporations instead of C-Corporations, these smaller financial institutions don't even qualify as investors under current at risk and passive activity loss restriction rules. The limited investor pool means that the amount of equity per credit that investors are willing to invest is less than it could be with increased competition. If more equity is contributed per credit, each project requires less credit, and more projects can be subsidized with the same number of credits.

By amending the statute to provide that the credit is not subject to at risk and passive activity loss restrictions, the universe of potential investors increases exponentially to include individuals, companies and banks who don't have sufficient passive income to currently qualify. This means that not only will C-Corps based all over the country continue to invest in LIHTC projects, but -small and medium sized local businesses and local banks and individuals actually located in Hawaii will have the opportunity to invest. When local banks, businesses and individuals invest, they increase their net income, creating a positive cycle of investing back into local businesses and the local economy.

There is no risk and but a high reward for these changes. There is no loss of state income tax revenue—the changes are completely revenue neutral. The reward is, given the added demand for the credits, pricing for LIHTC deals will increase. Local jobs, economic impact and tax revenues will increase with that pricing.

Hawaii is not the only state that is struggling to expand their LIHTC program to accommodate housing crises. Programs in CO, GA, MO, NE and OK all have discarded their passive activity loss rules to great success. With these small changes to the statute, Hawaii has the opportunity to not only increase the number of affordable housing units being built, but also to increase jobs, tax revenue and the general welfare of its citizens. That is why we urge the committee to support SB2402.

Thank you for this opportunity to testify.

Chart 1: Estimated Economic Impact of 2013 LIHTC Deals

Estimated Economic Impact for 1416 units at produced in Hawaii					
Estimates Based on research by					
National Home Builders Association**					
Direct & Indirect Impact of Construction Activity:					
Local Jobs Supported		1274	(Construction, Wholesale/Retail,Business/Professional)		
Local Wages & Salaries	\$	65,861,553			
Local Taxes Paid	\$	24,058,782			
Total Impact including profit & other	\$	104,797,824			
Induced (Ripple)Effect of Spending The Income & Taxes from Above					
Local Jobs Supported		1019	(Construction, Utilities, Retail, Finance, Insurance, Real Estate		
Local Wages & Salaries	\$	48,396,839	Personal & Repair, Business/Professional, Restruant/Grocery		
Local Taxes Paid	\$	7,240,561	Auto repair, Entertainment,Health, Education, Social Services		
Total Impact including profit & other	\$	60,711,170	Local Government, Other)		
Total Economic Impact due to Construction*					
Local Jobs supported during Construction		2293			
Local wages & Salaries	\$	114,258,392			
Local Taxes Paid	\$	31,299,343			
Total Economic Impact due to Construction	\$	165,508,994			
Ongoing, Annual Effect once Units are Placed in Service					
Local Jobs Supported		623			
Local Wages & Salaries	\$	13,961,430			
Local Taxes Paid	\$	7,129,102			
Total Impact including profit & other	\$	37,388,495			
*Combined Totals of Direct and Induced Above					
** Estimates only-actual results may vary					

LATE

SB-855

Submitted on: 2/5/2019 2:57:32 PM

Testimony for WAM on 2/6/2019 10:00:00 AM

Submitted By	Organization	Testifier Position	Present at Hearing
Ann S Freed	Individual	Support	No

Comments:

LATE

SB-855

Submitted on: 2/6/2019 8:13:49 AM

Testimony for WAM on 2/6/2019 10:00:00 AM

Submitted By	Organization	Testifier Position	Present at Hearing
David Z. Arakawa	Testifying for Land Use Research Foundation of Hawaii	Support	No

Comments:

The Land Use Research Foundation of Hawaii (LURF) **SUPPORTS SB 855**, which 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 (LIHTC).

The LIHTC is a valuable tool to assist with the financing of affordable housing projects. Unfortunately, at this time, LIHTCs are difficult to access for many capable affordable housing developers and taxpayers, because the existing laws (and *at-risk rules and deductions to passive activity loss*) have the unintended consequence of disqualifying many potential developers and investors, except for the large corporations or financial institutions. Thus, these current restrictions in the existing law and rules lower demand for the LIHTCs, and, therefore, reduces the opportunity for more private equity to be generated, for each dollar of State LIHTC that is issued.

This measure is intended to further encourage the expansion of the pool of applicants that could qualify for the LIHTCs, by eliminating the current *at-risk and passive activity loss rules* which presently restrict the number of developers and taxpayers that could qualify for the State LIHTC. This bill would allow affordable rental housing developers to de-couple the State LIHTC from an ownership share in affordable rental project being financed, thereby allowing any Hawaii affordable housing developer or taxpayer with income tax liability to apply for, and use the State LIHTC. If this measure passes, it will make the State LIHTC a more attractive investment and drastically improve demand for the State LIHTC, therefore, increasing the dollar-per dollar value of equity generated by the State LIHTC for the affordable rental housing projects being developed.

Based on the above, LURF respectfully urges your favorable consideration of SB 855.

If you have any questions, please feel free to contact David Arakawa, LURF Executive Director at (808) 521-4717 or darakawa@lurf.org.

LATE

SB-855

Submitted on: 2/6/2019 8:54:51 AM

Testimony for WAM on 2/6/2019 10:00:00 AM

Submitted By	Organization	Testifier Position	Present at Hearing
Christopher Oakes	Testifying for Stanford Carr Development, LLC	Support	No

Comments: