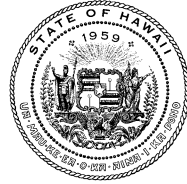


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To: The Honorable Sylvia Luke, Chair;
The Honorable Ty J.K. Cullen, Vice Chair;
and Members of the House Committee on Finance

From: Rona M. Suzuki, Director
Department of Taxation

Re: **H.B. 2627, H.D. 1, Relating to Taxation**

Date: Thursday, February 20, 2020

Time: 11:00 A.M.

Place: Conference Room 308, State Capitol

The Department of Taxation (Department) defers to the Department of Business, Economic Development, and Tourism regarding the economic development impact of this bill. The Department provides the following comments regarding the tax administration of H.B. 2627, H.D. 1. This measure amends the Hawaii income tax law to decouple from the income tax deferral provided to qualified opportunity zones for Hawaii income tax purposes.

Internal Revenue Code (IRC) sections 1400Z-1 and -2, created by the Tax Cuts and Jobs Act of 2017, allows tax deferral on capital gains that are reinvested in qualified opportunity zones. Qualified opportunity zones in each state are to be identified by the Governor of each state. Hawaii Revised Statutes sections 235-2.3(a) and 235-2.45(k) provide similar tax deferral for Hawaii income tax purposes. H.B. 2627, H.D. 1, repeals the tax deferral for Hawaii income tax purposes. The bill has a defective effective date of July 1, 2112, but otherwise and applies to taxable years beginning after December 31, 2022.

If this bill passes, the federal tax deferral will still be available for qualified opportunity zones located in Hawaii.

Thank you for the opportunity to provide comments.

TAX FOUNDATION OF HAWAII

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SUBJECT: INCOME, Make Federal Opportunity Zone Rules Inoperative in Hawaii

BILL NUMBER: HB 2627, HD-1

INTRODUCED BY: House Committee on Economic Development & Business

EXECUTIVE SUMMARY: Provides that Chapter 1, Subchapter Z (with respect to opportunity zones), of the Internal Revenue Code shall not be operative for the purposes of state income tax law. Takes effect on 7/1/2112. Applies to tax years beginning after 12/31/2022.

SYNOPSIS: Amends sections 235-2.3(b) and 235-2.45, HRS, to make Chapter 1, Subchapter Z (with respect to opportunity zones), of the Internal Revenue Code shall not be operative for the purposes of state income tax law.

EFFECTIVE DATE: This Act shall take effect on July 1, 2112, and shall apply to taxable years beginning after December 31, 2022.

STAFF COMMENTS: Opportunity Zones (secs. 1400Z-1 and 1400Z-2 of the Code) were added to the federal Internal Revenue Code by the Tax Cuts and Jobs Act, Pub. L. No. 115-97.

The TCJA provides for the temporary deferral of inclusion in gross income for capital gains reinvested in a qualified opportunity fund and the permanent exclusion of capital gains from the sale or exchange of an investment in the qualified opportunity fund. The provision allows for the designation of certain low-income community population census tracts as qualified opportunity zones, where low-income communities are defined in Section 45D(e). The designation of a population census tract as a qualified opportunity zone remains in effect for the period beginning on the date of the designation and ending at the close of the tenth calendar year beginning on or after the date of designation.

Governors (including the chief executive of the District of Columbia) may submit nominations for a limited number of opportunity zones to the Secretary for certification and designation. If the number of low-income communities in a State is less than 100, the Governor may designate up to 25 tracts, otherwise the Governor may designate tracts not exceeding 25 percent of the number of low-income communities in the State. Governors are required to provide particular consideration to areas that: (1) are currently the focus of mutually reinforcing state, local, or private economic development initiatives to attract investment and foster startup activity; (2) have demonstrated success in geographically targeted development programs such as promise zones, the new markets tax credit, empowerment zones, and renewal communities; and (3) have recently experienced significant layoffs due to business closures or relocations.

In addition, each population census tract in each U.S. possession that is a low-income community is deemed certified and designated as a qualified opportunity zone effective on the date of enactment.

The provision provides two main tax incentives to encourage investment in qualified opportunity zones. First, it allows for the temporary deferral of inclusion in gross income for capital gains that are reinvested in a qualified opportunity fund. A qualified opportunity fund is an investment vehicle organized as a corporation or a partnership for the purpose of investing in qualified opportunity zone property (other than another qualified opportunity fund) that holds at least 90 percent of its assets in qualified opportunity zone property. The provision intends that the certification process for a qualified opportunity fund will be done in a manner similar to the process for allocating the new markets tax credit. The provision provides the Secretary authority to carry out the process.

If a qualified opportunity fund fails to meet the 90 percent requirement and unless the fund establishes reasonable cause, the fund is required to pay a monthly penalty of the excess of the amount equal to 90 percent of its aggregate assets, over the aggregate amount of qualified opportunity zone property held by the fund multiplied by the underpayment rate in the Code. If the fund is a partnership, the penalty is taken into account proportionately as part of each partner's distributive share.

Qualified opportunity zone property includes: any qualified opportunity zone stock, any qualified opportunity zone partnership interest, and any qualified opportunity zone business property.

The maximum amount of the deferred gain is equal to the amount invested in a qualified opportunity fund by the taxpayer during the 180-day period beginning on the date of sale of the asset to which the deferral pertains. For amounts of the capital gains that exceed the maximum deferral amount, the capital gains must be recognized and included in gross income as under present law.

If the investment in the qualified opportunity zone fund is held by the taxpayer for at least five years, the basis on the original gain is increased by 10 percent of the original gain. If the opportunity zone asset or investment is held by the taxpayer for at least seven years, the basis on the original gain is increased by an additional 5 percent of the original gain. The deferred gain is recognized on the earlier of the date on which the qualified opportunity zone investment is disposed of or December 31, 2026. Only taxpayers who rollover capital gains of non-zone assets before December 31, 2026, will be able to take advantage of the special treatment of capital gains for non-zone and zone realizations under the provision.

The basis of an investment in a qualified opportunity zone fund immediately after its acquisition is zero. If the investment is held by the taxpayer for at least five years, the basis on the investment is increased by 10 percent of the deferred gain. If the investment is held by the taxpayer for at least seven years, the basis on the investment is increased by an additional five percent of the deferred gain. If the investment is held by the taxpayer until at least December 31, 2026, the basis in the investment increases by the remaining 85 percent of the deferred gain.

The second main tax incentive in the bill excludes from gross income the post-acquisition capital gains on investments in opportunity zone funds that are held for at least 10 years. Specifically, in the case of the sale or exchange of an investment in a qualified opportunity zone fund held for more than 10 years, at the election of the taxpayer the basis of such investment in the hands of

the taxpayer shall be the fair market value of the investment at the date of such sale or exchange. Taxpayers can continue to recognize losses associated with investments in qualified opportunity zone funds as under current law.

The Secretary or the Secretary's delegate is required to report annually to Congress on the opportunity zone incentives beginning 5 years after the date of enactment. The report is to include an assessment of investments held by the qualified opportunity fund nationally and at the State level. To the extent the information is available, the report is to include the number of qualified opportunity funds, the amount of assets held in qualified opportunity funds, the composition of qualified opportunity fund investments by asset class, and the percentage of qualified opportunity zone census tracts designated under the provision that have received qualified opportunity fund investments. The report is also to include an assessment of the impacts and outcomes of the investments in those areas on economic indicators including job creation, poverty reduction and new business starts, and other metrics as determined by the Secretary.

The 2018 federal income tax conformity act, Act 27, SLH 2018, did not conform to the Opportunity Zone provisions of the TCJA. The 2019 federal income tax conformity act, Act 69, SLH 2019, adopted the provisions for purposes of Hawaii law as to opportunity zones designated by the Governor of Hawaii.

The Foundation notes that Hawaii does not typically conform to federal incentive provisions such as this one, but there have been exceptions.

The Foundation notes the EDB Committee's wish to make the incentive applicable temporarily and suggests that if this Committee wishes to do so it could make the measure applicable for only investments made before a date certain. The current cut-of language is not adequate to accomplish this because benefits from gain deferral or forgiveness are typically realized several years in the future.

Digested 2/18/2020