DAVID Y. IGE
GOVERNOR

JOSH GREEN M.D.
LT. GOVERNOR

RONA M. SUZUKI
DIRECTOR OF TAXATION

DAMIEN A. ELEFANTE
DEPUTY DIRECTOR

STATE OF HAWAII
DEPARTMENT OF TAXATION
P.O. BOX 259
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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. 2527, H.D. 1, Relating to the Low-Income Housing Tax Credit**
Date: Thursday, February 20, 2020
Time: 1:00 P.M.
Place: Conference Room 308, State Capitol

The Department of Taxation (Department) provides the following comments on H.B. 2527, H.D. 1.

H.B. 2527, H.D. 1, amends the low-income housing tax credit (LIHTC) to eliminate conformity to several Internal Revenue Code (IRC) sections:

- 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 for state allocations. The Department notes that section 704 of the IRC already does not apply to the LIHTC through section 235-2.45(d)(e), Hawaii Revised Statutes.

H.B. 2527, H.D. 1, has a defective effective date of July 1, 2025 and otherwise applies to low-income buildings placed in service after December 31, 2020.

The Department notes that two important provisions that were in the original version of this measure were deleted in H.D. 1. These provisions were intended to prevent abuse and unintended revenue losses for the State:

1. The first provision that was deleted was intended to disallow the special treatment proposed by this bill if a building ceases to be a qualified low-income building. To impose this limitation, the Department recommends **restoring the following clause to the end of paragraph (j)(1)**:

   `provided that this paragraph shall not apply to investments made in a building if such building ceases to be a qualified low-income building as defined under section 42(c) of the Internal Revenue Code;`

2. The second provision that was deleted was intended to prevent unintended consequences,

such as the inflation of the depreciable basis using nonrecourse financing, caused by the relaxation of at-risk and PAL rules. In order to prevent this, the Department suggests **restoring the following as a new paragraph (j)(4)**:

(4) The state depreciation basis of the qualified low-income building shall not exceed the federal depreciation basis of the building.

H.B. 2527, H.D. 1, extends the deadline that the LIHTC must be claimed from 12 months to 24 months. The Department notes that this would be the only credit with a 2-year window to make claims.

H.B. 2527, H.D. 1, subsection (i) provides that theLIHTC, a nonrefundable credit, must be used to reduce tax liability first. This is a deviation from the general rule contained in section 235-91.5, HRS, which establishes that refundable credits are used to reduce tax liability before nonrefundable credits are applied. The Department **prefers that the credit hierarchy established in section 235-91.5 be maintained for consistency in administration**.

Thank you for the opportunity to provide comments.

DAVID Y. IGE
GOVERNOR

DENISE ISERI-MATSUBARA
INTERIM EXECUTIVE DIRECTOR

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
DENISE ISERI-MATSUBARA
Hawaii Housing Finance and Development Corporation
Before the

HOUSE COMMITTEE ON FINANCE
February 20, 2020 at 1:00 p.m.
State Capitol, Room 308

In consideration of
H.B. 2527, H.D. 1
RELATING TO THE LOW-INCOME HOUSING TAX CREDIT.

The HHFDC ***supports*** H.B. 2527, H.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.

By eliminating the applicability of the at-risk and passive activity loss limitations to State LIHTC investors, this bill would expand the pool of Hawaii taxpayers that can invest in the State LIHTC and increase its pricing, thereby generating more equity towards the affordable rental housing projects.

Thank you for the opportunity to testify.

TAX FOUNDATION OF HAWAII

126 Queen Street, Suite 304 Honolulu, Hawaii 96813 Tel. 536-4587

SUBJECT: INCOME, Low-Income Housing Credit, Passive Activity Loss and At-Risk Rules

BILL NUMBER: HB 2527, HD-1

INTRODUCED BY: House Committee on Housing

EXECUTIVE SUMMARY: Changes tax credit allocation for partnerships and corporations. Makes inoperative at risk and passive activity loss rules with respect to certain low-income housing projects. 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 section 235-110.8, HRS, to provide that the low-income housing tax credit may be allocated among the partners or members of the taxpayer earning the credit in any manner agreed to by such parties regardless of whether any such partner or member is deemed a partner for federal income tax purposes as long as the partner or member would be considered a partner for Hawaii state law purposes in accordance with section 425E-301, and may be claimed whether or not the taxpayer is eligible to be allocated a federal low-income housing tax credit pursuant to section 42 of the Internal Revenue Code. In addition, any allocation of a tax credit under this section may be made among the partners or members of a taxpayer in accordance with the immediately preceding sentence provided such partners or members have been admitted to the taxpayer in accordance with section 425E-301 on or prior to the date for filing the partner's or member's tax return (including any amendments thereto) with respect to the year of the tax credit.

Requires all claims for this credit to be filed on or before the end of the twenty-fourth month following the close of the taxable year for which the credit may be claimed. Failure to properly and timely claim the credit shall constitute a waiver of the right to claim the credit.

Requires the claimant to include a copy of form 8609 issued by the corporation with respect to the building; provided that if a taxpayer has not received form 8609 from the corporation with respect to its qualified low-income building at the time the taxpayer files its original tax return claiming the credits under this section, the taxpayer may later amend its tax return to include form 8609.

Amends section 235-110.8, HRS, to state that for any qualified low-income building that is placed in service after December 31, 2020:

(1) Section 453 (with respect to the installment method), section 465 (with respect to deductions limited to amount at risk), and section 469 (with respect to passive activity losses and credits limited) of the Internal Revenue Code shall not be operative with respect to investments made in buildings and projects claiming the credit under this section;

(2) All allocations to partners of their distributive shares of income, loss, and deductions under chapter 235 shall be made in accordance with the written agreement of the partners or members; and

(3) In no event shall the total amount of state credits allocated by the corporation for the qualified low-income building exceed fifty per cent of the amount of federal credits allocated to the building for the ten-year federal credit period.

EFFECTIVE DATE: July 1, 2025

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

Digested 2/18/2020

Chamber of Commerce HAWAII
The Voice of Business

Testimony to the House Committee on Finance
Thursday, February 20, 2020 at 1:00 P.M.
Conference Room 308, State Capitol

<u>RE: HB 2527 HD 1, RELATING TO THE LOW-INCOME HOUSING TAX CREDIT</u>

Chair Luke, Vice Chair Cullen and Members of the Committees:

The Chamber of Commerce Hawaii ("The Chamber") **supports** HB 2527 HD1, 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 to low-income housing tax credit allocations after December 31, 2020.

The Chamber is Hawaii's leading statewide business advocacy organization, representing 2,000+ businesses. Approximately 80% of our members are small businesses with less than 20 employees. As the "Voice of Business" in Hawaii, the organization works on behalf of members and the entire business community to improve the state's economic climate and to foster positive action on issues of common concern.

We understand that the bill proposes to expand the Hawaii State Low Income Housing Tax Credit (LIHTC) investor rules from just C corporations to include local companies and individuals. We support the intent to broaden the pool of investors, which will in turn increase inventory of affordable housing units.

We appreciate the opportunity to express our support of HB 2527 HD1.

733 Bishop Street, Suite 1200 • Honolulu, Hawaii 96813 • Phone: (808) 545-4300 • Facsimile: (808) 545-4369

Hunt Companies, Inc.
737 Bishop St., Suite 2750
Honolulu, HI 96813
808-585-7900

Representative Sylvia Luke, Chair
Representative Ty Cullen, Vice Chair
Committee on Finance

RE: **HB 2527 HD1 Relating to the Low-Income Housing Tax Credit – Support, Request Amendment**
February 20, 2020; 1:00 P.M.; conference room 308; Agenda #3

Aloha Chair Luke, Vice Chair Cullen and members of the committee:

Hunt Companies – Hawaii and Hunt Capital Partners, LLC supports HB 2527 HD1, which specifies that certain provisions of the Internal Revenue Code related to at-risk rules and deductions and passive activity loss do not apply to the state low-income housing tax credit ("LIHTC") allocations after 12/31/2020, among other things.

HB 2527 HD1 will allow for the Hawaii low-income housing tax credit program to serve even more Hawaii residents at little to no additional cost to the State. This bill aims to expand the market of tax credit buyers and in turn, increase the price paid for these credits. A broader and more competitive marketplace for these tax credits will compel higher equity pricing and result in more affordable units in Hawaii. We appreciate the amendments made in the HD1 to clarify the process by which individual credit buyers may enter into project partnerships in order to more flexibly claim tax credits and provide an extended safe harbor period in which to claim the credit should unforeseen delays occur.

We respectfully request your consideration of the following additional amendment:

- *Page 7, lines 14 to 15, "For a low-income building placed in service under this section after **December 31, 2019**"*

This date is preferred to 12/31/2020 as it provides greater flexibility for projects completed this year.

Thank you for all your efforts to address Hawaii's affordable housing crisis. We ask for your support in passing HB 2527 HD1 with our requested amendment.

Steven W. Colón
President – Hawaii Division

Jeff Weiss
President, Hunt Capital Partners, LLC

LATE

HOUSE COMMITTEE ON FINANCE
State Capitol, Conference Room 308
415 South Beretania Street
2:00 PM

February 20, 2020

RE: HOUSE BILL NO. 2527, HD 1, RELATING TO THE LOW-INCOME HOUSING TAX CREDIT

Chair Luke, Vice Chair Cullen, and members of the committee:

My name is Dwight Mitsunaga, 2020 President of the Building Industry Association of Hawaii (BIA-Hawaii). Chartered in 1955, the Building Industry Association of Hawaii is a professional trade organization affiliated with the National Association of Home Builders, representing the building industry and its associates. BIA-Hawaii takes a leadership role in unifying and promoting the interests of the industry to enhance the quality of life for the people of Hawaii. Our members build the communities we all call home.

BIA-Hawaii is in strong support of H.B. 2527 HD 1, 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 to low-income housing tax credit allocations after 12/31/2020.

We understand that the bill proposes to expand the Hawaii State Low Income Housing Tax Credit (LIHTC) investor rules from just C corporations to include local companies and individuals. The intent is to broaden the pool of investors.

We appreciate the opportunity to provide our comments on this matter.

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LATE

SUGAR CREEK CAPITAL
A forward approach.

17 West Lockwood Avenue
St. Louis, MO 63119

p: 314-968-2205

Testimony of Sugar Creek Capital

Before the
House Committee on Finance

Thursday, February 20, 2020
1:00 p.m.
State Capitol, Conference Room 311

On the following measure:
H.B. 2527 HD1, RELATING TO THE LOW-INCOME HOUSING TAX CREDIT

Chair Luke, Vice-Chair Cullen and Members of the Committee:

My name is Lou Bosso, and I am the State Equity Director for Sugar Creek Capital. Sugar Creek Capital specializes in state low-income housing tax credit investments that benefit working families and fixed-income seniors.

Sugar Creek submits testimony in strong **support** of HB 2527 HD1, **with technical amendments**. which will enhance the value of the tax credits for the state, and allow for greater private equity investment in low-income housing.

We respectfully submit the following technical amendments:

Section 1, subsection j:
(j) For a qualified low-income building placed in service under this section after December 31, ~~2020~~ [2019]:

Section 3:
SECTION 3. This Act shall take effect on July 1, 2025, and shall apply to low-income buildings placed in service in taxable years beginning after December 31, ~~2020~~ [2019]; provided that:

In addition, we request the date change be reflected in the **bill description**.
"…tax credit allocations after 12/31/~~2020~~ [2019].

SUGAR CREEK CAPITAL
A forward approach.
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We believe the 2020 date included in the HD1 was inadvertently changed from 2019. To not make the proposed amendments would cause the tax credit process to have an additional, and unintended year inserted in to the process. It is our belief, this would create issues in the implementation and allocation of the low-income housing tax credits.

Mahalo for the opportunity to provide testimony.

LAND USE RESEARCH
FOUNDATION OF HAWAII

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LATE

February 20, 2020

Representative Sylvia Luke, Chair
Representative Ty J.K. Cullen, Vice Chair
House Committee on Finance

Strong Support of HB 2527, HD1, RELATING TO THE LOW-INCOME HOUSING TAX CREDIT (Specifies that certain provisions of the Internal Revenue Code related to at-risk rules and deductions and passive activity loss do not apply to the state low-income housing tax credit allocations after 12/31/2020. Extends the time period in which to claim the low-income housing tax credit. Enables state partnerships to claim the tax credit even if the partnerships are not considered partners for federal tax purposes. Takes effect 7/1/2025. [HD1])

<u>FIN Hearing</u>: Thursday, February 20, 2020, 1:00 p.m., in Conf. Rm 308
Agenda #3, Agenda Item #13

The Land Use Research Foundation of Hawaii (LURF) is a private, non-profit research and trade association whose members include major Hawaii landowners, developers and utility companies. LURF's mission is to advocate for reasonable, rational and equitable land use planning, legislation and regulations that encourage well-planned economic growth and development, while safeguarding Hawaii's significant natural and cultural resources, and public health and safety.

LURF appreciates the opportunity to express its **strong support of HB 2527, HD1** and strong support of the LURF members and other homebuilders who are trying to increase the number of housing units for low income families and all income levels in Hawaii.

<u>HB 2527, HD1</u>. This measure specifies that certain provisions of the Internal Revenue Code related to *at-risk rules and deductions* and *passive activity loss* do not apply to the state low-income housing tax credit allocations after 12/31/2020; extends the time period in which to claim the low-income housing tax credit; enables state partnerships to claim the tax credit even if the partnerships are not considered partners for federal tax purposes.

<u>LURF's Position</u>. The LIHTC is a valuable tool to assist with the financing of affordable housing projects, because it provides a tax credit for developers and investors to support the development and construction of affordable housing units for low-income homebuyers. 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.

For the reasons set forth above, LURF is **in support of HB 2527, HD1** and respectfully urges your favorable consideration of this bill.