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TAX INFORMATION RELEASE NO. 2002-3

RE: Residential Construction and Remodeling Tax Credit

As originally enacted by Act 10, Third Special Session Laws of Hawaii 2001, the Residential Construction and Remodeling Tax Credit (hereinafter referred to as "Residential Credit" or "Credit") provides a nonrefundable residential construction and remodeling income tax credit equal to four percent of the construction or renovation costs incurred after December 31, 2000 and before July 1, 2002, up to a maximum of $250,000 in aggregate cost for each unit.

During the 2002 Legislative Session, the Legislature passed S.B. No. 2831, S.D. 1, H.D. 1, C.D. 1 which extends the Credit for one year to costs incurred before July 1, 2003 and clarifies other Credit provisions. The Governor signed the bill into law on June 21, 2002 as Act 174, Session Laws of Hawaii 2002 ("Act 174"). Thus, this Tax Information Release ("TIR") provides guidance regarding this Credit as amended by Act 174.

I. In General

The nonrefundable, four percent Residential Credit, which is codified in section 235-110.45, Hawaii Revised Statutes ("HRS"), is applicable to:

- Construction, alteration, or modification costs incurred;
- For a residential unit;
- By a taxpayer subject to the net income tax under chapter 235, HRS.

The Credit must be claimed by the taxpayer on or before the end of the twelfth month following the close of the taxable year for which the Credit may be claimed. The taxpayer may reduce the basis of property by the amount of the Credit allowable or treat the Credit as taxable income.

II. "Construction or Remodeling Costs"

Section 235-110.45(g), HRS, as amended by Act 174, defines "construction or remodeling cost" to mean:

> any costs incurred after December 31, 2000, for plans, design, construction, and equipment that is permanently affixed to the building or structure related to new construction, alterations, or modifications to a residential apartment unit or house, and shall not include any costs for which another credit was claimed under this chapter.

A. Capital Expenditures Will Qualify for the Credit; Repair Expenses, Generally, Do Not Qualify for the Credit

There are four categories of costs that qualify for the Credit:

- plans;
- design;
- construction; and
- equipment,

related to the new construction of a residential unit, or alterations and modifications (renovation) to an existing residential unit. Section 235-110.45(g), HRS. These costs must be incurred after December 31, 2000, but before July 1, 2003. Section 235-110.45(a), HRS, as amended by Act 174.

The plain meaning of the terms "alter" and "modify" require actions that change a facility by renewing its condition. Expenditures to change or remodel a residential unit by renewing its condition are often characterized as capital expenditures and will generally qualify for the Credit.[1]

The Department of Taxation ("Department") will generally allow expenditures that meet all of the following criteria, subject to other requirements of the Credit statute:

[1] While income tax principles provide guidelines to determine whether a cost is capitalized or expensed, these principles are not controlling for purposes of the Credit.

- The expenditure is for a new residential unit or an improvement made to increase the value or significantly extend the useful life of the residential unit;

- The improvement is of a permanent nature (e.g., equipment is permanently affixed and not removable without causing substantial damage to the building or structure, and the installation of such equipment is intended to be permanent); and

- The expenditure is not incurred for routine repairs and maintenance of the residential unit.

"Maintenance" is the act of making repairs to preserve or keep in an existing state or condition. Maintenance, therefore, would not qualify for the Credit because maintenance does not change or remodel a facility by improving its condition. However, to the extent that routine maintenance repairs are incurred as part of a general plan of renovation, these expenses will qualify for the Credit since they are incurred as part of a capital expenditure to improve a facility.

The following costs qualify for the Credit:

- Replacing or recovering a floor;
- Reconditioning elevators;
- Replacing or recovering a roof; or
- Installing a central air conditioner unit.

The following costs do not qualify for the Credit:

- Patching and repairing floors;
- Reinforcing sagging floors;
- Piecemeal repair to floors; or
- Replacement of small parts.

B. Construction or Remodeling Costs Must be Incurred After December 31, 2000 and Before July 1, 2003

In order to be eligible for the Credit, residential construction and remodeling costs must be incurred after December 31, 2000 and before July 1, 2003.[2] While the term "incurred" is not defined in

[2] "Construction or remodeling cost" is defined in section 235-110.45(g), HRS, as "any costs incurred after December 31, 2000..." The residential construction or remodeling costs also must be incurred before July 1, 2003.

the statute, the Department will use the plain meaning of this term to administer the law. "Incurred" in this context means "to become liable or subject to." The taxpayer's method of accounting will determine when costs were "incurred."

Example 1: Taxpayer uses the cash method of accounting. Taxpayer signs a contract in May 2003 to remodel a residential unit. Taxpayer pays for these costs beginning in July 2003. These costs are not eligible for the Credit.

Example 2: Taxpayer uses the cash method of accounting. Taxpayer pays construction or remodeling costs for a residential unit, which is not completed before July 1, 2003. The costs paid before July 1, 2003 may be eligible for the Credit; costs paid on or after July 1, 2003 are not eligible for the Credit.

Example 3: Assume the same facts as in Example 2, except that Taxpayer uses the accrual method of accounting.[3] Costs incurred before July 1, 2003, may be eligible for the Credit depending on when Taxpayer recognizes the costs in its books and records.

C. $250,000 Limitation for Each Residential Unit

Section 235-110.45(a), HRS, as amended by Act 174, states that the "residential construction or remodeling costs incurred...shall not exceed $250,000 in the aggregate for each residential unit." Therefore, there is a lifetime "cap" for each residential unit. For purposes of applying this cap, each house and each apartment unit will be treated as a single "residential unit."

Section 235-110.45(a), HRS. Another provision in section 235-110.45 (e), HRS, states that "[t]he tax credit allowed under this section shall be available for taxable years beginning after December 31, 2000, and shall not be available for taxable years beginning after December 31, 2003." This language is to ensure that there is sufficient time for taxpayers to claim the credit. Thus, for a calendar year taxpayer, the costs may be incurred up to June 30, 2003 and the taxable year would end on December 31, 2003. The costs must be claimed by December 31, 2004, within twelve months after the end of the tax year in which the eligible costs were incurred.

[3] Under the accrual method of accounting, income is recognized when all the events that establish the right to receive the income have occurred and when the amount of the income is known with reasonable accuracy. Expenses are recognized when the taxpayer becomes liable for the expenses whether or not the expenses are paid.

Example 4: Taxpayer incurs $200,000 in construction or remodeling costs in 2001 for Taxpayer's residential unit and claims a Credit for these costs. Taxpayer incurs $100,000 in construction or remodeling costs in 2002. The amount of construction or remodeling costs upon which Taxpayer can claim a Credit for 2002 is limited to $50,000.

D. Credit Carried Forward Until Used

Any unused Credit may be carried forward by the taxpayer and used as a credit against income tax liability in subsequent years until exhausted.[4]

Example 5: Assume the same facts as in Example 4, except that in April 2003 Taxpayer files for a Credit for the $50,000 in construction or renovation costs incurred in 2002 ("on or before the end of the twelfth month following the close of the taxable year for which the credit may be claimed"). Taxpayer does not have taxable income in the 2002 and 2003 tax years, and thus, has no tax liability against which to apply the Credit. Taxpayer has taxable income in 2004. Taxpayer may apply the Credit against its tax liability in 2004 because the Credit may be carried forward and used as a credit against Taxpayer's tax liability in subsequent years until exhausted.

E. Costs for Which Another Credit Was Claimed Are Not Eligible for the Residential Credit

Act 174 clarifies that "construction and remodeling cost" does not include costs for which the taxpayer has or will claim another net income tax credit under chapter 235, HRS.

III. Costs Must Be Incurred to Construct or Remodel a "Residential Unit"

The taxpayer must incur costs to construct or remodel a "residential apartment unit or house." Section 235-110.45(g), HRS. The Department will interpret "residential apartment unit or house" to mean a house or apartment used to provide living accommodations in a building or structure. Costs incurred to construct or remodel any structure not constituting a living accommodation (i.e., living area) or not an integral part of the living accommodation will not be eligible for the Credit.

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[4] "If the tax credit under this section exceeds the taxpayer's income tax liability, the excess of credit over liability may be used as a credit against the taxpayer's income tax liability in subsequent years until exhausted. Section 235-110.45(c), HRS.

The following examples illustrate this "living accommodation" concept as well as the concepts discussed in Section II.A. of this TIR:

Example 6: Taxpayer incurs costs to replace the carpet and a roof for a house (residential unit). Taxpayer also incurs costs to install siding, skylights, rain gutters, new windows, and new doors. These costs are eligible for the Credit because the components substantially increase the value of the house and are permanently affixed to the house (and are intended to be a permanent installation).

Example 7: Taxpayer incurs costs to replace some of the floor tiles in a hallway in the taxpayer's house (residential unit). This cost does not qualify for the Credit because it constitutes regular repair and maintenance that is not incurred as a part of a general plan of renovation.

Example 8: Assume the same facts as in Example 7, except that the Taxpayer incurs the cost of replacing some of the floor tiles as part of a general plan of renovating a substantial portion of the house. The cost for the new floor tiles qualifies.

Example 9: Taxpayer incurs costs to replace a broken light fixture in the bathroom of the taxpayer's residential apartment unit. The cost of the light fixture does not qualify for the Credit because replacing the light fixture alone does not substantially increase the value of the apartment and it constitutes regular repair and maintenance of the unit.

Example 10: Assume the same facts as in Example 9, except that Taxpayer incurs costs to substantially remodel the bathroom, including replacing light fixtures, counter tops, cabinets, tub/shower, basin, toilet, and flooring. These costs are eligible for the Credit, including the light fixture, because it is replaced as part of a general plan of renovation.

Example 11: Taxpayer purchases new drapes for a living room in a house (residential unit). These costs do not qualify for the Credit because drapes do not substantially increase the value of a house and are not permanently affixed to the structure.

Example 12: Taxpayer incurs costs for a new washer, dryer, window air conditioning unit, and dishwasher for a residential unit. These costs are not eligible for the Credit because appliances are not permanently affixed to the residential unit.[5]

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[5] Costs for appliances such as refrigerators, floor fans, and window-mounted air conditioners and costs for furniture are generally not eligible for the Credit because they are not <u>permanently</u> affixed to the structure, even if incurred as part of a general plan of renovation.

Example 13: Taxpayer incurs costs for fencing, sidewalk, a retaining wall, and a swimming pool at the taxpayer's house (residential unit). These costs are not eligible for the Credit because they are not costs incurred to construct or remodel the residential unit (i.e., the building or structure that provides living accommodations) or an integral part of the residential unit.

Example 14: Taxpayer is constructing a new residential unit and incurs interest expenses to finance the construction project. These costs are not eligible for the Credit because interest expenses are not part of the actual physical construction or remodeling of a residential unit (i.e., plans, design, construction, or equipment costs). Therefore, the Department will not allow financing costs as an "eligible cost" for purposes of the Credit.

With regard to residential apartment buildings, the Credit will be allowed only for costs incurred for the construction or remodeling of common areas that are an integral part of the building or structure that provides living accommodations. If costs are incurred to construct or remodel common areas that are not an integral part of the residential apartment building or structure, the Credit will not be allowed for those costs.

Example 15: An association of apartment owners ("AOAO") incurs costs to renovate the parking garage located below the main level of the apartment building; replace the roof; refurbish the elevators; and re-carpet the lobby and hallways of the apartment building. These costs will qualify for the Credit because these common areas are integral parts of the apartment building or structure, the renovation of which will substantially increase the value of the building.

Example 16: Assume the same facts as Example 15, except that the AOAO incurs costs to remodel an outdoor swimming pool and to re-pave and re-paint a parking lot located adjacent to the apartment building or structure. These costs incurred to renovate these common areas will not qualify for the Credit because they are not an integral part of the residential building or structure.

Costs incurred to construct or remodel commercial property (i.e., non-residential property) will not qualify for the Credit because these are not costs to construct or remodel a residential unit.

IV. Taxpayer, Generally, is the Owner or Developer Who Incurs Costs

Act 174 clarified that the term "taxpayer" means the owner, developer, or lessee of residential real property who is subject to the tax imposed under chapter 235, HRS, (Hawaii net income tax). Section 235-110.45(a), HRS. To determine which taxpayer is eligible for the Credit, the Department will look to the person who incurs the costs of construction or remodeling of a residential unit.

Example 17: Homeowner incurs construction or remodeling costs for Homeowner's principal residence. These costs are eligible for the Credit.

Example 18: Homeowner-Landlord incurs construction or remodeling costs for a residential duplex. Homeowner-Landlord lives in one of the units and rents the other unit. These costs are eligible for the Credit.

Example 19: Tenant incurs construction or remodeling costs for a residential unit, which Tenant leases from the Owner. The costs incurred by Tenant are eligible for the Credit; Owner is not eligible for the Credit for costs incurred by its tenant.

Example 20: Developer builds residential units and incurs construction or remodeling costs for a residential unit, which Developer will sell. The costs incurred by Developer are eligible for the Credit.

Example 21: Assume the same facts as in Example 20. Developer may not assign the Credit to the purchaser of the residential unit.

Example 22: Homeowner receives a loan and contracts with a Contractor (who is not a developer) for the construction of a second story and the remodel of the original existing lower-level and incurs construction and remodeling costs. Homeowner is eligible for the Credit; Contractor is not eligible for the Credit.

A. The Eligible Costs Flow-Through a Partnership, S corporation, Estate, Trust, Association of Apartment Owners

In the case of a partnership, S corporation, estate, trust, association of apartment owners, the Credit allowable is for construction or renovation costs incurred by the entity for the taxable year. The cost upon which the Credit is computed shall be determined at the entity level. Distribution and share of costs shall be determined pursuant to section 235-110.7(a), HRS. Section 235-110.45(a), HRS.

Example 23: An AOAO incurs construction and remodeling costs for replacing and upgrading the central air conditioning throughout the building including the ducts that reach each residential unit in the apartment building. For purposes of claiming the Credit, the cost of the upgrade will flow through the AOAO to the residential apartment owners, who shall be allocated a share of the costs according to any reasonable allocation method, such as a share proportionate to the apartment owner's ownership interest in the building.

V. Reduction In Basis

The taxpayer who is depreciating the residential unit may reduce the basis of property by the amount of the Credit allowable or treat the Credit as taxable income. If the residential unit does not constitute business property, the taxpayer need not reduce the basis or treat the Credit amount taken as taxable income.[6]

Example 24: Taxpayer incurs construction or remodeling costs for a residential rental unit. These costs are eligible for the Credit. Taxpayer may reduce the basis of the residential unit by the Credit allowable or treat the Credit as taxable income.

Example 25: Taxpayer, a developer of residential units, incurs construction or remodeling costs for a residential unit, which Taxpayer will sell. These costs are eligible for the Credit. Taxpayer may reduce the basis of the residential unit by the Credit allowable or treat the Credit as taxable income.

Example 26: Taxpayer incurs construction or remodeling costs for Taxpayer's principal residence. These costs are eligible for the Credit. Taxpayer is not required to reduce the basis of the residence by the Credit allowable or treat the Credit as taxable income because the property is non-business property.

VI. Compliance With Laws and Rules

The law that enacted the Credit provides that A[t]o qualify for the income tax credit, the taxpayer shall be in compliance with all applicable federal, state, and county, statutes, rules, and regulation.@ Section 235-110.45(g), HRS.

In order to process the Credit, the Department will presume that the taxpayer filing for the Credit has complied with applicable statutes, rules, and regulations. If an issue regarding compliance subsequently arises, however, the taxpayer has the burden of establishing that there was compliance at

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[6] AThe basis of eligible property for depreciation or accelerated cost recovery system purposes for state income taxes shall be reduced by the amount of credit allowable and claimed. In the alternative, the taxpayer shall treat the amount of the credit allowable and claimed as a taxable income item for the taxable year in which it is properly recognized under the method of accounting used to compute taxable income." Section 235-110.45(a), HRS.

the time the claim for the Credit was filed.

Forms and other tax information are available at the Department=s website at: **www.state.hi.us/tax**. On Oahu, forms may be ordered by calling the Department=s Forms Request Line at: 587-7572. Persons not calling from Oahu, may call: 1-800-222-7572 (toll-free) to receive forms by mail or by fax.

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HRS Sections Explained: HRS Section 235-110.45.

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