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March 19, 2009

**Senate Committee on Commerce and Consumer Protection
Hearing Date: Thursday, March 19, 2009 at 9:00 AM in CR 229**

**Testimony in Opposition to HB 1604: Relating to Real Property
(Leases – New Chapter Taxing Lessor for Improvements by Lessee)**

Honorable Chair Rosalyn Baker, Vice Chair David Ige and Senate Committee
on Commerce and Consumer Protection Members:

My name is Dave Arakawa, and I am the Executive Director of the Land Use Research Foundation of Hawaii (LURF), a private, non-profit research and trade association whose members include major Hawaii landowners, developers and a utility company. One of LURF's missions is to advocate for reasonable, rational and equitable land use planning, legislation and regulations that encourage well-planned economic growth and development, while safeguarding Hawai'i's significant natural and cultural resources and public health and safety.

LURF must respectfully testify in **strong opposition to HB 1604**.

HB 1604. HB 1604 adds a new section to the Hawaii Revised Statutes entitled "Tax on Surrendered Leasehold Improvements. The purpose of HB 1604 is to establish a tax on the value of improvements, surrendered by a lessee to a lessor, without compensation to the lessee, at the expiration of a long-term lease of non-residential real property. The new Chapter's purpose is to "establish a tax on the value of improvements on non-residential real property that are constructed or installed by a lessee and surrendered to a lessor, without compensation to the lessee, at the expiration of a long-term lease." The new chapter defines long term lease as "twenty years or more, including any periods for which the lease may be extended or renewed at the option of the lessee."

Section 3 of the new Chapter provides that:

§ -3 Tax on improvements surrendered to a lessor without compensation to the lessee. (a) There is established a tax on the value of improvements on a non-residential real property parcel that are surrendered by the lessee to the lessor at the expiration of a long-term lease if:

(1) The lessee, without financial or capital assistance from the lessor, constructed or installed the improvements during the period the lessee held the long-term lease to the non-residential real property parcel; and

(2) The lessee did not receive compensation equaling the value of the surrendered improvements at the time of surrender.

(b) Except as provided under subsection (c), the tax shall be levied at a rate of ____ per cent of the value of the improvements surrendered to the lessor. The value of the improvements shall be the same as established by the county for real property tax purposes for the taxable year in which the lease expires.

(c) If the lessor has paid compensation to the lessee for surrendered improvements, but in an amount less than the value of the improvements, then the tax shall be levied on the difference between the total value of the improvements and the compensation paid.

The new Chapter's proposed sections 4 – 7 provides guidelines for the counties to follow including Administration, Enforcement, Appeal, Drafting of Ordinances or Rules and Revenue Distribution. The effective date of HB 1604 is January 1, 2010.

LURF's Position. HB 1604 attempts to penalize the lessor, who is already burdened with maintenance and re-lease costs upon turning any leased property around for re-lease, by requiring them to pay for taxes on any improvements. It also could provide a windfall for lessees who surrender improvements at the end of a lease – the lessor would be faced with the statute-imposed dilemma of choosing to pay a tax on the improvements, or purchasing the improvement from the lessee. We believe that the attempt by HB 1604 to establish such a new tax – to the benefit of lessees and the detriment of lessors, would constitute **an unconstitutional interference with existing contract rights**. Our **opposition to HB 1604**, is based on, among other things, the following:

- **Unconstitutional alteration of existing lease contracts.** This new law is an unconstitutional infringement on the Contract Clause of the United States Constitution, as it would change the terms of existing contracts. At the beginning of the lease, the lessor and lessee fully negotiate the terms of the lease, including the status of the improvements at the end of the lease, which is a part of the negotiated price. Taxing such improvements at the end of the lease, would constitute a substantial change in a major term of the lease - the value of the lease itself. Many existing leases already provide that any improvements constructed or installed by a lessee on the property must be surrendered to the lessor at the end of the lease term, at no cost to the lessor. The original lease negotiations, terms and lease payments are based on the understanding that the improvements will remain on the land at the end of the lease term and that the improvements will not be taxed to the lessor. This proposed law would change the terms and conditions of such existing leases, and would create a situation favorable to the lessee, who could force a “negotiated a sale” of the improvements to the lessor, in order for the lessor to avoid paying taxes on said improvements at the end of the lease term.
- **Non-conformance with the Internal Revenue Code.** In its testimony dated February 26, 2009, regarding a similar bill which proposed to tax a lessor for improvements upon termination of a lease (HB 1598), the State Department of Taxation has commented that “this bill would take Hawaii out of conformity with the Internal Revenue Code with respect to the taxation of capital improvements made by lessee upon the termination of a lease.”

- **Valuation of the proposed tax may not be fair and equitable and will create a contentious audit issue which would require the State Tax Department to hire appraisers.** HB 1604, HD1 mandates that the value of the improvements shall be the same as established by the county for real property tax purposes for the taxable year in which the lease expires and the county may use the gross value of the improvements as assessed by mass appraisal for real property tax purposes, without reduction for exemptions or appeals. However, the real property tax value may not always accurately represent the value of the improvements. The State Department of Taxation's testimony on a similar bill (HB 1598), dated February 26, 2009, includes the following warning: "This bill will create a contentious audit issue regarding the fair market value of the property. The Department would need to hire real estate appraisers to handle the issue. "
- **No justification of a legitimate public use or public purpose.** This law could affect thousands of leases on a state-wide basis, however, there are no facts presented, statistics or studies to support any public purpose, or state-wide compelling need which would justify imposing such a new tax;
- **No showing that the proposed tax law is rationally related to a public use or public purpose.** HB 1604 provides that the revenues collected from this new tax shall be distributed to the county in an amount equaling the cost of collection; the county shall retain fifty per cent of the remainder; and transfer the other fifty per cent to the State to be deposited in the state general fund. As noted above, there is no explanation of the purpose of the tax, or if there is a rational relationship between the value of improvements at the end of a lease term and taxes to be paid to the County and State.
- **The Counties may not have the legal authority under the Hawaii State Constitution to collect taxes on leasehold improvements at the end of a lease term, and share the collected taxes with the State?** The State Constitution authorizes the counties to collect real property taxes, however, it is unclear whether it authorizes the counties to collect taxes on leasehold improvements at the end of a lease term, retain some of the tax revenues for the benefit of the counties and share a portion of the taxes with the State.
- **Unenforceable "Unfunded Mandate."** While HB 1604, HD1 allows the counties to retain a portion of the tax revenues equal to the costs of collection only, it does not address all of the costs relating to the requirement that all counties must establish rules to administer the tax imposed in this chapter, establish value of improvements of non-residential parcels, enforce the collection of such taxes imposed by this chapter, establish an administrative appeal process, draft all administration, enforcement and appeal provision by ordinance or rule. Such a state law that requires the counties to establish and enforce rules, based on a state initiative or policy, and does not reimburse the counties for such costs, could be an "unfunded mandate," which the counties could refuse to implement.
- **Questionable legality of imposing a tax on lessors for improvements with no economic value or which have already been fully depreciated by the lessee.** Sometimes, at the end of a lease, buildings may have no economic value. Also, in the case of many long-term commercial and industrial leases, the lessees fully depreciate the improvements on their leased lands. If such improvements have been fully depreciated, it raises major questions

regarding the propriety and legality of imposing a new tax on the lessors for the same improvements which have been fully depreciated by the lessees.

- **The lessor may be unfairly taxed on improvements which negatively affect the value of the property.** At the termination of a lease, sometimes a lessor is left with improvements that they may not have wanted, which negatively affect the value of the property and may other wise be burdensome due to a number of factors, including, but not limited to technical obsolescence, poor maintenance, high operating costs, poor building construction, etc. Under those circumstances, it would be unfair to tax the lessor on the questionable “value” of such improvements.
- **In fairness, the HB 1604 could be amended to allow lessors to require lessees to remove any improvements and/or return the land to the lessor in the same condition as the beginning of the lease.** As noted above, sometimes the improvements may not be worth retaining on the property, and lessors may not want the improvements left by lessees and plan to demolish said improvements upon the expiration of a lease. Under the new law, lessors could be unfairly taxed on improvements they did not want and would demolish anyway. Assuming arguendo, that changing the terms of existing contracts is legally permissible, then, to be fair to the lessors, HB 1604 could be amended to allow lessors the right to require that lessees to demolish such improvements, at no cost to the lessor, and return the land to the lessor in the same condition that the lessee originally received it.
- **This proposed tax could actually be detrimental to lessees, by halting the practice of long term leasing of non-residential properties.** This proposed tax on improvement applies only to long-term leases of non-residential properties. To avoid such a tax, lessors will only provide short-term leases, which will not benefit lessees, as such leases will not provide lessees with the longer terms necessary to finance and install necessary improvements. The Tax Foundation of Hawaii has submitted written testimony on similar bills (SB 767 and HB 1598), which include the following warning:

“It should be noted that this proposal may bring a halt to the leasing of real property, depending on how confiscatory the tax would be. Why would a fee owner of real property want to make his property available for use when there is a possible exposure to tax at the termination of the lease for which there is no compensation? If that is the result, it will become even more expensive to establish a new business or build multi-family housing in Hawaii, as theree is the prospect thtat the fee owner will have to pay this tax.”
- **Effective Date.** The bill, which would go into effect on January 1, 2010, is impracticable and not feasible especially in these hard economic times for lessors to assume new and unexpected costs for leasehold properties.

Based on the above, we respectfully request that the Senate Committee on Commerce and Consumer Protection **hold HB 1604**.

Thank you for the opportunity to express our **opposition to HB 1604**.