KAMEHAMEHA SCHOOLS

Testimony to the House Committee on Water, Land & Ocean Resources

By Paul A. Quintiliani

Vice President of Endowment, Kamehameha Schools

Hearing Date: Monday, February 9, 2009

9:00 a.m., Conference Room 325

RE: House Bill No. 1604 Relating to Real Property

Kamehameha Schools submits the following comments regarding H.B. No. 1604 (the "*Bill*"). The Bill sets out to tax the value of improvements surrendered to a lessor by a lessee without compensation to the lessee, upon the expiration of a long-term non-residential lease.

As a lessor of residential, commercial and industrial real property, Kamehameha Schools objects to this Bill because, as written, it would likely hurt both lessors and lessees and could negatively impact our communities.

1. When surrendered, many properties that revert to lessors are in disrepair and require major capital improvements to bring into code compliance. This bill does not recognize the severe burdens and risks placed on lessors when such properties are surrendered, including the need to make expenditures on repairs, demolition and environmental remediation, which may be difficult to impossible to collect from lessees. A tax on the value of the improvements without a corresponding deduction or credit to lessor for its "losses" on these reversionary events would be unfair.

2. This bill amends the contractual relationships between parties to a lease by statutorily changing the expected allocation of benefits and costs established in the original contract. For example, a lessor may agree to lower near term rent in exchange

for the expectation of receiving a well maintained property at the lease's termination. If the lessor is now required to pay additional compensation to the lessee for such improvements constructed, the lessee will enjoy an unintended windfall profit.

3. Passage of this bill will have the unintended consequence of altering future contractual arrangements whereby a) lessors may be disinclined to provide early periods of low rent and/or b) may cause lessors to re-evaluate future transactions and ultimately pass tax consequences on to lessees.

4. The determination of value is equated to the tax assessed value. This is not always a fair representation of the value of the improvements and does not take into account the cost to the landowner to clear or remove these improvements if the property is deemed unusable.

5. The administrative procedures established in this bill are cumbersome.

6. According to the study by the Legislative Reference Bureau – Report No. 5, 2003 "Real Property Leases" (the "*2003 Report*"), "there is no indication at this time of a broad based compelling need for the Legislature to pass legislation to mandate the alteration of existing lease agreements." 2003 Report at 24.

Thank you for this opportunity to express our objection to this Bill.

L E G I S L A T I V E

TAXBILLSERVICE

126 Queen Street, Suite 304 TAX FOUNDATION OF HAWAII Honolulu, Hawaii 96813 Tel. 536-4587

SUBJECT: MISCELLANEOUS, Tax on surrendered leasehold improvements

BILL NUMBER: SB 766; HB 1604 (Identical)

INTRODUCED BY: SB by Chun Oakland, Sakamoto and 2 Democrats; HB by Say

BRIEF SUMMARY: Adds a new chapter to the HRS to establish a new tax on the value of improvements on nonresidential real property that are constructed or installed by a lessee and surrendered to a lessor, without compensation to the lessee when the long-term lease expires if: (1) the lessee, without financial or capital assistance from the lessor, constructed or installed the improvements; and (2) the lessee did not receive compensation equaling the value of the surrendered improvements at the time of surrender.

The tax shall be ____% of the value of 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 tax year in which the lease expires. If the lessor has paid any 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.

Each county shall administer the tax, establish the deadline for the payment of the tax within 90 days of the expiration of the lease, and enforce the collection of the tax. Requires each county to establish a process for appeals by the lessor. The revenues collected from the tax shall be distributed to: (1) the county that collected the revenues to retain an amount equaling the cost of collection; and (2) of the remainder, the county shall retain 50% and transmit the other 50% to the state for deposit into the general fund.

The tax shall be imposed on a lessor who receives the surrendered improvements upon the expiration of a long-term non-residential lease from the effective date of this act, even if the term of the long-term lease commenced before that date.

EFFECTIVE DATE: January 1, 2010

STAFF COMMENTS: This measure proposes to levy a tax on the owner of leasehold property equal to ____% of the value of the improvements on the leasehold property at the termination of the lease under the conditions delineated and provides that the revenues generated from this surcharge shall be used for public education and affordable housing in the state.

Obviously, there is some lessee who is not happy that such improvements have to be surrendered upon the termination of the lease without any compensation. However, it should be noted that the lessee knew full well that someday the lease would come to an end and that there was no promise of compensation for improvements. Further, it should be acknowledged that leasing, as opposed to outright purchasing, gives the lessee an economic and financial gain in not having to sink as much capital into acquiring the site, capital that can then be used for equipment, the improvements, and payroll. Thus, the lessee had a choice between leasing the real property or attempting to find a site which was available in fee.

It should be noted that the 1978 Constitutional Convention, with the ratification of the electorate, turned all powers governing the real property tax over to the counties. Therefore, the enactment of this measure will have no effect on the taxation of real property in the state. It is also questionable whether or not the state can change the terms and conditions of an existing contract by imposing a tax where one was never a consideration in the lease of the property.

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 the 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 there is the prospect that the fee owner will have to pay this tax. As noted above, the lessee knew and understood the terms of the lease when it was entered into including the prospect that the improvements may have to be forsaken at the end of the lease with no compensation.

Digested 2/6/09