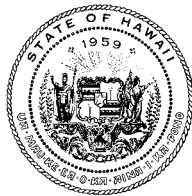


LINDA LINGLE
GOVERNOR

JAMES R. AIONA, JR.
LT. GOVERNOR



KURT KAWAFUCHI
DIRECTOR OF TAXATION

SANDRA L. YAHIRO
DEPUTY DIRECTOR

STATE OF HAWAII
DEPARTMENT OF TAXATION
P.O. BOX 259
HONOLULU, HAWAII 96809

PHONE NO: (808) 587-1510
FAX NO: (808) 587-1560

**SENATE COMMITTEE ON COMMERCE & CONSUMER PROTECTION
TESTIMONY REGARDING HB 1598 HD 1
RELATING TO TAXATION**

TESTIFIER: KURT KAWAFUCHI, DIRECTOR OF TAXATION (OR DESIGNEE)

DATE: MARCH 19, 2009

TIME: 9AM

ROOM: 229

This measure amends Chapter 235 of the Hawaii Revised Statutes by adding a section that taxes lessors on the value of improvements made to property by lessees upon the termination of the lease.

The Department of Taxation (Department) **opposes** this measure.

NONCONFORMITY WITH INTERNAL REVENUE CODE - This bill would take Hawaii out of conformity with the Internal Revenue Code with respect to the taxation of capital improvements made by a lessee upon the termination of a lease.

WILL FINANCIALLY IMPACT PARTIES INVOLVED—The Department is also concerned that this measure will likely impact all parties involved in a negative way. Given the current economic climate, additional burdens on the leasing transactions in Hawaii is not advisable.

CREATES A VALUATION ISSUE—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.

Cognizant of the State's fiscal constraints, the Department recognizes that this bill would generate additional revenue. The amount; however, is indeterminate.



[Via Capitol Website](#)

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 1598 HD1: 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 respectfully testifies in **strong opposition to HB 1598, HD1.**

HB 1598, HD1. Upon termination of a lease, HB 1598, HD1 would statutorily burden the lessor, instead of the lessee with any tax on capital improvements during the lease period. HB 1598 HD1 adds a new section to Chapter 235 of the Hawaii Revised Statutes as follows:

"§235- Taxable income; leased real property. At the termination of a lease to real property, the value of capital improvements made by a lessee to the leased real property shall be taxable under this chapter to the lessor of the property.

The department of taxation may adopt rules pursuant to chapter 91 to effectuate this section."

The House Finance Committee amended this measure with an HD1, by making technical, nonsubstantive amendments for clarity, consistency, and style.

LURF's Position. HB 1598, HD1, 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 capital improvements at the end of the lease. We believe that the attempt by HB 1598, HD1 to establish such a new tax, would constitute **an unconstitutional interference with existing contract**

rights. Our **opposition to HB 1598, HD1**, 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 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 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.** The State Department of Taxation’s testimony on 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, ere 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;
- **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 1598, HD1 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 1598, HD1 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 allowing capital improvements to be made on leases of real property.** This proposed tax on capital improvements applies only to any lease of real property. To avoid such a tax, lessors may prohibit capital improvements on leases of real property. If this happens, it will be detrimental to lessees, because such a prohibition will not allow lessees the opportunity to finance and construct necessary capital improvements. The Tax Foundation of Hawaii has submitted written testimony on HB 1598, which included 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 there is the prospect that the fee owner will have to pay this tax.”
- **Effective Date.** The bill, which would go into effect on its approval and shall apply to taxable years beginning after December 31, 2008, 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 1598 HD1**.

Thank you for the opportunity to express our **opposition to HB 1598 HD1**.