LINDA LINGLE
GOVERNOR

JAMES R. AIONA, JR.
LT. GOVERNOR

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DIRECTOR OF TAXATION

STANLEY SHIRAKI
DEPUTY DIRECTOR

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HOUSE COMMITTEE ON FINANCE
TESTIMONY REGARDING HB 2890
RELATING TO TAXATION

TESTIFIER: KURT KAWAFUCHI, DIRECTOR OF TAXATION (OR DESIGNEE)
DATE: FEBRUARY 10, 2010
TIME: 3PM
ROOM: 308

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.

The Department points out that this section will be in direct conflict with Section 109 of the Internal Revenue Code, which has remained unchanged for decades. Though this provision seeks to expressly tax the improvements (versus an imputed tax), this provision will also contravene US Supreme Court case law that found imputed income from the reversion of improvements on leased land were not taxable. *See M. E. Blatt v. US,* 305 US 267 (1938).

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.

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: INCOME, Tax value of capital improvements

BILL NUMBER: HB 2890

INTRODUCED BY: Say

BRIEF SUMMARY: Adds a new section to HRS chapter 235 to provide that at the termination of a lease, the value of capital improvements made by a lessee to the leased property shall be taxable to the lessor of the property. Directs the department of taxation to adopt rules pursuant to HRS chapter 91 to effectuate this section.

Amends HRS section 235-2.3(b) to provide that IRC section 109 (with respect to taxing capital improvements made by a lessee upon the termination of a lease) shall not be operable for Hawaii income tax purposes, subject to HRS section _____.

EFFECTIVE DATE: Tax years beginning after December 31, 2009

STAFF COMMENTS: This measure proposes to levy a tax on the owner of leasehold property equal to the value of the capital improvements made by the lessee at the termination of the lease. 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, improvements, and payroll. Thus, the lessee had a choice between leasing the real property or attempting to find a site that was available in fee.

It is 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.

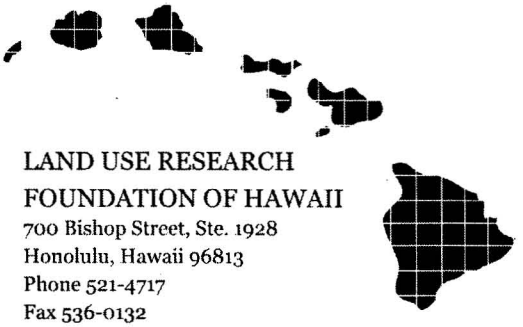
It should be noted that this proposal may bring a halt to the leasing of real property depending on how confiscatory the tax would be. Why would a fee owner of real property want to make his property available for use when there is the possible exposure to tax at the termination of the lease for which 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.

Consider the possible alternatives should this proposed tax be adopted. Will lessors write their contracts such that at the end of the term of the lease the lessee must return the property to the way it was before entering into the lease? In the case of improvements made by the lessee, that might mean demolishing

and removing the improvement at the lessee's expense. Would it prompt lessors to ban the improvement of the property as the lease term winds down, contributing to a deterioration of the property and create blight in the neighborhood? Advocates proclaim that they are just trying to protect the interests of small business who are at the mercy of the lessor, but would this bill truly protect small businesses or make it more difficult for small businesses to find reasonable facilities for their business?

It should be noted that banks and other institutions of lending always take into account the remaining term of the lease and weight the prospects of whether or not the tenant has a long enough tenure to recover the cost of the capital improvements for which the loan application is being made. If the term of the lease is too short for the tenant to recover the capital costs and repay the bank, then the loan will be denied. Thus, even financial institutions recognize the importance of recovering the cost of the capital improvements on leased property. Thus, the useful life of the property should coincide with the term of the lease and, therefore, when the lease terminates, one has to ask what value is there in the improvements surrendered to the lessor. From an economic standpoint, this proposal makes little sense.

Digested 2/9/10



LAND USE RESEARCH
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Via: FINtestimony@Capitol.hawaii.gov

February 10, 2010

House Committee on Finance
Hearing Date: Wednesday, February 10, 2010 at 3:00 PM in CR 308

Testimony in Opposition to HB 2890: Relating to Real Property
(Leases – New Chapter Taxing Lessor for Improvements by Lessee)

Honorable Chair Representative Marcus Oshiro, Vice Chair Marilyn Lee and Members of the House Committee on Finance,

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 2890**, which imposes the income tax on a lessor of real property for capital improvements made by a lessee upon the termination of a lease.

HB 2890. Upon termination of a lease, HB 2890 would statutorily burden the lessor, instead of the lessee with any tax on capital improvements during the lease period. HB 2890 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."

LURF's Position. HB 2890, 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 2890 to establish such a new tax would

constitute **an unconstitutional interference with existing contract rights.** Our **opposition to HB 2890** is based on, among other things, the following:

- **Creates a "double tax" on landowners who have "purchased" the improvements through lease rent over the least term.** Many landowners and lessees negotiate the "purchase" of the improvements built by the lessee by the landowner/lessor over time through reduced effective rent. Thus, forcing the landowner/lessor to pay a new tax on the improvement at the end of the lease would be "paying for it twice." This is a real-life situation. One example is a current lease where the farmer may install a well. The landowner/lessor will amortize the value of the well across a number of years so that if the lessee leaves during that time it is clear that the landowner will pay $x as a reimbursement for the unrealized (to the landowner value of the well. Thus if the lease ends early, the landowner is paying for the well clearly if we end the lease at the end of the expected term he has explicitly agreed that our ownership is complete based on the terms – again we have paid for it. What if a State appraiser comes along and gives a value to the well – and the landowner has already "paid" for it. What if there is inflation during that time? What if deflation? What if the improvement increases in value - should the State tax the gain? What if there is loss? These are economic risks that are taken into account at the initial lease negotiations. However, if the State imposes a new tax on capital improvements at the end of the lease – it disregards the original intent of the parties and the lease contract.

- **Unconstitutional alterations 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 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.** Such a tax would have to take into account technical obsolescence. That is, the facility may exist and have a construction value but not an economic value. What if the cost of refurbishing exceeds the value of the property such that it is destroyed rather than kept? Does the

proposed tax allow for a negative value – and if so who is to make that judgment? One can easily see a situation where all or part of an "improvement" is removed although it has a theoretical capital value that has been taxed. 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 2890 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 2890 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, or requiring the demolition of such improvements.** 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, 2010, is impracticable and not feasible especially in these hard economic times for lessors to assume new and unexpected costs for leasehold properties.

Thank you for the opportunity to express our **opposition to HB 2890**.

KAMEHAMEHA SCHOOLS

WRITTEN TESTIMONY TO THE HOUSE COMMITTEE ON FINANCE
By: Paul A. Quintiliani, Director
Commercial Real Estate Division/Endowment

Hearing Date: Wednesday, February 10, 2010
3:00 p.m., Conference Room 308

February 9, 2010

To: Representative Marcus R. Oshiro, Chair
Representative Marilyn B. Lee, Vice Chair
Members of the Committee on Finance

RE: House Bill No. 2890 - Relating to Taxation.

Kamehameha Schools submits the following comments regarding H.B. No. 2890 (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.

February 9, 2010

Representative Marcus R. Oshiro, Chair
Representative Marilyn B. Lee, Vice Chair
Members of the Committee on Finance

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 administrative procedures established in this bill are cumbersome.

5. 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.

ALEXANDER & BALDWIN, INC.

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HB 2890
RELATING TO TAXATION

PAUL T. OSHIRO
MANAGER – GOVERNMENT RELATIONS
ALEXANDER & BALDWIN, INC.

FEBRUARY 10, 2010

Chair Marcus Oshiro and Members of the House Committee on Finance:

I am Paul Oshiro, testifying on behalf of Alexander & Baldwin, Inc. (A&B) on HB 2890, "A BILL FOR AN ACT RELATING TO TAXATION." We respectfully oppose this bill.

This bill establishes as taxable income to the lessor, the value of capital improvements on real property made by a lessee and surrendered to a lessor at the termination of a real property lease. As leases for commercial and industrial properties reflect contractual business decisions between a lessor and a lessee, we have concerns with the impact that this bill may have upon the scope within which leases are negotiated and executed. It is envisioned that the inclusion as taxable income of the value of the capital improvements made by a lessee may result in the exclusion of certain lease conditions that may be mutually agreeable and meet the business requirements of both the lessor and the lessee. Agreements to provide lower lease rents at the beginning of a long term lease to allow the lessee to grow their business in exchange for a commitment by the lessee to construct or install improvements on the property and/or to maintain and improve the property may no longer be feasible under the provisions of this bill.

Based on the aforementioned, we respectfully request that this bill be held in Committee. Thank you for the opportunity to testify.

Hawai'i Association of REALTORS®
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February 9, 2010

The Honorable Marcus R. Oshiro, Chair
House Committee on Finance
State Capitol, Room 308
Honolulu, Hawaii 96813

RE: H.B. 2890 Relating to Taxation

HEARING: Wednesday, February 10, 2010 at 3:00 p.m.

Aloha Chair Oshiro, Vice Chair Lee and Members of the Committee:

I am Craig Hirai, a member of the Subcommittee on Taxation and Finance, here to testify on behalf of the Hawai'i Association of REALTORS® ("HAR"), the voice of real estate in Hawai'i, and its 8,800 members in Hawai'i. HAR has the following **comments** with respect to H.B. 2890, Relating to Taxation, which imposes the income tax on a lessor of real property for capital improvements made by a lessee upon the termination of a lease.

HAR notes that a lessor could possibly avoid the tax (and the cost of demolition) by having the lessee demolish or remove the improvements prior to the termination of a lease to real property. If the lessor elects to keep the improvements, the lessor would presumably have made a decision that the improvements (less the possible cost of future demolition) were worth more than the tax.

Similar to the premature demolition of many affordable rentals prior to a City moratorium in Waikiki at the end of the Japanese bubble, a possible consequence of this bill could therefore be that properties awaiting redevelopment may be delayed and/or planned for a number of years in the future due to the premature demolition or removal of improvements with a remaining useful life (including affordable residential and commercial units).

HAR looks forward to working with our state lawmakers in building better communities by supporting quality growth, seeking sustainable economies and housing opportunities, embracing the cultural and environmental qualities we cherish, and protecting the rights of property owners.

Mahalo for the opportunity to testify.

House COMMITTEE ON FINANCE
Rep. Marcus R. Oshiro, Chair
Rep. Marilyn B. Lee, Vice Chair
DATE: Wed., February 10, 2010
TIME: 3pm
PLACE: Conference Room 308

Honorable Chairs and Members of the Committee:
Testimony in **Opposition to H.B. 2890 Relating to Taxation**: Imposes the income tax on a lessor of real property for capital improvements made by a lessee upon the termination of a lease.

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Our names are Manya Vogrig and Phyllis Zerbe, and we are testifying on behalf of ourselves and the members of our families and organizations. Our families leased the lots that our homes were on to provide land for developers to build apartments to provide affordable housing after Statehood. Since then, we have had to fight to keep from losing our property because of legislation like this.

We **STRONGLY OPPOSE** this type of legislation! It is the unconstitutional taking and breaking up of our private property and legal contracts, under the guise of claiming that the purpose is for tax revenues.

The "improvements"mentioned in the proposed legislation, when they revert back to the landowners, may be a detriment because the landowner may not wish the same use on their property. Furthermore, our leases are all different and most, if not all, of our families were not compensated for our homes or "improvements" on our properties ... which were demolished in order for the lessee/developer to build their "improvements" ... And who sold the apartments without giving the landowner any of the profits??? ... the Developer!! And each of those lessees who purchased the apartments were able to sell their apartments at any time ... also without sharing any of the profits with the landowner.

Furthermore, it is an integral part of our lease, as to whether the "improvements" are to be removed by the lessee or surrendered at the end of the term. This legislation would be interfering with our contracts by altering these terms.

We trust that you will hold this legislation in order to prevent the breaking of our individual contracts and the taking of our private properties under the guise of public purpose.

Manya Vogrig

T. Phyllis Zerbe

Manya Vogrig

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Honolulu, HI 96815

Phone: 922-6934

T. Phyllis Zerbe

1434 Punahou St.

Honolulu, HI 96822

Phone: 949-9998

For: Small Landowners of Oahu

Small Landowners Assn. of Hawaii

(Small Landowners who own the land under

Residential Condominiums and Cooperatives in the State of Hawaii)
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House Committee on Finance
State Capitol, Room 308
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