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HOUSE COMMITTEE ON WATER, LAND & OCEAN RESOURCES

TESTIMONY OF THE DEPARTMENT OF TAXATION REGARDING HB 1180 RELATING TO TAXATION

TESTIFIER: FREDERICK D. PABLO, INTERIM DIRECTOR OF
TAXATION (OR DESIGNEE)

COMMITTEE: WLO

DATE: FEBRUARY 14, 2011

TIME: 9AM

POSITION: SUPPORT INTENT

This bill amends the conveyance tax to capture the tax on the sale of stock in entities that own Hawaii real property.

The Department of Taxation (Department) **supports the intent of capturing the tax lost due to complex tax advantaged deal structuring.**

SUPPORT FOR MINIMIZING THE TAX LOSS FROM STRUCTURING—
The intent of this legislation appears to close the "loophole" that is perceived in the taxation of real property transfers where the stock in the entity that owns the property is sold and not the property itself. Though there is nothing inherently wrong with this structuring, it can result in the loss of tax revenue, specifically conveyance tax. The Department supports legislation to capture the proper amount of tax that, in reality and looking through structuring, should be paid for the sale of real property.

CONCERN FOR COMPLEXITY – The Department is concerned that the complexity of these new provisions would be difficult to administer.



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February 12, 2011

The Honorable Jerry L. Chang, Chair
House Committee on Water, Land, & Ocean Resources
State Capitol, Room 325
Honolulu, Hawaii 96813

RE: H.B. 1180, Relating to Taxation

HEARING: Monday, February 14, 2011 at 9:00 a.m.

Aloha Chair Chang, Vice Chair Har and members of the Committee:

I am Craig Hirai, Chair of the Subcommittee on Affordable Housing, here to testify on behalf of the Hawai'i Association of REALTORS® ("HAR"), the voice of real estate in Hawai'i, and its 8,500 members. HAR would like to make the following **comments** with respect to H.B. 1180, Relating to Taxation, which: (a) imposes Conveyance Tax on the transfer of a controlling interest of an entity with an interest in Hawaii real property; and (b) imposes the Conveyance Tax on certain transfers of real property between related entities at the lowest tax rate. The purpose of this H.B. 1180 is to apply the Conveyance Tax to transfers of entity ownership when the transfer of entity ownership is essentially equivalent to the sale of an interest in Hawaii real property.

HAR believes that the transfer of control of a business entity is comparable to the sale of an interest in the real property held by the entity. HAR further believes that all transfers of possession or use of real property in Hawaii should be subject to the same Conveyance Tax obligations and that the burden of the Hawaii Conveyance Tax currently falls primarily on smaller Hawaii business and property owners and Hawaii homeowners who generally convey title to real property itself and not controlling interests in entities that own Hawaii real property.

HAR would note, however, that your committee is also hearing H.B. 1408, Relating to a Controlling Interest Transfer Tax, Taxation, today, and that: (a) unlike H.B. 1408 which establishes a new Controlling Interest Transfer Tax, the transfer of a controlling interest under H.B. 1180 is subject to the Conveyance Tax which among other things supports the Rental Housing Trust Fund; and (b) the conveyance of real property interests between certain controlling and controlled entities under H.B. 1180 will only be subject to Conveyance Tax at the lowest rate. **If you are going to pass one of these two bills, HAR would therefore prefer that you pass H.B. 1180.**

HAR would also note that an Administration Bill (H.B. 1014, Relating to Conveyance Tax) has requested the repeal of current HRS §247-3(17), and that you should therefore consider removing §247-B(3) from Section 2 of H.B. 1180.

Mahalo for the opportunity to testify.

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SUBJECT: CONVEYANCE, Transfer of a controlling interest

BILL NUMBER: HB 1180

INTRODUCED BY: Choy

BRIEF SUMMARY: Amends a new section to HRS chapter 247 to provide that the conveyance tax shall be applicable to the transfer or acquisition, or a series of transfers or acquisitions, including those combined with otherwise exempt transfers, by any person or entity, either acting alone or in concert, within any 12-month period, that result in the transfer of a controlling interest in an entity with an interest in real property located in this state for valuable consideration and which also results in the transfer of control or ownership of the real property located in this state.

In determining whether a controlling interest was transferred or acquired within a 12-month period, the date that the option agreement was executed shall be the date on which the transfer or acquisition of the controlling interest is deemed to occur. For all other purposes, the date upon which the option is exercised is the date of the transfer or acquisition of the controlling interest.

Stipulates that for the purposes of this section with regard to persons acting in concert: (1) all acquisitions of persons acting in concert shall be aggregated for the purpose of determining whether a transfer or acquisition of a controlling interest has taken place; (2) persons shall be considered as acting in concert when they have a relationship with each other such that one person influences or controls the actions of another through common ownership; (3) persons shall be considered to be acting in concert only when the unity with which the purchasers negotiate and consummate the transfer of ownership interests supports a finding that the persons are acting as a single entity; and (4) if acquisitions are completely independent and each purchaser purchases without regard to the identity of the other purchasers, then the acquisitions shall be considered separate acquisitions.

“Controlling interest” shall mean: (1) in the case of a corporation, either 50% or more of the total combined voting power of all classes of stock of the corporation entitled to vote, or 50% or more of the capital, profits, or beneficial interest in the voting stock of the corporation; and (2) in the case of a partnership, association, trust, or other entity, 50% or more of the capital, profits, or beneficial interest in the partnership, trust, or other entity.

Directs the director of taxation to adopt rules pursuant to HRS chapter 91 to implement this section, including rules for determining whether persons are acting in concert for the purpose of transferring or acquiring a controlling interest.

Adds a new section to HRS chapter 247 to provide that the conveyance tax imposed by HRS section 247-1 shall apply to the following at the lowest rate regardless of the value of the real property: (1) any document or instrument conveying real property, or any interest therein, from an entity that is a party to a merger or consolidation under HRS chapters 414, 414D, 415A, 421, 421C, 425, 425E, or 428 to the

surviving or new entity; (2) any document or instrument conveying real property, or any interest therein, from a dissolving limited partnership to its corporate general partner that owns, directly or indirectly, at least a ninety per cent interest in the partnership, determined by applying section 318 (with respect to constructive ownership of stock) of the federal Internal Revenue Code of 1986, as amended, to the constructive ownership of interests in the partnership; (3) any document or instrument conveying real property to any nonprofit or for-profit organization that has been certified by the Hawaii housing finance and development corporation for low-income housing development; and (4) any document or instrument conveying real property, or any interest therein, to or from a wholly-owned corporation or limited liability company.

Makes conforming amendments to HRS section 247-1 and HRS section 247-3.

EFFECTIVE DATE: July 1, 2011

STAFF COMMENTS: The proposed measure would subject to the conveyance tax rates “complex transactions” involving the transfer of real property to ensure that the transactions are taxed, even though they are not currently taxable under the conveyance tax as the real property is owned by a legal entity like a corporation or partnership. While it is the intent of the measure to close this loophole as the measure argues that these transfers attempt to evade taxation, it should be noted that the current conveyance tax was never established to be a source of revenue. Only in recent years as lawmakers sought to fund their favorite programs did the conveyance tax come under fire as a way to raise new sources of revenue to fund favored programs. With rates as high as \$1.25 per hundred dollars of value transferred, lawmakers now believe that transfers of real property, albeit as part of the acquisition of a company or partnership, are an intentional evasion of the tax. Thus, it is not hard to believe that while the measure proposes that the conveyance tax at the lowest rate shall be imposed on these transfers, there is not doubt that this policy may be amended and the rate will mushroom in a few years as the legislature may target these transfers as another way to raise additional revenue.

Unfortunately, the imposition of the conveyance tax on these transfers may add another nail in the economic coffin of Hawaii as it is just one more cost that an investor must weigh in deciding whether or not the return on an investment in Hawaii is attractive or reasonable.

It should be remembered that the conveyance tax was initially enacted by the 1966 legislature after the repeal of the federal law requiring stamps for transfers of real property. It was enacted for the sole purpose of providing the department of taxation with additional data for the determination of market value of properties transferred. This information was also to assist the department in establishing real property assessed values and at that time the department stated that the conveyance tax was not intended to be a revenue raising device. The conveyance tax is imposed each time property changes title or ownership. However, over the years the tax has been increased and conveyance tax revenues have been tapped to provide revenue for the land conservation fund, rental housing trust fund, and the natural area reserve fund.

While this proposal tries to address what looks like a sale of an entity or organization that has as part of its portfolio real property in Hawaii, there are other ways of transferring a company and the controlling interest of such an entity without the appearance that the organization or entity is being sold or transferred. This proposal would increase the cost of affordable housing that is developed by a partnership or joint venture of a for-profit entity and a not-for-profit entity. The partnership may have

been created out of necessity where a for-profit developer brings the expertise and the ability to market various government subsidies while the nonprofit partner is able to secure the public subsidies like foundation and federal grants or in the case of low-income housing tax credits which the for-profit can then market to investors to raise the necessary capital to construct the project. When the compliance period expires, the for-profit may want to exit the partnership transferring its ownership to the nonprofit. Under this proposal there would be the imposition of the conveyance tax which then would add to the cost of the nonprofit taking on the for-profit's title to the real property. The bottom line is that this added cost will be passed on to the low-income tenants renting the affordable housing. This appears to be one of the unintended consequences of this proposal.

Digested 2/11/11