

TAXBILLSERVICE

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SUBJECT: INCOME, Real estate investment trusts

BILL NUMBER: HB 1726, HD-1

INTRODUCED BY: House Committee on Consumer Protection & Commerce

BRIEF SUMMARY: Amends HRS section 235-2.45(a) to provide that Section 857 (with respect to taxation of real estate investment trusts and their beneficiaries) of the Internal Revenue Code (IRC) shall be operative for Hawaii income tax purposes, except that IRC section 857(b)(2)(B) relating to the deduction for dividends paid shall **not** be operative for Hawaii income tax purposes.

Makes conforming amendments to HRS section 235-7.

EFFECTIVE DATE: Tax years beginning after December 31, 2013

STAFF COMMENTS: Currently, under federal and state income tax law, a real estate investment trust (REIT) is allowed a dividend paid deduction, unlike most other corporations, resulting in that dividend being taxed once, to the recipient, rather than to the paying corporation. It appears that this measure is intended to tax REITs the same as other corporations.

Apparently the evil sought to be addressed by the bill is that REITs are in Hawaii but do not get taxed under the net income tax system because of the deduction allowed for dividends paid, while the REIT owners who receive the dividend income are outside of Hawaii and don't get taxed either because they are outside of Hawaii. If this measure is adopted, the REITs will be taxed if they make net income in Hawaii, and shareholders will be taxed the same as before.

It also should be noted that some years ago there was a concern about Hawaii corporations that formed "captive" REITs in order to claim both the dividend paid deduction at the REIT level and the dividend received deduction at the parent corporation level. The department of taxation addressed this issue administratively by Tax Information Release No. 98-6.

Digested 2/23/14

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Testimony of Hawai'i Appleseed Center for Law and Economic Justice
House Bill 1726 Relating to Taxation
House Committee on Finance
Scheduled for Hearing Tuesday, February 25, 2014, 1:00 PM, Room 308

Hawai'i Appleseed Center for Law and Economic Justice is a nonprofit, 501(c)(3) law firm created to advocate on behalf of low income individuals and families in Hawai'i on civil legal issues of statewide importance. Our core mission is to help our clients gain access to the resources, services, and fair treatment that they need to realize their opportunities for self-achievement and economic security.

Thank you for the opportunity to testify in **support** of House Bill 1726, which would eliminate the dividends-paid deduction allowed for Real Estate Investment Trusts on their Hawai'i state income taxes. Because of the dividends-paid deduction (DPD), real estate investment trusts (REITs) in Hawai'i are able to avoid significant taxation on wealth derived from land values in Hawai'i without providing any significant benefits to the state in return.

First established in the 1960s by Congress, REITs are a special investment vehicle intended to allow and encourage small investors to invest in the then-booming real estate market. REITs were given special tax treatment through an income deduction on all dividends paid out to their investors, and are required by statute to pay out at least 90 percent of their net income in dividends. This ensured that they would be an attractive investment vehicle. In order to ensure that REITs did not become a means for wealthy individuals and large corporations to avoid taxation, REITs were further required to have at least 100 investors. Most states, including Hawai'i, have followed suit.

In Hawai'i, many of our large and valuable real estate investments are held by REITs owned by large corporations and wealthy individuals on the mainland and in foreign countries. The rents collected on these properties are collected by REITs and then paid out to their investors. Because Hawai'i allows a deduction for these dividends, this income goes untaxed here. In most cases, the investors will be required to pay income taxes on the dividends they receive in their home states. However, given that few of these investors live in Hawai'i, those tax revenues go to other states. In short, REITs have become a vehicle whereby large mainland investors are able to profit from Hawaii's high land values, and export that wealth without paying taxes on the income in Hawai'i.

In some cases, REITs have become a vehicle for even more abusive and egregious tax avoidance. As reported nationally, large corporations have been able to structure real estate ownership of facilities to allow rents to be paid into a self-owned REIT. This allows the corporations to deduct the cost of rent they are paying to the REIT from their income, and then pay themselves dividends out of the REIT, taking another deduction and avoiding taxation. When structured this way, these arrangements have become a means for large retail outlets to avoid taxation on large portions of their normal income.

Eliminating the dividends-paid deduction is the easiest way to ensure that Hawai'i will see the benefits of owning and operating real estate in Hawai'i do not accrue only to wealthy out-of-state investors. For this reason, Hawai'i Appleseed Center for Law & Economic Justice request that you **pass HB 1726**.



NATIONAL ASSOCIATION OF
REAL ESTATE INVESTMENT TRUSTS®

WRITTEN TESTIMONY OF

DARA F. BERNSTEIN
SENIOR TAX COUNSEL
NATIONAL ASSOCIATION OF REAL ESTATE INVESTMENT TRUSTS, INC.
IN OPPOSITION TO H.B. 1726, H.D. 1

BEFORE THE HAWAII HOUSE OF REPRESENTATIVES
COMMITTEE ON FINANCE
REPRESENTATIVE SYLVIA LUKE, CHAIR
REPRESENTATIVE SCOTT Y. NISHIMOTO, VICE CHAIR
REPRESENTATIVE AARON LING JOHANSON, VICE CHAIR

HEARING ON H.B. 1726, H.D. 1

TUESDAY, FEBRUARY 25, 2014



Chair Luke, Vice Chair Nishimoto, Vice Chair Johanson, and members of the Committee, the National Association of Real Estate Investment Trusts, Inc. (NAREIT) thanks you for this opportunity to submit testimony in opposition to H.B. 1726, H.D. 1, legislation that would eliminate the “dividends paid deduction” (DPD) for all real estate investment trusts (REITs) contrary to federal income tax rules and the existing laws of virtually every other state with an income-based tax system. NAREIT is the worldwide representative voice for REITs and publicly traded real estate companies with an interest in U.S. real estate and capital markets. NAREIT's members are REITs and other businesses throughout the world that own, operate, and finance income-producing real estate, as well as those firms and individuals who advise, study, and service those businesses.

In Hawaii, approximately twenty widely held REITs have invested about six billion dollars in commercial real estate that results in the employment of many Hawaii residents. The Hawaii real estate owned by REITs generates millions of dollars in property taxes. These taxes are on top of the individual income taxes currently generated by REIT dividends paid to Hawaii residents from income earned wherever the distributing REIT resides or does business, as well as the sales and other taxes generated by the tenants that conduct business on the premises owned and operated by REITs.

Background: REITs Were Designed to Benefit the “Small Investor.” By way of background, Congress created REITs in 1960 to enable investors from all walks of life to own professionally managed, income-producing real estate through companies modeled after mutual funds. REITs are corporations or business trusts that combine the capital of many investors to benefit from a diversified portfolio of income-producing real estate, such as apartments, hotels, health care facilities, shopping centers, senior housing, offices, timberlands, storage facilities, and warehouses. Among other things, federal tax law requires REITs to be widely held and to distribute at least 90% of their taxable income to their shareholders. In exchange for distributing taxable income (and for satisfying a number of other requirements to ensure that REITs remain real estate-focused), federal tax law grants REITs (and mutual funds) a dividends paid deduction. In 2012, publicly traded REITs distributed more than \$29 billion to their shareholders, who in turn pay income taxes on those distributions.

REITs Benefit Investors and the Economy. Congress’ vision has been realized: as of February 24, 2014, 203 publicly traded REITs had a total market capitalization of over \$700 billion. Investors, large and small, have benefited from owning REITs: the 15-year compound annual return for the period ending December 31, 2013 of the S&P 500 stock index was 4.68%, while that of equity (property–owning, as opposed to mortgage-owning) REITs was 10.49%. The economy benefits from REITs as well – because REITs cannot pass through losses to investors (unlike partnerships), their focus must be on creating value for shareholders. Furthermore, unlike other real estate owners that use high levels of debt, average debt levels for public equity REITs are around 35%, leading to less volatility in the real estate market and fewer bankruptcies and workouts. Over 25 countries have some form of REIT legislation in place that allows for a single level of taxation.

REITs Benefit Hawaii. Exchange-traded REITs, such as General Growth Properties, Inc. (GGP) and Taubman Centers Inc. (Taubman), have both access to the public capital markets to raise funds for new investments and the professional expertise to manage investment-grade real estate. These investments include the renovation and expansion of the Ala Moana Mall with respect to which GGP has committed to invest over \$500 million, and International Market Place, with respect to which the Queen Emma Land Company has partnered with Taubman to redevelop and revitalize. Taubman has committed to invest approximately \$400 million to redevelop International Market Place, and this redevelopment is expected to result in approximately 1,000 construction jobs and 2,500 permanent jobs, increased property value (and presumably property taxes) and sales taxes, and it also will support



the mission of The Queen's Medical Center to improve the well-being of Native Hawaiians and the people of Hawaii. Revenues generated from the redeveloped property will directly fund the Center's operations as well as upcoming community initiatives, such as the opening of The Queen's Medical Center – West O'ahu.

Most States Tax REIT Income Only Once at the Shareholder Level. Nearly every state with an income-based tax system, including Hawaii currently, allows the DPD for widely held REITs. As a result of the DPD, most, if not all, of a REIT's income is taxed at one level – the shareholder level. Hawaii thus benefits by taxing Hawaii residents investing in REITs that have no Hawaii operations.

NAREIT opposes H.B. 1726, H.D.1 for the following reasons:

- H.B. 1726, H.D. 1 would enact a serious policy change that would put Hawaii at odds with virtually all other states regarding the taxation of REIT income at the shareholder level only based on the state of shareholder residence. Virtually every state with an income-based tax system, including Hawaii currently, allows widely held REITs a deduction for dividends paid. **Additionally, Hawaii currently taxes all REIT dividend income received by Hawaii resident shareholders, regardless of where the REIT's real estate is located or the REIT does business.** All other states that impose income taxes also tax the REIT income based on the location of the resident that receives the REIT dividends and not based on the location of the real estate. H.B. 1726, H.D. 1 would upset this comity of state taxation principles by unilaterally double taxing REITs (and their shareholders) that do business in Hawaii. In the past decade, a number of states such as Idaho, Louisiana, New Jersey, North Carolina, and Rhode Island have examined, and then rejected, the disallowance of a widely held REIT's DPD.
- H.B. 1726, H.D. 1 Would Make Hawaii Non-Competitive. Disallowing the DPD would make Hawaii virtually the only state to impose a double level state income tax on widely held REITs, which would continue to be compelled by federal law to distribute their taxable income to shareholders. REIT shareholders resident in states with income taxes would face an additional level of income tax on their dividends from REITs with Hawaii properties, potentially causing them to avoid such investments. Most REITs investing in Hawaii have the overwhelming majority of their investments in states other than Hawaii, and many of them could choose to sell their Hawaii properties or, at the least, not expand their Hawaii operations, because investments in other states could produce better after-tax returns. Thus, H.B. 1726, H.D. 1 would create a higher cost of capital for investments in Hawaii compared to all other investment opportunities.
- H.B. 1726, H.D. 1 appears to assume that REITs operate just like other real estate companies without recognizing the asset, income, compliance and 90% distribution requirements placed on REITs that other companies need not satisfy.

Address "Captive" REITs on a Targeted Basis

NAREIT recognizes Hawaii's interest in adopting legislation that would limit any inappropriate use of REITs by denying the DPD in certain cases, but any such legislation should be narrowly tailored to prevent application to legitimate business transactions. If any legislative action is deemed necessary, our suggestion is to follow the template of model captive REIT legislation adopted by the Multistate Tax Commission in [2008](#) and in [2011](#).



Accordingly, NAREIT urges you not to enact H.B. 1726, H.D.1. Thank you again for the opportunity to submit this testimony.



February 24, 2014

Honorable Sylvia Luke, Chair
Honorable Scott Y. Nishimoto, Vice-Chair
Honorable Aaron Ling Johanson, Vice-Chair
Committee on Finance
House of Representatives
State Capitol
415 South Beretania Street
Honolulu, Hawaii 96813

Re: Testimony in Opposition to House Bill No. 1726, House Draft 1 relating to Taxation

Dear Chair Luke, Vice-Chairs Nishimoto and Johanson and Committee Members:

On behalf of Taubman Centers, thank you for the opportunity to provide our testimony with respect to House Bill No. 1726, House Draft 1, relating to taxation. Taubman is an S&P MidCap 400 publicly-traded and widely owned Real Estate Investment Trust (“REIT”) engaged in the ownership, operation, management, development and leasing of 27 regional, super-regional and outlet shopping centers in the U.S. and Asia. Taubman respectfully opposes House Bill No. 1726, House Draft 1, relating to taxation, which is being heard by your Committee on Finance on February 25, 2014 at 1:00 p.m.

The purpose of House Bill No. 1726, House Draft 1, is to eliminate the federal deduction for dividends paid by a REIT for purposes of Hawaii income taxation. REITs, or real estate investment trusts, are a vehicle designed to allow many small investors to participate in real estate developments. Many state and local pension and retirements funds also are REIT investors.

The elimination of the dividend paid deduction would effect a radical change in taxation of REITs. By law, REITs are required to distribute 90% of their income to shareholders. In practice, REITs normally distribute at least 100% of their taxable income. Because of the dividend paid deduction, the distributions effectively are taxed at the shareholder level by the state taxing jurisdictions in which the shareholders reside. This allows for a single level of taxation at the shareholder level and no double taxation (or once at the entity level and again at the shareholder level) and is consistent with investors in mutual funds treated as regulated investment companies for tax purposes. Therefore, in practice, state income taxation of REITs is based on the residence of its shareholders, rather than the location of the REIT or its projects. Thus, Hawaii will receive income tax on distributions received by Hawaii residents who are shareholders in REITs that may be located outside of the State and which may have projects outside of the State. For publicly-traded and widely held REITs, this is the uniform tax treatment in virtually all states that impose an income based tax system.¹

¹ We have no objection to limiting the dividend paid deduction for captive or privately owned REITs. They are different than widely owned REITs since captive REITs are primarily used as a tax strategy to

Approximately 20 publicly-traded REITs are active in Hawaii and are responsible for substantial economic activity in the construction industry, resort industry, retail industry and others. Such economic activity generates substantial economic benefit for Hawaii, including providing jobs, as well as substantial tax revenues for the State government. The tax revenues include substantial general excise taxes on rents from tenant and from the sale of goods at retail by the tenants, business income tax from profits from its tenants, real and personal property taxes and individual income tax from employment of residents of Hawaii.

Taubman's new development currently under construction INTERNATIONAL MARKET PLACE in Waikiki, Honolulu, Hawaii alone is projected to generate over \$14 million annually in general excise tax (from landlord rents and by tenants from retail sales of merchandise), over \$4 million annually in property taxes, and employment of over 1,000 construction jobs and 2,500 permanent job (generating individual income tax).

Such a change is likely to strongly discourage future investment by REITs in Hawaii, stifling the availability of capital.² Revoking the dividend paid deduction will increase taxation to the REIT and result in double taxation of its income distributed to its shareholders which will reduce investment returns on developments by the REIT and reduce annual dividend payments to shareholders in order to pay the additional state income tax (impacting shareholder returns on investment). Thus, this measure would put Hawaii at a competitive disadvantage versus every other state when trying to attract capital for investment in the State. Because investments by REITs generate so much economic activity and create so many local jobs in the State, disallowing the deduction for dividends paid not only would hurt workers in Hawaii, over the long run, it ultimately may result in less tax revenue for the State as its makes Hawaii unattractive for investment by REITs resulting in less economic activity.

Finally, we note that many publicly-owned REITs already have made substantial investments in Hawaii projects. To now change a fundamental rule of taxation applicable to REITs would unfairly affect the investments made by REITs in reliance upon the long-standing and universal tax rules allowing the paid dividend deduction. If the Legislature decides to make this fundamental change, we respectfully urge that it be delayed for a sufficient period to allow REITs to adjust their investments in Hawaii to account for this change.

lower their affiliates effective income tax rate from non-real estate business activities. As suggested in NAREIT's testimony, there is multistate tax commission model legislation for that purpose.

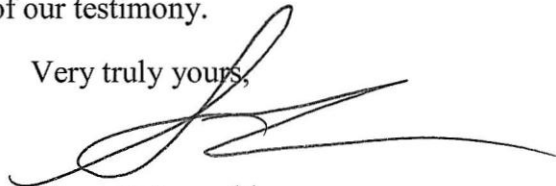
² As of February, 2014, there were approximately 204 publicly-traded REITs in the United States, with a market capitalization of around \$700 billion.

Honorable Sylvia Luke, Chair
Honorable Scott Y. Nishimoto, Vice-Chair
Honorable Aaron Ling Johanson, Vice-Chair
Committee on Finance
February 24, 2014
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For the foregoing reasons, we respectfully oppose House Bill No. 1726, House Draft 1.

Thank you for your consideration of our testimony.

Very truly yours,

A handwritten signature in black ink, appearing to read 'Simon J. Leopold', with a long horizontal flourish extending to the right.

Simon J. Leopold
Senior Vice President
Capital Markets and Treasurer

NEIL ABERCROMBIE
GOVERNOR

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FREDERICK D. PABLO
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LATE

To: The Honorable Sylvia Luke, Chair
and Members of the House Committee on Finance

Date: Tuesday, February 25, 2014
Time: 1:00 p.m.
Place: Conference Room 308, State Capitol

From: Frederick D. Pablo, Director
Department of Taxation

Re: H.B. No. 1726 H.D. 1 Relating to Taxation

The Department of Taxation (Department) provides the following comments regarding H.B. 1726 H.D.1 for your consideration.

H.B. 1726 H.D.1 amends the corporation income tax by taxing Real Estate Investment Trusts (REITs) without regard to the federal deduction for dividends paid. The measure would amend Hawaii Revised Statutes (HRS) section 235-71(d) to provide that the state income tax imposed on REITs is computed prior to the adjustments provided by Internal Revenue Code (IRC) section 857(b)(2), such that REITs would be taxed as any other corporation under Hawaii law. The measure would be effective upon approval and apply to taxable years beginning after December 31, 2013.

To properly understand the taxation of REITs, it is necessary to understand why they came into existence in the first instance. REITs were first created by Congress in 1960 to give all Americans, and not just the affluent, the ability to invest in income-producing real estate. It is similar to how many Americans invest in stocks and bonds through mutual funds. REITs allow anyone to invest in portfolios of large-scale properties as if they were purchasing shares of stock. REITs can own shopping malls, apartment buildings, student housing complexes, homes, medical facilities, office buildings, hotels, cell towers and timberlands. REITs have been formed in every state and contribute millions of dollars in jobs and investment income to the economy each year.

REITs are generally a pool of properties and mortgages bundled together and offered as a security in the form of unit investment trusts. Each unit in an REIT represents a proportionate fraction of ownership in each of the underlying properties. A REIT and its shareholders are taxed in accordance with IRC sections 856 through 859, provided certain requirements are met. A

REIT is generally organized as a corporation, trust or association, and generally results in federal income taxes being imposed on a current basis to its members through the form of dividend distributions.

The Department first notes that disallowing the dividend paid deduction would create a double taxation of income, which could cause taxpayers to lose the incentive to invest in Hawaii based REITs. While it is true that ordinary 'C' corporations also impose a double layer of taxation on income earned by the 'C' corporation, such corporations do not have the limitations that are placed upon REITs, such that 'C' corporations have benefits which offset such double taxation that REITs do not.

Under this proposed measure, REITs would still be required to follow the same rules as all other unit investment trusts, which means that REITs must be taxed first at the trust level, then to unit holders. REITs must follow the same method of self assessment as corporations; they have the same valuation and accounting rules as corporations, but instead of passing through profits, they pass cash flow directly to unit holders. In order for REITs to be exempt from taxation at the trust level, they must distribute at least 90% of their income to their unit holders, while 'C' corporations are not so required. 'C' corporations have the ability to retain income and would thus escape double taxation, unlike a REIT, which is required to distribute such income.

The Department also notes that the issue of Hawaii corporations forming “captive” REITs in order to claim both the dividend paid deduction at the REIT level and the dividend received deduction at the parent corporation level, was addressed in Tax Information Release No. 98-6.

While IRC section 243 is inoperative for Hawaii tax purposes (unless otherwise provided) and in lieu of the federal dividend received deduction, Hawaii instead provides a Hawaii corporation with a 100% deduction for dividends received from a national banking association, or dividends received by members of an affiliated group as defined by IRC section 243(b) or a small business investment company or a 70% deduction for dividends received from a corporation that is 95% owned by one or more corporations doing business in Hawaii, a bank or insurance company organized and doing business in Hawaii, or a corporation that can attribute at least 15% of its business to Hawaii, this provision is inapplicable to captive REITs.

Because IRC section 857(c) is currently operative for Hawaii tax purposes and HRS section 235-2.5(a)(2) provides that if a provision in the IRC that is operative in this State refers to an inoperative provision in the IRC that has been codified in chapter 235, HRS, then the reference shall be to the provision in chapter 235, HRS. Therefore, while IRC section 243 is generally inoperative for Hawaii tax purposes, it is codified with modifications under HRS section 235-7(c) and therefore IRC section 857(c) is applicable with reference to section HRS section 235-7(c) instead of IRC section 243. Accordingly, under IRC section 857(c), a dividend paid by a REIT is not considered a “dividend” for purposes of HRS section 235-7(c), and the dividend received deduction is not allowed for Hawaii income tax purposes. Thus, the Hawaii

tax treatment of the dividend received deduction as applied to REITs under these circumstances is the same as under federal law.

Thus, the issue of captive REITs and its parent companies avoiding State taxation has already been addressed through the operation of the relevant IRC and HRS sections.

Thank you for the opportunity to provide comments.