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To: The Honorable Angus L.K. McKelvey, Chair
and Members of the House Committee on Consumer Protection & Commerce

Date: Monday, February 10, 2014
Time: 2:45 p.m.
Place: Conference Room 325, State Capitol

From: Frederick D. Pablo, Director
Department of Taxation

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

The Department of Taxation (Department) offers the following comments on H.B. 1726 for the Committee's consideration.

H.B. 1726 disallows Real Estate Investment Trusts (REITs) to deduct from its income dividends paid to its unitholders. This measure would take effect upon its approval and apply to taxable years beginning after December 31, 2013.

The taxation of REITs are specifically covered under Internal Revenue Code (IRC) sections 856 to 859. IRC section 857(b)(2)(B) allows for the deduction of dividends paid by a REIT. Hawaii's income tax law currently conforms to IRC section 857; thus, REITs may deduct the dividends paid to its unitholders and avoid income tax at the REIT level. This deduction is limited by Hawaii Revised Statutes (HRS) section 235-71(d) to the amount of dividends that is attributable to income that is taxable for Hawaii income tax purposes. This measure disallows the deduction for dividends paid by disallowing the dividends paid deduction at HRS section 235-71(d).

In addition to the amendment to HRS section 235-71(d), the Department suggests that HRS section 235-2.3(b) be amended so that there is no potential conflict of law. Hawaii generally conforms to IRC, Subtitle A, Chapter 1, which is IRC sections.1-1400, unless otherwise specified. IRC section 857 which allows for the REIT dividends paid deduction falls within this IRC section range. In order eliminate any potential conflict of law, the Departments suggests adding the following to HRS section 235-2.3(b) to clarify that the provision is not operative for Hawaii income tax purposes:

`(31) Section 857(b)(2)(B) (with respect to the dividends paid deduction for real estate investment trusts);`

Thank you for the opportunity to provide comments.

SUBJECT: INCOME, Real estate investment trusts

BILL NUMBER: HB 1726

INTRODUCED BY: Choy and Say

BRIEF SUMMARY: Amends HRS section 235-71(d) to provide that the state income tax imposed on real estate investment trusts shall be computed prior to the adjustments provided by section 857(b)(2) of the Internal Revenue Code (IRC). Deletes the qualification that the deduction for dividends paid shall be limited to the amount of dividends attributable to the income taxable under Hawaii income tax law.

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, and is attempting to make the dividends paid deduction inoperative without regard to the federal deductions of dividends. As drafted, it is unclear as no specific reference is delineated regarding section 857(b)(2) of the IRC other than "computed prior to the adjustments provided by section 857(b)(2) of the IRC."

Apparently the evil sought to be addressed by the bill is that REITs are in Hawaii but do not get taxed 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 that is the intent, then as a technical matter the following may be preferable:

1. The nonconformity item should be set forth in section 235-2.45, HRS, as nonconformity items are normally listed in Code section order in sections 235-2.4 and 235-2.45, HRS. For example: "Section 857 of the Internal Revenue Code shall be operative for purposes of this chapter; except that section 857(b)(2)(B) relating to the dividends paid deduction shall not be operative."

2. There would no longer be a need for section 235-71(d), HRS, and that subsection could be repealed.

3. The reference to subsection (d) in section 235-71(a), HRS, could be deleted. For example: "(a) A tax at the rates herein provided shall be assessed, levied, collected, and paid for each taxable year on the taxable income of every corporation, including a corporation carrying on business in partnership, except that in the case of a regulated investment company the tax is as provided by subsection (b) [~~and further that in the case of a real estate investment trust as defined in section 856 of the Internal Revenue Code of 1954 the tax is as provided in subsection (d)~~]. "Corporation" includes any professional corporation incorporated pursuant to chapter 415A <u>and a real estate investment trust as defined in section 856 of the Internal Revenue Code</u>."

4. The reference in existing section 235-71(d), HRS, to sections 859 of the Internal Revenue Code in any event should be repealed because that Code section has been repealed.

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 2/8/14

HAWAI'I APPLESEED CENTER
LAW AND ECONOMIC JUSTICE

LATE

Testimony of Hawai‘i Appleseed Center for Law and Economic Justice
House Bill 1726 Relating to Taxation
House Committee on Consumer Protection & Commerce
Scheduled for Hearing Monday, February 10, 2014, 2:45 PM, Room 325

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 172, 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 the 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, unamended**.

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NATIONAL ASSOCIATION OF
REAL ESTATE INVESTMENT TRUSTS®

LATE

WRITTEN TESTIMONY OF

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

BEFORE THE HAWAII LEGISLATURE'S
COMMITTEE ON CONSUMER PROTECTION & COMMERCE
REPRESENTATIVE ANGUS L.K. MCKELVEY, CHAIR
REPRESENTATIVE DEREK S.K. KAWAKAMI, VICE CHAIR

HEARING ON H.B. 1726

MONDAY, FEBRUARY 10, 2014

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Chair McKelvey, Vice Chair Kawakami, 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, legislation that would eliminate the "dividends paid deduction" (DPD) for all widely-held 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 billions of dollars in commercial real estate and employ 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, ski resorts, offices, timberlands, storage facilities, and warehouses. Federal tax law requires REITs to distribute at least 90% of their taxable income to their shareholders. In exchange for distributing taxable income and any net capital gains (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 (DPD). In 2012, publicly traded REITs distributed more than $29 billion to their shareholders.

REITs Benefit Investors and the Economy. Congress' vision has been realized: as of February 7, 2014, 204 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.

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 for the following reasons:

- H.B. 1726 would enact a drastic 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 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 would shatter 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 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 shun 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.

- H.B. 1726 wrongly assumes 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.

Several States Have Reigned in Captive REITs on a Targeted Basis

In 2005, Louisiana reacted to the use of a taxable corporation's use of a nearly wholly-owned REIT designed to eliminate Louisiana state income taxes through the use of rental payments to a related entity. Louisiana enacted legislation, which limits its DPD to publicly traded REITs and REITs that are not more than 50% held by a taxable "C" corporation other than another REIT, or a qualified REIT subsidiary (a wholly-owned subsidiary of the REIT disregarded for federal tax purposes). Following Louisiana's lead and a February 2007 article in the *Wall Street Journal* about Wal-Mart's use of a "captive REIT," a number of states, including, among others, Alabama, Georgia, Illinois, Kentucky, Maryland, Rhode Island, and Virginia have enacted similar "captive REIT" legislation.

Additionally, the Multistate Tax Commission (MTC), an organization of state governments that works with taxpayers to administer tax laws that apply to multistate and multinational enterprises, adopted a model captive REIT law in June 2008, which essentially would disallow the DPD of a REIT more than 50% owned by most taxable C corporations (other than certain foreign REIT-like entities).[1] In 2011, the MTC adopted a related model law that would disallow deductions (*e.g.*, rental payments) made to a related captive REIT.[2]

[1]http://www.mtc.gov/uploadedFiles/Multistate_Tax_Commission/Uniformity/Uniformity_Projects/Adopted_Recommendations/By_Category/PROPOSED%20MODELREIT%20STATUTEasapproved.pdf.
[2]http://www.mtc.gov/uploadedFiles/Multistate_Tax_Commission/Uniformity/Uniformity_Projects/Current_Projects/captive%20REITpayment%20addback%20statute.pdf.

Furthermore, a number of states, including Hawaii and Massachusetts, have modified or clarified their tax structure with respect to corporate-owned REITs when both the REIT subsidiary claimed a DPD, and the parent shareholder claimed a dividends received deduction (DRD). Federal law does not permit a corporate shareholder to claim a DRD with respect to a REIT's dividend, but not all states conformed to that rule. Specifically, in 1998, Hawaii's Department of Taxation issued Tax Information Release No. 98-6,[3] in which it ruled that a REIT dividend is not considered a "dividend" for purposes of the DRD; thus, a corporate shareholder cannot claim a DRD with respect to a dividend paid by a REIT. This release also held that that neither the DRD nor DPD are recognized for dividends between members of the same unitary group.

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 model of the 2008 MTC model legislation.

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

[3]http://files.hawaii.gov/tax/legal/tir/1990_09/tir98-6.pdf.