H.B. NO. 1417

A BILL FOR AN ACT

RELATING TO THE CLARIFICATION OF THE DIVIDENDS RECEIVED DEDUCTION WITH RESPECT TO DIVIDENDS RECEIVED BY REAL ESTATE INVESTMENT TRUSTS.

BE IT ENACTED BY THE LEGISLATURE OF THE STATE OF HAWAII:

SECTION 1. The purpose of this Act is to clarify provisions of Hawaii's income tax law that deny a deduction for dividends paid by a real estate investment trust. Under the Internal Revenue Code as amended, dividends paid by a real estate investment trust are not deductible under section 857(c). Section 857(c) of the Internal Revenue Code is operative for purposes of chapter 235, Hawaii Revised Statutes. Under the State's income tax law, a "dividend" is a distribution that is treated as a dividend under the Internal Revenue code and section 857(c) provides that for purposes of the federal dividends received deduction, "a dividend received from a real estate investment trust which meets the requirements of this part shall not be considered a dividend."

The department of taxation provided guidance concerning the non-deductibility of dividends paid by real estate investment trusts in tax information release No. 98-6 (July 8, 1998).

Subsequently, in In the Matter of the Tax Appeal of HEI and Subsidiaries, T.A. No. 03-0169, the state tax appeal court also concluded that dividends paid by a real estate investment trust are not deductible under chapter 235, Hawaii Revised Statutes. Likewise, in In the Matter of the Tax Appeal of Central Pacific Bank, Inc., T.A. Nos. 00-0075, 03-0155 and 05-0041, the state tax appeal court again ruled that such dividends are not deductible.

Notwithstanding the provisions of chapter 235, Hawaii Revised Statutes, the department of taxation's tax information release providing guidance, and these tax appeal court rulings that deny the dividends received deduction for dividends paid by real estate investment trusts under existing law, confusion continues to persist among some taxpayers and tax practitioners. The purpose of this Act is clarify existing provisions of chapter 235, Hawaii Revised Statutes, to provide even greater clarity that a dividend paid by a real estate investment trust is not deductible under section 235-7(c), Hawaii Revised Statutes, which is the codification of the provisions of section 243 of the Internal Revenue Code, the federal dividends received deduction.

Because this Act is a clarification of existing law, this Act shall take effect on approval and apply to all tax years that are open for audit, examination, and assessment and to any tax appeal, case, or controversy pending on its effective date.

SECTION 2. Section 235-7, Hawaii Revised Statutes, is amended by amending subsection (c) to read as follows:

"(c) The deductions of or based on dividends paid or received, allowed to a corporation under chapter 1, subchapter B, Part VIII of the Internal Revenue Code, shall not be allowed. In lieu thereof there shall be allowed as a deduction the entire amount of dividends received by any corporation upon the shares of stock of a national banking association, qualifying dividends, as defined in section 243(b) of the Internal Revenue Code, received by members of an affiliated group, or dividends received by a small business investment company operating under the Small Business Investment Act of 1958 (Public Law 85-699) upon shares of stock qualifying under paragraph (3), seventy per cent of the amount received by any corporation as dividends:

(1) Upon the shares of stock of another corporation, if at the date of payment of the dividend at least ninety-five per cent of the other corporation's capital stock is owned by one or more corporations doing business in

this State and if the other corporation is subjected to an income tax in another jurisdiction (but subjection to federal tax does not constitute subjection to income tax in another jurisdiction);

(2) Upon the shares of stock of a bank or insurance company organized and doing business under the laws of the State;

(3) Upon the shares of stock of another corporation, if at least fifteen per cent of the latter corporation's business, for the taxable year of the latter corporation preceding the payment of the dividend, has been attributed to this State.

However, except for national bank dividends, the deductions under this subsection are not allowed when they would not have been allowed under section 243 of the Internal Revenue Code, as amended by Public Law 85-866, by reason of subsections (b) and (c) of section 246 of the Internal Revenue Code. For the purposes of this subsection fifteen per cent of a corporation's business shall be deemed to have been attributed to this State if fifteen per cent or more of the entire gross income of the corporation as defined in this chapter (which for the purposes of this subsection shall be computed without regard to source in

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the State and shall include income not taxable by reason of the fact that it is from property not owned in the State or from a trade or business not carried on in the State in whole or in part), under section 235-5 and the other provisions of this chapter, shall have been attributed to the State and subjected to assessment of the taxable income therefrom (including the determination of the resulting net loss, if any).

Notwithstanding the foregoing, any dividend received from a real estate investment trust which, for the taxable year of the trust in which the dividend is paid, qualifies under part II of subchapter M (section 856 and following) of the Internal Revenue Code, shall not be treated as a dividend for purposes of this subsection."

SECTION 3. New statutory material is underscored.

SECTION 4. This Act shall take effect upon approval, and shall apply to any tax year that is open for audit, examination, or assessment and to any tax appeal, case, or controversy pending on its effective date.

INTRODUCED BY: Calvin K.Y. Say

BY REQUEST

JAN 22 2007

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JUSTIFICATION SHEET

DEPARTMENT:	Taxation
TITLE:	A BILL FOR AN ACT RELATING TO THE CLARIFICATION OF THE DIVIDENDS RECEIVED DEDUCTION WITH RESPECT TO DIVIDENDS RECEIVED BY REAL ESTATE INVESTMENT TRUSTS.
PURPOSE:	To clarify the application of the deduction for dividends received by a corporation from a Real Estate Investment Trust ("REIT").
MEANS:	Amend section 235-7(c), Hawaii Revised Statutes (HRS).
JUSTIFICATION:	The purpose of this bill is to clarify that, in conformance with federal tax law, the State's deduction for dividends received by a corporation, as provided under section 235-7(c), HRS, is not available if such dividends are received from a REIT. This bill also reaffirms that section 235-7(c), HRS, is a codification of section 243 of the Internal Revenue Code of 1986, as amended, which is the federal provision for the dividends received deduction.

Because REITs are allowed to deduct the amount of dividends it pays to another corporation, both Hawaii and federal law disallow the dividends received deduction when a corporation receives distributions (i.e., dividends) from a REIT. Allowing the dividends received deduction in this instance would permit 70 percent of REIT dividends to entirely escape corporate income taxation.

Impact on the public: Prevents taxpayers from arguing that the dividends received deduction is available when such dividends are received from REITs. Instills confidence in the tax system by promoting equity and fairness.

Impact on the department and other agencies: This measure assists the department in administering the tax laws.

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GENERAL FUND:	None.
OTHER FUNDS:	None.
PPBS PROGRAM DESIGNATION:	TAX 100.
OTHER AFFECTED AGENCIES:	None.
EFFECTIVE DATE:	Upon approval and shall apply to any tax year that is open for audit, examination, or assessment and to any tax appeal, case, or controversy pending on its effective date.