

March 18, 2009

The Honorable Rosalyn H. Baker, Chair

Senate Committee on Commerce
and Consumer Protection
State Capitol, Room 229
Honolulu, Hawaii 96813

RE: H.B. 1598, H.D.1 Relating to Taxation

HEARING: Thursday, March 19, 2009 at 9:00 a.m.

Aloha Chair Baker and Members of the Committee:

I am Craig Hirai, a member of the Subcommittee on Taxation and Finance for the Government Affairs Committee of the Hawai'i Association of REALTORS® ("HAR"), here to testify on behalf of our 9,600 members in Hawai'i. HAR **opposes** H.B. 1598, H.D.1, which taxes a lessor of real property for capital improvements made by a lessee upon the termination of a lease.

HAR would note 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 the **premature demolition or removal of improvements with a remaining useful life** (including affordable residential and commercial units) on properties awaiting redevelopment.

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.



KAMEHAMEHA SCHOOLS

Written Testimony to the Senate Committee On Commerce & Consumer Protection

By: Paul A. Quintiliani, Director
Commercial Assets Division/Endowment

Hearing Date: Thursday, March 19, 2009
9:00 a.m., Conference Room 229

March 19, 2009

To: Senator Rosalyn Baker, Chair
Senator David Ige, Vice Chair
Members of the Committee on Commerce & Consumer Protection

RE: House Bill No. 1598 HD1 Relating to Taxation.

Kamehameha Schools submits the following comments regarding H.B. No. 1598 HD1 (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,

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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.

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 determination of value is equated to the tax assessed value. This is not always a fair representation of the value of the improvements and does not take into account the cost to the landowner to clear or remove these improvements if the property is deemed unusable.

5. The administrative procedures established in this bill are cumbersome.

6. 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.

**HB 1598 HD1
RELATING TO TAXATION**

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

MARCH 19, 2009

Chair Baker and Members of the Senate Committee on Commerce & Consumer Protection:

I am Paul Oshiro, testifying on behalf of Alexander & Baldwin, Inc. (A&B) on HB 1598 HD1, "A BILL FOR AN ACT RELATING TO TAXATION." We respectfully oppose this bill.

This bill includes the value of capital improvements made by a lessee as taxable income to the lessor upon termination of a 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 of the value of capital improvements made by a lessee as taxable income to the lessor upon termination of a lease 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.

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 1598, HD-1

INTRODUCED BY: House Committee on Finance

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 improvements made by lessee on lessor's property) shall not be operable for Hawaii income tax purposes, subject to HRS section _____.

EFFECTIVE DATE: Tax years beginning after December 31, 2008

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, the 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?

Digested 3/17/09

From: ManyaVogrg@aol.com
Sent: Tuesday, March 17, 2009 9:05 AM
To: CPN Testimony
Subject: In Opposition to HB 1598 HD1 & HB 1604

COMMITTEE ON COMMERCE AND CONSUMER PROTECTION
Senator Rosalyn H. Baker, Chair

Senator David Y. Ige, Vice Chair

DATE: Thursday, Mar. 19th, 2009
TIME: 9 a.m.
PLACE: Conference Room 229

Honorable Chairs and Members of the Committees:

**Re: [HB 1598](#) HD 1
RELATING TO TAXATION.**

Taxes a lessor of real property for capital improvements made by a lessee upon the termination of a lease. FIN

&

**Re: [HB 1604](#) ([HSCR864](#))
RELATING TO REAL PROPERTY.**

Imposes a tax upon 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. CPN, WAM

~~~~~  
**Our names are Manya Vogrig and Phyllis Zerbe, and we are testifying on behalf of ourselves and the members of our organizations.**

**We STRONGLY OPPOSE this type of legislation that is the taking and breaking up of our private property under the guise of tax revenues. The "improvements", when they revert back to the landowners, may be a detriment, as 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 and "improvements" on our properties ... which were demolished in order for the lessee to build their "improvements." 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. You would be interfering with our contracts by altering these terms.**

**We trust that you will hold this legislation in order to prevent the taking of private property under the guise of public purpose.**

**Thank you very much!**

**Manya Vogrig**

**T. Phyllis Zerbe**

2877 Kalakaua Ave. #1205  
Honolulu, HI 96815  
Phone: 922-6934

1434 Punahou St.  
Honolulu, HI 96822  
Phone: 949-9998

**For: Small Landowners of Oahu & Small Landowners Association of Hawaii  
(Small Landowners who own land under Condominiums and Co-operatives in the State of  
Hawaii)**

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STAND. COM. REP. NO. 751

Honolulu, Hawaii

March 6, 2009

RE: H.B. No. 1598  
H.D. 1

Honorable Calvin K.Y. Say  
Speaker, House of Representatives  
Twenty-Fifth State Legislature  
Regular Session of 2009  
State of Hawaii

Sir:

Your Committee on Finance, to which was referred H.B. No. 1598 entitled:

"A BILL FOR AN ACT RELATING TO TAXATION,"

begs leave to report as follows:

The purpose of this bill is to provide fairness to lessees who make capital improvements to leased property when the lease is terminated by imposing a tax on lessors for the value of these improvements upon termination of a lease.

Alexander & Baldwin, Inc., testified in opposition to this bill. The Department of Taxation, Tax Foundation of Hawaii, and Hawaii Association of REALTORS® submitted comments.

Your Committee has amended this bill by making technical, nonsubstantive amendments for clarity, consistency, and style.

As affirmed by the record of votes of the members of your Committee on Finance that is attached to this report, your Committee is in accord with the intent and purpose of H.B. No. 1598, as amended herein, and recommends that it pass Second Reading in the form attached hereto as H.B. No. 1598, H.D. 1, and be placed on the calendar for Third Reading.

HB1598 HD1 HSCR FIN HMS 2009-2532



Respectfully submitted on  
behalf of the members of the  
Committee on Finance,

  
MARCUS R. OSHIRO, Chair





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# A BILL FOR AN ACT

RELATING TO TAXATION.

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

1           SECTION 1. Chapter 235, Hawaii Revised Statutes, is  
2 amended by adding a new section to be appropriately designated  
3 and to read as follows:

4           "§235- Taxable income; leased real property. At the  
5 termination of a lease of real property, the value of capital  
6 improvements made by a lessee to the leased real property shall  
7 be taxable under this chapter to the lessor of the property.

8           The department of taxation may adopt rules pursuant to  
9 chapter 91 to effectuate this section."

10          SECTION 2. Section 235-2.3, Hawaii Revised Statutes, is  
11 amended by amending subsection (b) to read as follows:

12          "(b) The following Internal Revenue Code subchapters,  
13 parts of subchapters, sections, subsections, and parts of  
14 subsections shall not be operative for the purposes of this  
15 chapter, unless otherwise provided:

16           (1) Subchapter A (sections 1 to 59A) (with respect to  
17           determination of tax liability), except section

18           1(h)(2) (relating to net capital gain reduced by the



- 1 amount taken into account as investment income),  
2 except sections 2(a), 2(b), and 2(c) (with respect to  
3 the definition of "surviving spouse" and "head of  
4 household"), except section 41 (with respect to the  
5 credit for increasing research activities), except  
6 section 42 (with respect to low-income housing  
7 credit), and except sections 47 and 48, as amended, as  
8 of December 31, 1984 (with respect to certain  
9 depreciable tangible personal property). For  
10 treatment, see sections 235-110.91, 235-110.7, and  
11 235-110.8;
- 12 (2) Section 78 (with respect to dividends received from  
13 certain foreign corporations by domestic corporations  
14 choosing foreign tax credit);
- 15 (3) Section 86 (with respect to social security and tier 1  
16 railroad retirement benefits);
- 17 (4) Section 103 (with respect to interest on state and  
18 local bonds). For treatment, see section 235-7(b);
- 19 (5) Section 109 (with respect to improvements made by  
20 lessee on lessor's property). For treatment, see  
21 section 235- ;



1       ~~[(5)]~~ (6) Section 114 (with respect to extraterritorial  
2       income). For treatment, any transaction as specified  
3       in the transitional rule for 2005 and 2006 as  
4       specified in the American Jobs Creation Act of 2004  
5       section 101(d) and any transaction that has occurred  
6       pursuant to a binding contract as specified in the  
7       American Jobs Creation Act of 2004 section 101(f) are  
8       inoperative;

9       ~~[(6)]~~ (7) Section 120 (with respect to amounts received  
10       under qualified group legal services plans). For  
11       treatment, see section 235-7(a)(9) to (11);

12       ~~[(7)]~~ (8) Section 122 (with respect to certain reduced  
13       uniformed services retirement pay). For treatment,  
14       see section 235-7(a)(3);

15       ~~[(8)]~~ (9) Section 135 (with respect to income from United  
16       States savings bonds used to pay higher education  
17       tuition and fees). For treatment, see section 235-  
18       7(a)(1);

19       ~~[(9)]~~ (10) Subchapter B (sections 141 to 150) (with respect  
20       to tax exemption requirements for state and local  
21       bonds);



- 1     ~~[(+10)]~~ (11) Section 151 (with respect to allowance of  
2             deductions for personal exemptions). For treatment,  
3             see section 235-54;
- 4     ~~[(+11)]~~ (12) Section 179B (with respect to expensing of  
5             capital costs incurred in complying with Environmental  
6             Protection Agency sulphur regulations);
- 7     ~~[(+12)]~~ (13) Section 181 (with respect to special rules for  
8             certain film and television productions);
- 9     ~~[(+13)]~~ (14) Section 196 (with respect to deduction for  
10            certain unused investment credits);
- 11    ~~[(+14)]~~ (15) Section 199 (with respect to the U.S. production  
12            activities deduction);
- 13    ~~[(+15)]~~ (16) Section 222 (with respect to qualified tuition  
14            and related expenses);
- 15    ~~[(+16)]~~ (17) Sections 241 to 247 (with respect to special  
16            deductions for corporations). For treatment, see  
17            section 235-7(c);
- 18    ~~[(+17)]~~ (18) Section 280C (with respect to certain expenses  
19            for which credits are allowable). For treatment, see  
20            section 235-110.91;
- 21    ~~[(+18)]~~ (19) Section 291 (with respect to special rules  
22            relating to corporate preference items);



- 1     ~~[(19)]~~ (20) Section 367 (with respect to foreign  
2            corporations);
- 3     ~~[(20)]~~ (21) Section 501(c)(12), (15), (16) (with respect to  
4            exempt organizations);
- 5     ~~[(21)]~~ (22) Section 515 (with respect to taxes of foreign  
6            countries and possessions of the United States);
- 7     ~~[(22)]~~ (23) Subchapter G (sections 531 to 565) (with respect  
8            to corporations used to avoid income tax on  
9            shareholders);
- 10    ~~[(23)]~~ (24) Subchapter H (sections 581 to 597) (with respect  
11           to banking institutions), except section 584 (with  
12           respect to common trust funds). For treatment, see  
13           chapter 241;
- 14    ~~[(24)]~~ (25) Section 642(a) and (b) (with respect to special  
15           rules for credits and deductions applicable to  
16           trusts). For treatment, see sections 235-54(b) and  
17           235-55;
- 18    ~~[(25)]~~ (26) Section 646 (with respect to tax treatment of  
19           electing Alaska Native settlement trusts);
- 20    ~~[(26)]~~ (27) Section 668 (with respect to interest charge on  
21           accumulation distributions from foreign trusts);



- 1     ~~[(27)]~~ (28) Subchapter L (sections 801 to 848) (with respect  
2             to insurance companies). For treatment, see sections  
3             431:7-202 and 431:7-204;
- 4     ~~[(28)]~~ (29) Section 853 (with respect to foreign tax credit  
5             allowed to shareholders). For treatment, see section  
6             235-55;
- 7     ~~[(29)]~~ (30) Subchapter N (sections 861 to 999) (with respect  
8             to tax based on income from sources within or without  
9             the United States), except sections 985 to 989 (with  
10            respect to foreign currency transactions). For  
11            treatment, see sections 235-4, 235-5, and 235-7(b),  
12            and 235-55;
- 13    ~~[(30)]~~ (31) Section 1042(g) (with respect to sales of stock  
14            in agricultural refiners and processors to eligible  
15            farm cooperatives);
- 16    ~~[(31)]~~ (32) Section 1055 (with respect to redeemable ground  
17            rents);
- 18    ~~[(32)]~~ (33) Section 1057 (with respect to election to treat  
19            transfer to foreign trust, etc., as taxable exchange);
- 20    ~~[(33)]~~ (34) Sections 1291 to 1298 (with respect to treatment  
21            of passive foreign investment companies);



1        [~~34~~] (35) Subchapter Q (sections 1311 to 1351) (with  
2                    respect to readjustment of tax between years and  
3                    special limitations);

4        [~~35~~] (36) Subchapter R (sections 1352 to 1359) (with  
5                    respect to election to determine corporate tax on  
6                    certain international shipping activities using per  
7                    ton rate);

8        [~~36~~] (37) Subchapter U (sections 1391 to 1397F) (with  
9                    respect to designation and treatment of empowerment  
10                   zones, enterprise communities, and rural development  
11                   investment areas). For treatment, see chapter 209E;

12        [~~37~~] (38) Subchapter W (sections 1400 to 1400C) (with  
13                    respect to District of Columbia enterprise zone);

14        [~~38~~] (39) Section 14000 (with respect to education tax  
15                    benefits);

16        [~~39~~] (40) Section 1400P (with respect to housing tax  
17                    benefits);

18        [~~40~~] (41) Section 1400R (with respect to employment  
19                    relief); and

20        [~~41~~] (42) Section 1400T (with respect to special rules for  
21                    mortgage revenue bonds)."



1 SECTION 3. Statutory material to be repealed is bracketed  
2 and stricken. New statutory material is underscored.

3 SECTION 4. This Act shall take effect upon its approval  
4 and shall apply to taxable years beginning after December 31,  
5 2008.



**Report Title:**

Taxable Income; Leasehold property

**Description:**

Taxes a lessor of real property for capital improvements made by a lessee upon the termination of a lease. (HB1598 HD1)

