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**HOUSE COMMITTEE ON FINANCE  
TESTIMONY REGARDING HB 1598  
RELATING TO TAXATION**

**TESTIFIER: KURT KAWAFUCHI, DIRECTOR OF TAXATION (OR DESIGNEE)**

**DATE: FEBRUARY 26, 2009**

**TIME: 11 AM**

**ROOM: 308**

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This measure amends Chapter 235 of the Hawaii Revised Statutes by adding a section, which taxes lessors on the value of improvements made to property by lessees upon the termination of the lease.

The Department of Taxation (Department) **offers comments.**

**NONCONFORMITY WITH INTERNAL REVENUE CODE** - This bill would take Hawaii out of conformity with the Internal Revenue Code with respect to the taxation of capital improvements made by a lessee upon the termination of a lease.

**CREATES A VALUATION ISSUE**—This bill will create a contentious audit issue regarding the fair market value of the property. The Department would need to hire real estate appraisers to handle the issue.

Cognizant of the State's fiscal constraints, the Department recognizes that this bill would generate additional revenue. The amount, however, is indeterminate.

# TAXBILLSERVICE

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TAX FOUNDATION OF HAWAII

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**SUBJECT:** INCOME, Tax value of capital improvements

**BILL NUMBER:** SB 767; HB 1598 (Identical)

**INTRODUCED BY:** SB by Chun Oakland, Sakamoto, and 4 Democrats; HB by Say

**BRIEF SUMMARY:** Adds a new section to HRS chapter 235 to provide 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 taxing capital improvements made by a lessee upon the termination of a lease) shall 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. While the measure also proposes to make IRC section 109 (with respect to taxing capital improvements made by a lessee upon the termination of a lease), this section of the Internal Revenue Code states that "gross income does not include income (other than rent) derived by a lessor or real property on the termination of a lease, representing the value of such property attributable to buildings erected or other improvements made by the lessee." By making this section of the Internal Revenue Code operable for Hawaii income tax purposes, the new section added to HRS chapter will not take effect.

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.

Digested 2/24/09

**HB 1598  
RELATING TO TAXATION**

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

**FEBRUARY 26, 2009**

Chair Marcus Oshiro and Members of the House Committee on Finance:

I am Paul Oshiro, testifying on behalf of Alexander & Baldwin, Inc. (A&B) on HB 1598, "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.



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February 25, 2009

**The Honorable Marcus R. Oshiro, Chair**  
House Committee on Finance  
State Capitol, Room 308  
Honolulu, Hawaii 96813

**RE: H.B. 1598 Relating to Taxation**

**HEARING DATE:** Thursday, February 26, 2009 at 10:00 a.m.

Aloha Chair Oshiro and Members of the Committee on Finance:

I am Craig Hirai, a member of the Subcommittee on Taxation and Finance of the Government Affairs Committee of the Hawai'i Association of REALTORS® ("HAR"), here to testify on behalf of the HAR and its 9,600 members in Hawai'i. HAR has the following **comments** with respect to H.B. 1598, Relating to Taxation, 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.