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HOUSE COMMITTEE ON WATER, LAND & OCEAN RESOURCES

TESTIMONY OF THE DEPARTMENT OF TAXATION REGARDING HB 1408 RELATING TO A CONTROLLING INTEREST TRANSFER TAX

TESTIFIER: FREDERICK D. PABLO, INTERIM DIRECTOR OF
 TAXATION (OR DESIGNEE)

COMMITTEE: WLO

DATE: FEBRUARY 14, 2011

TIME: 9AM

POSITION: SUPPORT INTENT

This bill proposes a new controlling interest transfer tax to capture the tax on the sale of stock in entities that own Hawaii real property.

The Department of Taxation (Department) **supports the intent of capturing the tax lost due to complex tax advantaged deal structuring.**

SUPPORT FOR MINIMIZING THE TAX LOSS FROM STRUCTURING—
The intent of this legislation appears to close the "loophole" that is perceived in the taxation of real property transfers where the stock in the entity that owns the property is sold and not the property itself. Though there is nothing inherently wrong with this structuring, it can result in the loss of tax revenue, specifically conveyance tax. The Department supports legislation to capture the proper amount of tax that, in reality and looking through structuring, should be paid for the sale of real property.

SIMPLY MODIFY CURRENT CONVEYANCE TAX—The Department suggests that, rather than an entirely new tax chapter, simply make an amendment to the conveyance tax chapter. The Department is also concerned that the complexity of these new provisions would be difficult to administer.

February 12, 2011

The Honorable Jerry L. Chang, Chair
House Committee on Water, Land, & Ocean Resources
State Capitol, Room 325
Honolulu, Hawaii 96813

RE: H.B. 1408, Relating to a Controlling Interest Transfer Tax

HEARING: Monday, February 14, 2011 at 9:00 a.m.

Aloha Chair Chang, Vice Chair Har and members of the Committee:

I am Craig Hirai, Chair of the Subcommittee on Affordable Housing, here to testify on behalf of the Hawai'i Association of REALTORS® ("HAR"), the voice of real estate in Hawai'i, and its 8,500 members. HAR would like to make the following **comments** with respect to H.B. 1408, Relating to a Controlling Interest Transfer Tax, which establishes a new Controlling Interest Transfer Tax imposed at the rate set under the Conveyance Tax, to be administered by the Director of Taxation on any transfer of interest of more than 50% in an entity holding real property in the State of Hawaii.

HAR believes that the transfer of control of a business entity is comparable to the sale of an interest in the real property held by the entity. HAR further believes that all transfers of possession or use of real property in Hawaii should be subject to the same Conveyance Tax obligations, and that the burden of the Hawaii Conveyance Tax currently falls primarily on smaller Hawaii business and property owners and Hawaii homeowners who generally convey title to real property itself and not controlling interests in entities that own Hawaii real property.

HAR would note, however, that your committee is also hearing H.B. 1180, Relating to Taxation, today, and that: (a) the transfer of a controlling interest under H.B. 1180 is subject to the Conveyance Tax which among other things supports the Rental Housing Trust Fund; and (b) the conveyance of real property interests between certain controlling and controlled entities under H.B. 1180 will be subject to Conveyance Tax at the lowest rate. **If you are going to pass one of these two bills, HAR would therefore prefer that you pass H.B. 1180.**

Mahalo for the opportunity to comment on this bill.

TAXBILLSERVICE

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SUBJECT: CONVEYANCE, MISCELLANEOUS, Controlling interest transfer tax

BILL NUMBER: HB 1408

INTRODUCED BY: Say

BRIEF SUMMARY: Adds a new chapter to HRS to provide for the imposition of a tax on the sale or transfer for consideration of a controlling interest in any limited liability company which possesses any interest in real property when the present true and actual value of the interest in real property equals or exceeds \$2,000 and when: (1) the transfer of a controlling interest is made by a seller or transferor or by a group of sellers or transferors acting in concert; provided that sellers or transferors who are related to each other by blood or marriage are presumed, unless shown to the contrary, to be acting in concert; (2) the controlling interest in an entity transfers real property to a transferee or to a group of transferees acting in concert; provided that: (a) where transferees are related and one influences or controls the actions of another (such as parent and subsidiary corporations, parents and children, husbands and wives, etc.), the transferees shall be presumed to be acting in concert; and (b) where transferees have negotiated and will consummate their purchase of ownership interests in unity (such as transfers that are closely related in time, transferees that are few in number, or purchase contracts that contain mutual terms, and agreements among transferees binding them to a course of action with respect to the transfers, etc.), the transferees shall be presumed to be acting in concert.

The tax shall be imposed on the present true and actual value of the interest in real property transferred at the rates delineated in the measure that are identical to the rates set forth in HRS section 247-2. The tax shall be payable by the limited liability company selling or transferring the controlling interest, or as designated by the director pursuant to rule. If the entity owns less than 100% interest in the real estate, the tax shall be based on the actual percentage of ownership with no further discounts on account of minority ownership.

A taxable sale or transfer of a controlling interest may occur in one transaction or in a series of transactions; provided that transactions that occur within six months of each other are presumed to be a series of transactions.

Stipulates that the controlling interest transfer tax shall not be applicable to: (1) any sale or transfer of a controlling interest to the extent that the limited liability company possesses, directly or indirectly, an interest in real property located in an area of any county designated as an enterprise zone; or (2) any sale or transfer of a controlling interest in any entity to effectuate a change of identity or form of ownership or organization where there is no change in beneficial ownership.

EFFECTIVE DATE: Tax years beginning after December 31, 2010

STAFF COMMENTS: The proposed measure would create a controlling interest transfer tax subject to the rates identical to the conveyance tax rates to ensure that "complex transactions" involving the transfer of

real property in the state are taxed, even though they are not currently taxable under the conveyance tax as the real property is owned by a legal entity like a corporation or partnership. While it is the intent of the measure to close this loophole, it should be noted that the current conveyance tax was never established to be a source of revenue. Only in recent years as lawmakers sought to fund their favorite programs did the conveyance tax come under fire as a way to raise new sources of revenue to fund favored programs. With rates as high as \$1.25 per hundred dollars of value transferred, lawmakers now believe that transfers of real property, albeit as part of the acquisition of a company or partnership, are an intentional evasion of the tax. Thus, it is not hard to believe that the proposed modest rate will mushroom in a few years as the imposition of this new tax will be viewed as another way to raise additional revenue.

Unfortunately, this new tax will add another nail in the economic coffin of Hawaii as it is just one more cost that an investor must weigh in deciding whether or not the return on an investment in Hawaii is attractive or reasonable.

It should be remembered that the conveyance tax was initially enacted by the 1966 legislature after the repeal of the federal law requiring stamps for transfers of real property. It was enacted for the sole purpose of providing the department of taxation with additional data for the determination of market value of properties transferred. This information was also to assist the department in establishing real property assessed values and at that time the department stated that the conveyance tax was not intended to be a revenue raising device. The conveyance tax is imposed each time property changes title or ownership. However, over the years the tax has been increased and conveyance tax revenues have been tapped to provide revenue for the land conservation fund, rental housing trust fund, and the natural area reserve fund. If the proposed controlling interest transfer tax becomes enacted, there may be temptation to extract additional revenue from the new tax by increasing the tax rate in subsequent years. Once a tax has become planted and begins to sprout new tax revenue, such a tax will be difficult to repeal or eliminate.

While this proposal tries to address what looks like a sale of an entity or organization that has as part of its portfolio real property in Hawaii, there are other ways of transferring a company and the transfer of the controlling interest of such an entity can be effected without the appearance that the organization or entity is being sold or transferred.

This proposal would increase the cost of affordable housing that is developed by a partnership or joint venture of a for-profit entity and a not-for-profit entity. The partnership may have been created out of necessity where a for-profit developer brings the expertise and the ability to market various government subsidies while the nonprofit partner is able to secure the public subsidies like foundation and federal grants or in the case of low-income housing tax credits which the for-profit can then market to investors to raise the necessary capital to construct the project. When the compliance period expires, the for-profit may want to exit the partnership transferring its ownership to the nonprofit. Under this proposal there would be the imposition of the conveyance tax which then would add to the cost of the nonprofit taking on the for-profit's title to the real property. The bottom line is that this added cost will be passed on to the low-income tenants renting the affordable housing. This appears to be one of the unintended consequences of this proposal.