NEIL ABERCROMBIE
GOVERNOR

SHAN TSUTSUI
LT. GOVERNOR

FREDERICK D. PABLO
DIRECTOR OF TAXATION

JOSHUA WISCH
DEPUTY DIRECTOR

STATE OF HAWAII
DEPARTMENT OF TAXATION
P.O. BOX 259
HONOLULU, HAWAII 96809
PHONE NO: (808) 587-1540
FAX NO: (808) 587-1560

To: The Honorable Cliff Tsuji, Chair
and Members of the House Committee on Economic Development & Business

Date: Tuesday, February 4, 2014
Time: 8:30 a.m.
Place: Conference Room 312, State Capitol

From: Frederick D. Pablo, Director
Department of Taxation

Re: H.B. No. 2186 Relating to Real Estate Investment Trusts

The Department of Taxation (Department) offers the following comments on H.B. 2168 for the Committee's consideration.

H.B. 2186 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, 2014.

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 Internal Revenue Code 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 making IRC section 857(b)(2)(B) not operative under Hawaii income tax law.

The Department notes that the effective dates are not consistent. If the intent of the measure is to be effective for taxable years beginning after December 31, 2014 as stated in Section 4, the following bolded amendments to Section 2 are suggested:

> (d) In the case of a real estate investment trust there is imposed on the taxable income, computed as provided in sections 857 and 858 of the Internal Revenue Code but with the changes and adjustments made by this chapter (without prejudice to the generality of the foregoing, for taxable years beginning before

January 1, 2015, the deduction for dividends paid is limited to such amount of dividends as is attributable to income taxable under this chapter), for taxable years beginning after **December 31, 2014**, no deduction for dividends paid shall be allowed, a tax consisting in the sum of the following: 4.4 per cent if the taxable income is not over $25,000, 5.4 per cent if over $25,000 but not over $100,000, and on all over $100,000, 6.4 per cent.

Thank you for the opportunity to provide comments.

SUBJECT: INCOME, Real estate investment trusts

BILL NUMBER: HB 2186

INTRODUCED BY: Luke, Aquino, Awana, Belatti, Brower, Cachola, Choy, Cullen, Evans, Hanohano, Hashem, Ing, Jordan, Kawakami, Kobayashi, C. Lee, Lowen, Nakashima, Nishimoto, Ohno, Rhoads, Saiki, Takai, Ward, Woodson, and Yamane

BRIEF SUMMARY: Amends HRS section 2.3(b) to provide that section 857(b)(2)(B) (with respect to the dividends paid deduction for real estate investment trusts) shall not be operative for Hawaii income tax purposes.

Amends HRS section 235-71(d) to provide that for tax years beginning after December 31, 2013, no deduction for dividends paid shall be allowed for real estate investment trusts in the state.

EFFECTIVE DATE: Tax years beginning after December 31, 2014

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. The proposed measure would make that section of the IRC inoperative for Hawaii income tax purposes for tax years beginning after December 31, 2013, meaning that REITs would be subject to double taxation similar to other corporations.

This measure runs counter to Hawaii's intent to conform federal income tax law for simplicity and ease of compliance, as expressed in HRS section 235-3.

Perhaps 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 case, it may be worth studying the issue to see how other states have dealt with it.

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 2/3/14

Michael J. Fergus

125 MERCHANT STREET, SUITE 200
HONOLULU, HAWAII 96813
TELEPHONE (808) 545-1700
FAX (808) 545-1788

February 4, 2014, 8:30 a.m., Conference Room 312

TO: House Committee on Economic Development and Business
Rep. Clift Tsuji, Chair
Rep. Gene Ward, Vice Chair

FROM: Michael J. Fergus

RE: In Support of HB2186, Relating to Real Estate Investment Trusts

Members of the Committee on Economic Development and Business:

I strongly support HB 2186 which will eliminate the tax deductibility of dividends for REITs. Only REITs have been allowed to deduct dividends paid in determining their taxable income and the result is that they pay no state income tax. It was the intention of the REIT law that the tax will be paid at the shareholder level but 99%+ of the shareholders live on the mainland so Hawaii never gets its share of the income tax generated by these companies. REITs pay general excise tax, conveyance tax and real property taxes in Hawaii, but in the case of the retail, office and industrial properties, 100% of those taxes are passed on to the REITs' overburdened tenants; so the REITs effectively pay no tax in Hawaii. Why should we give out-of-state investors a tax break that we don't give to our own tax paying citizen investors?

REITs own a great amount of property in Hawaii; all the land in Mapunapuna and large amounts of land at Sand Island and Campbell Industrial Park are owned by REITs. Ala Moana and Pearlridge Shopping Centers are owned by REITs. The majority of downtown class A office space is owned by REITs, as well as a great number of hotels in Waikiki and the neighbor islands. Even Wal Mart and some of the other big retailers have set up REITs that will own their store buildings. They then rent the buildings to the operating businesses at high rents and effectively move their store operating earnings out of Hawaii.

It is clear that the REIT dividend deduction is eroding our tax base significantly. Please support the passage of this bill.

Thank you.