DAVID Y. IGE
GOVERNOR

DENISE ISERI-MATSUBARA
INTERIM EXECUTIVE DIRECTOR

STATE OF HAWAII
DEPARTMENT OF BUSINESS, ECONOMIC DEVELOPMENT AND TOURISM
HAWAII HOUSING FINANCE AND DEVELOPMENT CORPORATION
677 QUEEN STREET, SUITE 300
Honolulu, Hawaii 96813
FAX: (808) 587-0600

IN REPLY REFER TO:

Statement of
DENISE ISERI-MATSUBARA
Hawaii Housing Finance and Development Corporation
Before the

SENATE COMMITTEE ON HOUSING
January 28, 2020 at 1:30 p.m.
State Capitol, Room 225

In consideration of
S.B. 2409 RELATING TO DOWN PAYMENTS.

The HHFDC ***opposes*** S.B. 2409, because it discriminates against potential participants on the basis of their residency. The bill creates a new program in Chapter 201H, HRS, to provide returning residents meeting specific eligibility criteria with dollar-for-dollar matches up to a maximum of 10 percent of the value of the single-family residence being purchased, or $50,000 to assist with down payments on the purchase of a primary residence.

To be eligible, applicants must have (1) earned a high school diploma from a school located in Hawaii, (2) left the State to attend a four-year undergraduate degree at an accredited college or university, and (3) purchase a single-family residence to be used as a primary residence for a minimum of two years. The down payment assistance would be provided by a newly-created special fund funded in part by a new tax imposed on real estate investment trusts.

HHFDC is concerned that the creation of a government grant program that discriminates against potential participants on the basis of their residency may be unconstitutional. We also note that the bill's reference to §521-8, HRS limits the availability of this grant program to those who purchase a single-family residence only and precludes other dwellings such as a condominium unit in a high-rise structure. Finally, HHFDC does not have the current capacity to administer the returning resident down payment program and will require additional staffing and funding.

HHFDC does not take any position on the new taxes imposed in this bill.

Thank you for the opportunity to testify.

DAVID Y. IGE
GOVERNOR

JOSH GREEN M.D.
LT. GOVERNOR

RONA M. SUZUKI
DIRECTOR OF TAXATION

DAMIEN A. ELEFANTE
DEPUTY DIRECTOR

STATE OF HAWAII
DEPARTMENT OF TAXATION
P.O. BOX 259
HONOLULU, HAWAII 96809
Phone: (808) 587-1540 / Fax: (808) 587-1560
Email: Tax.Directors.Office@hawaii.gov

To: The Honorable Stanley Chang, Chair;
The Honorable Dru Mamo Kanuha, Vice Chair;
and Members of the Senate Committee on Housing

From: Rona M. Suzuki, Director
Department of Taxation

Re: **S.B. 2409, Relating to Taxation**
Date: Tuesday, January 28, 2020
Time: 1:30 P.M.
Place: Conference Room 225, State Capitol

The Department of Taxation (Department) has concerns about the constitutionality of and its ability to administer S.B. 2409.

S.B. 2409 establishes a returning resident down payment program to aid returning residents in purchasing housing. To fund this program, S.B. 2409 requires real estate investment trusts (REITs) to withhold 5% of each shareholder's pro rata share of income attributable to Hawaii. The proceeds of this withholding are deposited into the program's special fund. S.B. 2409 also requires extensive information reporting by REITs on each of its shareholder.

S.B. 2409 also repeals the dividend paid deduction REITs are allowed by current law. This will subject REITs' income to the Hawaii corporate income tax at the corporate level, in the same manner as other corporations. The measure is effective July 1, 2020 and applies to taxable years beginning after December 31, 2020.

The Department offers the following comments for the Committee's consideration:

1. Section 6 requires withholding on REIT shareholders is administratively problematic. The provision makes every REIT shareholder a separate taxpayer for Hawaii income tax purposes. If the intent is to impose tax on REITs, then the repeal of the dividends paid deduction as proposed in Section 7 of this bill is a simpler and more efficient method of doing so.

2. The general rule as to the situs of invisible and intangible personal property (notes, bonds, etc.) is that it follows the domicile of the owner, and it is held to be taxable at such domicile [See *Frick v. Pennsylvania*, 268 U.S. 473 (1925)]. Thus, changing the sourcing of a specific subset of intangible income as this bill proposes may have unintended consequences and goes against the general sourcing of intangible income. One unintended consequence is that if the REIT shareholder is domiciled in a state with an income tax, the dividends that these shareholders receive will be subject to income tax in Hawaii as well as the state of domicile.

California, New York, Colorado, and Hawaii do not allow a credit for taxes paid to another jurisdiction for income tax imposed on dividends.

3. The withholding provisions of S.B. 2409 are not borne solely by the REIT. The bill clearly states the proposed tax is that of the shareholders and is paid on behalf of the shareholders. This imposition on REIT shareholders who have no connection to Hawaii other than their ownership of shares in a REIT that operates in Hawaii may be problematic under the due process clause of the United States Constitution; the constitutionality of this provision deserves further scrutiny.

4. Sections 7 and 8 change the dividends paid deduction, but seem to conflict. Section 7 repeals the dividends paid exemption with the exception of low-income housing whereas Section 8 repeals the dividends paid deduction altogether. This conflict needs to be addressed.

5. By repealing the dividend paid deduction, REITs will be treated the same as other corporation, thus, the withholding provision is not necessary and would actually go beyond the REIT's full share of tax as stated in the measure's purpose clause. Hawaii does not tax any other dividends in this manner. In addition, the burden and inefficiencies caused by the withholding provision of this measure do not seem to outweigh the benefit as the dividends paid by REITs will be significantly less if the dividends paid deduction is repealed.

Thank you for the opportunity to provide comments.

LEGISLATIVE TAX BILL SERVICE

TAX FOUNDATION OF HAWAII

126 Queen Street, Suite 304 Honolulu, Hawaii 96813 Tel. 536-4587

SUBJECT: NET INCOME, Disallow REIT Dividends Paid Deduction, Withhold on Dividends Paid, Establish Returning Resident Down Payment Program

BILL NUMBER: SB 2409

INTRODUCED BY: FEVELLA, J. Keohokalole, Kim, Shimabukuro

EXECUTIVE SUMMARY: Encourages certain former Hawaii residents to move back to Hawaii by establishing the returning resident down payment program to provide matching funds for the down payment on a residence. Funds the program with taxes on dividends paid by real estate investment trusts. Repeals dividend paid deduction for real estate investment trusts. We have concerns that the program discriminates against interstate commerce.

SYNOPSIS: **Returning resident down payment program.** Adds two new sections to HRS chapter 201H to establish the returning resident down payment program and an associated special fund. The program is to award matching grants to those who: (1) have earned a high school diploma from a high school located in the State; (2) have ceased residency in the State for the purpose of attending a four-year course of study leading to a baccalaureate degree at a college or university accredited by the United States Department of Education or similar entity; (3) use the award to make a down payment for the purchase of a single family residence; and (4) use the purchased property as a primary residence for not less than two years from the date of purchase.

The special fund out of which the grants are awarded is funded by taxes collected under the REIT provisions described below.

REIT Dividend Withholding. Adds a new section to chapter 235, HRS, that establishes a withholding regime for REITs like that already in place for S corporations under section 235-122, HRS.

Requires each REIT shareholder receiving a dividend from the REIT to recognize a pro rata share of income attributable to the State and the pro rata share of income not attributable to the State, to the extent modified under Hawaii income tax law, under rules similar to those in section 235-122(c), HRS.

Requires any REIT to file information returns reporting shareholder level data.

Requires any REIT to withhold and pay to this State, on behalf of any shareholder, an amount equal to 5% multiplied by the amount of the shareholder's pro rata share of the income attributable to the State, as reflected on the real estate investment trust's return for the taxable period. A real estate investment trust shall be entitled to recover a payment made pursuant to this subsection from the shareholder on whose behalf the payment was made. The amount withheld shall be the minimum tax due to Hawaii by each real estate investment trust shareholder

on their Hawaii source income. A shareholder that is not otherwise required to file Hawaii tax returns need not file a Hawaii return to report the income received and tax paid. Any shareholder that is tax exempt under federal income tax law shall not be liable for the minimum tax on their REIT income and may file a claim for refund for the amount withheld.

Provides that any amount withheld and paid by the REIT to the State shall be considered to be a payment by the shareholder on account of the income tax imposed on the shareholder for the taxable period.

Provides that any officer of any REIT who willfully fails to provide any information, file any return or agreement, or make any payment as required shall be guilty of a misdemeanor.

Disallow Dividends Paid Deduction. Amends HRS section 235-2.3(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, provided that the deduction shall remain available for dividends generated from trust-owned housing that is affordable to households with incomes at or below one hundred per cent of the median family income, as determined by the United States Department of Housing and Urban Development.

Amends HRS section 235-71(d) to provide that for tax years beginning after December 31, 2020, no deduction for dividends paid shall be allowed for REITs for Hawaii income tax purposes.

EFFECTIVE DATE: July 1, 2020 and shall apply to taxable years beginning after December 31, 2020.

STAFF COMMENTS: **Returning resident down payment program.** We have concerns that a tax-funded program such as the one proposed here will violate the U.S. Constitution's prohibition on discrimination against interstate commerce because of the requirement that the applicant have graduated from high school in Hawaii.

The Commerce Clause of the U.S. Constitution informs analysis of taxes affecting business such as the General Excise Tax, *In re Hawaiian Flour Mills, Inc.,* 76 Haw. 1, 868 P.2d 419 (1994), and the Liquor Tax, *Bacchus Imports, Ltd v. Dias,* 468 U.S. 263 (1984).

Complete Auto Transit, Inc. v. Brady, 430 U.S. 274 (1977), which the Hawaii Supreme Court also follows when evaluating Commerce Clause tax issues, *In re Baker & Taylor, Inc.,* 103 Haw. 359, 82 P.3d 804 (2004), establishes that a state tax must pass a four-part test to survive scrutiny under the Commerce Clause:

1. The taxed activity has a substantial nexus to the taxing state;
2. The tax is fairly apportioned to activity in the state;
3. The tax does not discriminate against interstate commerce; and

4. The tax is fairly related to services provided by the state.

Bacchus Imports, Ltd v. Dias, 468 U.S. 263 (1984), called it a "cardinal rule of Commerce Clause jurisprudence" that "[n]o State, consistent with the Commerce Clause, may 'impose a tax which discriminates against interstate commerce … by providing a direct commercial advantage to local business." *Id.* at 268 (quoting *Boston Stock Exchange v. State Tax Commission,* 429 U.S. 318, 320 (1977)).

In *Bacchus,* the taxing statute facially discriminated against interstate commerce. *Bacchus* invalidated an exemption from Hawaii Liquor Tax on sales of locally produced okolehao and fruit wine. The bill before this Committee provides a grant to applicants for a down payment on a home but the applicant needs to have graduated from a high school in Hawaii. Thus, the bill gives a commercial advantage to local high school graduates applying for a loan over other people applying for a loan. This could be seen as facial discrimination against interstate commerce. For that reason, the bill should be carefully analyzed for compliance with this constitutional provision if it is to move forward.

REIT Dividend Withholding. Currently under federal and state income tax law, a 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. This is similar to the one level of tax imposed on owners of S corporations in lieu of taxing the S corporation at the corporate level.

All state income tax systems in the United States, including ours, have a set of rules that are used to figure out which state has the primary right to tax income. For example, most tax systems say that rent from real property is sourced at the location of the property, so if a couple in Florida rents out a property they own on Maui they can expect to pay our GET and our net income tax on that rent. These sourcing rules, which do vary by state but are relatively consistent across state lines, are there to assure consistent and fair treatment between states.

Real estate investment trusts (REITs) are source shifters. For income tax purposes, they take in rent income, which is sourced to the location of the property being rented. They don't pay income tax on that income as long as they distribute the money to their shareholders as dividends. The dividend income of their shareholders, on the other hand, is generally sourced to the residence of the shareholders. So, the income that the property states expected to tax is instead taxed in the states in which the shareholders live. Source shifting is an issue specific to state taxation.

Apparently, the evil sought to be addressed by the bill, which is apparently based on SB 675 (2019), is that REITs do substantial business in Hawaii, but do not get taxed because of the deduction allowed for dividends paid, while many REIT owners who receive the dividend income are either outside of Hawaii and don't get taxed either because they are outside of Hawaii, or are exempt organizations that normally are not taxed on their dividend income. Normally we like to have our income tax law conform to the Internal Revenue Code to

make it easier for people and companies to comply with it, but our legislature has departed from conformity when there's a good reason to do so (such as if it is costing us too much money). The issue is whether such a good reason exists here.

REITs do pay general excise and property taxes on rents received and property owned – as do the rest of us who are fortunate enough to have rental income or property to our name.

Disallow Dividends Paid Deduction. This proposal, apparently based on SB 301 (2019), addresses the issues discussed in the preceding section by disallowing the dividends paid deduction and then taxing the REIT on the resulting taxable income as if it were a regular C corporation.

Digested 1/27/2020

WRITTEN TESTIMONY OF

JEFFREY S. CLARK
SVP-TAX & RISK MANAGEMENT
HOST HOTELS & RESORTS, INC.

IN OPPOSITION TO SB 2409

BEFORE THE HAWAII SENATE
COMMITTEE ON HOUSING

THE HONORABLE STANLEY CHANG, CHAIR
THE HONORABLE DRU MAMO KANUHA, VICE CHAIR

HEARING ON SB 2409
JANUARY 28, 2020
1:30 P.M.

Thank you for the opportunity to submit this testimony in opposition to SB 2409 on behalf of Host Hotels & Resorts, Inc. (Host). Host is the largest lodging real estate investment trust (REIT) and one of the largest owners of luxury and upper-upscale hotels. The Company is headquartered in Bethesda, Maryland and is traded on the New York Stock Exchange. Host owns 80 hotels throughout the U.S., Canada and Brazil, including four hotels in Hawaii. Host strongly opposes, and asks you to hold, SB 2409.

Host agrees with the discussion points included in the testimony of Nareit in opposition to SB 2409 regarding the manner in which the bill's withholding and information provisions are unworkable and, if enacted, the State would lose revenue on a net basis and how it would cause REITs to invest more in other states since these other states do not have such anti-REIT provisions.

In addition, Host would like to emphasize that the federal tax law requirements of a hotel REIT like Host lead to the doubling or tripling of the liability for Hawaii general excise tax (GET) as compared with non-REIT hotel owners.

REITs are subject to federal income tax law requirements that do not apply to other forms of property owners. As relevant here, at least 75% of the annual gross income of a REIT must consist of "rents". Hotel room charges are not considered to be "rents" for this purpose. As a result, federal income tax law requires hotel REITs to:

- Lease their hotels to a third party or to a taxable subsidiary of the REIT, and
- If leased to a taxable subsidiary of the REIT, the subsidiary must hire an independent third party operator to operate and manage the hotel.

Again, these requirements do not apply to non-REIT hotel owners.

Hawaii imposes GET not only on the room charges and other hotel operating income earned by the hotel from guests, but also on the rent received by the REIT from the taxable subsidiary and on the management fee paid to the operator by the taxable subsidiary. Again, this additional GET is not imposed on a non-REIT hotel owner. As a result, GET is imposed on at least three levels of income of a hotel owned in a REIT structure: the room charges and other operating income received from guests, the rent received by the REIT from the taxable subsidiary, and the management fee paid by the taxable subsidiary to the hotel operator.

For example, Host leases its four hotels in Hawaii, the Fairmont Kea Lani on Maui, the Hyatt Regency Maui Resort & Spa, the Andaz Maui, and the Hyatt Place Waikiki Beach to a taxable subsidiary, and the taxable subsidiary hires independent third party operators (Fairmont and Hyatt) to operate and manage its four hotels. The **additional annual GET liability of approximately $6-$8 million** paid to Hawaii for each of 2017, 2018, and 2019 attributable to the rents received by the REIT from the taxable subsidiary and the management fees paid by the taxable subsidiary to Fairmont and Hyatt would not have been paid if the same entity were both the owner and the operator of the hotels. Because the GET is a gross receipts, rather than a net income, tax, it is a much more reliable source of revenue for the State. It also is a much greater source of revenue to the State than the corporate income tax. The enactment of SB 2409 immediately would risk elimination of this extremely valuable source of GET revenue to the State.

Because of these unique requirements applicable to hotel REITs, the State received more than $16 million of GET in 2018 alone from hotel REITs that own hotels in Hawaii that non-REIT hotel owners do not incur. Yet the proponents of SB 2409 claim that we operate tax-free in Hawaii!

Why own hotels in a REIT structure if it results in more aggregate tax than a non-REIT hotel owner-operator? The simple answer is that the ownership of hotels on the one hand and operating and managing

the hotels on the other hand require different knowledge, experience, and expertise and separating the hotel ownership from the hotel operations and management creates more value both for the investors in the REIT and the investors in the hotel operator/manager. As an additional benefit, this separation of ownership and operations/management also creates millions of dollars of tax revenues to, and many jobs, in, this State. This creates a win-win situation, all of which immediately could be jeopardized by the enactment of SB 2409. However, if SB 2409 is enacted, lodging REITs like Host would need to evaluate whether or not to retain their current ownership structure or to change it in order to offset the State corporate income taxes that the legislation would impose.

The estimate of $16 million of incremental GET generated by hotel REITs which could be eliminated if the hotel ownership were changed to a REIT's taxable subsidiary or another non-REIT owner rather than the REIT itself should be compared to the Department of Taxation's 2019 determination that repealing a REIT's dividends paid deduction would raise no more than $10 million per year. Then-Director of DoTax explained on a Hawaii Public Radio interview on April 4, 2019 (beginning at 10:10 in the recording), regarding similar legislation, that even this maximum amount does not contemplate basic planning opportunities that could be employed such as increased leverage or claiming tax credits to which a taxpayer already is entitled and that other non-REITs claim. It makes little sense to jeopardize jobs by scaring off needed investment in Hawaii, especially when the net result (even apart from the macroeconomic losses due to less investment in Hawaii) in terms of both corporate income taxes and GET is a LOSS to Hawaii.

As previously stated, Host Hotels & Resorts, Inc. currently owns four hotels in Hawaii, Hyatt Regency Maui on Kaanapali Beach, Andaz Maui at Wailea Resort, Fairmont Kea Lani, Maui and Hyatt Place Waikiki Beach. A key part of our disciplined approach to capital allocation is to make renewal and replacement capital expenditures that maintain the quality and competitiveness of our hotels. Enactment of SB 2409 would create a strong disincentive for us to employ this approach at our hotels in Hawaii. It would force us to revisit our plans to begin major renovation work at the Fairmont Kea Lani scheduled for 2021, discontinue our ground-up new construction of luxury villas at the Andaz Maui, as well as serve to discourage future investments in our hotels, potentially affecting hundreds of local jobs.

Accordingly, Host respectfully asks the Committee to hold SB 2409.

INVESTMENT COMPANY INSTITUTE

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202/326-5800 www.ici.org

January 27, 2020

The Honorable Stanley Chang
Chair, Hawaii Senate Committee on Housing
415 S Beretania St.
Honolulu, HI 96813

RE: *Fund Industry Opposes S.B. No. 2409*

Dear Chairman Chang and Members of the Senate Committee on Housing:

The Investment Company Institute[1] continues to oppose legislation that would require real estate investment trusts (REITs) to withhold and pay on behalf of their shareholders a five-percent tax on income attributable to Hawaii and file annual returns with shareholder identification information. The numerous issues that we identified in our opposition letter to S.B. No. 675, dated February 4, 2019,[2] are not addressed in S.B. No. 2409.

The ICI opposes S.B. No. 2409 because of its negative impact on shareholders in mutual funds that invest in REITs. The ICI's members, structured to provide average investors with a pooled vehicle for securities investing, own approximately 44 percent of listed REIT shares. The funds' investors are not wealthy. The typical mutual fund shareholder is a middle-class American with a median household income of $100,000 and modest holdings.[3]

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[1] The Investment Company Institute (ICI) is the leading association representing regulated funds globally, including mutual funds, exchange-traded funds (ETFs), closed-end funds, and unit investment trusts (UITs) in the United States, and similar funds offered to investors in jurisdictions worldwide. ICI seeks to encourage adherence to high ethical standards, promote public understanding, and otherwise advance the interests of funds, their shareholders, directors, and advisers. ICI's members manage total assets of US$24.7 trillion in the United States, serving more than 100 million US shareholders, and US$7.0 trillion in assets in other jurisdictions. ICI carries out its international work through ICI Global, with offices in London, Hong Kong, and Washington, DC.

[2] *See* Investment Company Institute "*Fund Industry Opposes S.B. No. 675"* letter to The Honorable Donovan M. Dela Cruz, dated February 4, 2019, and *"Fund Industry Opposes S.B. No. 3067"* letter to The Honorable Donovan M. Dela Cruz, dated February 14, 2018.

[3] The most recent ICI data show median mutual fund assets of $150,000 per household in four accounts. https://www.icifactbook.org/ch7/19_fb_ch7, Figure 7.2.

The proposed shareholder information return and withholding requirement, as explained below, is not administrable and would lead to over-withholding and potential double taxation on mutual fund shareholders.

Specifically:

- **REITs cannot report accurate information regarding their individual investors**
- **Over-withholding would occur**
- **Fund investors would be harmed even IF over-withholding did not occur**
- **IRS Form 1099-DIV is not available to report withholding taxes imposed on the mutual fund**

Why would these effects occur?

- REITs do not have access to the shareholder information needed to comply with the proposal's reporting requirement.
- Because REITs cannot calculate precisely—at the time each distribution is made—the portion attributable to income, gain, or return of capital, REITs can be expected to withhold on the entire amount of their distributions.
- Because mutual funds are not permitted by the Internal Revenue Code to "pass through" to their shareholders any state taxes paid by the funds, fund shareholders would not be able to claim a credit against their own state tax liability for any taxes paid by the funds to Hawaii.

REITs Cannot Report Information Regarding Their Individual Investors

REIT investor information typically is known only to the financial intermediary (*e.g.*, broker) through which shares of REITs that are publicly traded on stock exchanges are acquired.[4] These shares are registered in the name of the broker holding the shares for its customers in a "street name" or "nominee" account. Brokers historically established street name accounts to prevent the firms managing REITs, as potential competitors, from receiving highly sensitive and proprietary information regarding the identities of the broker's clients.

Because complete customer-identity information typically is known only to the brokers, REITs could not possibly identify all shareholders who have held their stock at any time during the year. Even if brokers were to provide this information to REITs, the difficulties of tracking and reporting the number of shares held by each investor on each day of the year would be extraordinary. Mutual funds investing in REITs, for example, may purchase and sell REIT shares every day to reflect the purchases

[4] The broker through which shares are purchased must comply with the applicable know-your-customer/anti-money-laundering requirements (including securing IRS Form W-9s from US persons); the broker also is responsible for all applicable US tax reporting and withholding requirements.

and redemptions of their investors' fund shares. Consequently, REITs would not be able to comply with the proposal's reporting requirements.

Over-Withholding Would Occur

Although the proposal envisions withholding only on the portion of a REIT's distribution equal to the income attributable to Hawaiian properties, over-withholding would occur. First, a REIT cannot determine until after the end of a calendar year the portion of its distributions that are taxable as income or as capital gain or instead are non-taxable returns of capital. Second, even if a REIT could determine with each distribution that portion that is taxable income—which it cannot—it would know the portion attributable to Hawaii only if the REIT invested *only* in Hawaii. To avoid the difficulties, including potential penalties, arising for under-withholding, REITs can be expected to withhold on the full amount of each distribution.

The mutual funds investing in REITs that over-withhold apparently would be required to file a Hawaiian tax return to recoup excess withholding tax. This filing could not be made, however, until the REIT determined the precise amount of over-withholding—on a per-share basis—for each distribution. The mutual fund then would need to determine and report the number of shares it held on each such date. Exactly how the fund would satisfy the State that it, in fact, held the number of REIT shares it claimed would be a bit unclear—as brokers are not required to report the holdings of their customers to every State. This legislation presumably would result in a significant burden to the State Department of Taxation as a result of having to process many tax refund claims.

Fund Investors Would Be Harmed Even IF Over-Withholding Did Not Occur

Hawaiian shareholders in mutual funds investing in REITs effectively would pay tax to Hawaii twice on the same income (even if all over-withheld tax is recovered). Specifically, these Hawaiian shareholders first would bear the economic cost of the tax when withholding is imposed on the distribution by the REIT to the mutual fund. They would pay Hawaiian income tax again when the mutual fund distributes its income to its shareholders (as it must do annually to comply with US federal income tax requirements).

Fund investors who do not reside in Hawaii also would be taxed twice—in both Hawaii and in their own residence State—on the same income. Specifically, any Hawaiian tax incurred by the fund would be deducted by the fund as a business expense rather than credited by either the fund or its shareholders against their residence State tax liability.[5] The fund-level deduction would result in only a slight reduction in the residence-State tax liability as a deduction is far less valuable than a dollar-for-dollar tax credit.

[5] The Federal income tax regime applicable to funds, taxable as regulated investment companies (RICs), is described in greater detail in the appendix at page five.

Finally, fund investors saving for retirement often invest in mutual funds through tax-deferred or after-tax retirement accounts.[6] These investors would bear the economic cost of the tax under this proposal even though their accounts otherwise are exempt from federal and state tax.

* * *

Because this legislative proposal would result in over-withholding by REITs and in double taxation on both Hawaiian and non-Hawaiian investors in mutual funds that invest in REITs subject to this tax, we urge you to reject it.

Please feel free to contact the undersigned at katie.sunderland@ici.org or 202-326-5826 if we can provide you with any additional information regarding our concerns with S.B. No. 2409.

Kind regards,

Katie Sunderland

Katie Sunderland
Assistant General Counsel - Tax

[6] The most recent ICI data show 53% of mutual fund assets were held in employer-sponsored defined contribution plans (such as 401(k) plans) and individual retirement accounts (IRAs). https://www.icifactbook.org/ch8/19_fb_ch8, Figure 8.22.

Appendix: Federal Income Taxation of Funds and Their Shareholders

Subchapter M of the Internal Revenue Code provides the tax regime for mutual funds, and other investment pools, that qualify for regulated investment company (RIC) treatment. All RICs are corporations for Federal income tax purposes. They are treated as such—except to the extent otherwise provided by Subchapter M.

Unlike most corporations, RICs are not subject to taxation on their income or capital gains at the entity level, if they meet certain gross income and asset requirements and distribute their income annually. Instead, RIC shareholders are subject to tax at the federal and state levels based on their residence.

RICs normally do not pay state income taxes since states typically base taxable income on federal income, which takes into account the dividends paid deduction. In the unusual instance that a RIC pays state taxes, it would deduct such amounts under section 164 of the Internal Revenue Code, which reduces its investment company taxable income and the amount it must distribute. While this deduction provides some economic relief to shareholders, it is not as beneficial as a tax credit which reduces a taxpayer's tax liability dollar-for-dollar.

There is, however, no statutory mechanism to allow for the flow through of credits for state taxes paid by a RIC to its shareholders. We note that Form 1099-Div, Box 14 "State Tax Withheld" is used to report any state backup withholding that a mutual fund or intermediary is required to withhold. This box is not available to report withholding taxes imposed on the mutual fund; rather it pertains to withholding taxes that the mutual fund (or, in most instances, the broker) imposes on the shareholder.

In contrast, there is a statutory mechanism in Section 853 of the Internal Revenue Code that permits RICs to pass through foreign taxes credits to their shareholders. Unless there were a similar statutory mechanism available at the state level that was adopted by all states, there would be no way for a RIC to provide a similar pass-through of state tax credits to its shareholders.

Brookfield
Properties

January 27, 2020

Hearing Date: January 28, 2020
Time: 1:30 pm
Place: State Capitol, Conference Room 225

Senator Stanley Chang, Chair
Senator Dru Mamo Kanuha, Vice Chair
State Capitol
Committee on Housing
415 South Beretania Street
Honolulu, Hawaii 96813

Re: Testimony in Opposition to Senate Bill No. 2409

Dear Chairman Chang, Vice-Chairman Kanuha and Committee Members:

Thank you for the opportunity to provide written testimony on Senate Bill No. 2409. My name is Francis Cofran, the Senior General Manager of Ala Moana Center, the largest retail center in the state of Hawaii, and I am Jared Chupaila, Chief Executive Officer of Brookfield Properties' retail group, operator of Ala Moana Center. Simply put, we do not support this Bill that would disallow the dividends paid deduction and subject shareholders to a withholding tax on Hawaii sourced dividend distributions. This measure would subject REIT investment in Hawaii to taxation more onerous than that of regular corporations engaged in business in Hawaii and contradict the taxation of REITs nationwide. As we have previously testified, this legislative path is clearly inappropriate and will ultimately harm Hawaii.

In the past, we have testified on behalf of Ala Mona and GGP; GGP is now known as Brookfield Property REIT and is an affiliate of Brookfield Asset Management. Brookfield Properties' retail group, which encompasses the former GGP portfolio, as well as other retail properties within Brookfield Properties, has an extensive portfolio of mall properties encompassing over 170 locations across 43 U.S. states. Brookfield Properties assures premier quality and optimal outcomes for our tenants, business partners and the communities in which we do business. Brookfield Properties continues GGP's legacy of being a part of the economic fabric of Hawaii for more than 30 years (since 1987) – managing, owning and reinvesting in its Hawaii real estate assets as part of a long-term commitment that provides economic stability, growth, and jobs through all economic cycles.

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Indeed, across its portfolio and in Hawaii, Brookfield Properties' REIT capital and investment are focused on producing stable, long term cash flows over a variety of economic conditions. Brookfield Properties operates three major retail shopping centers in Hawaii – the Prince Kuhio Plaza ("PKP") in Hilo, Whalers Village in Lahaina, and the Ala Moana Center in Honolulu. As the largest indoor shopping center on the island of Hawaii, PKP provides great event space for local Kupuna groups passing on their knowledge of music and dance, artisan craft fairs and the celebration of other local traditions. The latter two properties are iconic visitor attractions that help sustain Hawaii's important tourism industry. Home to more than 350 stores and restaurants, Ala Moana Center is the primary shopping, dining and leisure destination for Kama`aina and visitors. Our two office buildings, which include the Ala Moana Building (Bank of Hawaii) and Ala Moana Pacific Center (Shokudo Building), primarily are occupied by local tenants who cater to residents. In addition to their important role in tourism, all three centers directly benefit the state and local economy through the Hawaii general excise tax.

Efficient REIT capital allows us to constantly reinvest in and enhance the customer experience as well as evolve to meet the needs of Hawaii. For example, at Ala Moana during 2012-2016, we invested almost $1 billion to construct additional retail square footage and residential condominiums. We announced in October 2019, that starting in 2021, we plan to build a 550-unit residential tower with a mix of unit sizes with 110 apartments being rented to tenants making no more than 80% of the area median income. This new investment will continue to enhance Ala Moana's standing as a live, work, play destination for all.

Senate Bill No. 2409 proposes an unworkable system with respect to withholding on shareholder distributions. A publicly traded REIT is not limited to 100 shareholders like an S corporation; instead, most shares are held in "street name" by Cede & Co. (an affiliate of The Depository Trust Corporation) on behalf of the ultimate beneficial owners which can be several layers removed through mutual funds and brokerage firms. It would be impossible to provide the information required by SB No. 2409. The likely outcome of such a withholding tax is an over withholding by a REIT and an increased administrative burden for the Department of Revenue. In 2019, the Hawaii Attorney General, in connection with a similar bill, submitted testimony that such provisions may be unconstitutional. Even if constitutional, this provision could cause inter-state conflicts that could take years and significant judicial resources to sort out.

In prior year legislative sessions, we have testified in opposition to attempts to eliminate the deduction for dividends paid by REITs. That testimony has focused on the following points:

- If Hawaii enacts this legislation, it will be out of step with all other states with respect to the dividends paid deduction for REITs (except for New Hampshire, where we believe REIT investment has been inhibited).
- The deduction for dividends paid by REITs results in a single level of taxation at the shareholder level which is consistent with how limited liability companies, Subchapter S corporations and partnerships that own real estate are taxed. Changing the taxing structure here would put REITs at a disadvantage in relation to these other forms of doing business.

- REITs produce substantial economic benefits to the State of Hawaii in the form of jobs, general excise tax, income tax from persons working or engaging in business at REIT properties, and real property taxes. The three properties annually pay more than $40 million in real property and general excise taxes – metrics that clearly demonstrate that REITs are investing in the economic well-being of the state and its residents.

As we look forward over the next 30 years, future expansion plans could be reconsidered if the attractiveness of investing in Hawaii relative to the rest of the United States is diminished. Proponents of the legislation say that REIT investment would not leave Hawaii but both the Department of Business, Economic Development & Tourism ("DBEDT") and the Department of Taxation have noted that there is no surety that investment will not be reduced and that estimates of revenues will be realized. In 2019, the Hawaii Department of Taxation said that a disallowance of the dividends paid deduction would have raised approximately $2 million its first year and, at best, $10 million each subsequent year. Deviation from a long-held national legislative norm is not good policy.

Please do not allow the perception of a revenue increase override the long-term economic benefits that REIT investment, under the existing tax regime, brings to the state of Hawaii and its residents. For the foregoing reasons, we respectfully oppose Senate Bill No. 2409 and urge you to oppose it as well. Thank you for your consideration.

Sincerely,

Francis Cofran
Senior General Manager

Jared Chupalla
Chief Executive Officer

WAIKELE
PREMIUM OUTLETS®
A SIMON CENTER

January 27, 2020

The Honorable Stanley Chang, Chair
The Honorable. Dru Mamo Kanuha, Vice Chair
Senate Committee on Housing
State Capitol
415 South Beretania Street
Honolulu, HI 96813

RE: SB 2409/Hearing on January 28, 2020

Dear Chair Chang, Vice Chair Mamo Kanuha and Members of the Committee:

On behalf of Simon Property Group (Simon), thank you for the opportunity to submit this testimony in strong opposition to SB 2409. Simon is a publicly traded real estate investment trust (REIT). We own, develop and manage premier shopping, dining, entertainment and mixed-use destinations, including Waikele Premium Outlets in Waipahu. As of September 30, 2019, we owned or held an interest in 204 income producing properties in the United States, which consisted of 106 malls, 69 Premium Outlets, a number of other retail properties in 37 states and Puerto Rico. We also own a number of overseas properties.

SB 2409 would eliminate the REIT dividends paid deduction (DPD), contrary to federal law and the laws of virtually every state with a corporate income tax.

Modeled after mutual funds, Congress created REITs in 1960 to provide a way for ordinary Americans to combine their capital in order to invest in professionally-managed, income producing real estate with a single level of taxation. In the past, such investment was generally limited to wealthy investors through partnerships. Unlike other real estate owners, as a REIT, we must meet strict asset, income, and operational tests to ensure that we are a widely-held, real estate-focused company. Unlike other real estate owners, but like mutual funds, we can't retain our earnings. We must distribute at least 90% of our taxable income to shareholders. If we satisfy this distribution requirement as well as the other REIT rules, we are entitled to claim a DPD. We must pay corporate tax on an income we retain.

Like other REITs, we invest for the long-term. We have owned the Waikele Premium Outlets since 2004. Since we've owned this property, we have invested over $95 million to improve the

WAIKELE
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A SIMON CENTER

property. This investment has improved the property's value, allowing it to generate about $1.4 million annually in property taxes and $1.5 million annually in general excise taxes.

As a publicly traded REIT that invests in multiple states and throughout the world, we must consider the local business climate as a factor in terms of where to invest, and to continue to invest, capital. Enactment of this bill would lead to double taxation of our shareholders and would make Hawaii a less attractive place to invest, not just for Simon, but for other investors who may view its enactment as meant to discourage future investment, thereby jeopardizing jobs and future revenues in the State. Investments in virtually all other states would not be subject to this second level of tax, so SB 2409 would make it more likely that we would invest outside of Hawaii. Please consider the important contributions that REITs have made in Hawaii. We respectfully ask that you hold SB 2409.

Thank you again for the opportunity to submit this testimony.

Sincerely,

Desiree Mosiman

Desiree A. Mosiman
Manager
Waikele Premium Outlets

WAIKELE

An American Assets Trust, Inc. Property

January 27, 2019

Committee on Housing
Senator Stanley Chang, Chair
Senator Dru Mamo Kanuha, Vice Chair
State Capitol
415 South Beretania Street Room 211
Honolulu, Hawaii 96813

Re: Written Testimony to Senate Bill No. 2409, Requires that Real Estate Investment Trusts file returns reporting their shareholders' pro rata shares of net income and net income attributable to this State. Requires withholding on all payments to shareholders.

Dear Chair Chang, Vice-Chair Kanuha, and Committee Members:

My name is Pamela Wilson, and I am the General Manager of Hawaii Real Estate for American Assets Trust (AAT). American Assets Trust is a New York Stock Exchange-listed Real Estate Investment Trust (REIT) engaged in acquiring, improving, developing and managing premier retail, office and residential properties primarily in Hawaii, Southern California, Northern California, Oregon, and Washington State. Currently, AAT owns four properties in Hawaii: The Shops at 2150 Kalakaua; Waikele Center; Waikiki Beach Walk and the Embassy Suites-Waikiki Beach Walk.

The text from S.B. 2409 states that Real Estate Investment Trusts (REITs) "should be required to withhold a portion of dividends attributable to the State and remit them to the State" and that, in connection therewith, each REIT file returns reporting their shareholders' pro rata shares of net income and net income attributable to the State of Hawaii. Further it requires withholding on all payments to shareholders.

American Assets Trust opposes this legislation because of its negative impact on shareholders. Senate Bill 2409 proposes an unworkable system on REITs. Unlike an S corporation, a publicly traded REIT is not limited to 100 shareholders who can be easily identified. In fact, many such REITs have millions of shares outstanding, with approximately 99 percent held in "street name" by a central securities depository on behalf of the ultimate owners. It is and would be impossible for a given REIT to provide the name, address and federal identifying information required under Senate Bill 2409 with respect to all of these shares. And the way in which capital markets operate, with thousands of shareholders entering and leaving the market in a single day or an hour, further compounds an already impossible challenge.

Furthermore, as with all REITs, and unlike other non-REIT property owners, we must satisfy many strict and expensive requirements in order to maintain our REIT status. As an example, one of the requirements of REIT Hotel ownership is to lease to a Taxable REIT Subsidiary, more commonly known as a TRS. This results is a double GET payment. So in essence a REIT is taxed twice and pays taxes that other non-REIT owners don't. The first time it is included in the Guest's bill which amount is remitted back to the State and the second time is when the Taxable REIT Subsidiary charges rent to the hotel to comply with Federal REIT tax rules. Another GET is paid on that amount. And as a tax on gross receipts rather than a tax on net income that makes up the majority of the State's revenue, the GET is a much more stable source of State revenues than corporate income tax. SB 2409's enactment would threaten this extremely valuable source of GET revenues to the State.

I ask that you consider how burdensome this new legislation as proposed would be resulting in a potential loss of GET revenue, over withholding and double taxation on both Hawaiian and non-Hawaiian investors that invest in REITs. Compliance would be difficult if not unfeasible. For these reasons, please hold Bill 2409. Thank you for the opportunity to submit this testimony.

Sincerely,

Pamela R. Wilson
General Manager, Hawaii Real Estate
American Assets Trust

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Telephone: 808 671-7977 Facsimile: 808 678-8170
Email: pwilson@americanassets.com

January 26, 2020

Hearing Date: January 28, 2020
Time: 1:30 P.M.
Place: Conference Room 225

The Honorable Stanley Chang, Chair
The Honorable Dru Mamo Kanuha, Vice Chair
Senate Committee on Housing

Re: Testimony ***Opposing*** the Funding Mechanism in SB 2409 – Imposing Tax on REIT Shareholders, and Reporting and Withholding Requirements on REITs

Dear Chair Chang, Vice Chair Kanuha, and Members of the Committee on Housing:

My name is Tim Scott and I am Public Storage's Tax Counsel. Public Storage does not have a position on the stated substantive goal of SB 2409, to encourage former residents to return to Hawaii by assisting with down payments for primary residences, but we ***strongly oppose*** the funding mechanism proposed in SB 2409.

The bill would impose Hawaii income taxes on the shareholders of real estate investment trusts (REITs), along with related withholding and reporting requirements on REITs. ***As is explained below, (1) key aspects of the required information CANNOT be obtained or provided by publicly traded REITs like Public Storage, (2) the bill will result in multiple taxation, and (3) the bill is of questionable constitutionality***. If the bill is enacted and survives legal challenge, such an anti-business tax would strongly incentivize REITs to reduce or avoid future investment in, and possibly redirect investments away from, the state. This could be expected to have adverse long term effects on the Hawaii economy and the state's tax collections.

Public Storage and Hawaii. Public Storage is a real estate investment trust that is the largest owner and operator of self-storage facilities in the United States, with over 162 million rentable square feet of real estate in 38 states. In the United States we have nearly 2,500 facilities and 1.4 million customers. We own 11 facilities in Hawaii. In 2019, those Hawaii properties generated more than $30 million of gross revenue and we paid the state about $1.4 million of general excise tax. For the 2019/2020 fiscal year, we will pay real estate taxes in Hawaii of roughly $2.25 million.

REITs were designed by Congress to distribute their taxable income to their shareholders, who then report and pay state and federal tax on those dividends. Our shareholders in Hawaii are taxable by the state on the full amount of our dividends, not just the very limited portion of those dividends attributable to the 11 properties we have in the state (compared to our almost 2,500 properties across the nation). This means that Hawaii benefits from the REIT regime because Hawaii shareholders are taxed on all of the distributed income. The same basic treatment (required distributions taxable to shareholders) is not a "loophole" and applies across the U.S. No other state imposes tax, withholding or reporting requirements like those proposed in SB 2409.

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701 Western Avenue, Glendale, CA 91201
Tel: 818-244-8080
publicstorage.com

SB 2409 Deficiencies. The following briefly notes some key problems with the bill.

Publicly Traded REITs Do NOT Know Who Their Underlying Shareholders Are and So CANNOT Comply. SB 2409 appears to be patterned on a similar Hawaii law that applies to Subchapter S corporations. An S corporation cannot have more than 100 shareholders, so it is practical for S corporations to identify and provide Hawaii with specific information about their shareholders. By contrast, particular publicly traded REITs can have **hundreds of thousands of beneficial shareholders**, with the shareholders changing constantly. More critically, **publicly traded REITs do NOT know who those shareholders are**.

Public Storage's common stock is traded on the New York Stock Exchange under the symbol PSA. As with most publicly traded companies, the great bulk of PSA's stock is held by a depositary (Cede & Co.) in street name. Public Storage has about 174 million outstanding common shares, and likely has tens of thousands (perhaps hundreds of thousands) of beneficial shareholders at any time. Of course, that underlying ownership changes constantly as trades take place through the stock exchange; during 2017 and 2018 reported daily trading volume ranged up to 3.8 million shares. But, Public Storage does not know how many shareholders beneficially hold PSA common stock at any time, or who those shareholders are, and would not be able provide detailed and specific information about all shareholders as SB 2409 purports to require at all times during a year (names, addresses, TINs, shares owned, imputed allocations of Hawaii and other income, etc.).

Exceeds Constitutional Authority. Even putting aside the practical impossibility of applying the bill, it is doubtful that any state has the constitutional authority to tax nonresident shareholders of public companies on an imputed share of income earned by the company in that state, when the only connection of the shareholders to the state trying to impose the tax is the shareholders' passive ownership of shares through a public stock exchange in the company that has some operations in that state. The dubious legality is compounded by the fact that the bill will impose multiple taxation on the shareholders.

Multiple Taxation. The bill effectively imputes to shareholders a proportionate interest in a REIT's Hawaii income and would force the REIT to pay a five percent withholding tax "on behalf of [the] shareholder[s]" on that imputed income. The bill does not appear to reflect any understanding of the fact that shareholders (in Hawaii and elsewhere) will receive (and be taxable on) the dividends that the REIT pays (without regard to where the REIT earned the funds used to pay those dividends). While the backers of the bill may believe that the shareholders would be able to credit the Hawaii withholding tax against their Hawaii and other state taxes (including taxes payable on the REIT dividends), that almost certainly would not be the case. First, how would shareholders claim, or Hawaii's or other states' tax administrators allow, credits or refunds for taxes anonymously paid on the shareholders' behalf, given that a publicly traded REIT cannot identify the great majority of its shareholders, much less track them on a daily basis? Moreover, even if the taxes paid on the shareholders' behalf could be properly matched to particular anonymous beneficial shareholders, it is doubtful that the shareholders' states of residence would allow credits because the shareholders' dividend income typically will be treated as derived from the shareholders' states of residence.

So, the practical impact of the bill would be to impose multiple taxation on publicly traded REITs' earnings in Hawaii, as shareholders would be taxable in Hawaii on the imputed

income and also taxable in their states of residence on dividends received, with no credits likely to be allowed.

The practical concerns about multiple taxation seem even more daunting given that very significant amounts of REIT shares are held by investment advisors for their underlying customers, as well as pass-through entities, such as mutual funds, partnerships or S corporations. REITs have no ability to trace through those levels to identify the underlying beneficial owners or where they reside and the bill provides no useful guidance as to how those shareholders would or should be affected.

Summary: As outlined above, SB 2409 would be very unfair to REIT shareholders and REITs, as it:

1. cannot be applied to publicly traded REITs, because the REITs do not (and cannot) know who most of their beneficial public shareholders are;
2. exceeds the state's authority, given the limited contact of public shareholders with the state, and because the bill would impose multiple taxation on shareholders of publicly traded REITs (credits would NOT be available to shareholders for taxes imposed by the bill);
3. would impose taxes, withholding and reporting requirements in a way that no other state has pursued; and
4. would push REITs away from Hawaii, likely harming the state by decreasing overall tax collections and economic activity in the state.

Conclusion: SB 2409 Should NOT Move. We believe Public Storage and other REITs have been, and can continue to be, positive forces in the Hawaii economy. For the reasons outlined above, Hawaii should not pursue unfair, impossible legislation that will dissuade REITs from investing in the state. We respectfully request that you do ***not*** move forward SB 2409.

Very truly yours,

A. Timothy Scott
Tax Counsel of Public Storage
tscott@publicstorage.com
818.244.8080, extension 1286

cc: Department of Taxation
Department of Business, Economic Development & Tourism

Park Hotels & Resorts Inc.
Scott Winer, SVP Tax
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7th Floor
Tysons, VA 22102
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WRITTEN TESTIMONY OF

Scott D. Winer
Senior Vice President, Tax
Park Hotels & Resorts Inc.

IN OPPOSITION TO SB 2409

BEFORE THE COMMITTEE ON HOUSING

HEARING ON SB 2409

JANUARY 28, 2020

On behalf of Park Hotels & Resorts Inc. ("PARK"), thank you for this opportunity to provide our testimony on SB 2409. PARK submits this testimony in **opposition** to SB 2409.

As described in more detail below, PARK opposes SB 2409 for the following reasons:

- It would not add significant revenue to the State. The Hawaii Department of Taxation ("DoTax") has stated elimination of the DPD would raise only modest amounts of income taxes while likely resulting in less General Excise Tax ("GET").
- It would impose an information reporting burden and withholding tax obligation both of which are administratively unworkable and may be unconstitutional.
- It would threaten the GET revenue associated with the statutorily required lodging REIT structure.
- It would impose significant resource demands on the DoTax.

PARK is a publicly traded lodging real estate investment trust ("REIT") (NYSE:PK) that owns 62 premium branded hotels and resorts primarily located in the United States. Included within PARK's portfolio of hotels are (i) the iconic Hilton Hawaiian Village Waikiki Beach Resort located along Oahu's prestigious Waikiki Beach, and (ii) the Hilton Waikoloa Village located on the Kohala Coast of the Big Island of Hawai'i. PARK strives to be the preeminent lodging REIT, focused on consistently delivering superior, risk adjusted returns for shareholders that invest in the hotel sector. PARK, like most REITs, has a long-term investment focus and is committed to creating sustainable value at its properties.

As you know, Congress enacted the REIT legislation in 1960 to allow individual investors the ability to own and benefit from professionally managed, institutional quality, income-producing real estate. As with all REITs, PARK must meet multiple stringent, complex and costly requirements in order to maintain its status as a REIT, including: organizational requirements, asset holding requirements, passive income generation requirements, and importantly REITs must distribute at least 90% of their taxable income annually. These stringent, complex and costly requirements do Not apply to non-REIT real estate owners and require REITs to continuously access the debt and equity capital markets to obtain capital for maintenance, improvements and growth projects. By meeting these stringent, costly and complex requirements REITs are allowed to claim a dividend paid deduction ("DPD") essentially passing through their taxable income to shareholders.

As state above, one of the REIT requirements is the passive income generation requirement, which separates the federal tax rules for REITs and the rules applicable to non-REIT real estate owners. Federal tax law dictates that a REIT must earn most of its income from "rents", and income from operating a hotel is not "rents". Thus, federal law requires that a lodging REIT lease its hotels to a third party or one or more fully taxable subsidiaries. If leased to a taxable subsidiary (which is the structure used by public REITs), the taxable subsidiary is required to hire an independent operator, like Hilton, to manage the hotel. The rents paid by the taxable subsidiary to the REIT hotel owner and the management fees paid to the independent operator are both subject to Hawaii GET.

Thus, hotels operating within the REIT structure are subject to **triple GET taxation**. The over-whelming majority (approx..85%) of the additional GET is a direct result of federal law requirements governing hotel REIT operations and is not be paid by a typical non-REIT hotel owner.

As described below, Park's acquisition and ownership of the two Hawai'i hotels results in excess of **$10 million in additional GET being paid to the State of Hawaii annually**.

Further, as REITs are passive real estate companies, they cannot actively trade in real estate properties without being subject to a 100% tax on the gain. Thus, unlike non-REIT owners, as a passive real estate company, REITs are long term investors in their real estate. Park, as is widely known, acquired land adjacent to the Hilton Hawaiian Village Waikiki Beach Resort complex with the express intent of investing in an additional hotel tower. The construction of such a new hotel tower will likely cost hundreds of millions of dollars and create significant jobs and additional revenues for the State.

SB 2409 would eliminate the dividends paid deduction for REITs and thus require REITs to pay corporate income tax to the State of Hawai'i. In addition, SB 2409 would impose an information reporting burden and withholding tax obligation both of which are administratively unworkable. Like all publicly traded companies – both REIT and non-REIT, PARK does not know the identities of its shareholders.

We believe **the DPD should not be eliminated**. Not only is SB 2409 bad public policy, it would not add significant revenue to the State. DoTax has stated elimination of the DPD would raise only modest amounts of income taxes while likely resulting in less GET, both because of less investment by REITs and the likely planning that would reduce lodging REIT double GET payments. The elimination of the DPD would be inconsistent with federal tax rules and the existing rules of virtually all other states with an income-based tax system. Further, it would be impossible to comply with SB 2409's withholding and information return provisions that the Hawai'i attorney general has stated may be unconstitutional.

We believe that our investment and the investments by other REITs in Hawai'i are beneficial to the state and that eliminating the DPD would have the undesirable consequence of discouraging future investment by REITs in Hawai'i. In fact, Park is currently in the planning phase related to the possible construction of a hotel tower adjacent to, and to be an addition to, the Hilton Hawaiian Village Waikiki Beach Resort complex. If SB 2409 were to become law, it will force us to reconsider whether we will proceed with this and future capital investment projects in the State of Hawai'i.

We believe the proposed legislation will not increase tax revenue for the state as the cost of doing business in Hawai'i will diminish investment returns and result in less investment. Further, elimination of the DPD could result in foundations or pension funds replacing REIT ownership of real property. Foundations and pension funds generally are passive owners that pay no federal or state income taxes and do not make the same capital investments as REITs. Further, if hotels in Hawai'i are converted to non-REIT ownership, including ownership by taxable subsidiaries of REITs, the additional GET revenue generated solely as a result of the REIT structure will disappear.

We believe the GET, which is a tax on gross receipts rather than a tax on net income, is a more reliable and steadier source of state revenues than Corporate income tax and SB 2409's enactment would threaten this extremely valuable source of revenues to the State.

PARK's two landmark, oceanfront resorts cater to residents from Hawai'i and the mainland, and international travelers. PARK's Hawai'ian resorts provide significant economic benefit to the State of Hawai'i. We have made extensive renovations in excess of ~$228 million at Hilton Hawaiian Village and Hilton Waikoloa Village, over the last 5 years.

PARK's economic footprint benefits the State of Hawai'i in many ways, including:

JOBS: PARK's hotels directly employ more than 2,857 employees. The payroll and associated benefits for these direct employees is in excess of $203,001,326 million annually.

CAPITAL MAINTENANCE: Over the next five years, PARK will likely spend almost $200 million at Hilton Hawaiian Village and Waikoloa Village on capital maintenance projects, exclusive of any expansion capital.

CAPITAL DEVELOPMENT / IMPROVEMENTS. Given the long-term nature of our investment, PARK is currently analyzing significant development opportunities that will require meaningful capital investment at both resorts. These capital investments which are at various stages of feasibility / underwriting would be **hundreds of millions** of dollars.

HAWAII TAXES GENERATED / PAID BY PARK:

- General Excise and Use Tax - Operations. The tax revenues generated from our operations totaled $27,981,455 in 2019.
- General Excise Tax – Rent / Management Agreement. As described above as a REIT, unlike other real estate owners, PARK must use a lease structure. As a result, we are required to pay General Excise Tax on the rent paid between our related companies. Effectively a double taxation of the same revenue. This additional GET paid by PARK was $9,349,896 in 2019 and the additional GET paid by PARK on the management fees paid to our independent operator was $1,400,294 in 2018.
- Property taxes. Property taxes at PARK's two resorts totaled $22,403,103 in 2019.

CHARITABLE ENDEAVORS BY PARK and ITS ASSOCIATES in HAWAII:

- PARK associates spend thousands of hours annually volunteering for local events and charities.
- PARK and its associates provide cash and in-kind charitable contributions more than $600,000 annually.

We believe that Park has been a solid corporate citizen and partner to the state of Hawai'i – paying significant tax, supporting numerous jobs and benefitting the community at-large. PARK's REIT structure and hotel ownership benefits the State of Hawai'i and Kama'aina tremendously in a variety of economic and charitable ways.

If adopted, this controversial legislation would (i) put Hawai'i at a competitive disadvantage for REIT investment, (ii) penalize Hawai'ian citizens, including the Hawaii Employer-Union Health Benefits Trust Fund beneficiaries, that invest in REITs by reducing their investment returns, (iii) discourage REITs from investing in Hawai'i, (iv) require PARK to reassess the level of future capital invested in Hawai'i and our Hawai'ian assets including the potential construction of an additional hotel tower as part of the Hilton Hawaiian Village Waikiki Beach Resort complex, and (v) require Park, as a publicly-traded company, to address our form of ownership and operation in Hawai'i, which could lead to implementing one or more appropriate tax planning techniques or strategies to maintain shareholder value. Further, this legislation would have a chilling effect on the positive economic and charitable impact PARK provides through its REIT ownership and capital investment in Hawai'i.

We thank you again for this opportunity to provide testimony against SB 2409 and sincerely hope you consider our **strong opposition** to this proposed legislation.

Respectfully submitted,

Scott Winer
Senior Vice President, Tax

Hawai'i Association of REALTORS®

808-733-7060
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1259 A'ala Street, Suite 300
Honolulu, HI 96817

January 28, 2020

The Honorable Stanley Chang Chair
Senate Committee on Housing
State Capitol, Room 225
Honolulu, HI 96813

RE: S.B 2216, Relating to Taxation

HEARING: Wednesday, January 28, 2020, at 1:30 p.m.

Aloha Chair Chang, Vice Chair Kanuha and Members of the Committee,

I am Ken Hiraki, Director of Government Affairs, testifying on behalf of the Hawai'i Association of REALTORS® ("HAR"), the voice of real estate in Hawai'i, and its over 10,000 members. HAR **opposes Part II of** S.B. 2409 which disallows the dividend paid deduction on Real Estate Investment Trusts (REIT.) This measure also encourages former Hawai'i residents to move back to Hawaii by establishing the returning resident down payment program to provided matching funds for the down payment of a residence.

In 1960, the United States Congress created REITs to allow all individuals, and not just the wealthy, the opportunity to invest in large-scale diversified portfolios of income producing real estate.

REITs are tied to all aspects of the economy, and have a major economic impact on our state and encompasses a full range of real estate, including:

- Affordable Housing: Waena Apartments and The Lofts at Kapolei
- Student Housing: Hale Mahana Student Housing
- Healthcare Facilities: Hilo Medical Center, Kapiolani and Pali Momi Medical Center
- Retail: Prince Kuhio Plaza, Whaler's Village and Ka Makana Ali'i

REITs bring in investment to help build thriving communities where residents can live, work and play. REITs not only provide a boost to our economy through construction of these projects, but create real job opportunities.

Under this measure, it proposes to remove the income tax deduction for dividends from a REIT, thereby creating a double taxation of income. HAR has concerns that this will become a disincentive to invest in Hawai'i, which would negatively impact the economy.

Additionally, this would also impact those that invest in REIT, such as retirees who use this as part of their retirement income.

Mahalo for the opportunity to testify.

WRITTEN TESTIMONY OF

DARA F. BERNSTEIN
SENIOR VICE PRESIDENT & TAX COUNSEL
NAREIT

IN OPPOSITION TO SB 2409
BEFORE THE HAWAII SENATE
COMMITTEE ON HOUSING

THE HONORABLE STANLEY CHANG, CHAIR
THE HONORABLE DRU MAMO KANUHA, VICE CHAIR

HEARING ON SB 2409
JANUARY 28, 2020
1:30 P.M.

Dear Chair Chang, Vice Chair Kanuha, and Members of the Senate Committee on Housing:

Thank you for the opportunity to submit this testimony on behalf of the Nareit and its REIT members active in Hawaii. Nareit is the worldwide representative voice for real estate investment trusts—REITs—and publicly traded real estate companies with an interest in U.S. real estate and capital markets.

For the reasons discussed in more detail below, these REITs, which have substantial long-term investments in Hawaii, strongly oppose, and ask you to hold, SB 2409, legislation that would require REIT shareholder withholding and information reporting and eliminate the REIT "dividends paid deduction" (DPD) in order to fund a down payment program for returning residents.

- **SB 2409's enactment would likely produce less overall revenue than current law; thus, it would not achieve its goals of funding a down payment program for returning residents.**
  - **Department of Taxation's (DoTax) public testimony regarding similar legislation estimates at best an incremental increase in revenue from enactment of similar legislation:** Enactment would raise, at best, approximately $2.5 million the first year and $10 million annually thereafter according to DoTax's public testimony.[1]
  - **DoTax says actual revenue could be lower–even zero:** A DoTax representative cautioned in public testimony and a radio interview that actual revenue raised could be lower.[2]
  - **Loss of general excise tax (GET) would likely more than offset any increase:** Federal law applicable to hotel REITs requires them to use a lease structure that results in an additional level of GET **not applicable to non-REITs.** As described below, jeopardizing this additional GET could more than offset any revenue gains.
  - **What about the larger amounts asserted by proponents?** DoTax testimony suggests proponents are relying on "incorrect" numbers in an earlier DBEDT study.[3]
- **SB 2409's enactment would risk job loss at a time when the construction industry is reportedly weakening.** It would not be prudent to risk this job loss given the unlikelihood of any overall revenue gain.

[1] Note comments around 3:40:23 to 3:40:38 of the Feb. 12, 2019 video of the House Consumer Protection & Commerce hearing on a 2019 bill that also would have eliminated the REIT DPD, HB 475, HD 1, available at this link.
[2] Note comments around 3:41:02 to 3:41:41 of the Feb. 12, 2019 video of the House Consumer Protection & Commerce hearing on HB 475 HD 1 available at this link and comments of Former Director of the Hawaii Department of Taxation, Linda Chu Takayama in this Feb. 4, 2019 interview with Hawaii Public Radio ("Raising Taxes on REITs"), beginning at 10:10.
[3] Note comments around 3:40:40 to 3:40:56 of the Feb. 12, 2019 video of the House Consumer Protection & Commerce Committee hearing on HB 475 HD 1, available at this link.

- **Because publicly traded REITs do not know the identities of their shareholders, SB 2409's provisions would not be administrable, thus would result in over-withholding and additional demands on the Department of Taxation's resources to deal with refund claims.**

- **Contrary to its goals of fairness, SB 2409's enactment would impose obligations and liabilities on REITs that are not imposed on non-REIT corporations or partnerships.** Unlike non-REIT corporations and partnerships, REITs must be widely-held, focused on real estate, and can't keep their profits. **Unlike partnerships**, REITs can't pass through losses or tax credits to shareholders. If SB 2409 were enacted, REITs still would be subject to these requirements. **Unlike non-REIT corporations**, REITs would be required to withhold and meet impossible shareholder reporting requirements. Further, REIT shareholders' residence states would not be required–and often would not–provide a tax credit for any Hawaii tax withheld.

The remainder of this testimony provides additional detail and information.

REITs in Hawaii

REITs are companies that provide a way for anyone, including Hawaii residents, to own professionally managed, income-producing real estate for the long term—just like the way mutual funds let small investors buy stock in a corporation. Many local people own REITs, either as individual investors or through mutual funds and employer or union pension plans.

Many Hawaii residents may not even realize that they benefit from REITs either through mutual funds or their pension or retirement accounts. Nareit analysis of data from 2016 Federal Reserve Board Survey of Consumer Finances (SCF), the Employment Benefit Research Institute data on 401(k) equity allocations (EBRI), Census population and household counts, and Morningstar Direct data, indicates that about 47% of Hawaii households own REIT stock directly and/or through mutual funds or certain retirement accounts. There are more than 200 publicly traded REITs, and only about 30 REITs with Hawaii properties. As a result, a significant portion of REIT ownership most likely relates to REITs with properties outside of Hawaii.

REITs are long-term property holders that own, renovate, and manage affordable housing projects, commercial buildings, medical facilities, shopping centers, cell phone towers, and hotels throughout Hawaii. Examples of REIT-owned properties in Hawaii include:

- the state-of-the-art Hale Pawa'a Medical Building in Downtown Honolulu (Healthcare Realty Trust);
- nearly 500 soon-to-be available affordable housing rentals at Bishop Place in Honolulu for tenants earning between 80% and 120% of area median income and workforce rentals at Moanalua Hillside apartments (Douglas Emmett Inc.)
- Pearlridge Center in Aiea, which just last year completed a $33 million renovation (Washington Prime Group);
- Ka Makana Ali'i in Kapolei, whose revenues assist DHHL in building homes for Native Hawaiians;
- A number of hotels, including Hilton Hawaiian Village (Park Hotels & Resorts, Inc.); Fairmont Kea Lani on Maui (Host Hotels & Resorts, Inc.); and Wailea Beach Marriott Resort & Spa (Sunstone Hotel Investors, Inc.), all of which, as described below, are required to use a lease

structure that generates at least $16 million in general excise taxes to the state over what non-REITs would owe.

In addition, Brookfield Property REIT recently announced that starting in 2021, it plans to build a 550-unit residential tower with a mix of unit sizes with 110 apartments being rented to tenants earning 80% or less of the area median income.

REITs also have increased student housing opportunities at the University of Hawaii. EdR developed the Hale Mahana apartments at the University of Hawaii at Manoa. American Campus Communities also redeveloped Frear Hall for the University of Hawaii a number of years ago.

SB 2409's Enactment Would Produce Less State Tax Revenue than Current Law

According to the Department of Taxation, enactment would only raise an incremental amount of revenue; however, enactment could result in a potential $6 million loss when factoring in potential lost general excise tax (GET) revenue.

In an April 4, 2019 Hawaii Public Radio interview regarding similar legislation, former Department of Taxation Director Linda Chu Takayama stated the following when speaking merely of the corporate income tax impact of enactment of similar legislation (beginning at 10:10 in "Raising Taxes on REITs"): "[Our economist's analysis] is that it might bring in $2 million the first year, something less than $10 million in the out years, and even that's a little bit fuzzy because that doesn't represent all of the deductions that these companies could be taking; once you factor that in, the number goes way down." See also footnotes 1-3 above and accompanying text for more detail.

Because of unique requirements applicable to REITs, essentially resulting in an additional level of GET, the state received more than $16 million in annual GET in 2018 alone just from hotel REITs in Hawaii that non-REIT hotel owners wouldn't owe.

- Federal law requires that lodging REITs–**unlike non-REIT hotel owners**–to lease their hotels either to an unrelated company or to a fully taxable REIT subsidiary at market rent that must hire an unrelated hotel operator (like Marriott or Hilton).

- Park Hotels & Resorts, Inc.'s' 2019 testimony said this extra GET was $8 million more than the prior (non-REIT) owner paid in GET–and that is just one hotel REIT. When aggregated with other REIT hotel owners in Hawaii, this additional GET is estimated to have **exceeded $16 million in 2018**.

- And as a tax on gross receipts rather than a tax on net income, the GET is a very stable source of almost half of state revenues and compared with the corporate income tax (around 1-3%) (For example, see data from Council on State Revenues for FY 2019 To FY 2025). **SB 2409's enactment would seriously endanger this extremely valuable source of GET revenues to the state.** Not only that, enactment also would put at risk the revenues and jobs created by non-hotel REITs that invest in the state.

- Given the risk of losing up to $16 million in GET annually, and the risk of lost jobs, it would not be prudent to enact SB 2409.

SB 2409 Enactment Would Risk Job Losses for Hawaii Residents

SB 2409 risks significant job loss, at a time when the construction industry is reportedly weakening. Enactment of SB 2409 would potentially result in a reduction of millions of dollars of new REIT investment, a shift in property ownership to tax-exempt owners like pensions and endowments, and loss of revenue and the stability of hundreds of the jobs generated by REITs to the state. These existing and potential jobs belong to real people. Is it fair to risk significant job loss by enacting this proposal, particularly in light of DBEDT's report to the Hawaii Senate Ways & Means Committee and House Finance Committee on Jan. 7, 2020 that the construction industry is weakening?

Enacting this proposal would signal Hawaii's discouragement of long-term capital investment in the state. REITs provide sorely needed investment capital to Hawaii. If this measure is passed it is very likely that potential REIT and non-REIT investors, fearing unexpected law changes post-investment, would choose to deploy their capital elsewhere, and Hawaii would be on the outside looking in.

Hawaii's significant economic growth over the past several years is, and we hope into the future, will be, in large part a direct result of REIT investment. The popular new addition to Ala Moana Center was made possible by REIT funding. That project alone was estimated to have brought in more than $146 million in state revenue in 2016. Since completion, the additional retail sales produced some estimated $33 million in GET revenue for the state, along with 3,000 new jobs.

Hawaii residents have benefitted from REIT investment, which made possible dining at the Cheesecake Factory at Ka Makana Ali'i or taking their family to Wet'n'Wild, or going shopping at Pearlridge, more eating choices and better Waikiki parking opportunities with the redevelopment of the International Market Place, not to mention the financial benefits to the Queens Health System, which is the landowner.

These jobs and tax revenue would not be here without REIT funding. REIT investment continued during the recession we recently experienced. While regular investors shied away from redevelopment, REITs continued to build and improve their properties, providing a boost to the state's local economy through needed construction jobs and later retail jobs for the completed projects.

SB 2409's withholding and information reporting return provisions would not be feasible or administrable.

The lack of administrability is described in testimony submitted to the Hawaii Senate Ways & Means Committee for a Feb. 6, 2019 hearing regarding similar legislation, SB 675, by:

- Martin J. Bentsen, on behalf of shareholder information reporting company FIS Wall Street Concepts (beginning on page 94) (noting "**insurmountable challenges**) (Emphasis added);
- Katie Sunderland, Counsel-Tax, on behalf of the trade association representing the mutual fund industry, The Investment Company Institute (ICI) (beginning on page 11) (under the

proposal "REITs **cannot report accurate information regarding their individual investors"**) (Emphasis added); and

- the trade association representing the securities and investment community, SIFMA (beginning on page 20) ("**double taxation**") (Emphasis added).

A significant portion of REIT shareholders are mutual funds, who, like REITs are not subject to income tax if they distribute all of their income to shareholders. As the ICI noted in its testimony last year with regard to similar legislation, "[t]he proposal is not administrable and would lead to over-withholding and potential double taxation on mutual fund shareholders." The reasons are:

- Because REITs cannot calculate precisely—at the time each distribution is made—the portion attributable to income, gain, or return of capital, REITs can be expected to withhold on the entire amount of their distributions.
- Because mutual funds are not permitted by the Internal Revenue Code to "pass through" to their shareholders any state taxes paid by the funds, fund shareholders would not be able to claim a credit against their own state tax liability for any taxes paid by the funds to Hawaii.

In the testimony filed by the Hawaii Attorney General last year regarding SB 675 (beginning on page 70), the Attorney General requested that the bill be held because "the provisions in S.B. No. 675 may be challenged as unconstitutional to the extent the bill seeks to collect taxes on the income attributable to intangibles held by a nonresident."

Further, also in testimony filed last year with regard to SB 675 (beginning on page 85), noted constitutional scholar and professor at the University of Georgia School of Law Walter Hellerstein wrote that states of residence would not be constitutionally required to grant a tax credit for tax withheld by REITs as a result of enactment of SB 675, "because there is no constitutional bar against double taxation that arises from states' inconsistent sourcing rules."

Contrary to its goals of fairness, SB 2409's enactment would impose obligations and liabilities on REITs that are not imposed on non-REIT corporations or partnerships.

The text of SB 2409 argues that its enactment would ensure that the "state is paid its fair share of income taxes from the economic activity generated by real estate investment trusts." Contrary to these goals, enactment of SB 2409 would be anything but fair by imposing additional obligations and liabilities on REITs not imposed on non-REIT corporations or partnerships.

Specifically, REITs are just corporations or business trusts that file a tax return with the IRS electing REIT status. If they comply with the many requirements imposed on REITs, among them, being widely-held (no family-owned, closely-held businesses); investing mostly in real estate; not "flipping" properties (or paying a 100% tax on gains if they do) and distributing all of their income, they can deduct their distributions from their taxable income. As a result, their income is taxed at the investor level–like that of partnerships. If they don't meet these requirements, they are taxed at the entity level like non-REIT corporations, and then again at the shareholder level when their income is distributed. Non-REIT corporations and partnerships aren't subject to the burdens and obligations imposed on REITs; most importantly, unlike REITs, they can retain their profits.

If enacted, SB 2409 wouldn't eliminate the requirements applicable to REITs–they would still need to be widely held, invest mostly in real estate; distribute all of their income, and not flip properties, but these requirements would not apply to non-REIT corporations or partnerships. Despite being subject to these requirements, REITs would be unable to claim the DPD in Hawaii with respect to distributed income. Thus, although non-REITs in Hawaii could retain 100% of their income; REITs in Hawaii would be required to distribute at least 90% of their income, and both would be unable to claim a DPD. Not only that, only REITs would be required to withhold tax on distributions to shareholders. On the other hand, non-REIT corporations would not be required to withhold tax on any distributions to shareholders.

SB 2409 would not change the tax exemption of other entities that earn rental income from real property such as tax-exempt pension funds and endowments, who invest in rental real estate though partnerships, sometimes along with REITs, and pay no income tax on their earnings.

Finally, because REITs generally have no income tax liability, they generally do not claim tax credits, and they cannot pass through credits or losses to investors. Non-REIT corporations and partnerships can and do claim tax credits, and partnerships can pass through credits and losses to investors.

SB 2409 Would Violate Core State Comity Principles

SB 2409 would be contrary to federal income tax rules and the existing laws of virtually every other state with an income-based corporate tax system. Virtually every state with an income-based tax system, including Hawaii currently, allows REITs a deduction for dividends paid. (New Hampshire is the only state with income-based corporate tax that does not permit a DPD. New Hampshire has much less REIT investment than Hawaii despite having a similarly sized economy). Additionally, Hawaii currently taxes all REIT dividend income received by Hawaii resident shareholders, regardless of where the REIT's real estate is located or the REIT does business.

Please Hold SB 2409

For the reasons described above, Nareit requests the Committee to hold SB 2409.

LAND USE RESEARCH
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January 27, 2020

Senator Stanley Chang, Chair
Senator Dru Mamo Kanuha, Vice Chair
Senate Committee on Housing

Comments and Concerns in Support of the Intent of Program Proposed, but in Strong Opposition to Method of Program Funding Proposed by SB 2409, Relating to Returning Resident Down Payment Program; Special Fund; Real Estate Investment Trust (REIT); Deductions (Establishes the returning resident down payment program; funds the program with taxes on dividends paid by real estate investment trusts; repeals dividend paid deduction [DPD] for REITs; appropriates funds.)

Tuesday, January 28, 2020, 1:30 p.m., in Conference Room 225

The Land Use Research Foundation of Hawaii (LURF) is a private, non-profit research and trade association whose members include major Hawaii landowners, developers and utility companies. LURF's mission is to advocate for reasonable, rational and equitable land use planning, legislation and regulations that encourage well-planned economic growth and development, while safeguarding Hawaii's significant natural and cultural resources, and public health and safety.

SB 2409. The purpose of this bill is reportedly to encourage former Hawaii residents to move back to Hawaii by establishing the returning resident down payment program to provide matching funds for the down payment on a residence. The program is proposed to be funded with taxes on dividends paid by REITs through the repeal of the DPD for REITs. The measure would require REITs to file returns reporting their shareholders pro rata shares of net income and net income attributable to this State; and to require withholding and payment to the State on behalf of shareholders, an amount equal to five per cent multiplied by the amount of the shareholder's pro rata share of the income attributable to the State. Should SB 2409 be adopted, non-resident REIT shareholders will be taxed on dividend income attributable to this State, despite paying income tax in their home state, resulting in a double tax for those shareholders.

LURF's Position. While LURF fully understands and supports the concerns and efforts of the legislature to address the economic, social and cultural burdens of the State, it has consistently been LURF's position that it is improper for lawmakers to utilize inappropriate and arguably unconstitutional means to effectuate and fund

programs to achieve stated objectives, regardless of how well-intentioned or benevolent they may be.

It is LURF's belief that this and numerous prior versions of anti-REIT measures have in actuality been introduced over the past years in response to what may be inaccurately perceived as the potential for tax avoidance and abuse by foreign/mainland corporations and wealthy individuals through real estate ownership arrangements structured through REITs. Reported justifications for this type of anti-REIT bill, however, have yet to be proved as credible and the proposed measures have thus far failed to be substantiated or supported by any reliable facts or evidence.

LURF's Opposition to the Repeal of the DPD for REITs Proposed by SB 2409 is Premised on the Following Concerns and Issues:

The State's Final Report on the Impact of REITs in Hawaii Has Failed to Validate the Alleged Purpose of and Need to Repeal the DPD.

Given that an unwarranted change of a universal tax rule in place since 1960 could undoubtedly affect investments made by REITs in Hawaii, significantly reduce the availability of capital in this State, as well as result in other economic repercussions, the Legislature determined in 2015 that it was necessary and prudent to require support for this type of measure prior to considering its passage. Thus, Act 239, Session Laws of Hawaii 2015, was passed which required the State Department of Business, Economic Development & Tourism (DBEDT) and the State Department of Taxation (DOTAX) to study the impact of REITs in Hawaii, and to present material facts and evidence which could show that such proposed legislation is in fact needed, and whether the State's economy will not be negatively affected because of taking the action proposed.

An interim report was released in December 2015 (the "Interim Report"),[1] followed by a final report issued in September 2016 (the "Final Report"),[2] however, even the Final Report is based on assumptions and estimates; relies on inconclusive results of surveys admittedly taken with a small sample size and low response rate; and is fraught with uncertainties, inconsistencies and weighting errors, making it unfeasible and ill-advised to rely upon for presenting any conclusive calculations or impacts.

Inquiries which critically must be, yet have not been proficiently or accurately addressed in the Final Report, include the amount of income the State would in fact receive as a result of the proposed legislation,[3] especially given the likelihood that REIT investment

[1] Department of Business, Economic Development & Tourism Research and Economic Analysis Division. *Real Estate Investment Trusts in Hawaii: Preliminary Data and Analysis - Interim Report*. December 2015.

[2] Department of Business, Economic Development & Tourism Research and Economic Analysis Division. *Real Estate Investment Trusts in Hawaii: Analysis and Survey Results*. September 2016.

[3] LURF understands that even the State DOTAX does not know how much tax income the government might receive as a result of the proposed legislation.

in Hawaii will in turn decline (i.e., whether the proposed measure is fiscally reasonable and sound); and whether it would be possible to replace the billions of dollars in investments currently being made by REITs should they elect to do business elsewhere if this proposed legislation is passed.

Given the inadequacy, inaccuracy and unreliability of the tenuous findings contained in the Interim and Final Reports, as well as the complete failure of said Reports to come to any meaningful and valid conclusions required to be made pursuant to Act 239, it should be brought to this Committee's attention that another study on the economic impacts of REITs in Hawaii dated December 2015, was prepared by economic expert Paul H. Brewbaker, PhD., CBE for the National Association of Real Estate Investment Trusts (the "Brewbaker Study").[4] The Brewbaker Study concludes that the repeal of the dividend paid deduction (DPD) for REITs in Hawaii would likely result in a net revenue loss to the State due to a number and combination of negative consequences which would be experienced by the local economy.

In view of the inconsistency between findings contained in the Final Report and the Brewbaker Study, LURF believes it would be irresponsible for this Committee to consider, let alone support the method of funding the Program proposed by SB 2409 which may potentially have the opposite effect of stifling, if not reversing the current growth of the State's economy, in reliance solely upon the untenable findings of the Final Report and must respectfully urge this Committee to at the very least, conduct an independent investigation and analysis of all the available facts and information relating to the disallowance of the DPD, and the potential financial and economic consequences thereof, prior to making any decision on this bill.

In view of the inability of the Final Report to conclusively support the validity of this measure, LURF must oppose the proposed disallowance of the DPD based on the following reasons and considerations:

1. The "Double Tax" Resulting from the Proposals in this Measure is Contrary to the Underlying Intent of REITs.

REITs are corporations or business trusts which were created by Congress in 1960 to allow small investors, including average, everyday citizens, to invest in income-producing real estate. Pursuant to current federal and state income tax laws, REITs are allowed a DPD resulting in the dividend being taxed a single time, at the recipient level, and not to the paying entity. Most other corporations are subject to a double layer of taxation – on the income earned by the corporation and on the dividend income received by the recipient.

Proponents of this attempt to eliminate the DPD, however, appear to ignore that the deduction at issue comes at a price. REITs are granted the DPD for good reason - they are required under federal tax law to be widely held and to distribute at least 90% of

[4] Paul H. Brewbaker, Ph.D., CBE. *Economic Impacts of Real Estate Investment Trusts in Hawaii*. December 2015.

their taxable income to shareholders,[5] and must also comply with other requirements imposed to ensure their focus on real estate. In short, REITs earn the DPD as they must comply with asset, income, compliance and distribution requirements not imposed on other real estate companies. In exchange for such compliance, REIT dividends are allowed to be passed through to its shareholders, taxes on which are paid in the individual shareholders' home states regardless of where the REIT property is located or where REIT income is derived.

Should the DPD be disallowed, non-resident shareholders will be made subject to double taxation on income derived from REIT property in this State, in direct contravention to the intent underlying the federal government's establishment of REITs.

According to the Brewbaker Study, repealing the DPD for REITs and subjecting shareholders to double taxation may reduce future construction and investment by REITs locally, thereby resulting in revenue loss to the State.[6] Moreover, replacement investor groups may likely be tax-exempt institutions such as pension plans and foundations which would generate even less in taxes from their real estate investments.[7]

The Proposed Repeal Raises Constitutionality Issues.

LURF further believes that by proposing to require REITs to withhold and pay tax on behalf of non-resident investors, SB 2409, in effect inappropriately asserts jurisdiction over non-residents who otherwise lack any contact with Hawaii other than being purely passive investors in a publicly traded company. SB 2409 thus arguably raises questions of constitutionality as to whether a sufficient connection exists between those non-resident investors and this State.

2. The Proposed Disallowance of DPD for REITs is Contrary to the Tax Treatment of REITs Pursuant to Current Federal Income Tax Rules and Laws of Other States with an Income-Based Tax System.

SB 2409 would enact serious policy change that would create disparity between current Hawaii, federal, and most other states' laws with respect to the taxation of REIT income.

The laws of practically every state with an income-based tax system now allow REITs a deduction for dividends paid to shareholders. Hawaii, as well as other states which impose income taxes currently tax REIT income just once on the shareholder level (not on the entity level), based on the residence of the shareholder that receives the REIT dividends and not on the location of the REIT or its projects.

By now proposing to double tax the REITs that do business in Hawaii as well as their shareholders, SB 2409 would upset the uniformity of state taxation principles as applied

[5] The State of Hawaii thus benefits from taxes it collects on dividend distributions made to Hawaii residents.

[6] *Brewbaker Study* at pp. 1, 32, 38.

[7] *Id.*

between states. Other states which have similarly explored the possibility of such a double tax over the past years have rejected the disallowance of the DPD for widely held REITs.

3. Compliance with this Measure Would be Unfeasible, if Not Impossible Given the Inability of REITs to Ascertain the Information Required to be Reported by this Bill.

LURF also understands that like all public companies, most REIT shares are held in street name by brokers, who are not obligated to report shareholder identifying information to the REIT. There is thus no feasible way for REITs to ascertain the identities of and other information relating to their non-resident shareholders in order to substantially comply with this measure.

4. Hawaii REITs Significantly Contribute to and Benefit the Local Economy.

Elimination of the DPD would result in a double taxation of income for Hawaii REITs which would certainly mitigate, if not extinguish interest and incentive in investing in Hawaii-based REITs, which currently contribute significantly to Hawaii's economy.

Results from the Final Report indicate that even as of September 2016, approximately 42 REITs operating in Hawaii reportedly held assets in the amount of an estimated $7.8 billion at cost basis[8], which has resulted in substantial economic activity in local industries including construction, retail, resort, healthcare and personal services, as well as employment for many Hawaii residents, and considerable tax revenues for the state and city governments. Such tax revenues include State General Excise Tax (GET) on rents and retail sale of goods, business income tax on profits made by tenants, income tax from employment of Hawaii residents, and millions of dollars in property taxes.

Proponents of the proposed repeal should be mindful that significant economic growth experienced in this State over the past years, and which is expected to continue in the future, is undoubtedly attributable in part to REIT investment in Hawaii. Outrigger Enterprises partnered with REIT American Assets Trust to successfully develop the Waikiki Beach Walk. General Growth' Properties' expansion and renovation of the Ala Moana Shopping Center, as well as its partnering with Honolulu-based, local companies (The MacNaughton Group, The Kobayashi Group and BlackSand Capital) to develop the Park Lane residential condominium project is another example. The capital invested in that project to construct additional retail space and luxury residences reportedly exceed $1 billion, and the development will have created an estimated 11,600 full- and part-time jobs and over $146 million of state revenue. Taubman Centers, Inc., another REIT, also partnered with CoastWood Capital Group, LLC to revitalize Waikiki through the redevelopment of the International Market Place at a cost of approximately $400 million.

[8] *Final Report* at pages 3, 15-16.

REIT projects have helped to support Hawaii's construction industry immensely[9] by providing thousands of jobs, and continue to significantly contribute to the local economy through development of more affordable housing (more than 2,000 rental housing units for Hawaii's families, such as the Moanalua Hillside expansion of more affordable housing rentals), student housing near the University of Hawaii, health care facilities, offices, shopping centers (Ala Moana Center addition; Pearlridge Center renovations; Ka Makana Ali'i), and hotels.

Despite claims made by detractors, the multibillion-dollar investments and contributions to Hawaii's economy made by REITs may not be so easily generated through other means or resources. Attracting and obtaining in-state capital for large projects is very difficult. The State should also be concerned with the types of entities willing and able to invest in Hawaii and should be wary of private investors looking only to make quick gains when the market is booming. Because federal regulations preclude REITs from "flipping" properties, REITs are by law, long-term investors which help to stabilize commercial real estate prices, and which are also likely to become a part of the local community.

5. The Disallowance of the DPD Proposed by this Bill will Unfairly Affect REITs and the Small Investors Which Have Already Made Substantial Investments in Hawaii.

Disallowance of the DPD and resulting increased taxation of REITs is expected to reduce investment returns as well as dividend payments to shareholders, which will no doubt have a significant negative effect on future investment by REITs in Hawaii.

Proponents of the proposed repeal attempt to minimize the negative consequences of disallowing the DPD by claiming that very few Hawaii taxpayers invest in REITs with property in Hawaii, however, LURF understands that in 2014 over 9,000 Hawaii investors had investments in over 70 public, non-listed REITs and received almost $30 million in distributions, and that tens of thousands more directly or indirectly own shares in stock exchange-listed REITs.

Supporters of the repeal also ignore the fact that tax law changes proposed by SB 2409 will unfairly impact those publicly traded REITs which have already made substantial investments in Hawaii and have contributed greatly to the State's economy in reliance on the DPD, which, as discussed above, is considered a fundamental principle of taxation applicable to REITs.

If passed, the disallowance of the DPD would strongly discourage future investment by REITs in Hawaii, which would ultimately impact jobs, reduce tax revenue and result in significant consequences for the State's future economy.

[9] In the past five years, REIT-related construction activity alone is estimated to have generated $3 billion in Hawaii GDP.

Conclusion. LURF's position is that the proposed method of funding the Returning Resident Down Payment Program is inappropriate and improper, especially given that the findings of the Final Report have not been updated or amended since issuance, and have failed to credibly present any material facts or circumstances to prove that a repeal of the DPD for REITs is in fact warranted. The proposed disallowance of the DPD and utilization of such a funding method for the Program pursuant to SB 2409 is thus unreasonable, unwarranted, and exceedingly anti-business.

Act 239, SLH 2015 was specifically enacted by the State Legislature to validate the alleged purpose of disallowing the DPD. The results of the Final Report are thus considered vital to confirm the need for any type of repeal measure. Therefore, based on the inability of said Report to convincingly and conclusively determine that the State's economy will be negatively impacted as a result of the action proposed, or that any repeal legislation is otherwise warranted, and given that an unjustifiable change of a universal tax rule in place since 1960 could significantly reduce the availability of capital in this State, as well as result in other negative economic repercussions, LURF must **strongly oppose the disallowance of DPDs for REITs to provide for a method of funding the Returning Resident Down Payment Program as proposed by SB 2409, regardless how well-intended this measure may be**, and respectfully requests that this bill be **held in this Committee.**

ALEXANDER & BALDWIN
PARTNERS FOR HAWAI'I

SB 2409
RELATING TO DOWN PAYMENTS

PAUL T. OSHIRO
DIRECTOR – GOVERNMENT AFFAIRS
ALEXANDER & BALDWIN, INC.

JANUARY 28, 2020

Chair Chang and Members of the Senate Committee on Housing:

I am Paul Oshiro, testifying on behalf of Alexander & Baldwin (A&B) on SB 2409, "A BILL FOR AN ACT RELATING TO DOWN PAYMENTS." We respectfully oppose this bill.

While A&B has always been a Hawaii-based company, in 2012, A&B made a strategic decision to be 100% Hawaii-based and to migrate its mainland investments back to Hawaii. Since then, A&B has sold all of its mainland properties and has reinvested the proceeds in Hawaii—acquiring properties including the Kailua Town commercial center, Manoa Marketplace, Waianae Mall, Laulani Village (Ewa Beach), Puunene Shopping Center (Maui), and Hokulei Village (Kauai). In 2017, to better support our Hawaii-focused strategy and increase our ability to invest in Hawaii in an increasingly competitive environment, A&B made the decision to convert to a real estate investment trust (REIT). A REIT structure enables A&B to attract new investors to its stock, giving us capital to invest in our Hawaii-focused strategy, and puts us in a better position to compete with large, out-of-state investors, with greater sources of capital, for the acquisition of Hawaii properties, thus keeping them in locally-owned hands, with a management team that lives here and is committed to Hawaii. Furthermore, REITs are structured to be long-term holders of real

estate, thus complementary to A&B's goal of being Partners for Hawaii, with a long-term commitment to our communities.

Real estate investment trusts were established by Congress in 1960 to enable all types of investors to invest in real estate. REITs generally own, operate, and finance income-producing commercial real estate such as shopping malls, hotels, self-storage facilities, theme parks, and apartment, office, and industrial buildings. Other REITs provide financing for income-producing real estate by purchasing or originating mortgages and mortgage-backed securities, which provides liquidity for the real estate market.

In Hawaii, REIT investments help communities grow through the development of workforce rental housing, medical facilities, shopping centers, and commercial buildings that enhance our quality of life. REITs own high-quality office, retail, and industrial space, which provide a favorable environment for numerous locally owned businesses to operate and grow. These REIT owned facilities also provide numerous employment opportunities and jobs for Hawaii's residents.

The purpose of this bill is to establish a Returning Resident Down Payment Program funded by the withholding and payment of a Hawaii tax on non-resident shareholders for dividends received from REITs with properties in Hawaii and the repeal of the REIT dividend paid deduction. While we understand the purpose and intent of the Returning Resident Down Payment Program, we respectfully oppose funding this program with revenue derived from the withholding and payment of a Hawaii tax on dividends received by non-resident Hawaii REIT shareholders and the repeal of the REIT dividend paid deduction.

WITHHOLDING OF HAWAII TAX ON NON-RESIDENT HAWAII REIT SHAREHOLDERS

Section 6 of this bill requires the withholding of a Hawaii tax on non-resident shareholders for dividends received from REITs with properties in Hawaii. In that all REIT shareholders nationwide are presently responsible to pay tax in their home state on all dividend income received from REITs irrespective of where the REIT properties are located, this provision will result in Hawaii becoming the only state to tax non-resident REIT shareholders.

A&B has significant concerns with this provision of the bill. First, it will be extremely difficult to fully implement. A significant portion of REIT shares are presently held in "street name" by stockbrokers, and the U.S. Securities and Exchange Commission does not require stockbrokers to disclose the names and addresses of shareholders of stock held in street name. Thus, it will be very difficult for REITs to ascertain the identities and addresses of all individual non-resident shareholders who hold their stock. In addition, with shares of REIT stock freely traded on stock exchanges with many REITs having thousands of shareholders, and shareholders often going in and out of the stock during the course of the year, recordkeeping on who owned how many shares of REIT stock on specific dates for varying durations of time and then allocating Hawaii taxable income to the amount of dividend earned off of Hawaii properties by each individual investor is envisioned to be a significant administrative challenge.

More importantly, this section will likely deter individuals and entities from acquiring shares of REITs that have Hawaii holdings because of the administrative burden that will be imposed on the shareholder. It is our understanding that this bill is premised on the assumption that the home state of the non-resident shareholder will grant tax credits to the

taxpayer for the amount of tax that is withheld and paid to the State of Hawaii, and relinquish the tax that previously would have been paid to their state. This, however, is not a given. For tax purposes, we understand that the situs or tax jurisdiction of intangible property such as stocks, bonds, and notes follows the domicile or residence of the owner. Thus, REIT shares are taxable in the shareholder's state of residence and not in any other state. It is questionable whether other states will grant tax credits to their resident taxpayer for taxes withheld and paid to Hawaii on REIT shares. Should states not provide this corresponding tax credit, this will result in a double taxation for residents of their state that hold shares of REIT properties situated in Hawaii**.** In addition, parties who are exempt from income tax such as pension funds, labor unions, and 401ks, as well as residents who reside in states that do not impose an income tax, may face significant challenges trying to recover taxes withheld in Hawaii. Thus, rather than face this financial uncertainty, taxpayers may choose to invest in entities other than Hawaii REITs.

DIVIDEND PAID DEDUCTION REPEAL

Sections 7 and 8 of this bill repeal the dividend paid deduction for real estate investment trusts. At present, all states except for one (New Hampshire) allow REITs to pass through its federally mandated shareholder dividend distribution without the imposition of a corporate tax, in that individual shareholders are responsible to pay the tax on these dividends. Repeal of the dividend paid deduction will result in the double taxation of Hawaii REIT shareholder dividends. This will essentially result in Hawaii REITs continuing to distribute, as mandated by Federal Law, at least 90% of their taxable income to shareholders. However, unlike the other states, the REIT will also pay Hawaii corporate income tax prior to making the dividend distribution to its shareholders, thus reducing the

amount of dividends shareholders will receive. In addition, shareholders of Hawaii REIT properties will also continue to be responsible to pay income tax on the distributed dividends—a second tax on the same profits.

If REITs and their investors are double taxed in Hawaii, it is likely that investors may shift their investments to other states where a better return on their investments can be realized. This will result in REITs spending and investing less money in Hawaii to operate, maintain, and enhance their properties. Hawaii's economy will inevitably be negatively impacted should the dividend paid deduction be repealed.

SUMMARY

REITs provide a much-needed source of outside capital for Hawaii. Very few individual investors and a fairly small number of corporate players in Hawaii have capital market access equivalent to what is enabled by REITs. REIT's bring this externally raised capital to invest in, develop, and enhance properties here in Hawaii. In addition, REITs continually invest during both good and bad economic times, thus softening the impact of recessions and local economic downturns.

Today, no other state requires the withholding and payment of a tax on non-resident REIT shareholders, and only New Hampshire disallows the REIT dividend paid deduction. No state in the nation has both of these provisions as proposed in this bill. If either of these provisions are enacted into law, REITs and their investors may prefer to invest in states other than Hawaii. Hawaii, along with REITs with properties in Hawaii, will be at a competitive disadvantage in attracting additional investors and capital to support continued investment, economic development, and growth in our state. When combined with the direct reduction in general excise and income taxes from diminished REIT related

construction, fewer jobs, and the reduction in business and individual income taxes because of the direct and indirect impacts of lower REIT related activity, this bill poses a significant risk to the health of the state's overall economy.

Based on the aforementioned, we respectfully request that this bill be held in Committee. Thank you for the opportunity to testify.

OPTrust

Paying pensions today, preserving pensions for tomorrow.

January 27, 2020

The Honorable Stanley Chang, Chair
And Committee Members
Committee on Housing
Hawaii State Senate
415 S. Beretania St., #225
Honolulu, HI 96813

Dear Chair Chang and Committee Members:

RE:SB2409 Relating to Down Payments

My name is Andrew Alcock, Director, Real Estate Investments, OPTrust, testifying in strong opposition to SB2409 Relating to Down Payments. OPTrust is one of Canada's largest pension funds with net assets of over $20 billion CAD. The trust administers a defined benefit plan with almost 95,000 members and retirees.

OPTrust partnered with DeBartolo Development ("DeBartolo") to develop the Ka Makana Ali'i center in Kapolei. DeBartolo's vision and partnership with the Department of Hawaiian Home Lands ("DHH") were important factors in OPTrust's decision to invest in Hawaii. One of the deciding factors in OPTrust making its investment in Ka Makana Ali'i, was the sound investment policies of both the State of Hawaii and its partnership with private developers like DeBartolo. OPTrust invests across the globe. Many of those investments are made through REIT structures, which provide a dividend exemption by law. By way of example, there is only one State in the United State of America (New Hampshire) which does not permit the REIT dividend deduction. The ability to invest in Ka Makana Ali'i through a REIT structure was paramount to OPTrust's decision to invest in Hawaii.

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optrust.com

OPTrust

REIT's provide a way to finance projects that local investors or the State of Hawaii would not be able to provide. Disallowing the dividends paid deduction for REIT's will result in the double taxation on REIT income and will place Hawaii at a disadvantage compared to other States when it comes to attracting investor capital. Disallowing the deduction would prevent numerous investors from investing in the State of Hawaii, resulting in far fewer development projects and less low-income housing.

Further, SB2409 requires a long list of reporting, including that REITs file a return for each taxable year specifying:

1. The name, address and social security or federal identification number of each person owning stock in the REIT at any time during the taxable year;
2. The number of shares of stock owned by each shareholder at all times during the taxable year;
3. The amount of money and other property distributed by the REIT during the taxable year to each shareholder; and
4. Any other information the department may prescribe by form or rule.

These requirements are overburdening. The report itself will be very voluminous and the information difficult to track, especially when some of the companies that we work with are public traded.

Should this bill pass, OPTrust would be forced to direct its investment capital to other States which recognize the benefit of attracting REIT investors. Unfortunately, we also understand and recognize that any changes in the law will have a very undesirable effect on DHHL and will negatively impact the income they receive to further their efforts to build housing and provide programs for their beneficiaries.

We urge you to strongly oppose SB2490 so that projects such as Ka Makana Ali'i can continue to be built and enhance not only Hawaii's economic growth but continue provide DHHL with the means to provide more housing for the native Hawaiian community.

Yours truly,

Andrew Alcock

DAVID Y. IGE
GOVERNOR

CRAIG K. HIRAI
DIRECTOR

ROBERT YU
DEPUTY DIRECTOR

EMPLOYEES' RETIREMENT SYSTEM
HAWAII EMPLOYER-UNION HEALTH BENEFITS TRUST FUND
OFFICE OF THE PUBLIC DEFENDER

STATE OF HAWAII
DEPARTMENT OF BUDGET AND FINANCE
P.O. BOX 150
HONOLULU, HAWAII 96810-0150

ADMINISTRATIVE AND RESEARCH OFFICE
BUDGET, PROGRAM PLANNING AND
MANAGEMENT DIVISION
FINANCIAL ADMINISTRATION DIVISION
OFFICE OF FEDERAL AWARDS MANAGEMENT (OFAM)

WRITTEN ONLY

TESTIMONY BY CRAIG K. HIRAI
DIRECTOR, DEPARTMENT OF BUDGET AND FINANCE
TO THE SENATE COMMITTEE ON HOUSING
ON
SENATE BILL NO. 2409

January 28, 2020
1:30 p.m.
Room 225

LATE

RELATING TO DOWN PAYMENTS

The Department of Budget and Finance offers comments on Senate Bill (S.B.) No. 2409.

S.B. No. 2409 establishes the Returning Resident Down Payment Special Fund (RRDPSF) under the administration of the Hawai‘i Housing Finance and Development Corporation (HHFDC); repeals dividend paid deductions for real estate investment trusts (REITs); and appropriates an unspecified amount of general funds for deposit into the RRDPSF.

Funds from the RRDPSF would be used to provide matching funds not to exceed the lesser of 10% of the value of a single-family residence purchased or $50,000, subject to certain eligibility requirements. Proposed funding for the RRDPSF would come from taxes on dividends paid by REITs.

As a matter of general policy, the department does not support the creation of any special fund which does not meet the requirements of Section 37-52.3, HRS. Special funds should: 1) serve a need as demonstrated by the purpose, scope of work,

and an explanation why the program cannot be implemented successfully under the general fund appropriation process; 2) reflect a clear nexus between the benefits sought and charges made upon the users or beneficiaries or a clear link between the program and the sources of revenue; 3) provide an appropriate means of financing for the program or activity; and 4) demonstrate the capacity to be financially self-sustaining. Regarding S.B. No. 2409, it is difficult to determine whether the proposed special fund would be self-sustaining.

The department defers to HHFDC for concerns regarding the implementation of this program and to the Department of Taxation regarding the establishment of a tax on REIT dividends.

Thank you for your consideration of our comments.

Chamber of Commerce HAWAII
The Voice of Business

Testimony to the Senate Committee on Housing
Tuesday, January 28, 2020 at 1:30 P.M.
Conference Room 225, State Capitol

RE: SB 2409, RELATING TO DOWN PAYMENTS

LATE

Chair Chang, Vice Chair Kanuha, and Members of the Committee:

The Chamber of Commerce Hawaii ("The Chamber") **opposes** SB 2409, specifically, the section that would make revisions to HRS Section 234 pertaining to Real Estate Investment Trust returns; withholding on dividends paid, and would disallow dividend paid deduction for real estate investment trusts applicable to taxable years beginning after December 31, 2020.

The Chamber is Hawaii's leading statewide business advocacy organization, representing about 2,000+ businesses. Approximately 80% of our members are small businesses with less than 20 employees. As the "Voice of Business" in Hawaii, the organization works on behalf of members and the entire business community to improve the state's economic climate and to foster positive action on issues of common concern.

Hawaii businesses already pay many taxes, and this bill represents yet another tax increase on our business community. REITs invest in many important projects that would not be able to secure funding otherwise. For example, before American Assets Trust became a partner in the Waikiki Beach Walk, the property owner was not able to secure funding locally.

Additionally, REITs are also long-term property owners. They do not flip properties, which keeps our commercial real estate prices down and adds stability to the market. An increase in taxes on these companies, who owns the commercial space, would likely be passed down to the hundreds of businesses that hold leases in their buildings. As a result, these businesses would have to pass the increased cost of operating onto their customers. In other words, this measure could have a ripple effect that affects not just REITs, but also their tenants and consumers.

Finally, like any business, REITs are going to be making their decisions based on where it will be able to generate the best return on investment. By increasing the costs to doing business in Hawaii, and diminishing the return on investment, REITs are going to look to other states to fund future projects.

In consideration of these concerns, we respectfully urge you to defer SB 2409. Thank you for the opportunity to testify.

733 Bishop Street, Suite 1200 • Honolulu, Hawaii 96813 • Phone: (808) 545-4300 • Facsimile: (808) 545-4369

LATE

SB 2409, RELATING TO DOWN PAYMENTS

JANUARY 28, 2019 · SENATE HOUSING COMMITTEE
· CHAIR SEN. STANLEY CHANG

POSITION: Support.

RATIONALE: IMUAlliance supports SB 2409, relating to down payments, which encourages certain former Hawai'i residents to move back to Hawaii by establishing the returning resident down payment program to provide matching funds for the down payment on a residence, funds the program with taxes on dividends paid by real estate investment trusts, and repeals dividend paid deduction for real estate investment trusts.

Under state taxation law, REITs are currently afforded an exemption from paying corporate income taxes on dividends paid to shareholders. REIT shareholders, however, pay federal and state income taxes on their earnings from the REIT in which they have invested. Unfortunately, since most shareholders of Hawai'i REITs don't live in the Aloha State, they pay income taxes in other locations. Thus, income generated by Hawai'i property is getting taxed elsewhere, sending sorely needed tax dollars for local schools, infrastructure, climate change mitigation, human and social services, and affordable housing outside of our shores.

Eliminating REIT dividend deductions will uplift Hawai'i's people. Over 30 REITs operate in Hawai'i, the most prominent of which is Alexander and Baldwin. Collectively, Hawai'i REITs own roughly $17 billion worth of real estate and produce almost $1 billion in dividend income exempt from the corporate income tax, amounting to over $50 million in lost tax revenue–a number that will only increase over time, as real estate values continue to soar.

Kris Coffield, Executive Director · (808) 679-7454 · kris@imuaalliance.org

Moreover, **the lack of affordable housing exacerbates the economic insecurity suffered by local families, which sex traffickers use to prey upon potential victims with false promises of financial stability and prosperity.** Hawai'i residents face the highest housing costs in the nation, at more than twice the national average. Researchers who authored the National Low Income Housing Coalition's *Out of Reach 2019* report found that a full-time worker would need to earn $36.82/hour to afford a two-bedroom apartment at fair market value in our state, with Honolulu experiencing a 67 percent increase in fair market rent between 2005 and 2015. Average rent for a two-bedroom unit surpassed $2,000 in recent years, with minimum wage workers needing to log 111 hours per week to afford a modest one-bedroom apartment at fair market value and 146 hours per week to afford a two-bedroom–a number that is equivalent to working over 20 hours a day with no days off year-round. In the past five years alone, Honolulu rent has increased by more than 25 percent. While 43 percent of Hawai'i residents are renters (a number that does not include individuals and families renting outside of the regulated rental market), they earn an average wage of $16.68/hour, according to NLIHC, scarcely enough to meet their basic needs. One out of every four households in Hawai'i report that they are "doubling up" or are three paychecks or less away from being homeless, per the Hawai'i Appleseed Center for Law and Economic Justice. Additionally, 63 percent of households are severely cost-burdened, following NLIHC data, meaning that they pay more than 30 percent of their income for housing costs, a number that rises to 83 percent of extremely low-income households, with only 74 homes available for every 100 households earning 80 percent of their respective area's median income.

Unsurprisingly, our state is now experiencing population decline. Hawai'i saw domestic out-migration increase for a third consecutive year in 2019, as the state's high cost of living continued to push people to the mainland. Census estimates show that our state's population dropped by more than 4,700 people, to 1,415,872, from July 2018 to July 2019, when births, deaths, and migration were accounted for. That's the biggest numerical population drop since 2015 and it made Hawai'i one of just ten states in the country to lose population in 2019, according to the U.S. Census Bureau.

We cannot continue to allow the islands to be used as a private Monopoly board for real estate speculators. To ensure that our islands are affordable for ourselves and future generations, we must take bold action ***now*** to increase our affordable housing supply for working families.

sifma
Invested in America

LATE

January 27, 2020

The Honorable Donovan M. Dela Cruz, Chair
The Honorable Gilbert S.C. Keith-Agaran, Vice Chair
Senate Committee on Ways and Means
Hawai'i State Capitol
415 South Beretania St.
Honolulu, HI 96813

RE: SIFMA Letter in Opposition to SB 2409 on Proposed Changes to Real Estate Investment Trusts ("REITs")

Dear Chair Dela Cruz, Vice Chair Keith-Agaran and Members of the Senate Committee on Ways and Means:

The Securities Industry and Financial Markets Association[1] is a national trade association which represents hundreds of large, medium and small broker-dealers, banks and assets managers many of whom have a presence in Hawaii. We appreciate the opportunity to comment on SB 2409, which is set to be heard in your committee January 28. SB 2409 would both create a returning resident down payment program and place new requirements related to tax withholding in real estate investment trusts. Our letter addresses Part II of the proposal only, concerning REITs.

SB 2409 would require real estate investment trusts ("REITs") to:

1. Prepare annual tax returns which include detailed personal information on each shareholder, the number of shares each shareholder owns, and a shareholder by shareholder breakdown of what REIT income is attributable to the State; and

2. Withhold and pay to the state an amount equal to five percent of the shareholder's pro rata share of the income attributable to the State as reflected on the REIT's return.

We are writing to respectfully express our opposition to the legislation. While broker-dealers are not referenced, both they and their clients would be adversely affected by the bill. Specifically, we urge you to consider the following:

[1] SIFMA is the leading trade association for broker-dealers, investment banks and asset managers operating in the U.S. and global capital markets. On behalf of our industry's nearly 1 million employees, we advocate on legislation, regulation and business policy, affecting retail and institutional investors, equity and fixed income markets and related products and services. We serve as an industry coordinating body to promote fair and orderly markets, informed regulatory compliance, and efficient market operations and resiliency. We also provide a forum for industry policy and professional development. SIFMA, with offices in New York and Washington, D.C., is the U.S. regional member of the Global Financial Markets Association (GFMA). For more information, visit http://www.sifma.org.

- Requiring Broker-Dealers and REITs to Compile and Disclose Information on Individual Investors Would Be Unduly Burdensome.

  For both proprietary and confidentiality reasons, REIT shares are typically registered in the name of the financial intermediary (e.g., broker) holding the shares for its customers in a "street name" or nominee account. REITs therefore often do not have the information requested by the bill and would be forced to go to broker-dealers to obtain it.

  This, of course, undercuts the premise behind registering the shares in a street name or nominee account. It also would be a tremendous amount of work both for brokers to provide this information and for REITs to take it and process it.

  In 2017, more than 48 billion REITs transactions were made through the New York Stock Exchange. The daily volume often exceeds 200 million transactions and can reach 400 million. It would be extremely costly and time consuming for our members to sort, track and report securely to REITs sensitive personally identifiable information on all the investors who might own REIT shares at some point during the year. REITs would then have the additional burden of calculating the pro rata share of income attributable to the state multiplied by 5%, withholding that amount, and making the payment.

- Additional Requirements Could Make Investments in Hawaii Real Estate Less Attractive.

  Imposing novel tax reporting, withholding, and investor tax return filing requirements on REITs with Hawaii investments inevitably will make REITs with a Hawaii presence less attractive to investors, and this could reduce the level of investment in Hawaii real property. U.S. equity market participants have other investment options that do not require them to commit to accept a state tax withholding requirement or to share sensitive PII with multiple intermediaries.

- Disclosing Personal Identifying Information Could Place Clients at Risk.

  SB 2409 would require detailed information on each individual investor, including name, address, and social security number, as well as additional filings with the Department of Taxation. Broker-dealers implement and maintain strict security procedures and practices to protect their client's PII. These measures are generally appropriate to the nature of the personal information owned or licensed and the nature and size of the entity or operation.[2] Limiting the collection and disclosure of sensitive data to that which is directly relevant and necessary to accomplish a specified purpose is one of the best practices to protect client information.[3] Requiring broker-dealers to disclose PII to REITs runs counter to protecting the client's private information. This is true even if similar information is already reported elsewhere. We would urge the Committee to eliminate the requirement to disclose shareholder PII which does not appear necessary if withholding is done by the Hawaii REIT and the shareholder is not otherwise required to file a Hawaii return.

[2] H.R. 4028, the "Promoting Responsible Oversight of Transactions and Examinations of Credit Technology Act of 2017"

[3] NIST Cybersecurity Framework, p. 16

- Over-Withholding Would Further Reduce the Appeal of Hawaii REIT Investments

  SB 2409 would require REITs to withhold 5% on distributions to their shareholders with income attributable to Hawaiian properties. However, many REIT shareholders are tax exempt under federal tax law. Requiring tax exempt shareholders to file a refund claim for tax withheld by the REIT is an unprecedented and burdensome process. It is inevitable that this will lead to significant over-withholding. Over-withholding is not in the investors' best-interest even if there is a process for recovering the over-withholding down the road. Such over-withholding would further reduce the appeal of Hawaii-based REITs for equity investors.

- Resident and Non-Resident Hawaii REIT Shareholders Would be Subject to Double Taxation.

  Whether or not over-withholding occurs, both resident and non-resident shareholders would be subject to double taxation. Non-Hawaiian shareholders would be taxed first in Hawaii and then in their own country or state of residence with respect to the same REIT dividend. It is unlikely that any other state or foreign jurisdiction would allow a credit for tax imposed by Hawaii and paid by a REIT under the proposed legislation.

  In the absence of a Hawaii credit for tax paid by REITSs on behalf of shareholders, which the legislation does not seem to provide, shareholders otherwise required to file a Hawaii return also appear to be subject to a double-tax when REITs pay dividends to such shareholders.

In short, for a variety of reasons we believe that SB 2409 is not good for brokers, investors or the State of Hawaii, and we urge you to oppose the legislation. We appreciate the opportunity to provide feedback. If you have any questions, or if there is any further information we can provide, please contact me at 202-962-7411.

Sincerely,

Kim Chamberlain
Managing Director & Associate General Counsel
SIFMA

sifma
Invested in America

LATE

January 27, 2020

The Honorable Stanley Chang, Chair
The Honorable Dru Mamo Kanuha, Vice Chair
Senate Committee on Housing
Hawaii State Capitol
415 South Beretania St.
Honolulu, HI 96813

RE: SIFMA Letter in Opposition to SB 2409 on Proposed Changes to Real Estate Investment Trusts ("REITs")

Dear Chair Chang, Vice Chair Kanuha and Members of the Senate Committee on Housing:

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We are writing to respectfully express our opposition to the legislation. While broker-dealers are not referenced, both they and their clients would be adversely affected by the bill. Specifically, we urge you to consider the following:

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- Additional Requirements Could Make Investments in Hawaii Real Estate Less Attractive.

  Imposing novel tax reporting, withholding, and investor tax return filing requirements on REITs with Hawaii investments inevitably will make REITs with a Hawaii presence less attractive to investors, and this could reduce the level of investment in Hawaii real property. U.S. equity market participants have other investment options that do not require them to commit to accept a state tax withholding requirement or to share sensitive PII with multiple intermediaries.

- Disclosing Personal Identifying Information Could Place Clients at Risk.

  SB 2409 would require detailed information on each individual investor, including name, address, and social security number, as well as additional filings with the Department of Taxation. Broker-dealers implement and maintain strict security procedures and practices to protect their client's PII. These measures are generally appropriate to the nature of the personal information owned or licensed and the nature and size of the entity or operation.[2] Limiting the collection and disclosure of sensitive data to that which is directly relevant and necessary to accomplish a specified purpose is one of the best practices to protect client information.[3] Requiring broker-dealers to disclose PII to REITs runs counter to protecting the client's private information. This is true even if similar information is already reported elsewhere. We would urge the Committee to eliminate the requirement to disclose shareholder PII which does not appear necessary if withholding is done by the Hawaii REIT and the shareholder is not otherwise required to file a Hawaii return.

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- Over-Withholding Would Further Reduce the Appeal of Hawaii REIT Investments

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  Whether or not over-withholding occurs, both resident and non-resident shareholders would be subject to double taxation. Non-Hawaiian shareholders would be taxed first in Hawaii and then in their own country or state of residence with respect to the same REIT dividend. It is unlikely that any other state or foreign jurisdiction would allow a credit for tax imposed by Hawaii and paid by a REIT under the proposed legislation.

  In the absence of a Hawaii credit for tax paid by REITSs on behalf of shareholders, which the legislation does not seem to provide, shareholders otherwise required to file a Hawaii return also appear to be subject to a double-tax when REITs pay dividends to such shareholders.

In short, for a variety of reasons we believe that SB 2409 is not good for brokers, investors or the State of Hawaii, and we urge you to oppose the legislation. We appreciate the opportunity to provide feedback. If you have any questions, or if there is any further information we can provide, please contact me at 202-962-7411.

Sincerely,

Kim Chamberlain
Managing Director & Associate General Counsel
SIFMA

Douglas Emmett

LATE

January 27, 2020

Senator Stanley Chang, Chair
Senator Dru Mamo Kanuha, Vice Chair
Senate Committee on Housing

RE: SB 2409 Relating to Down Payments – In Opposition
Tuesday, January 28, 2020; 1:30 PM; Conference room 225

Aloha Chair Chang, Vice Chair Kanuha and Members of the Committee:

On behalf of Douglas Emmett, Inc. ("Douglas Emmett"), we appreciate this opportunity to present testimony expressing concerns on SB 2409, which disallows a dividends-paid deduction ("DPD") for real estate investment trusts ("REITs") and imposes a five percent (5%) tax on shareholders' pro rata share of income attributable to the State of Hawaii.

Douglas Emmett has been investing in Oahu for over fifteen years. We currently own over 2,000 workforce rental apartment units (having recently built approximately 500 units in Moanalua), and we are working to add approximately 500 more workforce rental units in downtown Honolulu by converting one of our large office properties, Bishop Place, from office to multifamily. In order to complete the conversion of Bishop Place, we expect to invest between $80 million and $100 million into downtown Honolulu. The first units should come online in 2020 with rents targeted to serve local families in the 80% to 120% Average Median Income range. Douglas Emmett also owns two office properties in downtown Honolulu, and we employ over 275 local residents.

Douglas Emmett appreciates SB 2409's objective of encouraging former residents to return to Hawaii by assisting them in making down payments on primary residences. However, to seek to raise funding for this objective by changing the special federal income tax treatment of REITs followed generally by every state (with the exception in some states of special rules for disallowing the DPD received from so-called captive REITs) is not sound policy. SB 2409 will unfairly negatively impact those that invest in real estate through REITs, including Hawaii residents and Hawaii pension funds, because they will be subject to double taxation. It will also have a chilling effect on investment in Hawaii.

Real estate, historically and currently, is typically held in single tax entities. REITs were introduced to create a single tax structure so individual small investors could invest in real estate. Anyone can now buy a share of Douglas Emmett and own a "piece" of the Douglas Emmett's buildings. Those individuals are treated similarly to other institutional investors and wealthy individuals who invest through partnerships and limited liability companies ("LLCs") which do not subject them to "double tax". REIT shareholders pay tax on their dividends just like partnerships and LLCs. To describe the REIT structure as a "loophole" mischaracterizes the fact that everyone is paying both state and federal taxes on all income derived from REITs, and it disregards the original intent of Congress for the creation of these vehicles.

Instead of encouraging former residents to return to Hawaii, SB 2409 will likely discourage investment by REITs in Hawaii. By imposing a second state tax on REIT shareholders, Hawaii will be at a competitive disadvantage compared to other states for one of the best sources of capital to build workforce housing and improve our communities. The result will be that REITs will require a higher return to invest in Hawaii which will dramatically reduce the amount of capital allocated to Hawaii. It will also shift the group that invests in Hawaii back to the more typical tax exempt entities with large sums to make direct investments, such as endowments, foundations and pension plans. These investors pay no state income tax.

As a stakeholder in Hawaii, Douglas Emmett believes SB 2409 will eliminate an important source of capital that generates substantial local economic activity. Inasmuch as SB 2409 appears to be outside of the best interest of the residents of Hawaii and the objectives of the State to encourage the investment into, and growth of, Hawaii's economy, we respectfully ask that you defer SB 2409.

Respectfully,

Kevin Crummy
Chief Investment Officer

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January 27, 2020

The Honorable Stanley Chang, Chair
The Honorable Dru Mamo Kanuha, Vice Chair
Hawaii Senate Committee on Housing
State Capitol
415 South Beretania Street
Honolulu, HI 96813

RE: S.B. No. 2409

Dear Chairman Chang, Vice Chair Kanuha, and Members of the Senate Committee on Housing:

I am Walter Hellerstein, the Francis Shackelford Professor of Taxation Emeritus and Distinguished Research Professor Emeritus at the University of Georgia School of Law. I have devoted most of my professional life to the study and practice of state taxation and, in particular, to federal constitutional restraints on state taxation.

Per the request of Nareit, I have set forth my views regarding the question of whether states that tax their resident shareholders on their income from real estate investment trusts (REITs) would be required by federal constitutional law to grant a credit against a Hawaii tax on the same income imposed on nonresidents of Hawaii under S.B. No. 2409 to avoid double taxation. The short answer to this question is "no," because there is no constitutional bar against double taxation that arises from states' inconsistent sourcing rules, as explained below. The views expressed in this testimony are entirely my own based on my best professional judgment and do not necessarily represent those of Nareit or its members.

S.B. No. 2409 would impose a tax on REIT shareholders' pro rata share of REIT "income attributable to" Hawaii as reflected in the REIT's tax return. S.B. 2409 further identifies the shareholder's pro rata share of REIT income as "Hawaii source income." S.B. 2409 requires the REIT to "withhold and pay" to Hawaii "on behalf of any shareholder" the tax due on the "shareholder's pro rata share of the income attributable" to Hawaii. In substance, then, S.B. 2409 treats the source of REIT shareholders' income as attributable to the real estate activity underlying their intangible investment, namely, their shares in the REIT.

In contrast to the tax regime proposed by S.B. 2409, however, under the tax regimes in force in the overwhelming majority of states REIT shareholders are treated as passive investors in intangible property (the REIT shares) rather than as participants in the economic activity underlying their investment. Consequently, unlike the Hawaii tax regime proposed by S.B. 2409, other states' tax regimes do not impose a tax on nonresident investors in REITs that conduct real estate activity in their state, because states generally consider the source of income that

nonresidents earn from intangibles to be their residence unless the intangibles are associated with a trade or business carried on in the state. See 2 Jerome R. Hellerstein, Walter Hellerstein & John A Swain, *State Taxation* ¶ 20.05[6] (3rd ed. 2019 rev.) [hereafter Hellerstein, *State Taxation*].

> Arizona, for example, taxes nonresidents' income from intangible property only if the property has a business situs in the state or if the "nonresident buys or sells such property in this state or places orders with brokers within this state … so regularly, systematically and continuously as to constitute doing business in this state." Delaware taxes nonresidents' income from intangible property "only to the extent that such income is from property employed by the taxpayer in a business, trade, commerce, profession or vocation carried on in this State." Virginia taxes nonresidents' income from intangible property only "to the extent that such property is employed by the taxpayer in a business, trade, profession, or occupation carried on in Virginia."

Id. (footnotes omitted). Consequently, most states tax REIT shareholders' income from their REIT investments only at their state of residence.

Because most states consider a typical REIT shareholder's income to be taxable only by the shareholder's state of residence, S.B. 2409, if enacted, will create a serious problem of double taxation. Although every state that imposes a tax on personal income grants its residents a credit for taxes paid to other states, Hellerstein, *State Taxation* ¶ 20.10, the states generally limit that credit to income derived from sources in other states. *Id.* ¶ 20.10[2]. Consequently, if a REIT investor from a state like New York invested in a REIT with property situated in Hawaii, under S.B. 2409 Hawaii would tax the REIT shareholder's pro rata share of REIT "income attributable to" Hawaii, and New York would tax the same income as passive income that its residents earn from an intangible investment. Moreover, New York would not grant a credit for the Hawaii tax because, under New York law, which controls the question of the source of the income for purposes of the New York crediting provision, the source of the income would be in New York: "In general, it is the credit-granting state that determines the sourcing rules" for determining "whether the state that is purporting to tax on a source basis is taxing income that has its source" in that state. *Id.*

A New York case illustrates the point. New York provides a resident tax credit for "any income tax imposed … by another state … upon income both derived therefrom and subject to tax under this article." N.Y. Tax Law § 620(a) (Westlaw 2020). A New York resident sought a credit for taxes paid to Missouri from income earned from a trust administered in Missouri of which she was a beneficiary. The New York Tax Appeals Tribunal denied the credit, despite the resulting double taxation, because her income from the trust, though constitutionally taxable by Missouri, was not "derived" from Missouri within the meaning of the New York statute. *In re Mallinckrodt*, No. 807553, NY Tax App. Trib., Nov. 12, 1992, available at www.checkpoint.thomsonreuters.com. The tribunal relied on the New York regulation that denied a credit for taxes imposed by other jurisdictions on income from intangibles except when

such income is from property employed in a business, trade, or profession carried on in such jurisdiction.[1]

This brings me finally to the question on which on my views were requested: whether states that tax their resident shareholders on their income from REITs would be required by federal constitutional law to grant a credit against a Hawaii tax on such income under S.B. No. 2409 if it were enacted into law. In my opinion, the answer to that question is "no" for the simple reason that the Constitution does not require that the states adopt the same income sourcing rules even if the states' adoption of inconsistent sourcing rules may lead to double taxation. The dispositive authority on this point is *Moorman Manufacturing Co. v. Bair*, 437 U.S. 267 (1978).

In *Moorman*, the U.S. Supreme Court sustained Iowa's single-factor sales formula for apportioning corporate income to the state, even though at that time 44 of the 45 states other than Iowa utilized a three-factor formula to apportion corporate income. Moorman was engaged in manufacturing animal feed in Illinois and other states. It had over 500 sales representatives in Iowa as well as six warehouses from which it made deliveries to local customers. Moorman made approximately 22 percent of its total sales to Iowa customers. As a consequence, 22 percent of its net income was apportioned to the state. If Iowa had used the then-prevailing three-factor formula of property, payroll, and receipts, its apportionment percentage would have been reduced to about 14 percent. Moorman contended that the application of Iowa's single-factor sales formula to its net income violated the Constitution by subjecting it to extraterritorial taxation and subjecting it to multiple taxation.

In response to Moorman's argument that Iowa's single-factor sales formula, considered in conjunction with the three-factor formulas employed by most other states, exposed it to an unconstitutional risk of multiple taxation in violation of the Commerce Clause, the Court declared:

> The only conceivable constitutional basis for invalidating the Iowa statute would be that the Commerce Clause prohibits any overlap in the computation of taxable income by the States. If the Constitution were read to mandate such precision in interstate

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[1] The New York regulations provide that "the term *income derived from sources within* another state … is construed so as to accord with the definition of the term *derived from or connected with New York State sources*, as set forth in section 631of the Tax Law in relation to the New York source income of a nonresident individual." N.Y. Comp. Codes R. & Regs. tit. 20, § 120.4(d) (Westlaw 2020) (emphasis in original). Section 631 provides that a nonresident individual's items of income derived from or connected with New York State sources include "items attributable to: (A) the ownership of any interest in real or tangible personal property in this state … ." N.Y. Tax Law § 631(b) (Westlaw 2020) The resident credit regulation also provides:

> Thus, the resident credit against ordinary tax is allowable for income tax imposed by another jurisdiction upon compensation for personal services performed in the other jurisdiction, income from a business, trade, or profession carried on in the other jurisdiction, and income from real or tangible personal property situated in the other jurisdiction. *Conversely, the resident credit is not allowed for tax imposed by another jurisdiction upon income from intangibles, except where such income is from property employed in a business, trade or profession carried on in such jurisdiction.*

N.Y. Comp. Codes R. & Regs. tit. 20, § 120.4(d) (Westlaw 2020) (emphasis supplied).

> taxation, the consequences would extend far beyond this particular case. For some risk of duplicative taxation exists whenever the States in which a corporation does business do not follow identical rules for the division of income. Accepting appellant's view of the Constitution, therefore, would require extensive judicial law-making. Its logic is not limited to a prohibition on use of a single-factor apportionment formula. The asserted constitutional flaw in that formula is that it is different from that presently employed by a majority of States and that difference creates a risk of duplicative taxation. But a host of other division of income problems create precisely the same risk and would similarly rise to constitutional proportions.

Moorman, 437 U.S. at 278-279.

The Court illustrated the existing diversity in apportionment that tends to produce multiple taxation by referring to the varying state rules for attributing receipts from sales and by pointing out that some states allocate non-business income entirely to the taxpayer's state of incorporation or its commercial domicile, whereas other states apportion such income. Asserting that under these differing methods, the "potential for attribution of the same income to more than one State is plain," the Court concluded that it could not debar such "duplicative taxation" without prescribing "national uniform rules for the division of income," *Moorman*, 437 U.S. at 279, and declared:

> While the freedom of the States to formulate independent policy in this area may have to yield to an overriding national interest in uniformity, the content of any uniform rules to which they must subscribe should be determined only after due consideration is given to the interests of all affected States. It is clear that the legislative power granted to Congress by the Commerce Clause of the Constitution would amply justify the enactment of legislation requiring all States to adhere to uniform rules for the division of income. It is to that body, and not this Court, that the Constitution has committed such policy decisions.

Id. at 280.

The Court's holding and opinion in *Moorman* reflect its fundamental view that determining the appropriate source of income is a largely political judgment that lies beyond judicial competence. Accordingly, except in cases where the sourcing methodologies themselves are intrinsically flawed, or where the taxpayer has clearly demonstrated extraterritorial taxation, the Constitution does not compel the states to adopt uniform sourcing rules even though they may lead to double taxation. Because the rule adopted by the overwhelming majority of states for attributing the source of a REIT shareholder's income to the shareholder's residence cannot conceivably be characterized as being "intrinsically flawed" or "extraterritorial," the states' reliance on that sourcing rule in denying residents a credit for a tax paid to Hawaii under S.B. 2409 would not raise a substantial constitutional issue even if it resulted in double taxation.[2]

[2] It may be worth noting that in *Comptroller of the Treasury v. Wynne*, 135 S. Ct. 1787 (2015), the U.S. Supreme Court did invalidate a Maryland personal income tax for failure provide a credit for another state's tax on the same

Respectfully yours,

Walter Hellerstein

Walter Hellerstein

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income, but *only* because the Maryland taxing scheme was internally inconsistent, *not* because of states' adoption of different sourcing rules. Indeed, as I have explained elsewhere:

> Although the Court invalidated Maryland's tax on internal consistency grounds, *it explicitly rejected the argument that Maryland, as the state of the taxpayer's residence, had an obligation under the Commerce Clause to yield to a state that taxed its residents on the basis of source to avoid the risk of double taxation* ... . Thus, in response to a dissenting opinion's contention that the Court's decision in *Wynne* "requires a State taxing based on residence to 'recede' to a State taxing based on source," the Court declared: "We establish no such rule of priority." The Court later reaffirmed this point by noting that "*Maryland's desire to tax based on residence need not 'recede' to another State's desire to tax based on source.*"

Hellerstein, *State Taxation* ¶ 20.10[2][b] (emphasis supplied, footnotes omitted). See also W. Hellerstein, "Deciphering the Supreme Court's opinion in *Wynne*," 123 J. Tax'n 4 (2015). Because the tax regimes in force in the overwhelming majority of states that treat REIT shareholders as passive investors in intangible property and tax their income on the basis of residence are not internally consistent, i.e., they do not, at the same time, tax nonresident REIT shareholders on the basis of source (as proposed in S.B. No. 2409), there is no such constitutional defense against such regimes that fail to provide a credit for the tax proposed by S.B. No. 2409.