NATIONAL ASSOCIATION OF
REAL ESTATE INVESTMENT TRUSTS®

WRITTEN TESTIMONY OF

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NATIONAL ASSOCIATION OF REAL ESTATE INVESTMENT TRUSTS, INC.
IN OPPOSITION TO H.B. 1726, H.D. 1

BEFORE THE HAWAII HOUSE OF REPRESENTATIVES
COMMITTEE ON FINANCE
REPRESENTATIVE SYLVIA LUKE, CHAIR
REPRESENTATIVE SCOTT Y. NISHIMOTO, VICE CHAIR
REPRESENTATIVE AARON LING JOHANSON, VICE CHAIR

HEARING ON H.B. 1726, H.D. 1

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Chair Luke, Vice Chair Nishimoto, Vice Chair Johanson, and members of the Committee, the National Association of Real Estate Investment Trusts, Inc. (NAREIT) thanks you for this opportunity to submit testimony in opposition to H.B. 1726, H.D. 1, legislation that would eliminate the "dividends paid deduction" (DPD) for all real estate investment trusts (REITs) contrary to federal income tax rules and the existing laws of virtually every other state with an income-based tax system. NAREIT is the worldwide representative voice for REITs and publicly traded real estate companies with an interest in U.S. real estate and capital markets. NAREIT's members are REITs and other businesses throughout the world that own, operate, and finance income-producing real estate, as well as those firms and individuals who advise, study, and service those businesses.

In Hawaii, approximately twenty widely held REITs have invested about six billion dollars in commercial real estate that results in the employment of many Hawaii residents. The Hawaii real estate owned by REITs generates millions of dollars in property taxes. These taxes are on top of the individual income taxes currently generated by REIT dividends paid to Hawaii residents from income earned wherever the distributing REIT resides or does business, as well as the sales and other taxes generated by the tenants that conduct business on the premises owned and operated by REITs.

Background: REITs Were Designed to Benefit the "Small Investor." By way of background, Congress created REITs in 1960 to enable investors from all walks of life to own professionally managed, income-producing real estate through companies modeled after mutual funds. REITs are corporations or business trusts that combine the capital of many investors to benefit from a diversified portfolio of income-producing real estate, such as apartments, hotels, health care facilities, shopping centers, senior housing, offices, timberlands, storage facilities, and warehouses. Among other things, federal tax law requires REITs to be widely held and to distribute at least 90% of their taxable income to their shareholders. In exchange for distributing taxable income (and for satisfying a number of other requirements to ensure that REITs remain real estate-focused), federal tax law grants REITs (and mutual funds) a dividends paid deduction. In 2012, publicly traded REITs distributed more than $29 billion to their shareholders, who in turn pay income taxes on those distributions.

REITs Benefit Investors and the Economy. Congress' vision has been realized: as of February 24, 2014, 203 publicly traded REITs had a total market capitalization of over $700 billion. Investors, large and small, have benefited from owning REITs: the 15-year compound annual return for the period ending December 31, 2013 of the S&P 500 stock index was 4.68%, while that of equity (property–owning, as opposed to mortgage-owning) REITs was 10.49%. The economy benefits from REITs as well – because REITs cannot pass through losses to investors (unlike partnerships), their focus must be on creating value for shareholders. Furthermore, unlike other real estate owners that use high levels of debt, average debt levels for public equity REITs are around 35%, leading to less volatility in the real estate market and fewer bankruptcies and workouts. Over 25 countries have some form of REIT legislation in place that allows for a single level of taxation.

REITs Benefit Hawaii. Exchange-traded REITs, such as General Growth Properties, Inc. (GGP) and Taubman Centers Inc. (Taubman), have both access to the public capital markets to raise funds for new investments and the professional expertise to manage investment-grade real estate. These investments include the renovation and expansion of the Ala Moana Mall with respect to which GGP has committed to invest over $500 million, and International Market Place, with respect to which the Queen Emma Land Company has partnered with Taubman to redevelop and revitalize. Taubman has committed to invest approximately $400 million to redevelop International Market Place, and this redevelopment is expected to result in approximately 1,000 construction jobs and 2,500 permanent jobs, increased property value (and presumably property taxes) and sales taxes, and it also will support the mission of The Queen's Medical Center to improve the well-being of Native Hawaiians and the people of Hawaii. Revenues generated from the redeveloped property will directly fund the Center's operations as well as upcoming community initiatives, such as the opening of The Queen's Medical Center – West O'ahu.

Most States Tax REIT Income Only Once at the Shareholder Level. Nearly every state with an income-based tax system, including Hawaii currently, allows the DPD for widely held REITs. As a result of the DPD, most, if not all, of a REIT's income is taxed at one level – the shareholder level. Hawaii thus benefits by taxing Hawaii residents investing in REITs that have no Hawaii operations.

NAREIT opposes H.B. 1726, H.D.1 for the following reasons:

- H.B. 1726, H.D. 1 would enact a serious policy change that would put Hawaii at odds with virtually all other states regarding the taxation of REIT income at the shareholder level only based on the state of shareholder residence. Virtually every state with an income-based tax system, including Hawaii currently, allows widely held REITs a deduction for dividends paid. **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**. All other states that impose income taxes also tax the REIT income based on the location of the resident that receives the REIT dividends and not based on the location of the real estate. H.B. 1726, H.D. 1 would upset this comity of state taxation principles by unilaterally double taxing REITs (and their shareholders) that do business in Hawaii. In the past decade, a number of states such as Idaho, Louisiana, New Jersey, North Carolina, and Rhode Island have examined, and then rejected, the disallowance of a widely held REIT's DPD.

- H.B. 1726, H.D. 1 Would Make Hawaii Non-Competitive. Disallowing the DPD would make Hawaii virtually the only state to impose a double level state income tax on widely held REITs, which would continue to be compelled by federal law to distribute their taxable income to shareholders. REIT shareholders resident in states with income taxes would face an additional level of income tax on their dividends from REITs with Hawaii properties, potentially causing them to avoid such investments. Most REITs investing in Hawaii have the overwhelming majority of their investments in states other than Hawaii, and many of them could choose to sell their Hawaii properties or, at the least, not expand their Hawaii operations, because investments in other states could produce better after-tax returns. Thus, H.B. 1726, H.D. 1 would create a higher cost of capital for investments in Hawaii compared to all other investment opportunities.

- H.B. 1726, H.D. 1 appears to assume that REITs operate just like other real estate companies without recognizing the asset, income, compliance and 90% distribution requirements placed on REITs that other companies need not satisfy.

Address "Captive" REITs on a Targeted Basis

NAREIT recognizes Hawaii's interest in adopting legislation that would limit any inappropriate use of REITs by denying the DPD in certain cases, but any such legislation should be narrowly tailored to prevent application to legitimate business transactions. If any legislative action is deemed necessary, our suggestion is to follow the template of model captive REIT legislation adopted by the Multistate Tax Commission in 2008 and in 2011.

Accordingly, NAREIT urges you not to enact H.B. 1726, H.D.1. Thank you again for the opportunity to submit this testimony.