WRITTEN TESTIMONY OF

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NAREIT
IN OPPOSITION TO S.B. 301

BEFORE THE HAWAII SENATE
COMMITTEE ON WAYS AND MEANS

THE HONORABLE DONOVAN M. DELA CRUZ, CHAIR
THE HONORABLE GILBERT S.C. KEITH-AGARAN, VICE CHAIR

HEARING ON S.B. 301

FEB. 6, 2019

Thank you for the opportunity to submit this testimony on behalf of the Hawai‘i members of Nareit. 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. These REITs, which have substantial long-term investments in Hawai‘i, strongly oppose, and ask you to hold, S.B. 301, legislation that would eliminate the “dividends paid deduction” (DPD) for all widely-held REITs contrary to federal income tax rules and the existing laws of virtually every other state with an income-based tax system, for the reasons discussed below.

In summary, S.B. 301 would: 1) produce less net tax revenues (taking into account the GET as the predominant source of revenue in Hawai’i) than current law; 2) cause capital markets to invest less in the State, which in turn would create fewer jobs over the long-term; and, 3) violate core comity principles in relationship to other states and their citizens. Further, if the legislature wanted to enact true tax conformity between REITs and partnerships/LLCs, S.B. 301 should be broadened to impose on partnerships/LLCs the same burdens that would apply to REITs, namely that partnerships/LLCs would be required to annually distribute all their earnings to investors, and an entity-level tax would be applied to the partnership/LLC’s earnings. Of course, this solution could be expected to be met with fierce opposition by the investment community.

S.B.301 Would Produce Less Revenue Than Current Law

Because of unique requirements applicable to REITs, the State received more than $16 million in annual General Excise Tax (GET) in 2018 alone just from hotel REITs in Hawai‘i that non-REIT hotel owners wouldn’t owe. Federal law requires that REITs must earn most of their income from “rent” and similar real estate income. For this purpose, hotel room charges and other operating/service-related income are not “rent”. Unlike other owner-operators, REITs with operating properties like hotels, hospitals, parking garages, and theme parks must either lease those properties to a third party operator (like Marriott or Hilton) or with hotels and certain health care properties, to a fully taxable subsidiary in exchange for market-based rent. If leased to a taxable subsidiary, federal law requires the subsidiary to hire an independent operator. In Hawai‘i, the operator/subsidiary lease results in one level of REIT-specific GET revenue to the State, and the management fee results in yet another level of REIT-specific GET revenue to the State.

For example, Park Hotels & Resorts, Inc. leases its Hawaii hotels to a taxable subsidiary, and, in Hawai‘i, the taxable subsidiary hires Hilton to operate its hotels. Both the subsidiary rents and the operator fees have resulted in an **additional annual GET of approximately $9.5 million** to Hawaii for each of 2017 and 2018 that the prior owner, Hilton, as a non-REIT hotel owner-operator, wasn’t paying before. When aggregated with other REIT hotel owners in Hawaii, this additional GET is estimated to **exceed $16 million in 2018**. And as a tax on gross receipts rather than a tax on net income, the GET makes up the majority of the State’s revenue, constituting a much larger percentage of the State’s budget (more than 50%) than the corporate income tax (around 3%) and a much more stable source of State revenues than corporate income tax, which goes up and down according to the economy. (For example, see data from Council on State Revenues for FY 2019 To FY 2025). **S.B. 301’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.

This additional GET does not even consider the tens of millions of dollars of GET revenues generated from construction, repairs, and tenant businesses, as well as personal income tax and transient accommodation taxes directly attributable the billions of dollars invested by REITs over the past few years in the State to build, among other investments, student housing at UH Manoa or affordable rental housing, including Moanalua Hillside Apartments in Aiea. REITs also provide office space for small businesses that employ thousands of local residents. Medical facilities made possible by REITs, like Hale Pawa'a, also ensure Hawai'i physicians can deliver the highest quality care in state-of-the-art facilities.

Unlike non-REIT property investors, REITs can't keep their money. Instead, REITs must distribute their taxable income. In exchange for distributing all of their income – and for meeting other asset, income and operational tests, REITs can claim a DPD. REITs can retain up to 10% of taxable income (for example, during a recession) but must pay corporate tax on what they retain. While REITs are subject to requirements that other businesses are not, S.B. 301 would enact a drastic 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.

Unlike other real estate businesses, REITs cannot be in the business of "flipping" properties. – Any gain from a REIT's doing so is subject to a 100% tax. REITs are long-term neighbors in this community. The conflation of REITs with the activities in Kakaako suggests that the nature of REITs is not fully understood. REITs hold their investments for a very long time. These entities are not making a quick profit and leaving town; they are making long-term real investments back into the community and improving the State's retail, office, hotel, affordable rentals, and medical facilities.

In addition, several local investment firms which manage investments for their clients hold millions of dollars in REIT stocks. The chilling effect of this measure --which would result in Hawai'i's REIT investment's being taxed differently from REIT investment virtually anywhere else**--** would cause such local investors to avoid investment in REITs with Hawai'i interests if Hawai'i REIT investment is taxed differently from REIT investment virtually anywhere else, resulting in less revenue for the state.

S.B. 301's Enactment Would Lose Jobs for Hawai'i Residents

S.B. 301 risks significant job loss. Enactment of S.B. 301 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. While it may be easy to argue that no jobs will be lost by the onerous burdens and double taxation proposed by S.B .301, these existing and potential jobs belong to real people. Is it fair to risk significant job loss by enacting this proposal?

Enacting this proposal would signal Hawai'i's discouragement of long-term capital investment in the State. REITs provide sorely needed investment capital to Hawai'i. 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, Hawai'i would be on the outside looking in.

Hawai‘i’s significant economic growth over the past several years is, and we hope into the future, will be, 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.

Hawai‘i 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 re-development 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 occurred during the recession we recently experienced. While regular investors shied away from re-development, 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.

While REITs in Hawai‘i have been good for the local economy, they have also supported a wide variety of non-profit organizations providing much-needed services throughout the state. For example, Washington Prime Group’s Pearlridge Center has partnered with the Honolulu Chapter of the American Institute of Architects to support the “Canstruction” project. Over the past 13 years, more than 377,042 pounds of food has been raised through this event to help feed the hungry in Hawai‘i – providing more than 296,884 meals.

S.B. 301 Would Violate Core State Comity Principles

S.B. 301 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. 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. S.B. 301 would eliminate this comity of state taxation principles by unilaterally double taxing REITs (and their shareholders) that do business in Hawaii. In past years, 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.

S.B. 301 Would Not Create Parity Between Partnerships/LLCs and REITs

If the legislature wanted to enact true tax conformity between REITs and partnerships, S.B. 301 should be broadened to impose on partnerships the same burdens that would apply to REITs, namely that partnerships/LLCs would be required to annually distribute all their earnings to investors and be subject to an entity-level tax applied to those earnings even though the earnings would be distributed

to investors. Of course, any such effort would be met with fierce resistance from the investment community.

Please Do Not Enact S.B. 301

Considering the many problems with the provisions of this measure and the likelihood for real economic harm that could result if it were to pass, the Hawaiʻi members of Nareit respectfully ask that you hold this bill.