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WRITTEN TESTIMONY OF
GLADYS QUINTO MARRONE
EXECUTIVE DIRECTOR
NAREIT HAWAII
IN OPPOSITION TO SB 2697
BEFORE THE HAWAII SENATE
COMMITTEE ON WAYS & MEANS

THE HONORABLE DONOVAN M. DELA CRUZ, CHAIR
THE HONORABLE GILBERT S.C. KEITH-AGARAN, VICE CHAIR
HEARING ON SB 2697
FEB. 18, 2020
10:30 A.M.

1003 Bishop Street, Suite 2700
Honolulu, HI 96813
808-237-2474

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

Thank you for the opportunity to submit this testimony on behalf of Nareit Hawaii and its REIT members active in and that have substantial long-term investments 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.

Earlier this month, Nareit was pleased to open our new Nareit Hawaii office. Nareit Hawaii's responsibilities include representing REITs locally, coordinating outreach to investors and the investment community in Hawaii, and working with government agencies as well as community and charitable organizations to address social issues of importance.

For the reasons discussed in more detail below, we strongly oppose, and ask you to hold, SB 2697, legislation that would eliminate the REIT "dividends paid deduction" (DPD) temporarily.

- **SB 2697's enactment would likely produce less overall revenue than current law.**

- **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.

[1] Note comments around 3:40:23 to 3:40:38 /4:01:24 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 / 4:01:24 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.

- **What about the larger amounts asserted by proponents?** DoTax testimony suggests proponents are relying on "incorrect" numbers in an earlier DBEDT study.[3]

- **SB 2697'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.

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);

[3] Note comments around 3:40:40 to 3:40:56 /4:01:24 of the Feb. 12, 2019 video of the House Consumer Protection & Commerce Committee hearing on HB 475 HD 1, available at this link.

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- 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.

In addition to building affordable workforce rental units, there are REITs with a social impact mission that help to keep affordable units affordable in a verity of situations including, when after their housing assistance contracts expire, by providing needed equity and debt financing. This too adds to the inventory of affordable housing units in a community.

We are aware of a few social impact REITs that have been interested in investing in affordable housing in Hawaii. They have bid on properties in the past and remain interested in investing in affordable housing in Hawaii as part of their mission.

Thus, REITs can help contribute to community needs in many ways— very specific priority needs like housing and education, beyond providing jobs and increasing economic activity in Hawaii.

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.

However, retaining the DPD in Hawaii is critical to attracting this new REIT activity to our state. With every other state with a corporate income tax but one honoring the DPD, Hawaii would not be competitive for these REIT investments, should the DPD be repealed. Other states would be a much more attractive investment locales for these REITs which own investments throughout the U.S. At a time when Hawaii has many basic needs for its working residents, Hawaii needs to encourage REITs to continue to provide jobs for Hawaii's residents, and to continue to support broader community needs both through their business activities, other forms of tax revenue that they pay to the state and counties, and their charitable activities.

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SB 2697'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 lodging REITs, essentially resulting in an additional level of GET, the state received <u>more than $16 million in annual GET</u> 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' testimony (on page 28 of the posted testimony) with respect to a similar bill, SB 2409, said this extra GET was over $9 million more than a non-REIT would pay 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 2697'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.

- <u>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 2697.</u>

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SB 2697 Enactment Would Risk Job Losses for Hawaii Residents

SB 2697 risks significant job loss, at a time when the construction industry is reportedly weakening. Enactment of SB 2697 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 (who invest significantly in real estate), 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.

Contrary to its goals of fairness, SB 2697's enactment would impose obligations and liabilities on REITs that are not imposed on non-REIT corporations or partnerships

Contrary to the goals of "fairness," enactment of SB 2697 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 2697 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 <u>these requirements would not apply to non-REIT corporations or partnerships</u>. Despite being subject to these requirements, REITs would be unable to claim the DPD in Hawaii with respect to distributed income. Thus, although non-REIT corporations and partnerships 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.

SB 2697 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 from those properties.

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 2697 Would Violate Core State Comity Principles

SB 2697 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 2697

For the reasons described above, Nareit Hawaii requests the Committee to hold SB 2697.

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