WRITTEN TESTIMONY OF

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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.