NATIONAL ASSOCIATION OF
REAL ESTATE INVESTMENT TRUSTS®

WRITTEN TESTIMONY OF

DARA F. BERNSTEIN
SENIOR TAX COUNSEL
NATIONAL ASSOCIATION OF REAL ESTATE INVESTMENT TRUSTS, INC.
IN OPPOSITION TO H.B. 1726

BEFORE THE HAWAII LEGISLATURE'S COMMITTEE ON
CONSUMER PROTECTION & COMMERCE
REPRESENTATIVE ANGUS L.K. MCKELVEY, CHAIR
REPRESENTATIVE DEREK S.K. KAWAKAMI, VICE CHAIR

HEARING ON H.B. 1726

MONDAY, FEBRUARY 10, 2014

1875 I Street, NW, Suite 600, Washington, DC 20006-5413
Phone 202-739-9400 Fax 202-739-9401 REIT.com

Chair McKelvey, Vice Chair Kawakami, 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, legislation that would eliminate the "dividends paid deduction" (DPD) for all widely-held 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 billions of dollars in commercial real estate and employ 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, ski resorts, offices, timberlands, storage facilities, and warehouses. Federal tax law requires REITs to distribute at least 90% of their taxable income to their shareholders. In exchange for distributing taxable income and any net capital gains (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 (DPD). In 2012, publicly traded REITs distributed more than $29 billion to their shareholders.

REITs Benefit Investors and the Economy. Congress' vision has been realized: as of February 7, 2014, 204 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.

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 for the following reasons:

- H.B. 1726 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. 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. H.B. 1726 would shatter 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 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 shun 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.

- H.B. 1726 wrongly assumes 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.

Several States Have Reigned in Captive REITs on a Targeted Basis

In 2005, Louisiana reacted to the use of a taxable corporation's use of a nearly wholly-owned REIT designed to eliminate Louisiana state income taxes through the use of rental payments to a related entity. Louisiana enacted legislation, which limits its DPD to publicly traded REITs and REITs that are not more than 50% held by a taxable "C" corporation other than another REIT, or a qualified REIT subsidiary (a wholly-owned subsidiary of the REIT disregarded for federal tax purposes). Following Louisiana's lead and a February 2007 article in the *Wall Street Journal* about Wal-Mart's use of a "captive REIT," a number of states, including, among others, Alabama, Georgia, Illinois, Kentucky, Maryland, Rhode Island, and Virginia have enacted similar "captive REIT" legislation.

Additionally, the Multistate Tax Commission (MTC), an organization of state governments that works with taxpayers to administer tax laws that apply to multistate and multinational enterprises, adopted a model captive REIT law in June 2008, which essentially would disallow the DPD of a REIT more than 50% owned by most taxable C corporations (other than certain foreign REIT-like entities).[1] In 2011, the MTC adopted a related model law that would disallow deductions (*e.g.,* rental payments) made to a related captive REIT.[2]

[1] http://www.mtc.gov/uploadedFiles/Multistate_Tax_Commission/Uniformity/Uniformity_Projects/Adopted_Recommendations/By_Category/PROPOSED%20MODELREIT%20STATUTEasapproved.pdf.

[2] http://www.mtc.gov/uploadedFiles/Multistate_Tax_Commission/Uniformity/Uniformity_Projects/Current_Projects/captive%20REITpayment%20addback%20statute.pdf.

Furthermore, a number of states, including Hawaii and Massachusetts, have modified or clarified their tax structure with respect to corporate-owned REITs when both the REIT subsidiary claimed a DPD, and the parent shareholder claimed a dividends received deduction (DRD). Federal law does not permit a corporate shareholder to claim a DRD with respect to a REIT's dividend, but not all states conformed to that rule. Specifically, in 1998, Hawaii's Department of Taxation issued Tax Information Release No. 98-6,[3] in which it ruled that a REIT dividend is not considered a "dividend" for purposes of the DRD; thus, a corporate shareholder cannot claim a DRD with respect to a dividend paid by a REIT. This release also held that that neither the DRD nor DPD are recognized for dividends between members of the same unitary group.

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 model of the 2008 MTC model legislation.

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

[3] http://files.hawaii.gov/tax/legal/tir/1990_09/tir98-6.pdf.