D-13

STATE OF HAWAII
DEPARTMENT OF LAND AND NATURAL RESOURCES
Land Division
Honolulu, Hawaii 96813

October 23, 2015

Board of Land and Natural Resources
State of Hawaii
Honolulu, Hawaii

Statewide

Amend Assignment of Lease Evaluation Policy to Allow a Deduction of the Fair Market Value of the Improvements and Trade Fixtures being Transferred to the Assignee from the Consideration Paid by the Assignee to the Lessee-Assignor and to Make Clarifications Regarding the Treatment of Tangible and Intangible Personal Property.

APPLICANT:

Land Division.

LEGAL REFERENCE:

Section 171-36(a)(5), Hawaii Revised Statutes, as amended.

LOCATION:

Applicable statewide.

CHAPTER 343 - ENVIRONMENTAL ASSESSMENT:

Chapter 343 is not applicable. There is no proposed use of state funds or state lands.

REMARKS:

The current evaluation policy applicable to the consideration paid by the assignee to the lessee-assignor when a lease is assigned was established on December 15, 1989, to conform to Act 104, Session Laws of Hawaii 1989. Act 104 amended section 171-36, HRS, to provide that the Board may condition its consent to an assignment on the payment by the lessee of a premium based on the amount by which the consideration for the assignment exceeds the depreciated cost of improvements and trade fixtures being transferred to the assignee.

Currently, section 171-36(a)(5), HRS, states as follows:

> (5) No lease shall be transferable or assignable, except by devise, bequest, or intestate succession; provided that with the approval of the board of land and natural resources, the assignment and transfer of a lease or unit thereof may be made in accordance with current industry standards, as determined by the board; provided further that prior to the approval of any assignment of lease, the board shall have the right to review and approve the consideration to be paid by the assignee and may condition its consent to the assignment of the lease on payment by the lessee of a premium based on the amount by which the consideration for the assignment, whether by cash, credit, or otherwise, exceeds the depreciated cost of improvements and trade fixtures being transferred to the assignee; provided further that with respect to state agricultural leases, in the event of foreclosure or sale, the premium, if any, shall be assessed only after the encumbrances of record and any other advances made by the holder of a security interest are paid;

Attached to this submittal as Exh. A is the submittal to the Board dated December 15, 1989, that presented the policy to the Board for approval. Attached to this submittal as Exh. B is the Assignment of Lease Evaluation Policy that implements the policy adopted by the Board on December 15, 1989 and is attached to and made a part of the Board's general lease standard form.

On June 13, 2003, the Board established criteria for waivers of the Assignment of Lease Evaluation Policy. Attached to this submittal as Exh. C is the submittal to the Board on the waiver criteria, for information only. This agenda item does not address any changes to the criteria for a waiver.

Land Division and the Board have historically interpreted section 171-36(a)(5), HRS, as giving the Board the discretion to require that a premium be paid by the lessee to the Board based on the consideration paid by the assignee to the lessee-assignor and allowing the lessee a deduction from the consideration for the depreciated cost of the improvements and trade fixtures. The Board in 2003 also established criteria for a waiver of a premium as the statute does not require that the Board collect a premium in every instance. This agenda item is asking the Board to approve a change to the assignment of lease evaluation policy that would allow a deduction of the fair market value of the improvements and trade fixtures where the fair market value is greater than the value of the depreciated cost of improvements and trade fixtures. This would be applicable in the instance in which the fair market value of the improvements and trade fixtures is significantly greater than the depreciated cost because of significant monetary investment by the lessee in the improvements or trade fixtures and the original cost of the improvements and trade fixtures has been fully or nearly fully depreciated.

For example, on July 12, 2013, the Board approved a development agreement and proposed plans and specifications for improvements, and authorized the extension, amendment, and restatement of General Lease No. S-3961, for Hilo-Hawaiian

Associates, Inc. (HHA), lessee, pursuant to Act 219, Session Law of Hawaii 2011. (Note: No document has yet been executed.) The extension is for a period of 37 years for an aggregate term of 55 years. HHA committed to expending $5.8 million on improvements and to set aside 3% of the total room revenue each year, no less than $200,000 per year for the length of the extended term of the lease, to be spent entirely on maintaining the hotel during the extended term of the lease. However, HHA is concerned that if the lease were to be assigned, only the depreciated cost of the original improvements and trade fixtures could be deducted from any consideration paid by an assignee under the current lease assignment evaluation policy, and the cost of the original improvements and trade fixtures has been completely or nearly completely depreciated. HHA is concerned that it will not be treated fairly where the increased fair market value of the improvements and trade fixtures accounted for in the consideration for the assignment resulted from the significant investment by the lessee in the improvements and trade fixtures. In other words, the Board will share in the appreciation of the improvements and trade fixtures caused by the investment of the lessee in the improvements and trade fixtures.

Staff believes that the Hilo-Hawaiian Hotel lessee has valid reason for concern. Staff does not believe that the Board intends to benefit from investments of the lessee in the improvements and trade fixtures on the leased property. Staff believes that the current policy is intended only to discourage speculative assignments of the lease. Staff believes that allowing the deduction of the fair market value determined by a Hawaii-licensed appraiser from the consideration paid by the assignee to the lessee-assignor is fair when evaluating to what extent a premium is due to the Board from the lessee for the assignment.

Furthermore, staff believes that the policy should also be clarified to state that in addition to deducting the value of any inventory of merchandise or other tangible personal property paid for as a part of the consideration, that the deduction of the value of intangible property such as copyrights, patents, and goodwill will be allowed to the extent the lessee provides satisfactory evidence to the department that such intangible property exists and is included in the consideration paid by the assignee, and as to what the value of the intangible property is.

Thus, staff recommends that the assignment of lease evaluation policy be amended to provide as follows:

- The fair market value of the improvements and trade fixtures shall be used in place of the depreciated cost of the improvements and trade fixtures if the fair market value is greater than the depreciated cost.
- The fair market value shall be determined by an appraisal prepared for the lessee, lessor, or the assignee by a Hawaii-licensed real estate appraiser, and the fair market value of the improvements and trade fixtures will be based on the leasehold interest in the ground lease (for example, the value of the improvements and trade fixtures multiplied by the ratio of the unexpired term as it bears to the whole term of the lease).

- A clarification that the policy allows a deduction for the value of any inventory of merchandise or other tangible personal property included in the consideration paid by the assignee; and for the value of any intangible property such as copyrights, patents, and goodwill to the extent the lessee provides satisfactory evidence to the department that such intangible property exists and is included in the consideration paid by the assignee, and as to what the value of the property is.

These changes to the policy are shown in the Assignment of Lease Evaluation Policy that is a part of the general lease standard form and which is attached to this submittal as Exh. D. The additions are shown by double underscoring and deletions are bracketed and stricken. All changes are also shown in bold print.

RECOMMENDATION:

That the Board approve the amendments to the Assignment of Lease Evaluation Policy as shown on Exh. D attached to this submittal, subject to:

1. Review and approval by the Department of the Attorney General;

2. Provisions referenced above and incorporated herein;

3. This assignment of lease evaluation policy, as amended herein, shall prospectively apply to new leases and new amendments to leases; and

4. Such other terms and conditions as may be prescribed by the Chairperson to best serve the interests of the State.

Respectfully Submitted,

For

Russell Y. Tsuji
Land Division Administrator

APPROVED FOR SUBMITTAL:

Suzanne D. Chase
Chairperson

JOHN WAIHEE
GOVERNOR OF HAWAII

STATE OF HAWAII
DEPARTMENT OF LAND AND NATURAL RESOURCES
DIVISION OF LAND MANAGEMENT
P. O. BOX 621
HONOLULU, HAWAII 96809

AQUACULTURE DEVELOPMENT PROGRAM
AQUATIC RESOURCES
CONSERVATION AND ENVIRONMENTAL AFFAIRS
CONSERVATION AND RESOURCES ENFORCEMENT
CONVEYANCES
FORESTRY AND WILDLIFE
LAND MANAGEMENT
STATE PARKS
WATER AND LAND DEVELOPMENT

December 15, 1989

Board of Land and
Natural Resources
Honolulu, Hawaii

Gentlemen:

Subject: Resubmittal - Staff Recommendation to Adopt an Assignment of Lease Evaluation Policy to Conform with Act 104, Session Laws of Hawaii 1989

During the 1989 legislative session, Chapter 171-36(a)(5) was amended, effective May 24, 1989, to read in part:

> "... provided further that prior to the approval of any assignment of lease, the board shall have the right to review and approve the consideration to be paid by the assignee and **may condition its consent to the assignment of the lease on payment by the lessee of a premium based on the amount by which the consideration for the assignment, whether by cash, credit, or otherwise, exceeds the depreciated cost of improvements and trade fixtures being transferred to the assignee;"** (revision underlined)

Because the Department of Transportation also administers leases using the same statutes, they have developed a procedure to evaluate lease assignments with input from DLNR staff. The policy being proposed is an adaptation from the DOT procedure but **will only be applicable to leases from which the state can receive premiums** as determined by the Attorney General. It should also be noted that preparation and passage of the legislative act was largely the result of DOT's efforts.

To implement the statute, the proposed policy would use indices obtained from the U.S. Department of Labor, Bureau of Labor Statistics, to derive the depreciated cost of improvements and trade fixtures being transferred to the assignee. Using an index is recommended since it is a faster, simpler method and will eliminate the added expense of hiring an independent appraiser or cost estimator. However, for lessees that construct their own building, they alone will be given the option of asking for an appraisal (at their expense) to determine the value of the improvements to obtain due credit for their efforts.

All lessees will be required to provide information and/or evidence on actual costs of construction of all improvements or renovations (already a condition in leases with improvement requirements) and the purchase price of trade fixtures which will be maintained in the lease file along with the necessary indices. Lessees will also be required to provide an inventory of all personal property placed on the premises.

Amend

ITEM F-10

Exh. A

As shown on Schedule D, the evaluation typically begins by analyzing the consideration for the assignment to eliminate that portion attributable to inventory.

The adjusted depreciated cost for improvements or renovations is calculated by using the Construction Cost Index (CCI) for the evaluation year divided by the CCI for the year in which the improvements or renovations were completed (base year) multiplied by the original cost of the improvements or renovations. Depreciation, calculated by dividing the expired term of improvements or renovations by the whole term (completion date to lease expiration date) and multiplied by the adjusted cost, is subtracted from the adjusted cost. An example is shown on Schedule A.

For trade fixtures, the adjusted depreciated cost is similarly calculated by using instead the Consumer Price Index (CPI) for the evaluation year divided by the CPI for the purchase year (base year) against the original cost. The depreciation is calculated by dividing the expired life by the estimated life of a particular item and multiplied by the adjusted cost as indicated on Schedule B.

The excess is the amount, if any, derived by subtracting the depreciated value of the improvements or renovations and trade fixtures from the consideration for the assignment.

No other deduction is allowed as the statute only recognizes tangible items (intangibles such as "goodwill", business name recognition, etc., are not deductible).

The premium will be a maximum of 50% of the excess. The percentage will decrease by 5% after every 5 years of the term has elapsed. The sliding scale, as shown on Schedule C, will encourage long term occupancy and prevent speculation as well as recognize the investment, effort, and risk of the lessee.

This item was deferred at the Board's November 17, 1989 meeting.

RECOMMENDATION:

That the Board approve to adopt the Assignment of Lease Evaluation Policy, attached hereto as Exhibit A, to conform with Act 104, Session Laws of Hawaii 1989.

Respectfully submitted,

W. Mason Young

W. MASON YOUNG
Acting Land Management Administrator

APPROVED FOR SUBMITTAL:

WILLIAM W. PATY, Chairperson

ASSIGNMENT OF LEASE EVALUATION POLICY

1. Enabling Statute

(Act)

Act 104, effective May 24, 1989, amended Chapter 171-36(a)(5) to read in part:

"... provided further that prior to the approval of any assignment of lease, the board shall have the right to review and approve the consideration to be paid by the assignee and **may condition its consent to the assignment of the lease on payment by the lessee of a premium based on the amount by which the consideration for the assignment, whether by cash, credit, or otherwise, exceeds the depreciated cost of improvements and trade fixtures being transferred to the assignee;"** (revision underlined)

2. Qualifying Leases

The evaluation for premium determination will only be applicable to leases from which the state can receive premiums as determined by the Attorney General.

3. Prior Approval

purchase agreement and the

or balance sheet no older than 1-yr. prior to date of purchase agreement

Prior to giving its consent to an assignment, DLNR must receive (i) the name, legal composition and address of any proposed assignee, (ii) a complete copy of the proposed assignment agreement, including the total consideration to be paid by the assignee for the assignment whether by cash, credit or otherwise, and (iii) the best available financial statement of the proposed assignee or any other such statement, audited or certified as correct by a financial officer of the proposed assignee.

or balance sht

~~[illegible] no more than 1-yr from the date of submission~~

Assignments of lease shall not be entered into until the Attorney General has reviewed the proposed assignment and the Land Board have given their approval. Such assignments shall be entertained only if they meet the criteria set forth in Section 171-36(a)(5), HRS.

4. Qualifications of Assignee

If qualification was required of a lessee as a pre-condition of the lease, the prospective assignee must also be qualified to assume the lease.

5. Consideration to be Paid

Prior to review by the Attorney General and approval by the Land Board, the lessee (assignor) must present with written evidence of the consideration to be paid by the assignee and any other cost data that the state may require.

6. Payment of Premium

The ~~statute~~ Act permits the state to receive from the lessee (assignor) a premium based on the amount by which the consideration for the assignment, whether by cash, credit, or otherwise, exceeds the depreciated cost of improvements and trade fixtures being transferred to the assignee. The value of the inventory of merchandise shall be deducted from the consideration paid. The appropriate cost index is then applied to determine the adjusted depreciated cost.

& any other tangible assets in the sale of a business

EXHIBIT "A"

All lessees shall be required to furnish the state with the actual costs of construction of all improvements and renovations within 30 days after its completion as well as the purchase costs of all trade fixtures acquired for the lessee's operation on the premises within 30 days after their purchase. Lessees shall be required to furnish evidence of the actual costs by copy of the construction contract, receipts or otherwise. Lessees shall also be required to furnish an inventory of all personal property placed on the premises. Records of all costs incurred by the lessee for construction of improvements or renovations as well as trade fixtures submitted by the lessee shall be maintained in the lease file and shall include the Construction Cost Index for Apartments, Hotels, Office Buildings (CCI) and the Honolulu Consumer Price Index for All Urban Consumers (CPI) as published by the U.S. Department of Labor, Bureau of Labor Statistics for the year construction is completed.

The replacement cost for improvements or renovations is calculated by using the CCI for the evaluation year divided by the CCI for the year in which the improvements or renovations were completed (base year). The result is then multiplied by the original cost of the improvements or renovations. For trade fixtures, the cost is similarly calculated by using the CPI for the purchase year (base year) and the evaluation year.

Depreciation of improvements and trade fixtures will be determined on a straight line basis. Depreciation of improvements or renovations will be determined in the same proportion that the expired term of the improvements or renovations bear to the whole term. The whole term will be from the date the construction of the improvements or renovations are completed until the termination date of the lease. Depreciation of trade fixtures will be determined in the same manner, except that the whole term will be the anticipated life of the trade fixture.

however, for those leases that [illegible] complied with the required improvement requirement there shall be a 10% surcharge

The premium will be a maximum of 50% of the excess. The percentage will decrease by 5% after every 5 years of the term has elapsed in accordance with Schedule C. The sliding scale will encourage long term occupancy and prevent speculation as well as recognize the investment, effort, and risk of the lessee.

Only in cases where the lessee has essentially constructed or directed the construction of its own improvements, may the lessee be given the option of paying for an appraiser, but to be selected by the state, to determine the valuation of the improvements.

Schedule D attached provides a typical example of the evaluation calculations using Schedule A to calculate the replacement cost for improvements or renovations and depreciation, Schedule B to calculate the cost and depreciation for trade fixtures, and Schedule C to obtain the premium percentage.

7. Non-qualifying Deductions

The statute only recognizes tangible items. Intangibles such as "goodwill", business name recognition, etc., are <u>not</u> deductible.

SCHEDULE A. Adjusted Depreciated Cost of Improvements or Renovations

1. Adjusted Cost of Improvements or Renovations

Multiply the actual cost of the improvements or renovations by the most recent U.S. Construction Cost Index for Apartments., Hotels, Office Buildings (CCI)* and divide the result by the CCI of the year construction was completed (base year) to get the adjusted cost of improvements or renovations.

2. Depreciation

Determine the depreciation percentage on a straight-line basis by dividing the expired term of the improvements or renovations by the whole term of the improvements or renovations, the whole term beginning on the date the improvements or renovations are completed to the expiration date of the lease. Multiply the adjusted cost of the improvements or renovations by the depreciation percentage to determine the depreciation.

3. Depreciated Cost of Improvements or Renovations

Subtract the depreciation from the adjusted cost of improvements or renovations. The balance is the depreciated cost of improvements or renovations.

*As published by the U.S. Department of Labor, Bureau of Labor Statistics

<u>Example</u>

Actual cost:	\$500,000
CCI (most recent):	121.1
CCI (base year):	102.3
Expired term:	57 mos.
Whole term:	408 mos.

1. Adjusted Cost of Improvements or Renovations

$$\text{Actual Cost} \times \frac{\text{CCI (most recent)}}{\text{CCI (base year)}}$$

$$\$500{,}000 \times \frac{121.1}{102.3} = \$591{,}887$$

2. Depreciation

$$\$591{,}887 \times \frac{57 \text{ mos.}}{408 \text{ mos.}} = \$82{,}690$$

3. Adjusted Depreciated Cost of Improvements or Renovations

$$\$591{,}887 - \$82{,}690 = \underline{\$509{,}197}$$

SCHEDULE B. Adjusted Depreciated Cost of Trade Fixtures

1. Adjusted Cost of Trade Fixture

Multiply the actual cost of the trade fixture by the most recent Honolulu Consumer Price Index for All Urban Consumers (CPI)* and divide the result by the CPI of the year in which the purchase was made (base year).

2. Depreciation

Determine the depreciation percentage on a straight-line basis by dividing the expired term of the trade fixture by its anticipated life. Multiply the adjusted cost of the trade fixture by the depreciation percentage to determine the depreciation.

3. Depreciated Cost of Trade Fixtures

Subtract the depreciation from the adjusted cost of the trade fixture. The balance is the depreciated cost of the trade fixture.

*As published by the U.S. Department of Labor, Bureau of Labor Statistics

Example

Refrigerator	
Actual cost:	$1,510
CPI (most recent):	118.1
CPI (base year):	104.6
Expired term:	57 mos.
Whole term: (Anticipated life)	96 mos.

1. Adjusted Cost of Trade Fixture

$$\text{Actual Cost} \times \frac{\text{CPI (most recent)}}{\text{CPI (base year)}}$$

$$\$1{,}510 \times \frac{118.1}{104.6} = \$1{,}705$$

2. Depreciation

$$\$1{,}705 \times \frac{57\text{ mos.}}{96\text{ mos.}} = \$1{,}012$$

3. Adjusted Depreciated Cost of Trade Fixture

$$\$1{,}705 - \$1{,}012 = \$\ 693$$

Schedule C. <u>Premium Percentages</u>

1. For the first 5 years, the premium is 50% of the amount by which the consideration for the assignment, whether by cash, credit, or otherwise, exceeds the depreciated cost of improvements and trade fixtures being transferred to the assignee. The percentage will decrease by 5% after every 5 years of the total term has elapsed.

Years	Percentage
1 - 5	50%
6 - 10	45%
11 - 15	40%
16 - 20	35%
21 - 25	30%
26 - 30	25%
31 - 35	20%
36 - 40	15%
41 - 45	10%
46 - 50	5%
51 -	0%

didn't allow for lessee's interest

As an example, if a 55 year lease was assigned after 57 months, the premium percentage would be 50%. If the assignment occurs after 130 months (10+ years), the percentage would be 40%.

2. The lord may impose a 10% surcharge if the assignor has not performed lease covenants to improve or use the property

Schedule D. <u>Assignment of Lease Calculations</u>

1. Subtract the amount, if any, of the consideration for the assignment that is attributable to inventory.

2. Calculate the Adjusted Depreciated Cost of Improvements or Renovations (see Schedule A).

3. Calculate the Adjusted Depreciated Cost of Trade Fixtures (see Schedule B).

4. Calculate the amount by which the consideration for the assignment, whether by cash, credit, or otherwise, exceeds the depreciated cost of improvements and trade fixtures being transferred to the assignee by subtracting the amounts derived by no. 2 and no. 3 from the amount in no. 1 above.

5. Determine the appropriate premium percentage (see Schedule C). Multiply by the excess, if any, derived by no. 4.

<u>Example</u>

A lease is being assigned 57 months after completion of the improvements at a consideration of $600,000.

The initial cost of the improvements was $500,000 while the current year CCI and base year CCI were 121.1 and 102.3, respectively. The whole term for the improvements is 408 months.

For the trade fixtures, the initial cost was $1,510 with the current year CPI and base year CPI being 118.1 and 104.6, respectively. The total life expectancy is 96 months.

1.	Net Consideration:			$600,000
2.	Adj Cost Imp/Ren:		$591,887	
	Depreciation:		- 82,690	
	Adj Dep Cost Imp/Ren:			-509,197
3.	Adj Cost Trade Fixtures:		1,705	
	Depreciation:		- 1,012	
	Adj Dep Cost Trade Fixtures:			- 693
4.	Excess:			$ 90,110
5.	Premium:	Percentage:	50%	$ 45,055

ASSIGNMENT OF LEASE EVALUATION POLICY

1. Enabling Statute.

Act 104, effective May 24, 1989, amended Chapter 171-36(a)(5) to read in part:

"... provided further that prior to the approval of any assignment of lease, the board shall have the right to review and approve the consideration to be paid by the assignee and may condition its consent to the assignment of the lease on payment by the lessee of a premium based on the amount by which the consideration for the assignment, whether by cash, credit, or otherwise, exceeds the depreciated cost of improvements and trade fixtures being transferred to the assignee;" (revision underlined)

2. Qualifying Leases.

This policy shall be applicable to the subject lease.

3. Prior Approval.

Prior to giving its consent to an assignment, DLNR must receive (i) the name, legal composition and address of any proposed assignee, (ii) a complete copy of the purchase agreement and the proposed assignment agreement, including the total consideration to be paid by the assignee for the assignment whether by cash, credit or otherwise, and (iii) the best available financial statement or balance sheet no older than 1 year prior to date of purchase agreement of the proposed assignee or any other such statement, audited or certified as correct by a financial officer of the proposed assignee.

Assignments of lease shall not be entered into until the Attorney General has reviewed the proposed assignment and the Land Board have given their approval. Such assignments shall be entertained only if they meet the criteria set forth in Section 171-36(a)(5), HRS.

4. Qualifications of Assignee.

If qualification was required of a lessee as a pre-condition of the lease, the prospective assignee must also be qualified to assume the lease.

EXHIBIT "C"

Exh. B

5. Consideration to be Paid.

Prior to review by the Attorney General and approval by the Land Board, the lessee (assignor) must present with written evidence of the consideration to be paid by the assignee and any other cost data that the state may require.

6. Payment of Premium.

The act permits the state to receive from the lessee (assignor) a premium based on the amount by which the consideration for the assignment, whether by cash, credit, or otherwise, exceeds the depreciated cost of improvements and trade fixtures being transferred to the assignee. The value of the inventory of merchandise and any other tangible assets in the sale of a business shall be deducted from the consideration paid. The appropriate cost index is then applied to determine the adjusted depreciated cost.

All lessees shall be required to furnish the state with the actual costs of construction of all improvements and renovations within 30 calendar days after its completion as well as the purchase costs of all trade fixtures acquired for the lessee's operation on the premises within 30 calendar days after their purchase. Lessees shall be required to furnish evidence of the actual costs by copy of the construction contract, receipts or otherwise. Lessees shall also be required to furnish an inventory of all personal property placed on the premises. Records of all costs incurred by the lessee for construction of improvements or renovations as well as trade fixtures submitted by the lessee shall be maintained in the lease file and shall include the Construction Cost Index for Apartments, Hotels, Office Buildings (CCI) and the Honolulu Consumer Price Index for All Urban Consumers (CPI) as published by the U.S. Department of Labor, Bureau of Labor Statistics for the year construction is completed.

The replacement cost for improvements or renovations is calculated by using the CCI for the evaluation year divided by the CCI for the year in which the improvements or renovations were completed (base year). The result is then multiplied by the original cost of the improvements or renovations. For trade fixtures, the cost is similarly calculated by using the CPI for the purchase year (base year) and the evaluation year.

Depreciation of improvements and trade fixtures will be determined on a straight line basis. Depreciation of improvements or renovations will be determined in the same proportion that the expired term of the improvements or renovations bear to the whole term. The whole term will be from the date the construction of the improvements or renovations are completed until the termination date of the lease. Depreciation of trade fixtures will be determined in the same manner, except that the whole term will be the anticipated life of the trade fixture.

The premium will be a maximum of 50% of the excess. The percentage will decrease by 5% after every 5 years of the term has elapsed in accordance with Schedule C. The sliding scale will encourage long term occupancy and prevent speculation as well as recognize the investment, effort, and risk of the lessee.

In cases where the lessee is unable to furnish the Department of Land and Natural Resources with evidence of the actual cost of construction of improvements because the lessee has performed the work itself, the State may determine the cost or the lessee shall have the option of paying for an appraiser, to be selected by the Department of Land and Natural Resources, to determine what the improvements would have cost if the labor had been performed by a third party rather than the lessee. The lessee shall exercise its option by giving written notice to the lessor within thirty (30) calendar days after completion of construction of the improvements. If the lessee fails to exercise its option within this period, the lessor shall have the right to determine the cost of the improvements.

Schedule D attached provides a typical example of the evaluation calculations using Schedule A to calculate the replacement cost for improvements or renovations and depreciation, Schedule B to calculate the cost and depreciation for trade fixtures, and Schedule C to obtain the premium percentage.

7. Non-qualifying Deductions.

The statute only recognizes tangible items. Intangibles such as "goodwill", business name recognition, etc., are <u>not</u> deductible.

8. Subsequent Assignments.

If the consideration for any subsequent assignment includes the purchase of existing tenant owned improvements, the evaluation will be conducted in a similar manner as the first assignment. An example is shown on Schedule E.

Using Schedule E, the consideration the assignor paid less included inventory and any premiums will be used to obtain the adjusted depreciated cost of improvements and trade fixtures. Also, the Base Year is redefined to be the date the assignor received the Consent of the Board to occupy the premises. The holding period (redefined Base Year to assignment date), or actual occupancy of the assignor, is used in place of the "expired term" when calculating depreciation. Depreciation will be calculated by dividing the holding period by the whole term of the lease (The whole term will remain unchanged).

The change in the CCI will be reflected by comparing the CCI for the redefined base year to the most current CCI.

The holding period will be the basis for determining the appropriate premium percentage. Subtracting the included inventory and any premiums from the consideration the assignor paid will result in a reassessment of the market value of the improvements. If additional improvements were constructed by the assignor, they will be treated in the same manner as improvements constructed by an original lessee.

The excess of subtracting the adjusted depreciated consideration the assignor paid and the adjusted depreciated cost of additional improvements, if any, from the consideration the assignor received will be used against the appropriate premium percentage to determine the amount payable to the state.

9. Rights of Holders of Security Interest-Agricultural Leases only.

   In the event of foreclosure or sale, the premium, if any, shall be assessed only after the encumbrances of record and any other advances made by the holder of a security interest are paid.

10. When state-owned improvements are included in the leased premises, improvement renovation requirements shall be recognized as being tenant-owned improvements for evaluation in the policy.

   In other words, the total expenditure of the lessee to fulfill the requirement would be treated as though a new improvement was constructed.

SCHEDULE A. Adjusted Depreciated Cost of Improvements or Renovations

1. Adjusted Cost of Improvements or Renovations.

Multiply the actual cost of the improvements or renovations by the most recent U.S. Construction Cost Index for Apartments, Hotels, Office Buildings (CCI)* and divide the result by the CCI of the year construction was completed (base year) to get the adjusted cost of improvements or renovations.

2. Depreciation

Determine the depreciation percentage on a straight-line basis by dividing the expired term of the improvements or renovations by the whole term of the improvements or renovations, the whole term beginning on the date the improvements or renovations are completed to the expiration date of the lease. Multiply the adjusted cost of the improvements or renovations by the depreciation percentage to determine the depreciation.

3. Depreciated Cost of Improvements or Renovations

Subtract the depreciation from the adjusted cost of improvements or renovations. The balance is the depreciated cost of improvements or renovations.

*As published by the U.S. Department of Labor, Bureau of Labor Statistics

Example

Actual cost:	\$500,000
CCI (most recent):	121.1
CCI (base year):	102.3
Expired term:	57 mos.
Whole term:	408 mos.

1. Adjusted Cost of Improvements or Renovations

$$\text{Actual Cost} \times \frac{\text{CCI (most recent)}}{\text{CCI (base year)}}$$

$$\$500{,}000 \times \frac{121.1}{102.3} = \$591{,}887$$

2. Depreciation

$$\$591{,}887 \times \frac{57 \text{ mos.}}{408 \text{ mos.}} = \$82{,}690$$

3. Adjusted Depreciated Cost of Improvements or Renovations

$591,887 - $82,690 = <u>$509,197</u>

SCHEDULE B. Adjusted Depreciated Cost of Trade Fixtures

1. Adjusted Cost of Trade Fixture.

Multiply the actual cost of the trade fixture by the most recent Honolulu Consumer Price Index for All Urban Consumers (CPI)* and divide the result by the CPI of the year in which the purchase was made (base year).

2. Depreciation.

Determine the depreciation percentage on a straight-line basis by dividing the expired term of the trade fixture by its anticipated life. Multiply the adjusted cost of the trade fixture by the depreciation percentage to determine the depreciation.

3. Depreciated Cost of Trade Fixtures.

Subtract the depreciation from the adjusted cost of the trade fixture. The balance is the depreciated cost of the trade fixture.

*As published by the U.S. Department of Labor, Bureau of labor Statistics

<u>Example</u>

	Refrigerator
Actual cost:	$1,510
CPI (most recent):	118.1
CPI (base year):	104.6
Expired term:	57 mos.
Whole term: (Anticipated life)	96 mos.

1. Adjusted Cost of Trade Fixture

$$\text{Actual Cost X } \frac{\text{CPI (most recent)}}{\text{CPI (base year)}}$$

$$\$1,510 \text{ X } \frac{118.1}{104.6} + \$1,705$$

2. Depreciation

$$\$1.705 \text{ X } \frac{57 \text{ mos.}}{96 \text{ mos.}} = \$1,012$$

3. Adjusted Depreciated Cost of Trade Fixture

$1,705 - $1,012 = $ 693

SCHEDULE C. Premium Percentages

1. For the first 5 years, the premium is 50% of the amount by which the consideration for the assignment, whether by cash, credit, or otherwise, exceeds the depreciated cost of improvements and trade fixtures being transferred to the assignee. The percentage will decrease by 5% after every 5 years of the total term has elapsed.

Years	Percentage
1 - 5	50%
6 - 10	45%
11 - 15	40%
16 - 20	35%
21 - 25	30%
26 - 30	25%
31 - 35	20%
36 - 40	15%
41 - 45	10%
46 - 50	5%
51 -	0%

As an example, if a 55 year lease was assigned after 57 months, the premium percentage would be 50%. If the assignment occurs after 130 months (10+ years), the percentage would be 40%.

2. The Board of Land and Natural Resources may impose a ten percent (10%) surcharge if the assignor has not performed lease covenants to improve or use the property.

SCHEDULE D. Assignment of Lease Calculations

1. Subtract from the consideration for the assignment that amount, if any, that is attributable to inventory.

2. Calculate the Adjusted Depreciated Cost of Improvements or Renovations (see Schedule A).

3. Calculate the Adjusted Depreciated Cost of Trade Fixtures (see Schedule B).

4. Calculate the amount by which the consideration for the assignment, whether by cash, credit, or otherwise, exceeds the depreciated cost of improvements and trade fixtures being transferred to the assignee by subtracting the amounts derived by no. 2 and 3 from the amount in no. 1 above.

5. Determine the appropriate premium percentage (see Schedule C). Multiply by the excess, if any, derived by no. 4.

Example

A lease is being assigned 57 months after completion of the improvements at a consideration of $600,000.

The initial cost of the improvements was $500,000 while the current year CCI and base year CCI were 121.1 and 102.3, respectively. The whole term for the improvements is 408 months.

For the trade fixtures, the initial cost was $1,510 with the current year CPI and base year CPI being 118.1 and 104.6, respectively. The total life expectancy is 96 months.

1.	Net Consideration:		$600,000
2.	Adj Cost Imp/Ren:	$591,887	
	Depreciation:	- 82,690	
	Adj Dep Cost Imp/Ren:		-509,197
3.	Adj Cost Trade Fixtures:	1,705	
	Depreciation:	- 1,012	
	Adj Dep Cost Trade Fixtures:		- 693
4.	Excess:		$ 90,110
5.	Premium:	Percentage: 50%	$ 45,055

SCHEDULE E. Subsequent Assignment of Lease Calculations

1. Subtract from the consideration the assignor received for the assignment that amount, if any, that is attributable to inventory to derive the net consideration received.

2. Subtract from the consideration the assignor previously paid for the assignment that amount, if any, that was attributable to inventory. Also, subtract from the consideration the assignor previously paid for the assignment that amount, if any, that was attributable to premiums. The net consideration paid is now defined to be the value of improvements as of the date of the occupancy by the assignor.

3. Using the result from no. 2, calculate the Adjusted Depreciated Value of Improvements or Renovations (see Schedule A).

4. Subtract the amount derived by no. 3 from the amount in no. 1 to determine the amount by which the consideration received for the assignment, whether by cash, credit, or otherwise, exceeds the adjusted depreciated value of improvements being transferred to the assignee.

5. Determine the appropriate premium percentage (see Schedule C). Multiply by the excess, if any, derived by no. 4.

Example

An assignor is assigning a lease 107 months after receiving the consent of the Board. Occupancy or the holding period is defined to be 107 months. The consideration received is $1,000,000.

The consideration paid by the assignor was $600,000 while the current year CCI and redefined base year CCI were 156.4 and 121.1, respectively. The whole term was 408 months.

No inventory was included in either consideration. However, a premium of $45,055 was paid to the state by the previous occupant from the $600,000 consideration.

1.	Net Consideration Received:				$1,000,000
2.	Consideration Paid:		$600,000		
	Premium:		- 45,055		
	Net Consideration Paid:			$554,945	
3.	Adj Value Consideration (improvements):				
	$554,945 X	$\frac{156.4}{121.1}$	=	$716,708	
	Depreciation:				
	$716,708 X	$\frac{107 \text{ mos.}}{408 \text{ mos.}}$	=	-187,960	
	Adj Dep Value Consideration:				- 528,748
4.	Excess:				$ 471,252
5.	Premium:	Percentage:	45%		$ 212,063

D-28

STATE OF HAWAII
DEPARTMENT OF LAND AND NATURAL RESOURCES
Land Division
Honolulu, Hawaii 96813

June 13, 2003

Board of Land and Natural Resources
State of Hawaii
Honolulu, Hawaii

Statewide

Establishment of Criteria for Waivers of the Assignment of Lease Evaluation Policy

STATUTORY REFERENCE:

Pursuant to Section 171-36(a)(5), HRS:

> "No lease shall be transferable or assignable, except by devise, bequest, or intestate succession; provided that with the approval of the board of land and natural resources, the assignment and transfer of a lease or unit thereof may be made in accordance with current industry standards, as determined by the board; provided further that prior to the approval of any assignment of lease, the board shall have the right to review and approve the consideration to be paid by the assignee and may condition its consent to the assignment of the lease on payment by the lessee of a premium based on the amount by which the consideration for the assignment, whether by cash, credit, or otherwise, exceeds the depreciated cost of improvements and trade fixtures being transferred to the assignee. . ."

PURPOSE:

Recently, the Department has received requests to waive the assignment premium policy in certain cases. In processing the request to re-auction a new lease for the Naniloa property, Hawaii Naniloa Resort LLC has asked that the policy be waived. Kauai Beachfront Hotel, also seeking the re-auction of a longer term lease, has likewise requested a waiver of the policy. Sand Island Business Association, which manages the 73-acre industrial park at Sand Island has also requested the Department review its assignment policy.

Staff explained to these lessees that we would not recommend a waiver only in their specific cases unless criteria for waivers were developed or the policy was modified to ensure fair and consistent application to all lessees.

APPROVED BY THE BOARD OF
LAND AND NATURAL RESOURCES
AT ITS MEETING HELD ON
June 13, 2003

Exh. C

ITEM D-28

BACKGROUND:

By Act 104, SLH 1989, Subsection 171-36(a), HRS, was amended to allow the Department to share in the monetary consideration for the sale of State leases (refer to "Statutory Reference" above for language). The State's share or premium is a percentage based on the difference between the assignment consideration and the depreciated cost of lessee improvements and trade fixtures.

On December 15, 1989, under agenda item F-10, the Board adopted an Assignment of Lease Evaluation Policy which provides for the payment of a premium in accordance with this statutory provision and sets forth the method for calculating the premium amount (refer to Exhibit A). This policy provides a sliding scale that decreases the amount of the premium over the first 50 years of the lease. The purpose of the sliding scale is to "encourage long term occupancy and prevent speculation as well as recognize the investment, effort, and risk of the lessee."

The assignment policy can only be applied to those leases which include a provision allowing the application of such policy. Therefore, only leases after 1989 contain the provision, including all newly issued leases or older leases that were updated at the time of extension. According to the State Land Information Management System, approximately 34% of the current general leases contain the assignment premium policy. This figure is broken down as follows:

Not subject to policy:	594	63%
Subject to policy:	321	34%
Not applicable:	30	3%
Total	945	

From a cursory search of past records, the assignment premium has been applied in the following cases:

Doc. No.	Tenant Name	Date	Amt. of Premium
GL 5219	Tyco International Ltd.	08/19/1997	$208,302.00
GL 5281	Sand Island Business Assn.	08/29/1996	$14,518.18
GL 5284	Hawaiian Cement	10/04/1995	$11,500.00
GL 5284	Hawaiian Cement	08/01/1997	$185,267.00
GL 5372	Hawaii Outdoor Tours	06/16/1999	$51,750.00
GL 5496	Progressive Landscaping	05/06/2003	$20,250.00

ANALYSIS

To ensure a fair and consistent treatment of our lessees, the assignment policy itself could be re-evaluated and modified or criteria could be established to identify the conditions under which the policy would be waived. Staff initially proceeded to assess whether the assignment policy should be modified.

Our initial research shows that other state land offices on the mainland as well as private landowners in Hawaii do not have similar assignment premium provisions in their leases. The Hastings Conboy firm reviewed the assignment premium provisions of other large, private landowners in Hawaii. Of the six landowners surveyed, only Kamehameha Schools (KS) had standard lease provisions imposing a lease assignment premium. According to Hastings Conboy, these provisions were uniform between agricultural/pasture and commercial/industrial/ resort leases. All State agencies with leases (DLNR, DOT and DOA) have assignment premium provisions except for the Department of Hawaiian Home Lands (DHHL). In fact, our policy was developed based on the Department of Transportation's. The Department of Agriculture has mimicked our laws and policies to a large extent.

Staff reviewed a variety of factors:

- **Trust considerations:** The State may have a fiduciary duty to share in profits of assignments. In State Trust Lands, Jon Souder and Sally Fairfax write:

  "How the state handles subleasing and lease assignments provides important indicators about whether its agents are acting with undivided loyalty to the beneficiaries or with the traditional orientation toward the lessees. If the state does not adequately control either subleases or assignments, and if it allows the original lessee to receive substantial amounts of money to transfer use of the lease, the state evidently is not receiving full and fair market value and is not acting with undivided loyalty to the beneficiary."

- **Protection against market escalation:** The State should protect itself against possible escalations in market value of land for whatever reason. Most commonly, land value appreciates due to heightened demand in the market. In some cases, we may find that the land value was not initially established accurately. These cases may be more prevalent in uncommon or inaugural uses such as telecommunication sites, fiber optic cable easements, or open ocean leases. The State's reopening provisions should allow for some protection against the appreciation. Staff is unsure as to whether our standard ten-year intervals are sufficient for all markets.

- **Discouragement of speculation:** Because the statutory change was made in 1989, some speculate that it was prompted by the speculation occurring during the bubble period when Japanese investment pushed land values up. In general, the State wants to encourage long-term occupancy and investment in our properties and stable, healthy businesses.

- **Marketability/competitiveness of State leases:** The State should try to keep its leases competitive with the local market to ensure we can attract quality lessees. At a 1999 briefing of the Board on the assignment premium policy, concerns were expressed as to whether this policy was in line with private lessors and if not, whether it would make our leases less marketable. The research by Hastings Conboy shows the majority of the large landowners not charging any assignment premium. However, the two largest landowners in Hawaii, the State and Kamehameha Schools, do charge the assignment premium. This may reflect the ability of the largest landowners to dictate what terms and conditions they want. However, unless our lands have unique attributes (i.e., highly desired locations), then this thinking may just result in a lower quality level of lessees.

- **Fairness to lessees:** Where the lessee constructs improvements and the appreciation is attributable to those improvements (versus the land), it is not fair that the State should share in those profits and the State should be satisfied in receiving a fair return on its assets. At the Board's 1999 briefing, Board members raised concerns with this issue including whether the policy discourages investment in the property by the lessees. Obviously, the intent of the law is to deduct the lessee's improvement value. Whether the depreciated cost method accurately reflects that value is the question. Kamehameha Schools does not recognize depreciation in calculating improvement value. Any change to the method would likely require a statutory amendment since Section 171-36, HRS, specifically requires depreciated cost.

Despite the research showing that only Kamehameha Schools imposes a similar assignment premium provision, staff does not feel comfortable recommending modifiying or eliminating the provision for the following reasons:

1) While the other state land offices surveyed do not charge an assignment premium, there are other factors to consider:

    - One state had said their board has brought up this issue, questioning why they do not share in the profits; another state said that perhaps we (Hawaii) are doing it correctly from a trust perspective; another state asked us to fax a copy of our policy as they were interested in the concept.
    - A few states review sublease rents and take sandwich profits in these subleasing situations -- primarily the same philosophy underlying the assignment premium policy.
    - Some states have much shorter lease terms (e.g., 10 years) and/or reopening periods (e.g., every five years). Frequent reopenings would ensure that lease rents are keeping up with the market and that any assignment theoretically would not reflect land value appreciation.

2) Admittedly, Hawaii public land trust responsibilities are not clear. However, Souder's and Fairfax's comments regarding our trust responsibilities raise questions as to whether we should be eliminating the assignment premium. We

note that their comments were made specifically in reference to agricultural and pasture leases.

For these reasons, staff does not recommend modifying or eliminating the assignment premium policy. However, staff believes that there are situations in which it would be appropriate for the policy to be waived and propose the following criteria for such waivers.

CRITERIA

Granting of waivers to the Department's assignment premium policy shall meet all of the following criteria:

1. The lessee is required to make or made substantial capital improvements to the leased premises (i.e., buildings) and the major source of income to the lessee is generated from these improvements.

   Rationale: This requirement would provide some assurance that any appreciation in an assignment primarily derives from the lessee's improvements and operations versus appreciation to the land.

2. The market value of the lessee's improvements is primarily attributable to the operations conducted by the lessee on the leased premises and the cash flow generated by the operations, rather than the cost of the improvements.

   Rationale: In situations in which the market value of the lessee's improvements upon sale of the lessee's leasehold interest would be based on the cost of the improvements, the assignment premium policy should apply since the lessee receives credit for the depreciated cost of the improvements in the calculation of the premium.

   However, where the market value of the lessee's improvements are based on the lessee's operations and the cash flow generated by the lessee's operations, it is possible for the lessee to create value by its operations, in which case the State should not participate in such added value or profits.

3. The lease includes provisions that ensure ground rents keep up with market rents (e.g., frequent rental reopenings, step-ups, etc.).

   Rationale: This requirement would ensure that the State is not losing out on potential land value appreciation over time where the assignment premium policy is waived.

Based on the application of these criteria to specific requests, the Board may:

- Waive the assignment policy entirely for a new lease (i.e., eliminate the assignment premium provision altogether).

- Waive the assignment policy for certain assignments for a new lease (i.e., include the assignment provision in the new lease but specify when it would not apply).

- Waive the assignment premium for certain assignments for an existing lease (i.e., waive the premium when an assignment occurs).

For new leases to be auctioned, staff has the option of applying the criteria and requesting a waiver from the policy at the time submittals are presented to the Board for approval of sales of public auction leases.

RECOMMENDATION:

That the Board approve the above criteria to determine when the Board may waive the Assignment of Lease Evaluation Policy, provided that each individual request shall be presented to the Board for its review and approval with a staff analysis of the request and application of the criteria.

Respectfully Submitted,

DIERDRE S. MAMIYA
Administrator

APPROVED FOR SUBMITTAL:

PETER T. YOUNG, Chairperson

ASSIGNMENT OF LEASE EVALUATION POLICY

1. Enabling Statute.

Act 104, effective May 24, 1989, amended Chapter 171-36(a)(5) to read in part:

"... provided further that prior to the approval of any assignment of lease, the board shall have the right to review and approve the consideration to be paid by the assignee and may condition its consent to the assignment of the lease on payment by the lessee of a premium based on the amount by which the consideration for the assignment, whether by cash, credit, or otherwise, exceeds the depreciated cost of improvements and trade fixtures being transferred to the assignee;" (revision underlined)

In addition to using the depreciated cost of improvements and trade fixtures as a deduction from the consideration paid by the assignee, as the board is allowed to review and approve the consideration to be paid by the assignee, the board is authorized to condition its consent to the assignment of the lease on the payment by the lessee of a premium based on the amount by which the consideration for the assignment, whether by cash, credit, or otherwise, exceeds the fair market value of the improvements and trade fixtures being transferred to the assignee where the fair market value is greater than the depreciated cost of the improvements and trade fixtures.

2. Qualifying Leases.

This policy shall be applicable to the subject lease.

3. Prior Approval.

Prior to giving its consent to an assignment, DLNR must receive (i) the name, legal composition and address of any proposed assignee, (ii) a complete copy of the purchase agreement and the proposed assignment agreement, including the total consideration to be paid by the assignee for the assignment whether by cash, credit or otherwise, and (iii) the best available financial statement or balance sheet no older than 1 year prior to date of purchase agreement of the proposed assignee or any other such statement, audited or certified as correct by a financial officer of the proposed assignee.

EXHIBIT "C"

Exh. D

Assignments of lease shall not be entered into until the Attorney General has reviewed the proposed assignment and the Land Board have given their approval. Such assignments shall be entertained only if they meet the criteria set forth in Section 171-36(a)(5), HRS.

4. Qualifications of Assignee.

If qualification was required of a lessee as a pre-condition of the lease, the prospective assignee must also be qualified to assume the lease.

5. Consideration to be Paid.

Prior to review by the Attorney General and approval by the Land Board, the lessee (assignor) must present with written evidence of the consideration to be paid by the assignee and any other cost data that the state may require.

6. Payment of Premium.

The act permits the state to receive from the lessee (assignor) a premium based on the amount by which the consideration for the assignment, whether by cash, credit, or otherwise, exceeds the depreciated cost of improvements and trade fixtures being transferred to the assignee. The value of the inventory of merchandise and any other tangible assets in the sale of a business shall be deducted from the consideration paid. The appropriate cost index is then applied to determine the adjusted depreciated cost.

All lessees shall be required to furnish the state with the actual costs of construction of all improvements and renovations within 30 calendar days after its completion as well as the purchase costs of all trade fixtures acquired for the lessee's operation on the premises within 30 calendar days after their purchase. Lessees shall be required to furnish evidence of the actual costs by copy of the construction contract, receipts or otherwise. Lessees shall also be required to furnish an inventory of all personal property placed on the premises. Records of all costs incurred by the lessee for construction of improvements or renovations as well as trade fixtures submitted by the lessee shall be maintained in the lease file and shall include the Construction Cost Index for Apartments, Hotels, Office Buildings (CCI) and the Honolulu Consumer Price Index for All Urban Consumers (CPI) as published by the U.S. Department of Labor, Bureau of Labor

Statistics for the year construction is completed.

The replacement cost for improvements or renovations is calculated by using the CCI for the evaluation year divided by the CCI for the year in which the improvements or renovations were completed (base year). The result is then multiplied by the original cost of the improvements or renovations. For trade fixtures, the cost is similarly calculated by using the CPI for the purchase year (base year) and the evaluation year.

Depreciation of improvements and trade fixtures will be determined on a straight line basis. Depreciation of improvements or renovations will be determined in the same proportion that the expired term of the improvements or renovations bear to the whole term. The whole term will be from the date the construction of the improvements or renovations are completed until the termination date of the lease. Depreciation of trade fixtures will be determined in the same manner, except that the whole term will be the anticipated life of the trade fixture.

The fair market value of improvements and trade fixtures may be used in place of depreciated cost if the fair market value is greater than the depreciated cost. The fair market value shall be determined by an appraisal prepared for the lessee, lessor, or the assignee by a Hawaii-licensed real estate appraiser. The fair market value of improvements and trade fixtures will be based on the leasehold interest in the ground lease (e.g., value of the improvements multiplied by the ratio of the unexpired term as it bears to the whole term of the lease). In addition to subtracting the appraised fair market value of the improvements and trade fixtures from the consideration, the value of any inventory of merchandise or other tangible personal property shall be subtracted from the consideration paid if such property is paid for as a part of the consideration.

The premium will be a maximum of 50% of the excess. The percentage will decrease by 5% after every 5 years of the term has elapsed in accordance with Schedule C. The sliding scale will encourage long term occupancy and prevent speculation as well as recognize the investment, effort, and risk of the lessee.

In cases where the lessee is unable to furnish the Department of Land and Natural Resources with evidence of the actual cost of construction of improvements because the lessee has performed the work itself, the State may determine the cost or the lessee shall have the option of paying for an appraiser, to be selected by the Department of Land and Natural Resources, to determine what the improvements would have cost if the labor had been performed by a third party rather than the lessee. The lessee shall exercise its option by giving written notice to the lessor within thirty (30) calendar days after completion of construction of the improvements. If the lessee fails to exercise its option within this period, the lessor shall have the right to determine the cost of the improvements.

Schedule D attached provides a typical example of the evaluation calculations using Schedule A to calculate the replacement cost for improvements or renovations and depreciation, Schedule B to calculate the cost and depreciation for trade fixtures, and Schedule C to obtain the premium percentage.

7. Non-qualifying Deductions.

[~~The statute only recognizes tangible items.~~] Intangibles such as copyrights, patents, "goodwill", business name recognition, etc., are not deductible from the consideration paid unless lessee produces satisfactory evidence to the department that such intangible personal property exists and is included in the consideration paid by the assignee, and as to what the value of the intangible property is.

8. Subsequent Assignments.

Assignment evaluation using fair market value:

For a subsequent assignment where the existing assignment's premium evaluation used the fair market value of the improvements and trade fixtures, the higher of the fair market value or depreciated cost of the improvements and trade fixtures will be used.

Assignment evaluation using depreciated cost:

For a subsequent assignment evaluation where the existing assignment's premium evaluation used the depreciated cost of improvements and trade fixtures, the following methodology will be applied.

If the consideration for any subsequent assignment includes the purchase of existing tenant owned improvements, the evaluation will be conducted in a similar manner as the first assignment. An example is shown on Schedule E.

Using Schedule E, the consideration the assignor paid less included inventory and any premiums will be used to obtain the adjusted depreciated cost of improvements and trade fixtures. Also, the Base Year is redefined to be the date the assignor received the Consent of the Board to occupy the premises. The holding period (redefined Base Year to assignment date), or actual occupancy of the assignor, is used in place of the "expired term" when calculating depreciation. Depreciation will be calculated by dividing the holding period by the whole term of the lease (The whole term will remain unchanged).

The change in the CCI will be reflected by comparing the CCI for the redefined base year to the most current CCI.

The holding period will be the basis for determining the appropriate premium percentage. Subtracting the included inventory and any premiums from the consideration the assignor paid will result in a reassessment of the market value of the improvements. If additional improvements were constructed by the assignor, they will be treated in the same manner as improvements constructed by an original lessee.

The excess of subtracting the adjusted depreciated consideration the assignor paid and the adjusted depreciated cost of additional improvements, if any, from the consideration the assignor received will be used against the appropriate premium percentage to determine the amount payable to the state.

9. Rights of Holders of Security Interest-Agricultural Leases only.

   In the event of foreclosure or sale, the premium, if any, shall be assessed only after the encumbrances of record and any other advances made by the holder of a security interest are paid.

10. When state-owned improvements are included in the leased premises, improvement renovation requirements shall be recognized as being tenant-owned improvements for evaluation in the policy.

    In other words, the total expenditure of the lessee to fulfill the requirement would be treated as though a new improvement was constructed.

SCHEDULE A. Adjusted Depreciated Cost of Improvements or Renovations

1. Adjusted Cost of Improvements or Renovations.

   Multiply the actual cost of the improvements or renovations by the most recent U.S. Construction Cost Index for Apartments, Hotels, Office Buildings (CCI)* and divide the result by the CCI of the year construction was completed (base year) to get the adjusted cost of improvements or renovations.

2. Depreciation

   Determine the depreciation percentage on a straight-line basis by dividing the expired term of the improvements or renovations by the whole term of the improvements or renovations, the whole term beginning on the date the improvements or renovations are completed to the expiration date of the lease. Multiply the adjusted cost of the improvements or renovations by the depreciation percentage to determine the depreciation.

3. Depreciated Cost of Improvements or Renovations

   Subtract the depreciation from the adjusted cost of improvements or renovations. The balance is the depreciated cost of improvements or renovations.

*As published by the U.S. Department of Labor, Bureau of Labor Statistics

<u>Example</u>

Actual cost:	\$500,000
CCI (most recent):	121.1
CCI (base year):	102.3
Expired term:	57 mos.
Whole term:	408 mos.

1. Adjusted Cost of Improvements or Renovations

   $$\text{Actual Cost} \times \frac{\text{CCI (most recent)}}{\text{CCI (base year)}}$$

   $$\$500{,}000 \times \frac{121.1}{102.3} = \$591{,}887$$

2. Depreciation

   $$\$591{,}887 \times \frac{57 \text{ mos.}}{408 \text{ mos.}} = \$82{,}690$$

3. Adjusted Depreciated Cost of Improvements or Renovations
$591,887 - $82,690 = $509,197

SCHEDULE B. Adjusted Depreciated Cost of Trade Fixtures

1. Adjusted Cost of Trade Fixture.

Multiply the actual cost of the trade fixture by the most recent Honolulu Consumer Price Index for All Urban Consumers (CPI)* and divide the result by the CPI of the year in which the purchase was made (base year).

2. Depreciation.

Determine the depreciation percentage on a straight-line basis by dividing the expired term of the trade fixture by its anticipated life. Multiply the adjusted cost of the trade fixture by the depreciation percentage to determine the depreciation.

3. Depreciated Cost of Trade Fixtures.

Subtract the depreciation from the adjusted cost of the trade fixture. The balance is the depreciated cost of the trade fixture.

*As published by the U.S. Department of Labor, Bureau of labor Statistics

Example

	Refrigerator	
	Actual cost:	$1,510
	CPI (most recent):	118.1
	CPI (base year):	104.6
1. Adjusted Cost of Trade Fixture	Expired term:	57 mos.
	Whole term: (Anticipated life)	96 mos.

$$\text{Actual Cost X } \frac{\text{CPI (most recent)}}{\text{CPI (base year)}}$$

$$\$1,510 \text{ X } \frac{118.1}{104.6} + \$1,705$$

2. Depreciation

$1.705 X 57 mos. = $1,012

96 mos.

3. Adjusted Depreciated Cost of Trade Fixture

$1,705 - $1,012 = $ 693

SCHEDULE C. Premium Percentages

1. For the first 5 years, the premium is 50% of the amount by which the consideration for the assignment, whether by cash, credit, or otherwise, exceeds the depreciated cost of improvements and trade fixtures being transferred to the assignee **or the appraised fair market value of the improvements and trade fixtures, whichever is greater. The consideration excess against which the premium is to be applied shall be further reduced by subtracting the substantiated value of the tangible and intangible personal property described herein that is paid for by the assignee as a part of the assignment.** The percentage will decrease by 5% after every 5 years of the total term has elapsed.

Years	Percentage
1 - 5	50%
6 - 10	45%
11 - 15	40%
16 - 20	35%
21 - 25	30%
26 - 30	25%
31 - 35	20%
36 - 40	15%
41 - 45	10%
46 - 50	5%
51 -	0%

As an example, if a 55 year lease was assigned after 57 months, the premium percentage would be 50%. If the assignment occurs after 130 months (10+ years), the percentage would be 40%.

2. The Board of Land and Natural Resources may impose a ten percent (10%) surcharge if the assignor has not performed lease covenants to improve or use the property.

SCHEDULE D. Assignment of Lease Calculations **Using Depreciated Cost**

1. Subtract from the consideration for the assignment that amount, if any, that is attributable to inventory**, other tangible property, and intangible property properly supported by evidence of the assignor**.

2. Calculate the Adjusted Depreciated Cost of Improvements or Renovations (see Schedule A).

3. Calculate the Adjusted Depreciated Cost of Trade Fixtures (see Schedule B).

4. Calculate the amount by which the consideration for the assignment, whether by cash, credit, or otherwise, exceeds the depreciated cost of improvements and trade fixtures being transferred to the assignee by subtracting the amounts derived by no. 2 and 3 from the amount in no. 1 above.

5. Determine the appropriate premium percentage (see Schedule C). Multiply by the excess, if any, derived by no. 4.

Example

A lease is being assigned 57 months after completion of the improvements at a consideration of $600,000.

The initial cost of the improvements was $500,000 while the current year CCI and base year CCI were 121.1 and 102.3, respectively. The whole term for the improvements is 408 months.

For the trade fixtures, the initial cost was $1,510 with the current year CPI and base year CPI being 118.1 and 104.6, respectively. The total life expectancy is 96 months.

1.	Net Consideration:			$600,000
2.	Adj Cost Imp/Ren:	$591,887		
	Depreciation:	- 82,690		
	Adj Dep Cost Imp/Ren:			-509,197
3.	Adj Cost Trade Fixtures:	1,705		
	Depreciation:	- 1,012		
	Adj Dep Cost Trade Fixtures:			- 693
4.	Excess:			$ 90,110
5.	Premium:	Percentage:	50%	$ 45,055

SCHEDULE E. Subsequent Assignment of Lease Calculations **Using Depreciated Cost**

1. Subtract from the consideration the assignor received for the assignment that amount, if any, that is attributable to inventory**, other tangible property, and intangible property properly supported by evidence of the assignor** to derive the net consideration received.

2. Subtract from the consideration the assignor previously paid for the assignment that amount, if any, that was attributable to inventory**, other tangible property, and intangible property properly supported by evidence of the assignor**. Also, subtract from the consideration the assignor previously paid for the assignment that amount, if any, that was attributable to premiums. The net consideration paid is now defined to be the value of improvements as of the date of the occupancy by the assignor.

3. Using the result from no. 2, calculate the Adjusted Depreciated Value of Improvements or Renovations (see Schedule A).

4. Subtract the amount derived by no. 3 from the amount in no. 1 to determine the amount by which the consideration received for the assignment, whether by cash, credit, or otherwise, exceeds the adjusted depreciated value of improvements being transferred to the assignee.

5. Determine the appropriate premium percentage (see Schedule C). Multiply by the excess, if any, derived by no. 4.

Example

An assignor is assigning a lease 107 months after receiving the consent of the Board. Occupancy or the holding period is defined to be 107 months. The consideration received is $1,000,000.

The consideration paid by the assignor was $600,000 while the current year CCI and redefined base year CCI were 156.4 and 121.1, respectively. The whole term was 408 months.

No inventory**, other tangible property, or intangible property properly supported by evidence of the assignor** **[~~was~~]** **were included in either consideration**. However, a premium of

$45,055 was paid to the state by the previous occupant from the $600,000 consideration.

1.	Net Consideration Received:				$1,000,000
2.	Consideration Paid:		$600,000		
	Premium:		- 45,055		
	Net Consideration Paid:			$554,945	
3.	Adj Value Consideration (improvements):				
	$554,945 X	156.4 / 121.1	=	$716,708	
	Depreciation:				
	$716,708 X	107 mos. / 408 mos.	=	-187,960	
	Adj Dep Value Consideration:				- 528,748
4.	Excess:				$ 471,252
5.	Premium:	Percentage:		45%	$ 212,063