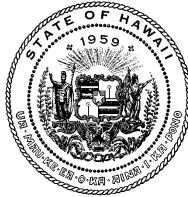


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July 8, 1998

TAX INFORMATION RELEASE NO. 98-6

RE: Application of Income Tax and Franchise Tax Laws to Real Estate Investment Trusts and Their Owners

This Tax Information Release (TIR) provides guidance regarding the application of Hawaii's income tax and franchise tax laws to real estate investment trusts and their owners.

The Department of Taxation has learned that certain corporations and financial institutions may be considering the formation of real estate investment trusts (REITs) under the premise that a corporation which is an owner of a REIT can derive the following income tax benefits: (1) the corporation may claim a 70% dividend received deduction for amounts received from the REIT; and (2) the dividend paid deduction allows the REIT to avoid income tax at the entity level if the REIT distributes the income to the corporation. Both of these deductions in tandem would allow 70% of the REIT's distributed income to escape State, but not federal, taxation. The first premise is incorrect. Under Hawaii law, as under federal law, a corporation which is an owner of a REIT cannot claim a dividend received deduction for amounts received from the REIT.

Internal Revenue Code (IRC) § 857(c), which is operative in Hawaii, states that a dividend paid by a REIT is not considered a "dividend" for purposes of IRC § 243, which generally allows the dividend received deduction. Hawaii Revised Statutes § 235-2.3(b)(11) (Supp. 1997), however, renders IRC § 243 inoperative for Hawaii tax purposes unless otherwise provided. In lieu of the federal dividend received deduction, Hawaii provides corporations with a 100% deduction for dividends received from a national banking association, or dividends received by members of an affiliated group as defined by IRC § 243(b) or a small business investment company; and a 70% deduction for dividends received from a corporation that is 95% owned by one or more corporations doing business in Hawaii, a bank or insurance company organized and doing business in Hawaii, or a corporation that can attribute at least 15% of its business to Hawaii.¹ See HRS § 235-7(c) (Supp. 1997).

¹ **The Department of Taxation is administering the 70% dividend received deduction provided by HRS § 235-7(c) without regard to the threshold requirement of Hawaii activity, ownership, or presence because such limitations are likely to be deemed unconstitutional. See Department of Taxation Announcement 98-5 (February 26, 1998).**

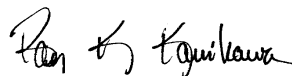
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To determine whether IRC § 857(c) applies to Hawaii's dividend received deduction, HRS § 235-2.5(a)(2) (Supp. 1997) explains that if a provision in the IRC that is operative in this State refers to an inoperative provision in the IRC that has been codified in chapter 235, HRS, then the reference shall be to the provision in chapter 235, HRS. Therefore, because IRC § 243 is generally inoperative for Hawaii tax purposes, but has been codified with modifications in HRS § 235-7(c), IRC § 857(c) is applicable with reference to section HRS § 235-7(c) instead of IRC § 243. Accordingly, under IRC § 857(c), a dividend paid by a REIT is not considered a "dividend" for purposes of HRS § 235-7(c), and the dividend received deduction is not allowed for Hawaii income tax purposes. Thus, the Hawaii tax treatment of the dividend received deduction as applied to REITs under these circumstances is the same as under federal law.

If the REIT and its owner are in a unitary group, intercompany items (including intercompany dividends) are eliminated for purposes of computing combined taxable income and the property, payroll, and sales factors of the group members. See Hawaii Administrative Rules (HAR) § 18-235-22-03(b)(1) (1994). Thus, neither the dividend paid deduction nor the dividend received deduction are recognized for dividends between group members.

This TIR is also applicable to banks, financial institutions, and small business investment companies that are subject to the franchise tax under chapter 241, HRS. See HRS §241-4 (Supp. 1997); HRS § 241-6 (1993). Therefore, if a bank, financial institution, or small business investment company is an owner of a REIT, the dividend received deduction is not allowed for franchise tax purposes.

The Department will challenge any tax benefits claimed in contravention of the Hawaii tax law as explained in this TIR.



RAY K. KAMIKAWA
Director of Taxation

HRS Section Explained: HRS §§ 235-2.5(a); 235-7(c)

Rules Sections Explained: HAR § 18-235-22-03