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COMPANY
INSTITUTE

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February 14, 2018

The Honorable Donovan M. Dela Cruz
Chair, Hawaii Senate Committee on Ways and Means
415 S Beretania St.
Honolulu, HI 96813

RE: *Fund Industry Opposes S.B. No. 3067*

Dear Chairman Dela Cruz and Members of the Senate Committee on Ways and Means:

The Investment Company Institute[1] opposes S.B. No. 3067 because of its negative impact on shareholders in mutual funds that invest in real estate investment trusts (REITs). The ICI's members, structured to provide average investors with a pooled vehicle for securities investing, own approximately 44 percent of listed REIT shares. The funds' investors are not wealthy. The typical mutual fund shareholder is a middle-class American with a median household income of $94,300 and modest holdings.[2]

The proposal, as explained below, is not administrable and would lead to over-withholding and potential double taxation on mutual fund shareholders. Specifically:

- **REITs cannot report accurate information regarding their individual investors**
- **Over-withholding would occur**
- **Fund investors would be harmed even IF over-withholding did not occur**
- **IRS Form 1099-DIV is not available to report withholding taxes imposed on the mutual fund**

[1] The Investment Company Institute (ICI) is the leading association representing regulated funds globally, including mutual funds, exchange-traded funds (ETFs), closed-end funds, and unit investment trusts (UITs) in the United States, and similar funds offered to investors in jurisdictions worldwide. ICI seeks to encourage adherence to high ethical standards, promote public understanding, and otherwise advance the interests of funds, their shareholders, directors, and advisers. ICI's members manage total assets of US$21.7 trillion in the United States, serving more than 100 million US shareholders, and US$7.1 trillion in assets in other jurisdictions. ICI carries out its international work through ICI Global, with offices in London, Hong Kong, and Washington, DC.

[2] The most recent ICI data show median mutual fund assets of $125,000 per household in four accounts. https://www.ici.org/pdf/2017_factbook.pdf, Figure 6.2.

Why would these effects occur?

- Because REITs do not have access to the shareholder information needed to comply with the proposal's report requirement, withholding on distributions to shareholders would be required.
- 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.

REITs Cannot Report Information Regarding Their Individual Investors

REIT investor information typically is known only to the financial intermediary (*e.g.*, broker) through which shares of REITs that are publicly traded on stock exchanges are acquired.[3] These shares are registered in the name of the broker holding the shares for its customers in a "street name" or "nominee" account. Brokers historically established street name accounts to prevent the firms managing REITs, as potential competitors, from receiving highly sensitive and proprietary information regarding the identities of the broker's clients.

Because complete customer-identity information typically is known only to the brokers, REITs could not possibly identify all shareholders who have held their stock at any time during the year. Even if brokers were to provide this information to REITs, the difficulties of tracking and reporting the number of shares held by each investor on each day of the year would be extraordinary. Mutual funds investing in REITs, for example, may purchase and sell REIT shares every day to reflect the purchases and redemptions of their investors' fund shares.

Consequently, REITs would not be able to comply with the proposal's reporting requirements. Instead, they would be required by the proposal to withhold on distributions to their shareholders (including the brokers holding REIT shares for their customers in street name accounts).

Over-Withholding Would Occur

Although the proposal envisions withholding only on the portion of a REIT's distribution equal to the income attributable to Hawaiian properties, over-withholding would occur. First, a REIT cannot determine until after the end of a calendar year the portion of its distributions that are taxable as income or as capital gain or instead are non-taxable returns of capital. Second, even if a REIT could

[3] The broker through which shares are purchased must comply with the applicable know-your-customer/anti-money-laundering requirements (including securing IRS Form W-9s from US persons); the broker also is responsible for all applicable US tax reporting and withholding requirements.

determine with each distribution that portion that is taxable income—which it cannot—it would know the portion attributable to Hawaii only if the REIT invested *only* in Hawaii. To avoid the difficulties, including potential penalties, arising for under-withholding, REITs can be expected to withhold on the full amount of each distribution.

The mutual funds investing in REITs that over-withhold apparently would be required to file a Hawaiian tax return to recoup excess withholding tax. This filing could not be made, however, until the REIT determined the precise amount of over-withholding—on a per-share basis—for each distribution. The mutual fund then would need to determine and report the number of shares it held on each such date. Exactly how the fund would satisfy the State that it, in fact, held the number of REIT shares it claimed would be a bit unclear—as brokers are not required to report the holdings of their customers to every State. This legislation presumably would result in a significant burden to the State Department of Taxation as a result of having to process many tax refund claims.

Fund Investors Would Be Harmed Even IF Over-Withholding Did Not Occur

Hawaiian shareholders in mutual funds investing in REITs effectively would pay tax to Hawaii twice on the same income (even if all over-withheld tax is recovered). Specifically, these Hawaiian shareholders first would bear the economic cost of the tax when withholding is imposed on the distribution by the REIT to the mutual fund. They would pay Hawaiian income tax again when the mutual fund distributes its income to its shareholders (as it must do annually to comply with US federal income tax requirements).

Fund investors who do not reside in Hawaii also would be taxed twice—in both Hawaii and in their own residence State—on the same income. Specifically, any Hawaiian tax incurred by the fund would be deducted by the fund as a business expense rather than credited by either the fund or its shareholders against their residence State tax liability.[4] The fund-level deduction would result in only a slight reduction in the residence-State tax liability as a deduction is far less valuable than a dollar-for-dollar tax credit.

Finally, fund investors saving for retirement often invest in mutual funds through tax-deferred retirement accounts.[5] These investors would bear the economic cost of the tax under this proposal even though their accounts otherwise are exempt from federal and state tax.

* * *

[4] The Federal income tax regime applicable to funds, taxable as regulated investment companies (RICs), is described in greater detail in the enclosed appendix.

[5] The most recent ICI data show 54% of mutual fund assets were held in tax-deferred accounts. https://www.ici.org/pdf/2017_factbook.pdf, Figure A.3

Because this legislative proposal would result in over-withholding by REITs and in double taxation on both Hawaiian and non-Hawaiian investors in mutual funds that invest in REITs subject to this tax, we urge you to reject it.

Please feel free to contact the undersigned at katie.sunderland@ici.org or 202-326-5826 if we can provide you with any additional information regarding our concerns with S.B. No. 3067.

Kind regards,

Katie Sunderland

Katie Sunderland
Counsel - Tax

Enclosure

Appendix: Federal Income Taxation of Funds and Their Shareholders

Subchapter M of the Internal Revenue Code provides the tax regime for mutual funds, and other investment pools, that qualify for regulated investment company (RIC) treatment. All RICs are corporations for Federal income tax purposes. They are treated as such—except to the extent otherwise provided by Subchapter M.

Unlike most corporations, RICs are not subject to taxation on their income or capital gains at the entity level, if they meet certain gross income and asset requirements and distribute their income annually. Instead, RIC shareholders are subject to tax at the federal and state levels based on their residence.

RICs normally do not pay state income taxes since states typically base taxable income on federal income, which takes into account the dividends paid deduction. In the unusual instance that a RIC pays state taxes, it would deduct such amounts under section 164 of the Internal Revenue Code, which reduces its investment company taxable income and the amount it must distribute. While this deduction provides some economic relief to shareholders, it is not as beneficial as a tax credit which reduces a taxpayer's tax liability dollar-for-dollar.

There is, however, no statutory mechanism to allow for the flow through of credits for state taxes paid by a RIC to its shareholders. We note that Form 1099-Div, Box 14 "State Tax Withheld" is used to report any state backup withholding that a mutual fund or intermediary is required to withhold. This box is not available to report withholding taxes imposed on the mutual fund; rather it pertains to withholding taxes that the mutual fund (or, in most instances, the broker) imposes on the shareholder.

In contrast, there is a statutory mechanism in Section 853 of the Internal Revenue Code that permits RICs to pass through foreign taxes credits to their shareholders. Unless there were a similar statutory mechanism available at the state level that was adopted by all states, there would be no way for a RIC to provide a similar pass-through of state tax credits to its shareholders.