

REAL ESTATE INVESTMENT TRUSTS

AND

CHAPTER 207, HAWAII REVISED STATUTES

by

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Request No. B-6714
October, 1969

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INTRODUCTION

House Resolution 268 of the 1969 Regular Session of the Fifth Legislature (see p. 22) requested the Legislative Reference Bureau to extend its study of foreign lenders prepared pursuant to House Resolution 109 of the 1968 Budget Session of the Fourth Legislature.

The study prepared in 1968, entitled "Foreign Lenders and Mortgage Activity in Hawaii",¹ concentrated on the impact on the economy of the State as well as possible adverse effects upon domestic (state-chartered) lending institutions by the inclusion of foreign (out-of-state) federally chartered savings and loan associations within the definition of a "foreign lender", thereby allowing them to make direct mortgage loans in Hawaii on a tax-exempt basis. None of the findings of the study indicated any adverse effects would result should the foreign federal savings and loan associations be allowed to make such mortgage investments in Hawaii.

On the basis of the Bureau study, H.B. 40 "Relating to Foreign Lenders and Mortgage Lending" was introduced in the 1969 Regular Session and was passed by the House of Representatives in a form that included federal savings and loan associations as foreign lenders. During the session, however, an

interest among some legislators in also including "real estate investment trusts" under the definition of foreign lenders resulted in the amendment of H.B. 40 by the Senate. The bill (H.B. 40, S.D. 1) was sent back to the House which did not agree to the change and was referred to the conference committee where it remains. The status of the bill carries over into the 1970 Regular Session.

At that time, several House members were concerned over the lack of information regarding real estate investment trusts and sponsored the resolution which resulted in the extension of the Bureau's study of foreign lenders. This report is limited to real estate investment trusts, and it is suggested that more detailed background material on mortgage activity in Hawaii can be found in the Legislative Reference Bureau's study referred to earlier which this report supplements.

BACKGROUND

A Foreign Lender Defined

Before discussing real estate investment trusts, it would be useful to review briefly Chapter 207 of the Hawaii Revised Statutes, the State's foreign lender law. In general, the term foreign lender refers to a bank or other lending institution chartered in another state which makes loans in Hawaii but does not maintain a place of business in Hawaii. A foreign lender law such as Chapter 207 allows these financial institutions to make loans without being subjected to regulation and taxation by the State. In Hawaii, qualifying foreign lenders are only required to file with the Department of Regulatory Agencies and thereafter are permitted to:

- (1) Make loans;
- (2) Receive security for loans;
- (3) Acquire by assignment or otherwise partial or entire interests in loans or in security for loans;
- (4) Service (but only by or through individuals who are residents of, or corporations doing business, in Hawaii), collect, enforce, or otherwise realize upon loans or upon security for loans or upon interests therein; and take, hold, and dispose of any property acquired (whether by purchase at any sale pursuant to foreclosure by suit or foreclosure under power of sale, or by foreclosure

by entry, or by conveyance in lieu of foreclosure) in enforcement of the rights of the foreign lender in the event of default by any borrower; and

- (5) Empower agents and servants or in connection with, and enter into and perform contracts, and do other acts and things necessary or appropriate for or preliminary or incident to, any of the foregoing activities, but not maintain any office in this State for the conduct of any such activities.²

A state which enacts a foreign lender law gains certain advantages because funds for financing, otherwise unavailable through local sources, are provided for development and construction. For Hawaii, which has had a history of a shortage of mortgage funds, the present law, passed in 1961, has encouraged lending from areas of high capital concentration and facilitated the boom in construction activity which has contributed heavily to the vigor of the state economy in the postwar period.

H.B. 40, S.D. 1, does not affect any other part of Chapter 207 and would only add foreign federal savings and loan associations and real estate investment trusts in the definition of foreign lenders. If Chapter 207 is amended by the bill, section 207-11(2) would read:

(2) "Foreign lender" means (A) a member of the Federal Reserve System, an "insured bank" as defined in the Federal Deposit Insurance Act, an "insured institution," as defined in the Federal Savings

and Loan Insurance Corporation Act, a federally chartered savings and loan association, a "real estate investment trust" as defined in the Internal Revenue Code, or an insurance company, the principal office of which is in another state, whether incorporated or unincorporated and whether acting in its individual capacity or in a fiduciary capacity, (B) the trustee or trustees from time to time in office of any employee benefit plan, and (C) any corporation all of the capital stock of which (except directors' qualifying shares) is owned by one or more foreign lenders of the classes specified in clauses (A) and (B) of this paragraph, but the term "foreign lender" does not include any small loan or industrial loan company of the general character covered by chapters 408 and 409.

Construction and Mortgage Activity in Hawaii

Since the 1968 Bureau study on foreign lenders was prepared, the construction industry in Hawaii has advanced to a new high in the total value of construction (\$463 million) in all categories including residential, commercial, and governmental projects.³ This is part of a construction trend which has continued virtually uninterrupted since 1955 in Hawaii. By mid-year 1969, construction was substantially ahead of the same period in 1968, and indications were that the demand would result in another record in construction volume for 1969.⁴

To support the high level of construction, financing is necessary and the relationship between the availability of mortgage money and construction activity is a direct one.

Mortgages outstanding in Hawaii totaled approximately \$1.38 billion in 1968. Of this amount about two-thirds of the holdings were held by Hawaii-based financial institutions while about one-third, or \$460 million of the mortgages outstanding, was made up of mainland investments.⁵ This indicates the degree to which Hawaii is dependent upon mainland mortgage money. The mainland share is even more significant since the \$460 million does not include the participation financing and outright mortgage purchases of mainland-based institutions which are included in the amount held by the Hawaii-based financial institutions.

The competition for mortgage money is more acute whenever a tight money market prevails. There is, at present, cause for concern. At the time of the preparation of this report, the prime interest rate (the rate charged by banks to their best clients in business borrowing) had been raised to an unprecedented 8-1/2 per cent which tends to have a restraining effect on the mortgage market by cutting off a flow of funds. This is because much of the money available for mortgages comes from savings. With high interest rates, savers find that their money can earn more in bonds and other high yielding investments and thus, the flow of savings slows down to institutions like savings and loan associations which are a

major source of residential construction. Insurance companies, which are another source of mortgage money, also find less money to invest in mortgages since policy holders may borrow on their life insurance at lower interest rates than any other source.

In a tight money market, construction activity usually suffers a slump. Hawaii, which continues to be dependent upon mainland investments to finance its construction, will very likely feel the impact, although it is still uncertain whether these effects will be major ones. If the objective of the legislators is to attract as much mortgage money as possible to ensure that construction will continue at its present level, then the inclusion of more foreign lenders may be a desirable policy. The decision, however, requires careful consideration and the difficulty with real estate investment trusts lies in the fact that their activities in the State have been of a limited nature to date.

REAL ESTATE INVESTMENT TRUSTS

Real Estate Investment Trusts in General

Real estate investment trusts (hereafter referred to as REITs) are unincorporated trusts or associations, managed by one or more trustees. They are similar to stock investment companies (commonly called "mutual funds") in that they enable investors to pool their individual funds to take advantage of investment opportunities and the probability of higher returns while at the same time enjoying centralized, experienced, and sound financial management to ensure the safety of these investments. The primary difference between the REITs and the stock investment companies is that the REITs invest in real estate and real estate mortgages while the stock companies invest in stock and securities.⁶

REITs actually date back to mid-nineteenth century Boston where an organization first offered shares to the public, promising a steady income to investors. Similar organizations were begun in other cities which provided the needed capital to develop these localities. In 1936, however, a federal court decision ruled that the REITs were corporations subject to the corporate income tax. Since the tax on the trusts diminished profits to investors by imposing a double taxation

on them once they received dividends, the REITs no longer proved attractive and many were liquidated.⁷

The current interest in REITs, however, goes back only to 1960 when Congress passed Public Law 86-779 which added sections 856, 857, and 858 to the Internal Revenue Code. Public Law 86-779 exempted the REITs from the corporate tax in the same manner "regulated investment companies" were exempted earlier.

In the cases of both the REITs and "regulated investment companies", where 90 per cent or more of ordinary income is distributed to shareholders, the federal government taxes only the undistributed income, while the distributed earnings of the company are taxed to the shareholders as ordinary income. Any amount which the trust retains is subject to the regular corporate income tax. In the case of the REITs, however, additional qualifications are applied.

As specified in the Internal Revenue Code, a real estate investment trust must:

- (1) Be organized under state law as an unincorporated trust or association managed by one or more trustees;
- (2) Have transferable shares or certificates of beneficial interest;
- (3) Be a type of organization which would be taxed as an ordinary domestic corporation in the absence of the provisions of these Sections.

The beneficial ownership of qualifying REITs must be held by 100 or more persons. No five or fewer individuals may directly or indirectly own more than 50 per cent of the trust. The REIT may not hold any property primarily for sale to customers in the ordinary course of trade or business. This provision, together with certain other provisions restricting trusts from providing services to tenants except through an independent contractor, are designed to make sure that the trust operates as a conduit strictly for investment income. Income requirements are divided into the three following categories, all three of which must be met by a trust in order to qualify:

- (1) Ninety per cent or more of a trust's gross income must be obtained from dividends, interest, rents from real property, gains from the sale of securities and real property and abatements and refunds of taxes on real property.
- (2) The second income test requires that at least 75 per cent of a real estate investment trust's income must be income from real property, which is defined to include rents from real property, gain from the sale of real property, mortgage interest, dividends and other distributions from other real estate trusts qualifying under the Internal Revenue Code and abatements and refunds of taxes on real property.

Thus, 75 per cent of the trust income must be derived from real property, another 15 per cent must be derived from either real property or from sources from which a regulated investment company may derive 90 per cent of its income, and the remaining 10 per cent is not limited as to source.

- (3) Under the third test, not more than 30 per cent of the trust's gross income may be obtained from sales of securities held for less than six months or from sales of real property held for less than four years from involuntary conversions.

There are certain investment requirements:

- (1) The first requires that 75 per cent of the value of the trust assets be in real estate assets, cash and cash items, and government securities. This test is designed to assure that most of the trust's assets will be in real estate.
- (2) Not more than 25 per cent of the value of the trust assets may be invested in securities of other companies (except other REITs which qualify as "real estate assets").
- (3) Not more than 5 per cent of the value of the trust assets may be invested in any one issuer, nor in more than 10 per cent of the voting securities of such issuer.⁸

The 1960 tax benefit legislation served as an impetus for the establishment and development of REITs. While REITs which sold shares only within a single state were exempt from filing with the Securities and Exchange Commission, all REITs selling shares outside a single state fell under federal regulation. As of June 30, 1968, registration statements of 61 REITs were effective under the SEC rules and the gross assets of these REITs were more than \$1 billion.⁹

"Equity" Trusts and "Mortgage" Trusts

REITs are organized in two different forms. Most REITs are "equity" trusts which invest primarily in income producing property such as commercial (shopping centers, office buildings, hotels, etc.), and industrial real estate. Their main source of income is from rents. The other form of REITs is the "mortgage" trust which invests primarily in loans secured by mortgages on real estate. These mortgages consist of both long-term mortgages (maturities of more than ten years) and short-term mortgages (one to two years) for construction or other interim financing. The income of mortgage trusts is primarily from interest earned and discounts received during the period of amortization of the loans.¹⁰

REITs in Hawaii

The impact of the REITs in Hawaii has still been minimal in the construction industry and has been limited to a few mortgage trusts involved primarily in the construction of condominium apartments and hotels.¹¹ Although the REIT investments in Hawaii have been for construction, REITs in other areas also make a variety of investments either alone or in participation (by purchasing a partial interest in a mortgage loan that was acquired by another lender in the locale) with other institutional investors. Most REIT investments include the following:

- (1) First mortgage construction loans, which finance the construction of residential, commercial or industrial buildings.
- (2) FHA insured, VA guaranteed, and conventional first mortgage loans, which finance the purchase or the refinancing of completed residential and income properties.
- (3) Warehousing loans, which are loans usually made to mortgage bankers or financial institutions on a short-term basis and secured by the pledge of first mortgage loans.
- (4) Standby commitments to make long-term first mortgage loans. The REIT charges a fee for issuing the letter of commitment against which a borrower may obtain a construction or interim loan.
- (5) Long-term first mortgage loans on property in Canada insured by an agency of the Canadian Government.
- (6) Ownership of income-producing real property, and unimproved real property for future development.
- (7) Securities or other equity interests in real property projects.
- (8) Securities of other corporations.
- (9) Municipal, state and federal obligations, and those of their instrumentalities, as well as bank time deposits, commercial paper and bankers' acceptances.

Although the REITs do invest in FHA insured, VA guaranteed and conventional long-term first mortgage loans on completed buildings, these have not been the type of commitments they have made in Hawaii because more attractive investment

opportunities exist here. The emphasis is on construction of commercial buildings and condominiums, and this is important to note since residential housing, other than multi-unit projects, will probably not attract funds from the REITs.

Short-term construction loans have a greater attraction, despite their high risk, because they allow a higher interest rate and provide the REITs with diversity in their investments. In interim financing of this sort, the REITs furnish the construction funds for a project while some other financial institution such as an insurance company, savings bank, savings and loan association, or commercial bank provides a commitment for a first mortgage loan or the permanent mortgage. Generally, the construction loans are repaid by the borrower out of proceeds of the long-term first mortgage. Making more funds available for short-term construction financing may be desirable in Hawaii since most Hawaii mortgage bankers, with the exception of commercial banks, ordinarily do not do interim construction financing. Commercial banks, however, like the Bank of Hawaii and the First Hawaiian Bank, have not taken any position against the REITs for the reason that banks have supported a policy of encouraging the influx of new investment capital into the State. Moreover, in the case of commercial banks on the Mainland, many have reduced their construction lending

because of tight money conditions leaving the investment field in land development and construction loans to the REITs.

Another reason why the REITs have not been viewed as a threat to local lenders is that the REITs have worked for the most part through mortgage correspondents or through participation with commercial banks or other financial institutions both here in Hawaii and throughout the country. In participation, local lenders originate and sell loans from their own portfolio, seeking investors on the Mainland who will either purchase the mortgage loans outright or a partial interest in the mortgage. Local lenders retain the servicing of the mortgage and the fees for the servicing vary with the size of the loan and are negotiated between the local lender and the foreign lender. Thus, the attitude of local lenders would tend to be cooperative rather than competitive, although this attitude may well change if the REITs begin to make direct loans to builders and developers, by-passing the local lender as the middleman, which the REITs might do under Chapter 207.

Taxation and Regulation under Chapter 207

The tax exemption provided in section 207-12 may well be regarded as the core of the foreign lender law and is a major feature in attracting investment. REITs, like other out-of-state

investors, are looking for investments which will produce high net yields, and tax benefits increase those yields. In the case of participation loans, the income derived from the share of the local lender on the loan is taxable by the State both as part of the 4 per cent general excise tax and the net income tax. On the other hand, the income of the foreign lender derived through its share in the participation or direct purchase is tax exempt. In a direct loan, no tax revenue would accrue to the State.

Although it has never been established whether the practices of participation or outright purchase of loans by out-of-state lenders other than foreign lenders as defined by law are in conflict with Chapter 207, many (such as the foreign federal savings and loan associations) have been using these methods in the past without being challenged. As was pointed out in the 1968 study, however, direct loans by a lender which did not qualify under Chapter 207 would appear to be a violation of the law. As the situation actually exists, however, the making of direct loans is not a common practice either of REITs or most qualifying foreign lenders with investments in Hawaii. There is some reason for doubt, moreover, that REITs will originate their own loans in Hawaii. On the Mainland, the REITs appear to work mainly through correspondents who have

an intimate knowledge of the local market and conditions. The pattern for most foreign lenders operating in Hawaii has been one of working with local mortgage bankers, and this should not differ to any great degree with the REITs. If the REITs do make direct loans, the projects are thoroughly investigated and careful attention is given to each step of the project. Through these methods, the REITs have avoided a "get-rich-quick" image, and the public as shareholders seem to be adequately protected by federal tax laws; the rules of the Securities and Exchange Commission, state securities commission, or both, which require a full disclosure of the factors to be made known to investors. While no definitive judgment can be made, the REITs, as a whole, have not been instruments of abuse since their reappearance after 1960.¹²

SUMMARY

The REITs have only begun to enter the Hawaii construction picture, and it is still difficult to measure their total impact because their activities have been limited to construction financing of a few hotel and condominium projects. There are no concrete figures of the amount of their investments to date although one estimate was \$15 to \$20 million. The REITs and their investment patterns are dependent on a number of factors, not the least of which is the activity on the stock market because of the nature of its organization and its share offerings.¹³ In the quest for high yield investments, the REITs have looked to Hawaii which is undergoing a construction boom, and the State can probably expect more investments, but not much other than short-term construction loans. No one can deny that the potential does exist for the REITs to become a major factor in mortgage financing in Hawaii, but the impact is not really measurable as yet.

In the face of continuing demands for mortgage funds and the high level of construction in Hawaii, there does not seem to be any reason why the REITs should not be included in the definition of foreign lenders, along with the federally chartered savings and loan associations which were the subject of the earlier study.

FOOTNOTES

1. Legislative Reference Bureau, University of Hawaii, Request No. B-4863, November, 1968 (Mimeographed).
2. Hawaii Rev. Stat., Sec. 207-13 (1967).
3. Construction in Hawaii 1969, Bank of Hawaii (Honolulu: 1969), p. 2.
4. "Review of Business and Economic Conditions," Bank of Hawaii, June, 1969.
5. Construction in Hawaii 1969, p. 5.
6. California, Division of Real Estate, Reference Book, 1968 edition (Sacramento: 1968), p. 222.
7. Don G. Campbell, The Handbook of Real Estate Investment (Indianapolis and New York: Bobbs-Merrill Company, Inc., 1968), pp. 118-22.
8. National Association of Real Estate Investment Funds, Handbook of Member Trusts (n.p. 1968), pp. 4-6.
9. Ibid., p. 3.
10. William A. Kelley, Jr., "Real Estate Investment Trusts After Seven Years," Business Lawyer, 23 (July, 1968), p. 1002.
11. Two of the REITs contacted in the course of the report who have invested in Hawaii were Continental Mortgage Investors and First Mortgage Investors which are both Boston-based but national in scope. Continental Mortgage Investors has more than 12,000 shareholders and has made loans in 40 states over the last 7 years totaling some \$500 million. First Mortgage Investors reported over 180 mortgage correspondents in 43 states and Puerto Rico and reported approximately 5,800 shareholders in 1968. Continental Mortgage Investors is listed on the New York Stock Exchange while First Mortgage Investors' shares are traded over the counter.

12. Kelley, p. 1011. A number of REITs organized in California appear to be interested in investments in Hawaii and if they do not sell their shares across state borders, are registered with and regulated by the California Corporations Commissioner.
13. Until the June-July (1969) stock market slump, stock in First Mortgage Investors moved up in price by nearly 30 per cent and Continental Mortgage Investors by 25 per cent from the beginning of the year.

ACKNOWLEDGMENTS

The following individuals were helpful in the preparation of this report and we are grateful for their cooperation.

Mr. Charles Wade, First Hawaiian Bank
Mr. H. Howard Stephenson, Bank of Hawaii
Mr. Peter Smith, AMFAC Financial Corporation

Correspondence was also conducted with several persons associated with REITs and we appreciate the information they provided us.

Mr. Hal Mendon, First Fidelity Company (Beverly Hills, California)
Mr. Durand A. Holladay, Mortgage Consultants (Investment Advisor to Continental Mortgage Investors) (Coral Gables, Florida)
Mr. Sumner H. Shafmaster, First Mortgage Advisory Corporation (Investment Advisor to First Mortgage Investors) (Miami Beach, Florida)

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HOUSE RESOLUTION

REQUESTING THE LEGISLATIVE REFERENCE BUREAU TO EXTEND ITS
 STUDY RELATING TO FOREIGN LENDERS.

1 WHEREAS, pursuant to House Resolution No. 109, adopted
 2 at the Fourth Legislature, Budget Session of 1968, the
 3 Legislative Reference Bureau conducted and duly submitted a
 4 study on the provisions of House Bill No. 185, introduced in
 5 the said Budget Session of 1968, which proposed to amend
 6 Section 98L-8(b), Revised Laws of Hawaii 1955, to include
 7 federally chartered savings and loan associations within the
 8 meaning of the term "foreign lender", enabling such associa-
 9 tions to file statements with the Department of Regulatory
 10 Agencies and thereafter make mortgage loans in Hawaii; and
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13 WHEREAS, it is now desirous to extend that study to
 14 cover the impact on the mortgage business in Hawaii by a
 15 proposed inclusion of a real estate investment trust as
 16 defined in the Internal Revenue Code within the meaning of
 17 the term "foreign lender"; now, therefore,
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 19

20 BE IT RESOLVED by the House of Representatives of the
 21 Fifth Legislature of the State of Hawaii, Regular Session of
 22 1969, that it request the Legislative Reference Bureau to
 23 extend its study on the provisions of House Bill No. 185
 24 with regard to a proposed inclusion of real estate investment
 25 trust as defined in the Internal Revenue Code within the
 26 meaning of the term "foreign lender" and with regard to the
 27 economic impact of such inclusion on the mortgage business
 28 in Hawaii; and
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31 BE IT FURTHER RESOLVED that the Legislative Reference
 32 Bureau submit the report of its findings and recommendations
 33 to the House of Representatives thirty days prior to the
 34 convening of the 1970 Regular Session; and
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1 BE IT FURTHER RESOLVED that a duly certified copy of this
2 Resolution be transmitted to the Legislative Reference Bureau.
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