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TESTIMONY OF GARY S. SUGANUMA, DIRECTOR OF TAXATION

TESTIMONY ON THE FOLLOWING MEASURE:
S.B. No. 1465, S.D. 1, Relating to Pass-Through Entity Taxation.

BEFORE THE:
House Committee on Finance

DATE: Thursday, March 27, 2025
TIME: 2:00 p.m.
LOCATION: State Capitol, Room 308

Chair Yamashita, Vice-Chair Takenouchi, and Members of the Committee:

The Department of Taxation (DOTAX) offers the following testimony in support of S.B. 1465, S.D. 1, an Administration measure, for your consideration.

S.B. 1465, S.D. 1, amends section 235-51.5(e), Hawaii Revised Statutes (HRS), relating to the pass-through entity (PTE) tax, by requiring qualified members of an electing PTE adjust their taxable income by adding back their share of taxes paid by the electing PTE.

Section 235-51.5, HRS, allows partnerships and S corporations to elect to pay Hawaiʻi income tax at the entity level, with a corresponding tax credit available to qualified members of the electing PTE equal to their pro rata share of PTE taxes paid. The PTE tax and related PTE tax credit were intended to allow PTEs to take advantage of federal income tax deductions with no revenue impact to the State.

Under current law, however, taxpayers claiming the PTE tax credit receive a double benefit, which results in a revenue loss for the State. Specifically, qualified members of a PTE receive (1) a PTE credit equal to their share of PTE taxes paid by the PTE and (2) a reduction of their taxable income from the PTE (because PTE tax payments may be deducted at the entity level as business expenses).

This bill eliminates the double benefit currently afforded to qualified members of an electing PTE by requiring qualified members to add their share of PTE taxes paid to their taxable income.

This bill has a defective effective date of July 1, 2050, and applies to taxable years beginning after December 31, 2024

DOTAX estimates this bill will result in a revenue gain as follows:

General Fund Impact ($ millions)

FY2026	FY2027	FY2028	FY2029	FY2030	FY2031
29.3	30.8	32.4	34.0	35.7	37.5

Thank you for the opportunity to provide testimony in support of this measure.

LEGISLATIVE TAX BILL SERVICE

TAX FOUNDATION OF HAWAII

735 Bishop Street, Suite 417 Honolulu, Hawaii 96813 Tel. 536-4587

SUBJECT: INCOME, Passthru Entity Election Members Recognize Share of Taxes Paid

BILL NUMBER: SB 1465 SD 1

INTRODUCED BY: Senate Committee on Ways and Means

EXECUTIVE SUMMARY: For taxable years beginning after December 31, 2024, requires all qualified members claiming a credit for pass-through entity taxation to adjust their income to include the qualified member's share of taxes paid by an electing pass-through entity.

SYNOPSIS: Amends HRS section 235-51.5 to provide that any qualified member claiming a credit shall add to the qualified member's taxable income the qualified member's share of taxes paid by an electing pass-through entity.

EFFECTIVE DATE: July 1, 2050; shall apply to taxable years beginning after December 31, 2024.

STAFF COMMENTS: This is an Administration bill sponsored by the Department of Taxation and designated TAX-02 (25).

At the federal level, the Tax Cuts and Jobs Act (TCJA) capped the state and local tax (SALT) deduction for individuals at $10,000 for the 2018-2025 tax years. The limit generally applies to any SALT liability, including tax on income received from a partnership or S corporation. This limitation causes the most hardship in states with higher income tax rates, a classification to which Hawaii most definitely belongs.

In response, several states enacted laws designed to provide individuals with SALT deductions notwithstanding the $10,000 limitation by imposing tax directly at the passthrough entity level. The entity, not the individual, pays the tax and is not burdened with the $10,000 limit.

In November 2020, the IRS released Notice 2020-75 (https://www.irs.gov/pub/irs-drop/n-20-75.pdf), in which the agency stated that it intended to publish regulations stating that the strategy works. The Notice cited a 1958 revenue ruling, Rev. Rul. 58-25, 1958-1 C.B. 95, which held that a partnership level tax levied by Cincinnati reduced the partnership's taxable income or loss, and did not preclude its individual owners from claiming the standard deduction.

Many other states have jumped on the bandwagon, including Hawaii; a majority of states now have passthrough entity (PTE) election laws.

To illustrate what this bill is trying to do, suppose a partnership has income of $100 and expenses of $60. Before the PTE election, a 50% individual owner would recognize on the owner's N-11 tax return partnership income of $20 (50% of the partnership's net income of $40) and would be expected to pay tax on the $20. Assume for simplicity that the tax on $20 is $2. The individual

owner can take a deduction for the tax because the itemized deduction limit under TCJA does not apply for Hawaii tax purposes. Thus, the owner has an additional $18 included in income.

With the PTE election in place, the partnership would pay the tax on the $40. In this example the tax is $4. The partnership would be able to deduct the tax. Thus, the owner would recognize additional income of $18 and a credit for tax paid of $2. The owner takes no deduction for tax paid, leaving the owner in roughly the same position as before.

This bill requires the 50% owner to recognize the full $20, which perhaps would be appropriate if the owner were unable to take the state tax deduction. The deduction may well be prevented on the federal side by the $10,000 limit, but, as mentioned earlier, that limit does not apply for Hawaii state tax purposes.

Thus, the correction proposed by this bill appears to be unnecessary.

Digested: 3/25/25