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To: The Honorable Jill N. Tokuda, Chair
and Members of the Senate Committee on Ways and Means

Date: Tuesday, February 7, 2017
Time: 9:30 A.M.
Place: Conference Room 211, State Capitol

From: Maria E. Zielinski, Director
Department of Taxation

Re: S.B. 1006, Relating to the Estate and Generation Skipping Transfer Taxes

The Department of Taxation (Department) strongly supports S.B. 1006, an administration measure, which seeks to close a loophole whereby nonresidents can completely or substantially avoid the estate tax by the use of a Single Member Limited Liability Company (SMLLC) which has not elected to be taxed as a corporation. The Department provides the following comments on S.B. 1006 for your consideration.

S.B. 1006 clarifies that if Hawaii real property is held by a SMLLC, that SMLLC will be disregarded for estate tax purposes. This means that the estate tax will be applied the same as if the nonresident decedent owned the Hawaii real property directly. A nonresident would not be able to avoid the estate tax by allowing using a SMLLC to hold the Hawaii real property. The measure is effective upon approval, and is applies to decedents dying after December 31, 2016.

The estate tax applies to both residents and nonresidents, whose property owned at death exceeds certain thresholds. For residents, that amount for 2017 is \$5,490,000 and for nonresidents, a proportionate amount based on the amount of property with situs in Hawaii compared the total federal gross estate. For residents, all property, wherever located, is subject to the tax, whereas for nonresidents, only property located in Hawaii is subject to tax.

Intangible property such as stocks, bonds, and the like are deemed to have the situs of the decedent's domicile. This rule determining the situs of intangible property is what allows for the loophole that this measure is intended to address. When Hawaii real property is placed into a SMLLC and the nonresident decedent transfers ownership of that SMLLC to a beneficiary upon death the Hawaii estate tax is not triggered because the decedent did not directly own the Hawaii real property. The intangible property rule would apply and the ownership interest in the SMLLC will be deemed to have the situs of the decedent's domicile.

Since it is clear that the estate tax was intended to apply to Hawaii real property owned by nonresidents, this measure simply supports that intent. The measure also creates consistent application of the estate tax, as it already applies to the Hawaii real property owned by a Hawaii resident, whether owned directly or through a SMLLC.

Accordingly, the Department strongly supports this measure, and will be able to implement the measure with the current effective date.

Thank you for the opportunity to provide comments.

TAX FOUNDATION OF HAWAII

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SUBJECT: ESTATE/GSTT, Look-Through of Single-Member LLCs

BILL NUMBER: SB 1006; HB 1140 (Identical)

INTRODUCED BY: SB by Kouchi by request; HB by Souki by request

EXECUTIVE SUMMARY: Now, the estate tax or generation-skipping transfer tax applies if the decedent is a Hawaii resident or has Hawaii real or personal property in the gross estate. The bill would look through single member LLCs that are disregarded for income tax purposes. That treatment is not justified, and treats other passthru entities differently.

BRIEF SUMMARY: Amends HRS section 236E-8 to require a Hawaii estate tax return to be filed if the decedent is the sole owner of a single member limited liability company that has not elected to be taxed as a corporation, and the LLC has Hawaii real estate or tangible personal property.

EFFECTIVE DATE: Upon approval. Applies to decedents dying after December 31, 2016.

STAFF COMMENTS: This is an administration measure submitted by the department of taxation TAX-05 (17). The bill, ostensibly to close a loophole, looks through an entity depending on its treatment under the income tax law.

It should be remembered that the income tax and the estate tax are different beasts. The former has quite a few provisions designed to shift the tax burden that otherwise would fall on business entities to their owners. Some that come to mind are the tax treatment of partnerships, S corporations, trusts (grantor trusts and otherwise), and REITs. The estate tax has provisions clawing back into the estate gifts made within three years of death (IRC section 2035), purported gifts with retained interests (IRC section 2036), transfers taking effect at death (IRC section 2037), revocable transfers (IRC section 2038). Entities are not looked through for estate tax purposes. However, the gross estate does include intangible property such as stock shares.

If the decision is to look through single member LLCs that have not elected to be taxed as a corporation, then what about single member LLCs that do elect to be taxed as a corporation and then make a subchapter S election? And why exclude partnerships or S corporations with multiple owners? A consistent rationale needs to be developed to prevent the estate tax law from being mucked up by income tax concepts, and vice versa.

Digested 2/5/2017