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To: The Honorable Donovan M. Dela Cruz, Chair
and Members of the Senate Committee on Ways and Means

Date: Monday, February 11, 2019
Time: 10:00 A.M.
Place: Conference Room 211, State Capitol

From: Linda Chu Takayama, Director
Department of Taxation

Re: S.B. 1360, Relating to Taxation

The Department of Taxation (Department) offers the following comments on S.B. 1360 for the Committee's consideration.

S.B. 1360 requires partnerships, estates, and trusts to withhold all taxes owed to the State from any gross income or adjusted gross income of a nonresident. The bill is effective upon its approval and applies to taxable years beginning after December 31, 2018.

The Department notes that this bill does not specify the rate of withholding and is not clear about the base amount on which the withholding should be calculated. Thus, the Department suggests the following amendment to Section 1 of the bill:

"**§235- Withholdings by partnerships, estates, and trusts.** Partnerships, estates, and trusts shall withhold an amount equal to the highest marginal tax rate applicable to a nonresident taxpayer multiplied by the amount of the taxpayer's distributive share of income attributable to the State reflected on the partnerships, estates, and trusts' return for the taxable period ~~all tax owed to the State from any gross income or adjusted gross income of a nonresident, in order to collect the tax imposed by this chapter on the nonresident~~. All amounts withheld shall be paid to the department of taxation in a manner that the department may prescribe."

Finally, the Department respectfully requests that this measure be made applicable to taxable years beginning after December 31, 2019 to allow time for the Department to make the necessary changes to forms, instructions, and computer system.

Thank you for the opportunity to provide comments.

LEGISLATIVE TAX BILL SERVICE

TAX FOUNDATION OF HAWAII

126 Queen Street, Suite 304 Honolulu, Hawaii 96813 Tel. 536-4587

SUBJECT: INCOME, Withholding Requirement for Partnerships, Estates, and Trusts

BILL NUMBER: SB 1360

INTRODUCED BY: DELA CRUZ

EXECUTIVE SUMMARY: Requires partnerships, estates, and trusts to withhold taxes on the income of nonresident partners and beneficiaries.

SYNOPSIS: Adds a new section to chapter 235, HRS, directing partnerships, estates, and trusts to withhold all tax owed to the State from any gross income or adjusted gross income of a nonresident.

EFFECTIVE DATE: Taxable years beginning after December 31, 2018.

STAFF COMMENTS: Currently under federal and state income tax law, partnerships, estates, and trusts who do business or otherwise have activity in Hawaii do not have to pay income tax to Hawaii, on the premise that the partners or beneficiaries, as the case may be, will pay Hawaii income tax on their distributive shares of the underlying entity's income. All partners or beneficiaries should therefore pay tax, but, sadly, not all of them do.

In the S Corporation context, the Model S Corporation Income Tax Act (MoSCITA), specifically section 235-122, HRS, imposes a withholding obligation on S Corporations to withhold tax on income paid to any shareholders who do not agree (on Schedule NS, Form N-35) to pay tax in Hawaii on their distributive shares of S corporation income. This bill legitimately raises the question of whether something similar should be done for partnerships, estates, and trusts.

Digested 2/5/2019

February 7, 2019

The Honorable Donovan M. Dela Cruz
Senate Ways and Means Committee Chair
Hawaii State Capitol, Room 208
415 South Beretania Street
Honolulu, HI 96813

Re: Senate Bill No. 1360 - Hearing Scheduled for February 11, 2019 at 10:00 AM

Dear Chair Dela Cruz:

This letter is written on behalf of the Master Limited Partnership Association (MLPA) to offer testimony related to the partnership nonresident withholding proposal included in Hawaii Senate Bill No. 1360 (SB 1360). Due to the considerations described below, MLPA requests an adjustment to SB 1360 to exempt publicly traded partnerships from any nonresident withholding requirements. Our proposed change would have the effect of making the proposed bill language consistent with many other states' legislation; adding consistency and clarification for public unitholders of publicly traded partnerships; and avoiding requiring unequal taxpayer treatment, which is not possible given the specifics of the publicly traded partnership structure. Additional background related to MLPA constituent concerns with the existing language in SB 1360 is included below.

Background

Publicly traded partnerships (PTPs), also known as master limited partnerships (MLPs), are limited partnerships, the interests in which (units) are traded each day on the New York, American and NASDAQ exchanges. Under section 7704 of the Internal Revenue Code, PTPs are taxed as partnerships as long as they meet certain statutory requirements. Currently, there are roughly 140 publicly traded partnerships in the country.

Rules added to the federal tax code in 1987 require any partnership that is publicly traded to receive 90 percent of its income from specified sources in order to be treated as a partnership rather than a corporation for income tax purposes. These qualified sources include mineral or natural resource activities such as exploration, production, mining, refining, marketing and transportation (including pipelines), of oil and gas, minerals, geothermal energy and timber, as well as income and gains from real property.

The reason the United States Congress provided for partnership tax treatment of PTPs was to stimulate the development and delivery of capital intensive businesses with low or controlled rates of return. Levying a tax directly on a PTP, or their lower-tier entities, defeats the very purpose of the structure. Further, such a payment of state tax may negatively impact PTP trading values due to the impact on the PTP's cash flow. It is also important to note that investors in PTPs do not receive any additional state liability protection by virtue of investing in these entities and such investors themselves remain subject to all applicable state tax laws.

PTP Nonresident Withholding Concerns

PTPs each have tens of thousands, and in some cases, more than 100,000 limited partners which will be referred to as partners or unitholders throughout these comments. PTP units are publicly traded and each unit must be fungible. As a result, PTPs cannot treat unitholders differently including the payment of any tax on behalf of only certain unitholders. Specific to SB 1360, any requirement that a PTP operating in the state withhold tax on behalf of only certain nonresident partners would cause said PTP units to have a different economic value thereby losing fungibility of the units.

This fungibility concern is part of the reason why states overwhelmingly exempt PTPs from nonresident withholding payment requirements. In fact, each state that currently imposes a partnership nonresident withholding requirement exempts PTPs from such withholding.

In addition to fungibility requirements, the requirement to withhold tax on behalf of nonresidents would be an extremely burdensome requirement for PTPs. Federal law does require brokers to report to PTPs specific ownership information on units held in street name, including name and address. However, this information is provided only once a year for the purpose of providing each PTP with the information needed to send K-1s to their unitholders so that the unitholders can include it in their federal tax returns. As any partnership tax manager can attest, it is an enormous job for the partnerships to process the information sent by brokers and report to partners within the time allotted by law.

PTPs typically distribute federal and state K-1 information to their partners in the early spring each year after the broker information process described above is complete. Any requirement to simultaneously report state withholding information to tens or hundreds of thousands of partners would increase the already overwhelming reporting burden facing PTPs.

Other Concerns

SB 1360 as currently drafted requires partnerships to "*withhold all tax owed to the State from any gross income or adjusted gross income of a nonresident."* However, SB 1360 provides no detail on the mechanics of such calculation including how "all tax owed to the State" will be calculated or which tax rates will be utilized to determine said tax. Further, SB 1360 currently does not include any nonresident withholding "opt-out" provision by which partners of a partnership that have themselves already made necessary state tax estimated payments can request to be exempted from any partnership payment requirement on their behalf. Such provisions are common in state nonresident withholding statutes and are generally necessary to help ensure affected partnerships remain in compliance with any state requirements.

Summary

For the aforementioned reasons, we ask that as SB 1360 progresses publicly traded partnerships are determined to be exempt from any nonresident withholding requirement.

Please let me know if we can provide additional information about this issue or be of assistance.

Best,

Lori Ziebart
Executive Director, MLPA