

ACT 50

S.B. NO. 2725

A Bill for an Act Relating to Pass-Through Entity Taxation.

Be It Enacted by the Legislature of the State of Hawaii:

SECTION 1. The legislature finds that pass-through entities, such as S corporations, partnerships, and limited liability companies, are a vital part of Hawaii's economy and comprise a significant portion of the State's business sec-

ACT 50

tor. These entities play a critical role in job creation, innovation, and economic growth, and are, in many cases, Hawaii's small businesses and startups.

The legislature further finds that Act 50, Session Laws of Hawaii 2023 (Act 50), allowed certain pass-through entities to elect to pay Hawaii income tax at the entity level. Act 50 was enacted to help Hawaii's small businesses by allowing taxpayers to deduct Hawaii state income taxes paid on their federal income tax returns. These deductions from federal taxable income had been eliminated by changes to the federal tax code in 2017, which deprived Hawaii taxpayers of significant federal tax benefits.

Under Act 50, the entity level tax is calculated by applying the highest individual income tax rate to the taxable income to be distributed, entitling members to receive a nonrefundable income tax credit that cannot be carried forward to a subsequent year if the credit exceeds the member's income tax liability. The legislature finds that, due to the inability to carryforward the tax credit, many pass-through entity members remain unable to benefit from Act 50 as intended.

Accordingly, the purpose of this Act is to, for taxable years beginning after December 31, 2023:

- (1) Add a definition for "qualified member" and repeal the definitions for "direct member" and "indirect member" as used in the State's pass-through entity taxation election law;
- (2) Amend the pass-through entity level tax rate to be the sum of all qualified member's distributive shares and guaranteed payments of Hawaii taxable income, as calculated under chapter 235, Hawaii Revised Statutes, multiplied by nine per cent; and
- (3) Allow certain qualified members entitled to a tax credit to use the credit against the member's net income tax liability in subsequent years until exhausted.

SECTION 2. Section 235-51.5, Hawaii Revised Statutes, is amended as follows:

1. By amending subsections (b) through (f) to read:

"(b) Notwithstanding any provision of law to the contrary, the following tax is imposed on each electing pass-through entity: the sum of all qualified member's distributive shares and guaranteed payments of Hawaii taxable income as calculated under this chapter, multiplied by [~~the highest rate of tax applicable to the individual under section 235-51; provided that the distributive shares and guaranteed payments of members who are corporations shall not be included in the sum and shall not be subject to the tax under this section.~~] nine per cent. If the income calculated pursuant to this subsection reflects a net loss for the electing pass-through entity, the net loss may be carried forward to subsequent tax years for as long as the electing pass-through entity elects to be subject to the tax pursuant to this section until exhausted.

(c) A nonresident individual who is a qualified member of an electing pass-through entity shall not be required to file an income tax return pursuant to this chapter for a tax year if the member's only source of Hawaii income is from electing pass-through entities and the electing pass-through entity or entities file and pay the tax due under this section.

(d) Each electing pass-through entity shall report to each of its qualified members, for each tax year, the member's pro rata share of the tax imposed pursuant to this section.

(e) Each qualified member of an electing pass-through entity whose distributive share or guaranteed payment of Hawaii taxable income is subject to tax under this section shall be entitled to a credit equal to the qualified member's

share of the tax paid pursuant to this section. If the amount of the credit authorized by this subsection exceeds the qualified member's tax liability imposed pursuant to this chapter, the excess ~~[amount shall not be refundable to the member.]~~ of the credit over liability may be used as a credit against the member's net income tax liability in subsequent years until exhausted. Any qualified member claiming a credit shall not be entitled to deduct from the member's Hawaii state taxable income those amounts of Hawaii state income taxes paid by the member on the qualified member's distributive share or guaranteed payment of income from the electing pass-through entity.

(f) Each qualified member that is subject to the tax imposed by this chapter as a resident or part-year resident of the State shall be entitled to a credit for the ~~[direct]~~ qualified member's ~~[or indirect member's]~~ pro rata share of taxes paid to another state or to the District of Columbia, on income of any partnership or S corporation of which the person is a member; provided that the taxes paid to another state or to the District of Columbia result from a tax that the director of taxation determines is substantially similar to the tax imposed pursuant to this section. Any credit shall be calculated in a form and manner prescribed by the director of taxation; provided that the calculation is consistent with the provisions of this section. If the amount of the credit authorized by this subsection exceeds the qualified member's tax liability for the tax imposed pursuant to this chapter, the excess amount shall not be refundable and shall not carry forward."

2. By amending subsection (h) to read:

"(h) For purposes of this section:

~~["Direct member" means a member that holds an interest directly in an electing pass-through entity.]~~

"Electing pass-through entity" means any eligible partnership or S corporation that elects to be subject to tax pursuant to subsection (a).

~~["Indirect member" means a member that itself holds an interest, through a direct member or indirect member that is a partnership or S corporation, in an electing pass-through entity.]~~

"Member" means:

- (1) A shareholder of an S corporation;
- (2) A partner in a general partnership, a limited partnership, or a limited liability partnership; or
- (3) A member of a limited liability company that is treated as a partnership or S corporation for federal income tax purposes.

"Partnership" means the same as in the Internal Revenue Code. "Partnership" includes a limited liability company that is treated as a partnership for federal income tax purposes but does not include any publicly traded partnership within the meaning of section 7704 of the Internal Revenue Code.

"Qualified member" means a member of an electing pass-through entity that is an individual, trust, or estate.

"S corporation" means a corporation for which a valid election under section 1362(a) of the Internal Revenue Code is in effect."

SECTION 3. Statutory material to be repealed is bracketed and stricken. New statutory material is underscored.

SECTION 4. This Act, upon its approval, shall apply to taxable years beginning after December 31, 2023.

(Approved June 19, 2024.)