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**STATE OF HAWAII  
DEPARTMENT OF TAXATION**

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To: The Honorable Sylvia Luke, Chair  
and Members of the House Committee on Finance

Date: Friday, March 15, 2019  
Time: 2:00 P.M.  
Place: Conference Room 308, State Capitol

From: Linda Chu Takayama, Director  
Department of Taxation

Re: S.B. 1360, S.D. 1, Relating to Taxation

The Department of Taxation (Department) offers the following comments on S.B. 1360, S.D. 1, for the Committee's consideration.

S.B. 1360, S.D. 1, requires partnerships, estates, and trusts to withhold income tax owed to the State from the distributive share of 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 Senate Committee on Ways and Means adopted its recommendation to 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.

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.

# 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, SD-1

INTRODUCED BY: Senate Committee on Ways & Means

EXECUTIVE SUMMARY: Requires partnerships, estates, and trusts to withhold taxes on the income of nonresident partners and beneficiaries. There may be constitutional concerns, as the Attorney General has stated in testimony on SB 675 (2019).

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.

Makes a conforming amendment to section 235-66, HRS.

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.

There also may be a constitutional issue. SB 675, also considered this session, involved a bill to impose withholding tax on shares in a real estate investment trust (REIT). The Attorney General, in testimony before the Senate Committee on Ways and Means, stated:

S.B. No. 675 may be subject to constitutional challenge to the extent it seeks to impose State taxes on a nonresident who owns shares in a REIT that owns real property located in the State. The general rule as to the situs of invisible and intangible property (stocks, bonds, notes, etc.) is that it follows the domicile of the owner, and it is taxable at such domicile and not elsewhere. Curry v. McCanless, 307 U.S. 357, 367, 59 S. Ct. 900, 906 (1939). The U.S. Supreme Court, opining on the constitutionality of a state taxing its own residents' intangible property noted:

As a matter of fact, there is more reason for the domiciliary state of the owner of the intangibles than for any other taxing jurisdiction to collect a property tax on

the intangibles. Since the intangibles themselves have no real situs, the domicile of the owner is the nearest approximation, although other taxing jurisdictions may also have power to tax the same intangibles. Normally the intangibles are subject to the immediate control of the owner. This close relationship between the intangibles and the owner furnishes an adequate basis for the tax on the owner by the state of his residence as against any attack for violation of the Fourteenth Amendment.

Greenough v. Tax Assessors of City of Newport, 331 U.S. 486, 493, 67 S. Ct. 1400, 1403–04, (1947). While not expressly stated, the clear implication is that an attempt by a state to tax income from intangible property held by a nonresident may be subject to attack under the Fourteenth Amendment of the U.S. Constitution. The Hawaii Supreme Court has also held that income accruing to intangible property is sourced to the domicile of its owner unless control of the intangible occurs entirely in a different state. See. Matter of McCormac, 64 Haw. 258, 263, 640 P.2d 282, 286 (1982). As current law allows states to tax intangibles where the owner is domiciled, the passage of this bill may create a situation where the intangible is subject to tax twice; once in the nonresident's state and again here. The U.S. Supreme Court has indicated this is impermissible in Farmer Loan and Trust Co. v. Minnesota, 280 U.S. 204 (1930):

Taxation is an intensely practical matter, and laws in respect of it should be construed and applied with a view of avoiding, so far as possible, unjust and oppressive consequences. We have determined that, in general, intangibles may be properly taxed at the domicile, and we can find no sufficient reason for saying that they are not entitled to enjoy an immunity against taxation at more than one place similar to that accorded to tangibles. The difference between the two things, although obvious enough, seems insufficient to justify the harsh and oppressive discrimination against intangibles contended for on behalf of Minnesota.  
[Emphasis added.]

Based on the foregoing, the provisions in S.B. No. 675, may be challenged as unconstitutional to the extent the bill seeks to collect taxes on the income attributable to intangibles held by a nonresident. Therefore we respectfully request that this bill be held.

Testimony of the Department of the Attorney General on S.B. 675 (Feb. 8, 2019). Because partnership interests, limited liability company units, and beneficial interests in an estate or trust could be thought of as intangible property similar to REIT shares, consideration should be given to the issue of whether the constitutional analysis above quoted applies to the withholding sought to be effected by this bill.



March 13, 2019

The Honorable Sylvia Luke  
Chair, House Committee on Finance  
Hawaii State Capitol, Room 306  
415 S. Beretania Street  
Honolulu, Hawaii 96813

Re: Senate Bill No. 1360

Dear Chair Luke:

This letter is written on behalf of Master Limited Partnership Associate (MLPA) to offer testimony related to the partnership nonresident withholding proposal included in 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. Proposed language related to this exemption is included. Additional background related to MLPA constituent concerns with the existing language in SB 1360 is additionally 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 102 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 PTPs units to have a different economic value and fungibility of units would be lost.

This fungibility concern is part of the reason why states overwhelmingly exempt PTPs from nonresident withholding payment requirements. In fact, every 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-1's 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.

### **Proposed Language**

We request that the Committee add the below language (in bold font) to SB 1360 to address the previously discussed PTP withholding concerns.

§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 partnership's, estate's, and trust's return for the taxable period. All amounts withheld shall be paid to the department of taxation in a manner that the department may prescribe. **Withholding shall not be required to be submitted by a publicly traded partnership, as defined by section 7704(b) of the Internal Revenue Code, otherwise in compliance with this section. A publicly traded partnership shall agree to file an annual information return reporting the name, address, taxpayer**

**identification number, and other information requested by the department of each unit holder with income sourced to the state.**

**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,

A handwritten signature in black ink, consisting of a large, stylized initial 'L' followed by a long horizontal line extending to the right.

Lori Ziebart  
Executive Director, MLPA



TO: HOUSE COMMITTEE ON FINANCE  
Representative Sylvia Luke, Chair  
Representative Ty J.K. Cullen, Vice Chair

FROM: Thomas A. Grimes  
President of Aloha Petroleum LLC

HEARING

DATE: Friday, March 15, 2019

TIME: 2:00 p.m.

PLACE: Conference Room 308, State Capitol

RE: **Testimony in Opposition to S.B. No. 1360 S.D. 1  
Relating to Taxation**

Chair, Vice Chair, and Members of the House Committee on FINANCE, I am Thomas A. Grimes, President of Aloha Petroleum LLC ("Aloha Petroleum").

S.B. No. 1360 S.D. 1 requires partnerships, estates, and trusts to withhold taxes on the income of nonresident partners and beneficiaries. Aloha Petroleum opposes S.B. No. 1360 S.D. 1 because there is no exemption for publicly traded partnerships ("PTPs"). Aloha Petroleum is owned by a PTP, Sunoco LP.

Every state that imposes a nonresident withholding requirement on partnerships exempts PTPs from such withholding due to SEC regulations requiring PTPs to treat all publicly traded units the same. Without such an exemption, PTPs would be in violation of such SEC regulations because those units where the PTP is required to withhold tax (on behalf of certain nonresident partners) would have a different economic value than the other publicly traded units.

We support the Master Limited Partnership Association's proposed language amendments to S.B. No. 1360 S.D. 1 providing for an exemption for PTPs together with taxpayer reporting requirements for PTPs for each unit holder with income sourced to the State of Hawaii.

Without an exemption for PTPs, please vote no on S.B. No. 1360 S.D. 1.

Thank you for the opportunity to testify in opposition to this Bill.

**SB-1360-SD-1**

Submitted on: 3/12/2019 11:48:50 PM

Testimony for FIN on 3/15/2019 2:00:00 PM

| <b>Submitted By</b> | <b>Organization</b> | <b>Testifier Position</b> | <b>Present at Hearing</b> |
|---------------------|---------------------|---------------------------|---------------------------|
| Mary Smart          | Individual          | Oppose                    | No                        |

Comments:

We don't need more taxes levied on us. Vote no.