Tax Insights

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Hawaii Pass-Through Entity Tax

Background

As part of the federal Tax Cuts and Jobs Act (TCJA) that became law in 2017, the federal deduction for state and local taxes paid was limited to $10,000 for individuals (SALT cap). The SALT cap is currently set to expire at the end of the 2025 tax year. Unlike a C-corporation, the income tax liability of a pass-through entity (PTE) is not paid at the entity level and flows through to its partners and shareholders. Without a workaround, state income taxes that partners and S-corporation shareholders pay would be subject to the SALT cap.

After the enactment of the TCJA, the Internal Revenue Service issued guidance indicating that state income taxes paid by a PTE at the entity level were not subject to the SALT cap. Since the issuance of this guidance over 30 other states have adopted various laws that allow PTEs to elect to pay state income taxes at the entity level.

Hawaii's new pass-through entity tax election

During the 2023 Regular Session, the Hawaii State Legislature passed S.B. 1437, S.D. 1, H.D. 2, C.D. 1, a SALT cap workaround measure that would allow partnerships and S-corporations to elect to pay Hawaii income tax at the entity level. By electing to pay Hawaii income tax on Hawaii PTE income at the entity level, partners and S-corporation shareholders would be able to avoid the SALT cap. Governor Josh Green has until July 11, 2023 to approve or veto the measure.

The amount of tax savings depends on the partner or shareholder's federal income tax rate. For the 2023 tax year, the highest federal individual income tax rate is 37%. For example, if a partner subject to the 37% federal tax rate paid $50,000 in state taxes on the partnership income, the federal deduction was limited to $10,000. Under this new measure, the partnership may elect to pay the state income tax at the partnership level allowing the entire $50,000 to be deducted. As a result, the partner would have a federal tax savings of almost $15,000.

What we know about Hawaii's SALT cap measure today

- It applies beginning with the 2023 tax year;
- Only partnerships, limited liability companies treated as partnerships, and S-corporations are allowed to make the election;
- An election must be made for each tax year, however, once it is made it may not be revoked for that tax year;

What we know about Hawaii's SALT cap measure today (continued)

- If an election is made, it applies to all partners and shareholders, unless the partner or shareholder is a corporation;
- PTE tax is calculated by multiplying the distributive shares and guaranteed payments of all partners and shareholders by 11% (highest Hawaii individual income tax rate); and
- Each partner or shareholder will receive a nonrefundable credit equal to the partner or shareholders prorata share of the PTE tax.

What should you do now?

You do not need to take any action at this time, but we encourage you to start thinking about whether your partnership or S-corporation should make the Hawaii PTE tax election. Details such as how the election is to be made (i.e. standalone form, form attached to return) and how the election will impact estimated income tax payments are still unknown. We will provide updates and more details as they become available.

If you have questions regarding how these measures may affect you, please don't hesitate to contact us.
