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ALERT
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Revised SALT Alert! 2015-13: Connecticut Governor Signs Budget and Supplemental Legislation on June 30, 2015

On June 3, 2015, after weeks of debate and controversy, Connecticut lawmakers approved a two-year, $40 billion budget (House Bill 7061) that included significant tax increases affecting business taxpayers, certain of which were retroactive. Almost immediately, amid reports that certain Connecticut-headquartered companies were considering leaving the state, the Governor and lawmakers agreed to hold a special session to address some of the more controversial changes in the June 3rd budget agreement. **On June 30, 2015, Governor Malloy signed the budget legislation (House Bill 7061), as well as a so-called "implementer bill" (House Bill 1502) that revises tax changes included in the original budget bill.** Notably revisions to the original budget legislation are bolded below. **Note that this bill was signed on June 30, 2015, which makes the changes a Q2 event**.

I. Adoption of Mandatory Unitary Combined Reporting

The most sweeping change in the budget for business taxpayers is the adoption of mandatory unitary combined reporting (MUCR). Under House Bill 7061, MUCR was effective for income years beginning on or after January 1, 2015**. The implementer legislation delays the effective date of MUCR to income years beginning on or after January 1, 2016 and makes corresponding changes to reflect the delay.** MUCR replaces the elective post-apportionment combined reporting methodology that had been in place for decades; it also replaces the elective and petition-based unitary filing methods available to certain taxpayers.

Definitional Changes

To implement MUCR, the CBT definitions section of Chapter 208 was

amended to include new definitions of the following terms: “combined group”, “combined group’s net income”, “common ownership”, “unitary business”, “designated taxable member”, “group income year”, “nontaxable member”, “taxable member”, and “pass-through entity” at Conn. Gen. Stat. § 12-213(29) – (37).

Unitary Group Composition

The Connecticut combined group includes entities subject to CBT that are affiliated by greater than 50 percent common ownership and are engaged in a unitary business. The Connecticut combined group includes not only all federal consolidated group members from one or multiple consolidated groups under common ownership, but also nonconsolidated domestic entities and certain foreign-incorporated entities that otherwise meet the definition of an includible member. The term “unitary business” is defined broadly and means “a single economic enterprise that is made up either of separate parts of a single business entity or a group of business entities under common ownership, which enterprise is sufficiently interdependent, integrated or interrelated through its activities so as to provide mutual benefit and produce a significant sharing or exchange of value among such entities and a significant flow of value among the separate parts.”

Water’s Edge – Default Methodology

The default method of determining the Connecticut combined group is a water’s edge combination. The following members are included in the water’s-edge group: (1) all domestic entities formed in the United States, D.C., or in any United States territory or possession are included, EXCEPT companies that have greater than 80 percent of their payroll and 80 percent of their property located outside the U.S.; (2) all foreign entities that have greater than 20 percent of their payroll and 20 percent of their property located within the United States, D.C., or any territory or possession; (3) **any member that earns more than 20 percent of its gross income from intangible property or service-related activities the costs of which are generally deductible for federal income tax purposes against the income of other group members, but only to the extent of the income and apportionment factors related thereto**; or (4) any entity incorporated in a jurisdiction determined by the Commissioner of the Department of Revenue Services (DRS) to be a “tax haven” (see below).

Tax Haven Provisions

Under the budget bill, “tax haven” is defined as a jurisdiction that (A) has laws or practices that prevent the effective exchange of information with other governments on taxpayers benefiting from the tax regime; (B) has a tax regime that lacks transparency; (C) facilitates the establishment of foreign-owned entities without the need for a local substantive presence or prohibits these entities from having any commercial impact on the local economy; (D) explicitly or implicitly excludes the jurisdiction's resident taxpayers from taking advantage of the tax regime benefits or prohibits enterprises that benefit from the regime from operating in the jurisdiction's domestic market; or (E) has created a tax regime that is favorable for tax avoidance, based upon an overall assessment of relevant factors, including whether the jurisdiction has a significant untaxed offshore financial or services sector relative to its overall economy.

The statute does not include a list of countries that are considered tax havens. However, not later than September 30, 2016, the Commissioner is required to publish a list of jurisdictions that he or she determines to be tax havens. The list shall be applicable to income years commencing on or after January 1, 2016, and will remain in effect until the Commissioner publishes a revised list. A member that is incorporated in a tax haven jurisdiction may be excluded from the water’s edge group if it is proven to the satisfaction of the Commissioner of Revenue Services that the member is incorporated in a tax haven for a legitimate business purpose.

Worldwide Election

A combined group wishing to file on a worldwide basis may elect to do so on a timely-filed, original return for the income year. Worldwide elections are binding for eleven years.

Affiliated Group Election

A taxpayer may elect to file a combined return on an “affiliated group” basis, meaning the taxable members shall report the income or loss and the apportionment factors of ALL members of the affiliated group (as defined under IRC § 1504, but expanded to include all domestic corporations that are commonly owned), regardless of whether the affiliated group’s members are engaged in a unitary business, and whether or not such members are doing business in Connecticut. The affiliated group will also include any member incorporated in a tax haven jurisdiction, as determined by the Commissioner, unless the member proves that it is in a tax haven jurisdiction for a legitimate business

purpose.

Unitary Net Income Determination

Generally, combined group net income is computed on a separate company basis— as if each group member was not consolidated for federal tax purposes— and is then aggregated. For entities not incorporated in the U.S. or included in the consolidated federal income tax return, the MUCR statute provides guidance on determining the income to be included in the combined group.

In determining total net income of the combined group, the following rules apply:

(1) The amount of pass-through income to be included in the combined group's net income is its member's direct and indirect distributive shares of the pass-through entity's unitary business income;

(2) Dividends paid by one member to another member of the group are eliminated from the income of the recipient;

(3) Business income from intercompany transactions between members of the combined group are deferred in a manner similar to Treas. Reg. § 1.1502-13. However, the deferred business income will be restored to the income of the seller if certain enumerated events occur;

(4) Charitable deductions incurred by a member of a combined group are subtracted first from the combined group's net income (subject to income limitations applied to the group as a whole) and any remaining amount may be carried forward;

(5) Gains and losses from the sale of capital assets, I.R.C. § 1231(a)(3) property, and involuntary conversion property are included in the combined group's income according to special rules; and

(6) The expense of any member of the combined group that is directly or indirectly attributable to income that Connecticut cannot tax shall be disallowed as a deduction in computing the combined group's net income.

Unitary Income Tax Apportionment

Each taxable member determines its apportionment percentage using its applicable apportionment methodology, including any special industry methods. The taxable member includes all of its separate company numerators and divides by the entire group's denominators. In computing the combined group's denominators all factors that apply to the taxable member are included, even if another group member utilizes an apportionment methodology that excludes such factors. For example, in a unitary group that includes a manufacturer qualifying for single-sales factor apportionment and another entity that is required to use a three-factor apportionment formula, the three-factor filer will include the manufacturer's payroll and property denominators in computing its apportionment percentage (despite the fact that the manufacturer is not required to use three-factor apportionment).

Each taxable member, in addition to determining its own sales factor numerator, must include a pro-rata portion of Connecticut sales of non-taxable members. In other words, Connecticut has adopted the so-called *Finnigan* apportionment rule, meaning that the sales of non-taxable group members are included in calculating the taxable group members' sales factors.

Each taxable member applies its separately-computed apportionment percentage to the combined group's net income to compute pre-NOL net income or net loss.

Unitary Net Operating Losses

Within the Connecticut MUCR methodology, net operating losses are computed, deducted, and carried forward on a separate company basis. Separate company losses are shareable under certain circumstances.

Losses Generated in 2015 and Subsequent Years

Losses generated by a taxable member of a unitary combined group may be shared with other unitary group members.

Losses Generated Prior to 2015

Losses generated in a “group” return in years prior to 2016 may be shared among members that were included in the prior group return and that are members of the unitary group. Group returns include traditional combined and alternative method unitary returns under Conn. Gen. Stat. § 12-223a, and elective unitary returns under Conn. Gen. Stat. § 12-218d.

As mentioned in greater detail below, net operating loss carryforwards are limited to 50 percent of income for tax years beginning on or after January 1, 2015.

Unitary Net Income Tax Computation

Each taxable member multiplies its taxable income or loss, net of any deductible NOLs as described above, by the applicable tax rate to determine its share of unitary net income tax.

Unitary Capital Tax

Tax Base

The unitary capital base is calculated by adding the separate capital bases of all taxable and nontaxable members.

Apportionment

Apportionment for individual unitary group members is calculated by using separate company numerators and group denominators. Nontaxable member denominators are included in the calculation of group denominators.

Tax Computation

Capital tax is calculated for each taxable member by multiplying the combined group’s capital base by the separate company

apportionment. Financial service companies are not included in the calculation of the group's capital base and are not included in the calculation of group apportionment denominators. Instead, financial service companies pay a flat $250 capital tax.

$1 Million Combined Group Cap

The total combined capital tax is capped at $1 million. If the sum of the separately-computed capital taxes exceeds $1 million, the excess over $1 million is reduced pro-rata in proportion to each taxable member's computed tax.

Tax Credits

As discussed in more detail below, for the 2015 income year and beyond, tax credits may be used to offset only 50.01 percent of the taxpayer's liability. Credits will be computed on a separate company basis, but can be shared among unitary group members for income years beginning on or after January 1, 2016. In addition, credits may also be shared among taxpayers that were included in prior "group" returns (traditional and alternative method combined returns and elective unitary returns).

Impact of MUCR on Interest Addback Statute and Elective Unitary Filing

The interest addback provisions are eliminated beginning in 2016, to the extent that the interest payor and recipient are included in the same unitary return. In addition, the elective unitary filing option under the interest addback statute is no longer available for 2016.

ASC 740 Fix

If the adoption of MUCR results in an aggregate increase in a combinec deferred tax liability, or an aggregate decrease to a group's deferred ta **or an aggregate change from a net deferred tax asset to a net defe liability,** the combined group is entitled to a deduction against net in offset the financial statement impact. Generally, the term "net defe liability" means deferred tax liabilities that exceed the deferred tax asse combined group, computed in accordance with generally accepted ac principles (GAAP). "Net deferred tax asset" means that deferred ta exceed the group's deferred tax liabilities, computed in accordance witl Only publicly traded companies and those affiliates that participate in the a publicly traded company's financial statements prepared in accorda

GAAP are eligible for this deduction. The reference to GAAP in the b limited to U.S. GAAP and may apply to companies that utilize othe accounting principles (e.g., international financial reporting standards).

The deduction, which will be taken over a seven-year period beginning combined group's income year that commences in 2018, will be equal seventh of the amount necessary to offset the increase in the net defe liability or decrease in the net deferred tax assets, or the aggregate thereof from a net deferred tax asset to a net deferred tax liability as a the implementation of MUCR. The change in net deferred tax liabilities c shall be computed without taking into account the availability of the dedu is important to note that the deduction will not be reduced as a resu events happening subsequent to the calculation, such as asset abandoned or disposed of. Any deduction in excess of the combined gro income may be carried forward.

Any combined group intending to claim the deduction must statement with the Commissioner on or before July 1, 2017 specify total amount of the deduction it will claim. The statement must be r provided by the Commissioner and no deduction will be allowed ex the extent claimed on or before July 1, 2017.

Prior Filing Methodologies and Preference Tax

The elective post-apportionment combined filing is completely repealed for 2016 and forward. It is somewhat unclear whether prior DRS agreements regarding alternative apportionment and calculation of combined tax are made obsolete by the new provisions.

The bill also eliminates the so-called preference tax.

Commissioner to Review Alternative Apportionment Methods

On or before February 1, 2016, the Commissioner has been instructed to evaluate the impact on Connecticut businesses of alternative methods of apportionment and sourcing of income. His recommendations, if any, will be provided in a report to the legislature.

II. Continuing the 20 Percent Corporate Surtax

Connecticut corporate taxpayers must calculate their liability under both the corporation business tax and an alternative capital stock-based tax and pay under whichever methodology results in a higher tax liability. The current capital stock tax rate is three and one/tenth mills per dollar of taxable basis and the current CBT rate is 7.5 percent. Under prior law, for tax years commencing on or after January 1, 2012, but prior to

January 1, 2016, a 20 percent surtax was imposed on the tax calculated under the CBT and the capital stock tax. The budget bill extends the 20 percent surtax through tax years beginning prior to January 1, 2018. For the income tax year commencing on January 1, 2018 and prior to January 1, 2019, the surtax is reduced to 10 percent. Note that the surtax does not apply to taxpayers that pay the $250 minimum tax, or that have less than $100 million in gross income for the tax year. However, taxpayers filing unitary or combined returns are subject to the surtax, regardless of income. As discussed above, this pool of taxpayers is expanded under the budget bill with the adoption of MUCR for all companies.

III. Limits on Credits and Losses

Under current Connecticut law, taxpayers are able to carry Net Operating Losses (NOLs) forward for a 20-year period. For income years beginning on or after January 1, 2015, the portion of operating loss that may be deducted as an operating loss carryover in any income year following the loss year is limited to the lesser of (i) fifty percent of the taxpayer's net income or apportioned net income, or (ii) the amount of any NOL carryovers in excess of NOLs allowed from prior income years. It is unclear whether the NOL limitation applies to losses generated in 2015 and beyond or to losses generated prior to the law change. However, per the bill's fiscal note, the limitation on losses is expected to generate $156 million in revenue in FY 2016, which seems to indicate that it applies to losses generated in income years prior to 2015.

House Bill 1502 provides an alternative limit for corporations that are currently part of a combined group with over $6 billion in unused NOLs from tax years prior to 2013. Groups meeting the NOL threshold must decide whether to apply the bill's limit before the deadline for filing their 2015 tax returns.

Finally, current law allows corporations to use tax credits to reduce their CBT liability by up to 70 percent in any income year. For each income year beginning on or after January 1, 2015, the bill reduces the maximum amount of tax that may be offset with credits to 50.01 percent of the tax due.

IV. Indirect Tax Rate Increases

The budget bill adopts certain indirect tax rate increases; however,

Connecticut's general sales and use tax rate remains 6.35 percent. Effective July 1, 2015, the 7.0 percent luxury tax rate that applies to the entire sales price of (1) motor vehicles exceeding $50,000; (2) vessels exceeding $100,000; (3) jewelry (real or imitation) exceeding $5,000, and (4) clothing, footwear, handbags, luggage, wallets, umbrellas, or watches with a sales price exceeding $1,000 is raised to 7.75 percent. Note that the luxury tax is imposed in lieu of the 6.35 percent general sales and use tax.

V. Computer and Data Processing Services Tax Changes

The original budget bill increased the sales and use tax rate applied to computer and data processing services. House Bill 1502 repeals the phased-in tax rate increase. As such, the reduced sales and use tax rate applied to computer and data processing services continues to be one percent.

In the original budget agreement, the definition of computer and data processing services was revised effective July 1, 2015 to eliminate an exclusion for "services rendered in connection with the creation, development, hosting or maintenance of all or part of a web site which is part of the graphical, hypertext portion of the Internet, commonly referred to as the World Wide Web." Under House Bill 1502, the revised definition is effective for sales on or after October 1, 2015 and therefore web-related services will be subject to tax as computer and data processing services as of that date.

House Bill 1502 repealed a planned new sales and use tax exemption for computer and data processing services performed by an entity for an affiliate.

VI. Clothing and Footwear Sales Tax Holiday and Exemptions

Historically, from the third Sunday in August through the following Saturday, Connecticut holds a sales and use tax holiday for purchases of clothing and footwear costing less than $300 per item. In addition, a permanent sales and use tax exemption for clothing and footwear costing less than $50 was scheduled to commence on July 1, 2015.

Under the budget bill, the general clothing and footwear exemption that was set to begin on July 1, 2015 is eliminated. Further, effective July 1,

2015, the clothing and footwear exemption amount for future sales tax holiday periods (i.e., the sales tax holiday occurring in August 2015 and thereafter) is reduced from $300 per item to $100 per item. For the purposes of the sales tax holiday, clothing or footwear does not include (1) any special clothing or footwear primarily designed for athletic activity or protective use and which is not normally worn except when used for the athletic activity or protective use for which it was designed, and (2) jewelry, handbags, luggage, umbrellas, wallets, watches and similar items carried on or about the human body, but not worn on the body in the manner characteristic of clothing.

VII. Expansion of Sales Tax Base to Car Wash Services

Effective July 1, 2015, all car wash services will be subject to Connecticut sales and use tax. Under the original budget bill, coin-operated car washes were not taxable. Under House Bill 1502, all car wash services, including coin operated car washes, are subject to sales and use tax.

VIII. Change in Due Dates for Monthly Sales and Use Tax Filers

House Bill 1502 revises the due date for monthly sales and use tax return filers. Effective for periods ending on or after December 31, 2015, such returns will be due on the last day of the month following the month covered by the return, rather than the 20th day of the month following the month covered by the return.

IX. Adoption of New 6 Percent Gross Receipts Tax on Ambulatory Surgical Centers

Effective October 1, 2015, a new 6 percent gross receipts tax on ambulatory surgical centers is imposed. The statutory language imposes tax on an ambulatory surgical center's entire gross receipts.

Next Steps and Contacts

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