SALT Alert! 2018-05: Connecticut: Bill Adopting a New Partnership Tax and Addressing Aspects of Tax Reform Passes Legislature; Heads to Governor for Signature

Connecticut Senate Bill 11, which was passed shortly before the legislature adjourned *sine die*, has been sent to Governor Malloy for signature. This bill makes certain changes to Connecticut's tax laws in light of federal tax reform, including adopting a new, mandatory entity-level tax imposed on partnerships and S corporations doing business in the state. This new tax is effective for tax years commencing on or after January 1, 2018.

The impetus behind the new entity level tax on partnerships and S corporations is that under the Tax Cuts and Jobs Act (P.L. 115-97), the state and local tax deduction for individuals is capped at $10,000 per year. No such limit applies to state and local taxes deducted by business entities. Thus, if the business entity, as opposed to the partner/shareholder, is paying Connecticut income tax, the business entity will be allowed to deduct the taxes for federal purposes. The legislation allows the owners of the business entity to take a corresponding tax credit against their Connecticut income taxes for the taxes paid at the business entity level. This revised structure will likely benefit Connecticut resident partners/owners, but may have harsh consequences for out-of-state partners/owners and the entities themselves.

New Entity-Level Tax

Overview

Under prior Connecticut law—consistent with most states—pass-through businesses did not pay income tax at the entity level. Rather, the income and losses of pass-through entities were "passed-through" to their owners and taxed as part of the owners' personal or corporate income tax returns (with the entity required to withhold tax under certain circumstances). Under Senate Bill 11, a new entity-level tax applies to each "affected business entity" that is required by state law to file a return with Department of Revenue Services under Conn. Gen. Stat. § 12-726. This statute sets forth information required to be reported by partnerships and S Corporations doing business in Connecticut. Under Senate Bill 11, entities subject to this statute must file an entity tax return on or before the 15th day of the third month following the close of each entity's taxable year for federal income tax purposes.

An "affected business entity" is defined as any partnership, including a limited liability company (LLC), that is considered a partnership for federal income tax purposes or (2) any

corporation treated as an S corporation for federal income tax purposes. It does not include publicly traded partnerships that have agreed to file an annual return reporting the name, address, Social Security or federal employer identification number, and other Department of Revenue Services-required information for each unit-holder whose income from Connecticut sources was more than $500.

Under Senate Bill 11, an affected business's entity's taxable income equals:

1. The entity's separately and non-separately stated income, as described in Section 702(a) of the Internal Revenue Code that is derived from or connected to Connecticut sources,
2. As increased or decreased by any adjustments under Connecticut's personal income tax law that are related to the business's income, gain, loss, or deduction, to the extent derived or connected to Connecticut sources.

In determining their taxable income, affected business entities must use the individual income tax sourcing rules under Conn. Gen. Stat. § 12-711 to determine income, gains, losses, or deductions that are derived from, or are connected to, Connecticut sources. If the end result is a net loss, the entity may carry the loss forward until it is fully used. The tax is imposed at a rate of 6.99 percent, the highest current individual income tax rate.

Tiered Business Entities; Reporting to Members; Nonresident Members

If an affected business entity (called the lower-tier entity in Senate Bill 11) is a member of another affected business entity (called the upper tier entity), Senate Bill 11 requires the lower-tier entity to make adjustments in determining Connecticut taxable income. Specifically, the lower-tier entity must subtract its distributive share of income or add its distributive share of loss from the upper-tier entity to the extent that the income or loss was derived from or connected with sources within Connecticut.

Each taxable year, an affected business entity must report to each of its members such member's direct pro-rata share of the tax imposed on such affected business entity and the indirect pro-rata share of the tax imposed on any upper-tier entity of which such affected business entity is a member.

Senate Bill 11 makes clear that if a nonresident individual's only source of income derived from Connecticut sources is from one or more affected business entities of which the individual is a member, and the affected business entity or entities file and pay the new partnership level tax, that nonresident individual is not required to file a Connecticut individual income tax return. This provision does not apply to a nonresident individual who is a member of an affected business entity that elects to file a return on a combined basis (see discussion below) and that nonresident's tax credit would not fully satisfy his or her Connecticut tax liability.

Credit Against Individual Income Tax and Corporation Business Taxes

Each individual subject to Connecticut personal income taxes who is a member of an affected business entity is entitled to a credit against his/her Connecticut individual income tax equal to the person's direct and indirect pro-rata share of the tax paid by any affected business entity of which such person is a member multiplied by ninety-three and one-hundredths per cent (93.01 percent). Any credit that exceeds such person's tax liability will be refunded to such person

Likewise, each person subject to Connecticut personal income taxes who is a member of an affected business entity will also be entitled to credit against his/her Connecticut income tax for such person's direct and indirect pro-rata share of taxes paid to another state or the District of Columbia, (but not including political subdivisions) assuming the tax paid in the other state is substantially similar to the tax imposed under Connecticut law. This credit will

be calculated in a manner prescribed by the Commissioner and shall be consistent with Conn. Gen. Stat. §12-704, which addresses the credit for income taxes paid to other states.

A company subject to Corporation Business Tax that is a member of an affected business group is likewise entitled to a similarly-computed credit. This credit will be applied after all other allowable credits are applied, but will not be subject to the general limitations that apply to use of credits (i.e., for each income year beginning on or after January 1, 2015, the maximum amount of tax that may be offset with credits is 50.01 percent of the tax due, with certain exceptions). However, in the case of a corporation, any credit not used during the applicable income year must be carried forward, rather than refunded.

Alternative Tax Base

Senate Bill 11 allows affected business entities to elect, each year, to calculate their entity tax on an alternative basis. The provisions outlining the alternative basis are quite complex and will likely require a comprehensive review, annually, to determine whether the alternative basis election is beneficial for the majority of partners in the partnership. The impetus behind the provision of an alternative base appears to be to remove from the tax base amounts passed through to corporations.

The alternative tax base is equal to the “resident portion of unsourced income” plus “modified Connecticut source income.” Both of these items are terms of art defined under Senate Bill 11. Once the alternative tax base is computed, the 6.99 percent rate is applied.

The “resident portion of unsourced income” means “unsourced income” multiplied by a percentage that equals the sum of the ownership interests in the affected business entity owned by in-state residents. “Unsourced income” means the separately and nonseparately stated items of income increased or decreased by state modifications required under the personal income tax law, regardless of the source of such income. From this amount, two subtractions are made. The first is for Connecticut-source income as computed under the general rules for computing the entity-level tax. Then, an additional subtraction is made for income connected with sources in another state that has jurisdiction (as determined under Connecticut law) to tax the affected business entity. Once this unsourced income is computed it is multiplied by the sum of the ownership interests in the affected business entity owned by state residents to get the “resident portion of unsourced income.” This amount is then added to “modified Connecticut source income.” “Modified Connecticut source income” is the entity’s taxable (i.e., Connecticut-sourced) income calculated under the provisions for computing the general entity-level tax, multiplied by a percentage equal to the sum of ownership interests in the business that are held by members that are (1) subject to Connecticut individual income tax or (2) pass-through businesses subject to the entity tax, to the extent such businesses are directly or indirectly owned by individuals subject to Connecticut individual income tax. Members that are pass-through businesses are assumed to be directly or indirectly owned as such, unless the business can establish otherwise through clear and convincing evidence satisfactory to the Commissioner.

Each taxable year, any affected business entity electing to calculate tax on the alternative basis must notify the Commissioner of its election to do so, in writing, by the tax's due date or extended due date (if applicable). The bill specifies that the election does not affect the calculation of any other state taxes due, except for the calculation of the tax credits authorized by the bill.

Combined Returns

Any affected business entity may elect to file a combined return together with one or more other commonly owned affected business entities subject to the new tax. “Commonly owned" means that more than eighty percent of the voting control of an affected business entity is directly or indirectly owned by a common owner or owners, either corporate or

noncorporate. Whether voting control is indirectly owned is determined under IRC section 318.

Entities wishing to make such an election must notify the Commissioner no later than the due date of the tax or the extended due date (if applicable). Each affected business entity electing to file a combined return is jointly and severally liable for the tax due. Affected business entities filing a combined return will separately compute the tax due and aggregate the resulting amounts. Affected business entities making the election will report to the Commissioner the portion of the direct and indirect pro-rata share the tax paid with the combined return that is allocated to each of their members. Such report shall be filed with the combined return and the allocation reported shall be irrevocable. The group may calculate tax under the alternative basis only if each group member elects to do so.

Estimated Payments

Senate Bill 11 requires pass-through businesses to make estimated entity tax payments on a quarterly basis, in a similar manner to the estimated income tax payments required under existing law. The entity's quarterly estimated payments are (1) generally equal to 25 percent of the "required annual payment" and (2) due on the 15th day of the taxable year's fourth, sixth, and ninth month, and on the 15th day of the first month of the next taxable year. The "required annual payment" means the lesser of (1) 90 percent of the entity tax reported or due for the current taxable year or (2) 100 percent of the entity tax reported on the entity tax return for the preceding taxable year, if the pass-through business filed a return for that year that covered a 12-month period.

Repeal of Composite Return Provisions

Senate Bill 11 amends Conn. Gen. Stat. §12-719, which addresses the filing of composite returns, to provide that such statute does not apply to tax years commencing on or after January 1, 2018.

Other Provisions in Senate Bill 11

Expenses related to dividends not deductible in Connecticut: Under Connecticut law, corporations are not allowed a deduction for expenses related to dividends that are allowable as a deduction or credit under the Internal Revenue Code.

Senate Bill 11 provides that, effective for income years commencing on or after January 1, 2017, expenses related to dividends will equal five percent <u>of all dividends</u> received by a company during an income year. The net income associated with the disallowance of expenses related to dividends must be apportioned if the company conducts business within and without Connecticut.

Addback of Bonus Depreciation and Section 179 expense: Senate Bill 11 requires individuals and pass-through entities to add back bonus depreciation for assets placed in service after September 27, 2017. The amount added back may be taken as an additional deduction in the each of the four succeeding years. Similarly, for tax years beginning on or after January 1, 2018, individuals and pass-through entities are required to add back eighty percent of deductions claimed under IRC section 179. Twenty-five percent of the disallowed section 179 deduction may be claimed as a deduction in each of the four subsequent tax years.

For corporations, for tax years beginning on or after January 1, 2018, Senate Bill 11 requires corporations to add back eighty percent of deductions claimed under IRC section 179. Twenty-five percent of the disallowed section 179 deduction may be claimed as a deduction in each of the four subsequent tax years. Connecticut had already decoupled from bonus

depreciation for corporations, so no changes were required to address the treatment of bonus depreciation at the corporate level.

Modification for Contributions to Capital: Senate Bill 11 contains a new subtraction modification for corporations. This new modification provides a deduction for the amount of any contribution made by the state of Connecticut or its political subdivisions to the extent included in gross income under IRC section 118(b)(2). It remains to be seen whether or not limiting the deduction to just Connecticut contributions, rather than all state and local contributions taxed under federal law, will survive any forthcoming constitutional challenges.

Decoupling from IRC 163(j): For income years beginning on or after January 1, 2018, Senate Bill 11 provides that the deduction for business interest paid or accrued shall be determined under the Internal Revenue code except that the provisions of section 163(j) shall not apply.

Provision Allowing Credits for Contributions to Municipal Charities: Under Senate Bill 11, municipalities are authorized to provide property tax credits to eligible taxpayers who make voluntary, unrestricted, and irrevocable contributions to new community supporting organizations approved by the municipality. This is another provision in the bill that is intended to alleviate the repeal of the uncapped SALT deduction, and Connecticut's law is similar to provisions enacted in New York weeks ago. Other states are also considering the establishment of such funds. A "community supporting organization" is a charitable nonprofit that is organized exclusively to support municipal spending on programs and services, such as public education. A "municipality" is any town, city, borough, consolidated town and city, or consolidated town and borough. The credit applies only to taxes on "residential property" as defined and the credit would generally be equal to 85 percent of the amount donated.

Next Steps and Contacts

Although Senate Bill 11 has yet to be signed, there is no indication that Governor Malloy will veto the bill. Because the new pass-through entity tax is retroactive to January 1, 2018, the Department of Revenue Services will likely need to issue guidance explaining how taxpayers should catch-up on estimated payments under the new regime, as well as addressing payments made under the prior pass-through entity regime. Because the amount of estimated payments owed will depend on whether the alternative election is made, affected partnerships should start thinking about whether to make the election relatively soon.

While the pass-through entity tax is brand new, and details are still being analyzed, there are a couple of points to note:

- First, while it is likely that Connecticut resident partners and partners residing in states that lack individual income taxes will benefit under the new regime, that outcome is less clear for a partner who is a resident of another state imposing an individual income tax. While states generally provide residents a credit for income taxes paid to other states, it's not clear whether or how the entity-level tax paid by partnerships in Connecticut would impact the credit provided to residents of other states.

- Second, it's important to carefully consider the implications for partners subject to Corporation Business Tax. Certain corporate partners will find the result neutral, but others may not be able to utilize the credit.

- Finally, it should be reiterated that this is not an elective regime and almost all partnerships doing business in Connecticut will need to account for this enactment.

Please contact Rick Hill at 860-297-5044 or Steve Kralik at 860-297-5431 with questions.

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