

# Connecticut enacts new pass-through entity tax and other tax law changes

## **Overview**

On May 31, 2018, Governor Dannel Malloy signed Senate Bill 11 (SB 11.)¹ The majority of SB 11's provisions are in response to recent federal tax reform legislation, the most notable being the enactment of a new pass-through entity (PET) income tax levied at the top personal income tax rate and offset by a credit at the personal or corporate income tax level. The PET, applicable to taxable years commencing on or after January 1, 2018, is detailed further below. Affected taxpayers should take note of the potential for a June 15 estimated tax installment payment as well as the recently issued estimated installment payment form and Special Notice issued by the Connecticut Department of Revenue on June 6.

SB 11 also enacts changes to Connecticut's tax laws affecting individuals and corporations, applicable to taxable years commencing on or after January 1, 2017 unless otherwise noted, including the following:

- Decouples from IRC Section 163(j) for corporate income tax purposes.
- Amends the required add-back of expenses related to the dividend received deduction (DRD) at five percent of all dividends received for corporate tax purposes.
- Decouples from IRC Section 168(k) bonus depreciation for individual income tax purposes.<sup>2</sup>
- Effective July 1, 2018, authorizes municipalities to issue residential property tax credits to eligible individual taxpayers who make contributions to approved community supporting organizations.

This tax alert summarizes these law changes and provides some taxpayer considerations.

# **Pass-Through Entity Tax<sup>3</sup>**

Connecticut's new pass-through entity tax or PET requires pass-through entities to pay tax at the entity level and provides an offsetting credit against individual income and corporate taxes. The PET represents Connecticut's attempt to provide relief from the \$10,000 federal limit imposed on individual state and local tax deductions.

#### Affected Business Entities

The PET is imposed on "affected business entities" which include partnerships, S corporations, and LLCs treated as either an S corporation or a partnership for federal income tax purposes. However, publicly-traded partnerships as defined by Sect. 7704(b) of the IRC that agree to unitholder reporting requirements are specifically excluded from the PET.

# PET calculation<sup>4</sup>

The primary elements of the PET calculation for an affected business entity are as follows:

- Separately and non-separately computed items under the IRC;
- Derived from or connected to Connecticut sources as determined by the sourcing rules that are currently applied to the Connecticut income tax;<sup>5</sup>
- Adjusted by applicable Connecticut state modifications;<sup>6</sup>
- Multiplied by 6.99%.

<sup>&</sup>lt;sup>1</sup> 2018 Conn. Pub. Act No. 18-49; SB 11, 2018 Gen. Assemb., Req. Sess. (Conn., May 31, 2018); available here.

<sup>&</sup>lt;sup>2</sup> SB 11 maintains Connecticut's historical decoupling of IRC Section 168(k) for purposes of the corporation business tax. See Conn. Gen. Stat. § 12-217(b)(1).

<sup>&</sup>lt;sup>3</sup> 2018 Conn. Pub. Acts. 18-49, SB 11, § 1-2.

<sup>&</sup>lt;sup>4</sup> 2018 Conn. Pub. Acts. 18-49, SB 11, § 1(c).

<sup>&</sup>lt;sup>5</sup> See Chapter 229 of the general statutes. See also Conn. DRS, Special Notice 2017(1).

<sup>&</sup>lt;sup>6</sup> Conn. Gen. Stat. § 12-701.

If the affected business entity's PET calculation results in a loss, the entity may carry the loss forward until it is fully utilized. $^{7}$ 

Affected business entities may elect to calculate their PET due using an alternative base method.<sup>8</sup> Similarly, affected business entities may elect to file the PET return on a combined basis.<sup>9</sup>

# Tiered partnership structures<sup>10</sup>

For purposes of the PET, an affected business entity that is a "member" of another affected business entity shall subtract/add its distributive share of income/loss from the subsidiary entity to the extent the income/loss was derived from or connected with sources within Connecticut.<sup>11</sup>

Each affected business entity is required to report to its members their direct pro rata share of the PET as well as their indirect pro rata share of any PET generated in a subsidiary entity. 12

# Credits and overpayments<sup>13</sup>

Individual and corporate members of affected business entities are entitled to an offsetting credit against their respective taxes. The credit is 93.01% of the member's direct and indirect pro rata share of the tax paid. For individuals, any portion of the credit exceeding their tax liability is treated as an overpayment and eligible for refund. 14 Credits for corporate members shall be applied only after all other available credits are used but are not otherwise restricted by the general limitations on how much liability can be offset. 15 Corporate members carry forward any unused credits indefinitely.

Non-resident individuals are not required to file a Connecticut income tax return provided their Connecticut income is derived exclusively from membership in affected business entities that file and pay the PET.<sup>16</sup> A filing obligation may still exist, however, if the member's affected business entity elects to file its return on a combined basis and such nonresident's Connecticut income tax due would not be fully satisfied by the credit generated by the PET.

# Due dates and estimated tax installment payments<sup>17</sup>

The PET annual return and payment are due on or before the fifteenth day of the third month following the close of each taxable year. Three required installment payments are due on the fifteenth day of the fourth, sixth, and ninth months of the taxable year. A fourth installment payment is due on the fifteenth day of the first month of the next succeeding taxable year. The amount due for any installment payment is 25% of the required annual payment. The sum of the four installments comprises the required annual payment, which must be equal to the lesser of 90% of the current year PET due or 100% of the PET paid during the last twelve-month taxable year where a PET return was filed.

Based on the provisions of the new PET legislation, **calendar year entities would have an estimated payment due on June 15, 2018.** The Connecticut Department of Revenue recently published an estimated installment payment form - CT-1065/CT-1120SI ES2018 Estimated Connecticut Pass-Through Entity Tax - on its website. 18

On June 6, 2018, the Connecticut Department of Revenue released *Special Notice 2018(4) Guidance on 2018 Estimated Payments for the Newly Enacted Pass-Through Entity Tax.*<sup>19</sup> The Department outlines three potential methods to comply with 2018 estimated payment requirements, considering that SB 11 was enacted after the April 15, 2018 first quarter estimated payment due date. These include the following:

Make a "catch-up" payment on June 15<sup>th</sup> to satisfy the first two installment payment requirements,

<sup>&</sup>lt;sup>7</sup> 2018 Conn. Pub. Acts. 18-49, SB 11, § 1(c)(2).

<sup>&</sup>lt;sup>8</sup> 2018 Conn. Pub. Acts. 18-49, SB 11, § 1(k).

<sup>&</sup>lt;sup>9</sup> 2018 Conn. Pub. Acts. 18-49, SB 11, § 1(j).

<sup>&</sup>lt;sup>10</sup> 2018 Conn. Pub. Acts. 18-49, SB 11, § 1(d).

<sup>&</sup>lt;sup>11</sup> SB 11, as well as Conn. Gen. Stat. § 12-719(d), refers to the parent entity as a "lower-tier entity." The subsidiary entity generating the distributive share of income (or loss) is the "upper-tier entity."

<sup>&</sup>lt;sup>12</sup> 2018 Conn. Pub. Acts. 18-49, SB 11, § 1(f).

<sup>&</sup>lt;sup>13</sup> 2018 Conn. Pub. Acts. 18-49, SB 11, § 1(g).

<sup>&</sup>lt;sup>14</sup> Subject to the limitations prescribed in Conn. Gen. Stat. § 12-739 and 12-742.

<sup>&</sup>lt;sup>15</sup> See Conn. Gen. Stat. 12-217zz for applicable corporate credit limitations.

<sup>&</sup>lt;sup>16</sup> 2018 Conn. Pub. Acts. 18-49, SB 11, § 1(e).

<sup>&</sup>lt;sup>17</sup> 2018 Conn. Pub. Acts. 18-49, SB 11, § 2.

<sup>&</sup>lt;sup>18</sup> CT-1065/CT-1120SI ES2018 Estimated Connecticut Pass-Through Entity Tax is available here.

<sup>&</sup>lt;sup>19</sup> Special Notice 2018(4) is available here.

- Make three estimated payments (by June 15, 2018, September 15, 2018, and January 15, 2019), each equal to 22.5% of the tax liability (the full amount of tax remains due by the return due date), or
- Annualize the payments for the year.

The Special Notice also provides that payments made by individual partners can be recharacterized, with such partner's consent, so that the payments are applied against the pass-through entity's 2018 estimated payment requirement. This recharacterization must be completed by December 31, 2018.

# **Amendments affecting corporations**

For purposes of calculating Connecticut taxable income, Connecticut is a "rolling conformity state," meaning that Connecticut conforms to the IRC as amended and in effect for the taxable year of the taxpayer that relate to the calculation of taxable income. Accordingly, Connecticut automatically conforms to the provisions of the 2017 Tax Act<sup>21</sup> that pertain to the calculation of taxable income. In response to changes in the federal law, SB 11 requires corporations to make the following modifications to federal adjusted gross income:

- Interest expense limitations pursuant to IRC Section 163(j)<sup>22</sup> shall not apply.
- Connecticut historically required the adding back of expenses related to dividends for which a DRD was claimed<sup>23</sup> but had permitted companies to make this computation. SB 11 amends this addback for "expenses related to dividends" to five percent of all dividends received.<sup>24</sup> SB 11 also provides that "[t]he net income associated with the disallowance of expenses related to dividends shall be apportioned if the company conducts business within and without the state or is required to apportion its income" under Connecticut law.<sup>25</sup>

# **Amendments affecting individuals**

For purposes of calculating Connecticut net income, SB 11 requires individuals to add back 100% of any additional allowance for depreciation under IRC Section 168(k) in computing federal adjusted gross income. Individuals are permitted to deduct 25% of the add-back in each of the four succeeding years.<sup>26</sup>

# Property tax credit for contributions to community supporting organizations<sup>27</sup>

SB 11 authorizes municipalities to issue residential property tax credits to eligible taxpayers who make contributions to approved "community supporting organizations." The amount of the credit may not exceed the lesser of the amount of property tax owed, or 85% of the contribution made. $^{28}$ 

The new credit regime seeks to address the recent federal changes limiting state and local tax deductions to federal personal income taxes. SB 11 defines "community supporting organization" as an organization, exempt from tax under IRC Section 501(c)(3), organized solely to support municipal expenditures for public programs and services, including public education.<sup>29</sup>

# **Considerations**

Connecticut's recently enacted PET creates new entity-level filing and payment obligations for certain businesses with Connecticut-sourced income. The PET applies to taxable years beginning on or after January 1, 2018, potentially triggering immediate deadlines (e.g., installment payment due June 15 for calendar year taxpayers) as is noted above.

<sup>&</sup>lt;sup>20</sup> See Conn. Gen. Stat. § 12-701(a)(19) for federal conformity for corporate taxpayers; see also Conn. Gen. Stat. § 12-217(a)(9) for federal conformity for individual taxpayers.

<sup>&</sup>lt;sup>21</sup> Pub. L. 115-97, 131 Stat. 2054 (Dec. 22, 2017).

<sup>&</sup>lt;sup>22</sup> 2018 Conn. Pub. Acts. 18-49, SB 11, § 13(a)(6).

<sup>&</sup>lt;sup>23</sup> Conn. Gen. Stat. § 12-217(a)(2)(A)(i).

<sup>&</sup>lt;sup>24</sup> 2018 Conn. Pub. Acts. 18-49, SB 11, § 13(a)(2)(B).

<sup>&</sup>lt;sup>25</sup> *Id*.

<sup>&</sup>lt;sup>26</sup> 2018 Conn. Pub. Acts. 18-49, SB 11, § 11(20)(A)(ix), (B)(v).

<sup>&</sup>lt;sup>27</sup> 2018 Conn. Pub. Acts. 18-49, SB 11, § 10. In IRS Notice 2018-54 the IRS stated their intent to review state provisions similar to this aimed at circumventing the new federal limitation and announced that the Treasury and the IRS intend to propose regulations addressing the federal income tax treatment of certain payments made by taxpayers for which taxpayers receive a credit against their state and local taxes.

<sup>&</sup>lt;sup>28</sup> 2018 Conn. Pub. Acts. 18-49, SB 11, § 10(b)(1).

<sup>&</sup>lt;sup>29</sup> 2018 Conn. Pub. Acts. 18-49, SB 11, § 10(a)(2).

#### **External Multistate Tax Alert**

Additionally, the provisions of SB 11 seeking to provide a charitable contribution mechanism to circumvent the new federal limitations on SALT deductions for individuals should be analyzed closely and cautiously in light of ongoing IRS scrutiny in this area. Taxpayers impacted by the enactment of SB 11 should consult with their Connecticut tax advisors for further assistance.

# Contacts:

If you have questions regarding S.B. 11 or other Connecticut tax matters, please contact any of the following Deloitte Tax professionals:

### **Jack Lutz**

Tax Managing Director
Deloitte Tax LLP, Hartford
+1.860.725.3150
jacklutz@deloitte.com

#### **Nicholas Rochedieu**

Tax Senior Manager
Deloitte Tax LLP, Hartford
+1.860.725.3101
nirochedieu@deloitte.com

## **R. Craig Aronson**

**Tax Managing Director**Deloitte Tax LLP, Hartford +1.860.725.3127
<a href="mailto:raronson@deloitte.com">raronson@deloitte.com</a>

## **Dareck Stringfield**

Tax Senior Manager
Deloitte Tax LLP, Stamford
+1.203.708.4236
dstringfield@deloitte.com

#### **Kimberly Sweeney**

**Tax Managing Director**Deloitte Tax LLP, Stamford +1.860.725.3101
<a href="mailto:ksweeney@deloitte.com">ksweeney@deloitte.com</a>

# **Maura Kathryn Zaneski**

Tax Manager
Deloitte Tax LLP, Hartford
+1.860.725.3348
mzaneski@deloitte.com

For further information, visit our website at www.deloitte.com

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