Connecticut's Response to the Tax Cuts and Jobs Act of 2017 (Part I)

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The Tax Cuts and Jobs Act of 2017 (TCJA) was signed into law on December 22, 2017. Most of the provisions of the New Federal Tax Act were effective January 1, 2018 (although some provisions went into effect in 2017). The adoption of the New Federal Tax Act had a significant impact on state taxation, especially in states like Connecticut, where the base for the Personal Income Tax starts with federal adjusted gross income. As a result, Connecticut needed to determine whether or to what extent the federal tax changes will impact Connecticut's tax collections. Connecticut's response can be found primarily in Public Act 18-49, which was signed into law by then Governor Malloy in May, 2018. The changes adopted by Connecticut are wide reaching, and will have an impact on virtually all individual and business taxpayers filing Connecticut returns. This article is the first of a two-part series that will examine the more significant provisions of the new Connecticut legislation. In Part I, Connecticut's new pass-through entity tax will be analyzed. In Part II, which will be published in March 2019, the remaining changes made by Connecticut in response to the New Federal Tax Act will be discussed.

New Pass-Through Entity Tax

One of the more publicized provisions of the New Federal Tax Act was the $10,000 limitation ($5,000 for a married individual filing a separate return) on the itemized deduction for individuals for certain state and local taxes. In an attempt to minimize the impact of the lost federal state and local tax deduction, Connecticut has responded with a new pass-through entity level tax. The new pass-through entity tax is effective for tax years beginning on or after January 1, 2018, and is imposed at the rate of 6.99%, which is currently Connecticut's highest marginal personal income tax rate. [1] The pass-through entity tax will apply to most pass-through businesses, including partnerships (other than "publicly traded partnerships"), S corporations and limited liability companies that are treated as partnerships or S corporations for federal income tax purposes. The new pass-through entity tax does not apply to businesses operated as a single

member limited liability companies (and treated as disregarded entities for federal tax purposes), so those taxpayers should consult with a tax advisor to determine whether it may be advantageous, for Connecticut tax purposes, to convert to pass-through status by adding a nominal partner to take advantage of the tax benefit (to be described below) afforded by the pass-through entity tax.

The pass-through entity tax can be calculated under one of two methods: either by using the "Standard Base" or the "Alternative Base." The pass-through entity will elect on its tax return which of the two bases it will be using. Under the Standard Base, the pass-through entity tax is imposed on the "Connecticut source income" of the business entity, as increased or decreased by the modifications applicable under the Connecticut personal income tax. Significantly, guaranteed payments to partners are not included when determining the amount of the business entity's income subject to the pass-through entity tax. If the business entity is a member of another pass-through business entity, then, when determining the amount of its Connecticut source income, it is required to subtract its distributive share of Connecticut-source income, or add its distributive share of Connecticut-source loss from such upper-tier entity.

Because the new pass-through entity tax will be an expense of the pass-through entity that pays the tax, the impact of the tax will be to lower the federal taxable income that is allocated to the owners of the pass-through business. In addition, each individual owner of the pass-through entity will be entitled to a refundable credit against his or her Connecticut personal income tax equal to 93.01% of that owner's pro rata share of the tax paid by the pass-through entity.[2] A trust that is an owner of a pass-through entity may allocate all or a portion of a credit between the trust and its beneficiaries. In order to claim the credit, the taxpayer must receive a Schedule CT K-1 from the entity showing the credit that has been allocated by the pass-through entity to such owner.

A nonresident individual is not required to file a Connecticut personal income tax return for any taxable year if the only Connecticut-source income of the nonresident individual for such year (and the nonresident individual's spouse, if the nonresident individual files a joint return with the spouse) is from one or more pass-through entities, and each of those entities pays the pass-through entity tax. However, a nonresident individual is required to file a Connecticut personal income tax return if the pass-through entity of which it is a member has elected to file a "combined return" (see below) with one or more other pass-through entities and the credit(s) allocated to the nonresident individual would not fully satisfy the nonresident individual's Connecticut income tax liability. As part of the adoption of the pass-through entity tax, the former composite tax return obligation that required a pass-through entity to report and pay tax on behalf of its nonresident owners has been repealed. One of the questions that nonresidents of Connecticut will need to address is whether or to what extent their home state will allow them to take a tax credit against their personal income tax due their home state. For example, in some states, such as Massachusetts, a credit is permitted to be taken against taxes that are imposed directly or indirectly on a pass-through entity owner. In other states, it is not as certain.

If the owner of the pass-through business is subject to the Connecticut corporation business tax, that corporate owner shall receive a similar credit against the corporation business tax in an amount equal to that owner's pro rata share of the tax paid by the pass-through entity multiplied by 93.01%. Such credit shall be applied after all other credits applied and shall not be subject to

the other statutory percentage limits. Any credit not used by the corporate owner in the income year in which the affected business entity incurs the pass-through entity tax may be carried forward to each succeeding income year, until such credit is fully taken against the corporate owner's Connecticut corporation business tax liability.

<u>The "Alternative Base"</u>

As an alternative to the use of the "Standard Base," the pass-through entity may elect to use the "Alternative Base" to calculate its pass-through entity tax liability. Under the "alternative base", the 6.99% rate is imposed on (i) the pass-through entity's "resident portion of unsourced income," plus (ii) the pass-through entity's "modified Connecticut source income," The purpose of the alternative base is twofold. First, is to bring non-sourced income into the base for Connecticut residents (thereby increasing the potential savings from the higher federal tax deduction for state taxes paid by the pass-through entity) and second, to exclude pass-through income allocable to corporations and tax exempt entities from the base.

The "resident portion of unsourced income" is defined as "unsourced income" multiplied by a percentage equal to the sum of the ownership interests in the business entity owned by individual members who are Connecticut residents. "Unsourced income" generally equals the pass-through entity's net income for federal tax purposes, as increased or decreased by any adjustments that apply under the Connecticut personal income tax regardless of the location from which the items of income and adjustments are derived, minus (i) the business's Connecticut-sourced income, without any adjustments for tiered business entities, and minus (ii) the business's net income, for federal tax purposes, that is derived from sources in another state with jurisdiction to tax the entity, as increased or decreased by any adjustments that apply under the personal income tax that are derived from, or connected to, sources in another state with jurisdiction to tax the entity.

"Modified Connecticut source income" is the business's Connecticut source income multiplied by a percentage equal to the sum of the ownership interests in the business that are owned by *individual* members that are (i) subject to the Connecticut personal income tax or (ii) pass-through businesses subject to the entity tax (to the extent that such businesses are directly or indirectly owned by individuals subject to the Connecticut personal income tax).

Use of the alternative tax base may be to the advantage of pass-through entities with Connecticut residents because the base used to calculate the available tax credit is increased to include "unsourced income" as well as Connecticut "sourced income." The use of the alternative tax base also should permit a business to avoid paying the pass-through entity tax to the extent of income earned by owners who are not subject to the Connecticut personal income tax, such as Subchapter C corporations and tax-exempt entities. In such a case, the pass-through entity would presumably want to allocate the pass-through entity's tax expense deductions away from the corporate and tax exempt owners. However, advisors to pass-through entities will need to consider whether their organizational documents will permit, this special allocation of expenses and credits and, in the case of Subchapter S corporations, whether a special allocation would create a prohibited second class of stock issue.

<u>Example</u>

Assume that a Connecticut limited liability company, ABC, LLC, has three equal members: a Connecticut resident, a Connecticut nonresident and a C corporation. In 2018, the LLC had $200,000 of taxable income, $150,000 of which was treated as Connecticut source income.

If ABC, LLC elects to use the "Standard Base" for computing its pass-through tax liability for 2018, the tax will be $10,485 ($150,000 of Connecticut source income times 6.99%). The $10,485 of tax will be allocated to the members on a pro rata basis, so each member will receive an allocation of tax shown on their Schedule CT K-1 of $3,495. Each member will then be entitled to a tax credit equal to 93.01% of $3,495, or $3,251 to be used against their Connecticut income tax liability. Because the pass-through entity tax is imposed on ABC, LLC, its taxable income will be reduced from $200,000 down to $189,515 ($200,000 - $10,485) and each of the three members in ABC, LLC will be allocated income on the Federal K-1 equal to one-third of $189,515, or $63,172.

Assume instead that ABC, LLC elects to use the "Alternative Base." Under the Alternative Base, ABC, LLC would first determine its "resident portion of unsourced income." In this case, ABC, LLC has $50,000 of unsourced income. Since only one-third of ABC, LLC's members are Connecticut residents, its "resident portion of unsourced income" would be one-third of $50,000, or $16,667. At 6.99%, the tax on the resident portion of unsourced income would be $1,165. The federal deduction attributable to this expense, would presumably be allocated to the Connecticut resident (assuming that is permitted under ABC, LLC's operating agreement), who would also be entitled to a Connecticut tax credit equal to 93.01% of $1,165, on account of the tax paid by ABC, LLC that would be allocated to him or her on the Schedule CT K-1. ABC, LLC would also determine its "modified Connecticut source income," which would be its Connecticut source income of $150,000 multiplied by the percentage interests held by members who are subject to the Connecticut Personal Income Tax. In this case, two of the three members of ABC, LLC are subject to the Connecticut Personal Income Tax. Therefore, 66.67% of ABC LLC's Connecticut source income, or $100,000 would be treated as its "modified Connecticut source income". This results in a tax of $6,990, the expense of which would presumably be specially allocated to ABC, LLC's Connecticut and New York residents, on a pro rata basis, which will reduce the federal taxable income allocable to the Connecticut resident and the New York resident from ABC, LLC, again, assuming the operating agreement of ABC, LLC permits the special allocation.

Payment and Estimated Tax Requirements.

Each pass-through entity that is required to file a Connecticut tax return is required to pay the pass-through entity tax on or before the 15th day of the third month following the close of its taxable year (e.g., March 15th for calendar year taxpayers), and to report to the entity's owners their share of the entity's tax payments. "Commonly-owned" pass-through entities (i.e., more than 80% common voting control) may elect to file a combined return. A combined return would allow commonly owned pass-through entities to offset gains and losses. A combined group also may allocate the pass-through entity tax credit to the group's owners in the manner it deems appropriate, but such allocation must be made when the original group return is filed and is irrevocable.

Each pass-through business subject to the new tax will be required to make quarterly estimated tax payments in a manner similar to the estimated tax payment rules that exist for purposes of the Connecticut personal income tax.[3] The business can calculate the payment due based upon (i) 25% of the "required annual payment" (i.e., 90% of the entity tax due for the current year or 100% of the entity tax due for the preceding year) or (ii) the annualized income installment calculation method.[4]

The tax collection, enforcement, interest, and penalty provisions applicable to the Connecticut personal income tax are generally incorporated into or are made applicable to the new pass-through entity tax.

It remains to be seen whether the federal government will challenge the ability of a pass-through entity to reduce its federal taxable income by the amount of the pass-through entity tax paid to Connecticut by the pass-through entity. This is clearly an issue that has received the attention of the Internal Revenue Service. Specifically, in its 2018-2019 Priority Guidance Plan (dated November 8, 2018), the Treasury Department indicated its intent to publish guidance "on applying the state and local deduction cap under [I.R.C.] §164(b)(6) to pass-through entities." It is hoped that such guidance will be forthcoming soon, as it could have a significant impact on the 2018 federal pass-through returns filed by pass-through entities that are subject to Connecticut's new tax.

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[1] Conn. Pub. Act No. 18-49, §§1-2 *(effective May 31, 2018, and applicable to taxable years commencing on or after January 1, 2018);* Conn. Gen. Stat. §§12-719(b)(1) and 12-719(c)(1), as amended by Conn. Pub. Act No. 18-49, §§3-4 *(effective May 31, 2018);* and Conn. Gen. Stat. §§12-726 and 12-733(b), as amended by Conn. Pub. Act No. 18-49, §§5-6 *(effective May 31, 2018, and applicable to taxable years commencing on or after January 1, 2018). See* Office of Commissioner Guidance (OCG)-6, *Regarding the Calculation of the Pass-Through Entity Tax.*

[2] For a more detailed discussion of issues arising in connection with the tax credit, *See*; Office of Commissioner Guidance (OCG)-7, *Regarding the Pass-Through Entity Tax Credit.*

[3] On June 5, 2018, the DRS released Form CT-1065/CT-1120SI ES, *2018 Estimated Pass-Through Entity Tax Payment Coupon*, allowing pass-through entities to print and mail the payment coupon together with estimated payments. The DRS accepts estimated payments electronically.

[4] In DRS Special Notice 2018(4), the DRS indicated that a pass-through entity may comply with its 2018 estimated tax payment requirements by: (i) making a catch-up payment with the June 15, 2018 estimated payment that satisfies both the first and second estimated payment requirements; (ii) making three estimated payments (on or

before each of June 15, 2018, September 15, 2018, and January 15, 2019) each equal to 22.5% of the tax liability (with the full amount of tax remaining due by the return due date); or (iii) annualizing their estimated payments for the taxable year.