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Connecticut Publishes Guidance on Economic Nexus Legislation

The Connecticut Department of Revenue Services (“DRS”) published yesterday Information Publication 2010(29), providing guidance as to when an out-of-state corporation, or when a nonresident of Connecticut who is an investor in a pass-through entity such as a partnership, will have to pay Connecticut income tax on income from sources within Connecticut even though neither the business entity nor the nonresident has any physical presence in Connecticut.

During its 2009 June Special Session, the Connecticut General Assembly enacted legislation (the “Economic Nexus Legislation”) that provides generally that, effective for tax years commencing on or after January 1, 2010, a corporation or a partnership that derives income from Connecticut and that has a “substantial economic presence” within Connecticut must file a Connecticut income tax return. Conn. Gen. Stat. §§ 12-216a, 12-726. A Subchapter C corporation would be required to file a Connecticut corporation business tax return and pay the applicable tax; a pass-through entity, such as a partnership or a Subchapter S corporation, would be required to file a Connecticut composite income tax return and pay tax on behalf of its nonresident owners. (A limited liability

company would be required to file either a corporation business tax return or a composite income tax return depending upon its characterization as a corporation or as a partnership for federal income tax purposes.) As set forth in the DRS guidance, the purpose of the Economic Nexus Legislation is to impose the Connecticut income tax on out-of-state corporations and nonresident investors in pass-through entities that derive income from the purposeful direction of business activities toward Connecticut, regardless of whether such corporations, pass-through entities or nonresidents ever physically enter the state.

The “Economic Nexus Legislation” states that “substantial economic presence” is to be “evidenced by a purposeful direction of business” toward Connecticut, “examined in light of the frequency, quantity and systematic nature” of the taxpayer’s contacts with Connecticut, “without regard for physical presence.” Given the extremely broad language of the Economic Nexus Legislation, the taxpayer community sought guidance from the DRS as to the proper application of the law. Information Publication 2010(29) constitutes the first guidance published by the DRS. The DRS guidance is in the format of responses to seven “frequently-

asked questions,” and provides the following commentary and rules regarding the application of the Economic Nexus Legislation:

- **Taxpayers Covered.** Although the legislative history of the Economic Nexus Legislation suggests that the focus of the Connecticut General Assembly’s concern was out-of-state businesses in the financial service industry, particularly credit card companies and mortgage companies, the guidance makes clear that the Economic Nexus Legislation will apply to almost all corporations and pass-through entities regardless of their income-producing activity.
- **“Purposeful Direction of Business Activities.”** Little light is shed by the DRS guidance on what constitutes the “purposeful direction of business activities toward Connecticut” other than to restate the law’s direction that a business’s economic presence will be evaluated based upon the “frequency, quantity and systematic nature” of the business’s economic contacts in Connecticut. The three examples given of businesses that have economic presence in Connecticut are (i) an out-of-state banking corporation that engages in the “active solicitation” of Connecticut residents, (ii) an out-of-state “online financial service” corporation that engages in the “active solicitation” of Connecticut residents, and (iii) an out-of-state car loan corporation that makes or holds loans issued to customers of an automobile manufacturer that sells automobiles to Connecticut residents. No definition of “active solicitation” is provided.
- **“Bright Line” Test.** Consistent with the practice of other states that have enacted economic nexus statutes, the DRS establishes a “bright line” test whereby a party will not be deemed to have economic nexus in Connecticut for a taxable year if the taxpayer has receipts from business activities that are less than \$500,000 attributable to Connecticut sources during such taxable year. In the case of a pass-through entity, the bright line receipts test is applied at the entity level. It is important to note that the “bright line” test does not specify that the receipts come from a minimum number of transactions. Accordingly, a single, one-time, large transaction could give rise to economic nexus despite the statutory mandate that “substantial economic presence” is to be evaluated based upon the “frequency, quantity and systematic nature” of a party’s contacts with Connecticut. Finally, please note that the “bright line” test is not applicable if an out-of-state party otherwise has nexus with Connecticut, such as a physical presence due to an office or employees in Connecticut.
- **Licensing of Intangible Property Rights.** The DRS guidance clarifies that the “in-state ownership and use of intangible property” in Connecticut will constitute economic nexus if: (i) the intangible property generates, or is otherwise a source of, gross receipts within Connecticut, including through a license or a franchise; (ii) the activity through which the party obtains such gross receipts from its intangible property is “purposeful” (the DRS cites as an example of a “purposeful” activity

a contract with an in-state company); and (iii) the presence satisfies the bright line test. The example provided expressly notes that the licensing of intangible property to an in-state entity will create economic nexus regardless of whether the in-state entity is affiliated with or related to the licensor. The guidance specifies that the out-of-state licensor does not have to include in gross income amounts that have been added back by an in-state related entity pursuant to Connecticut's royalty add-back statute, Conn. Gen. Stat. § 12-218c; however, the guidance does not indicate whether the out-of-state party, if a corporation, would still have to file a Connecticut corporation business tax return and be subject to a minimum tax or the capital base tax.

- **Passive Income.** The DRS guidance provides that income from a passive investment activity shall not be considered the basis for finding that a party has economic nexus. In particular, the examples clarify that income received by an out-of-state business entity from a bank account or an investment account with a Connecticut-based financial institution will not alone create economic nexus. Similarly, the purchase by an out-of-state partnership of shares of a Connecticut corporation with operations in Connecticut will not constitute economic nexus even if a representative of the partnership sits on the Board of Directors of the Connecticut corporation and attends meetings of the Board of Directors in Connecticut. By way of contrast, an out-of-state mortgage corporation

that engages in the active solicitation of Connecticut residents and generates more than \$500,000 in income from loans made to Connecticut customers will be deemed to have economic nexus.

- **Public Law 86-272.** Federal Public Law 86-272 generally restricts a state, such as Connecticut, from imposing an income tax on income derived from within its borders by an out-of-state party if the only business activity conducted within the state by the out-of-state party is the solicitation of orders for sales of tangible personal property, which orders are to be sent outside of the state for acceptance or rejection and, if accepted, are filled by shipment or delivery from a point outside of the state. An example of a party that would qualify for such protection is an Internet retailer of tangible personal property such as clothes or books. The guidance specifies that Public Law 86-272 will prevent the application of the Economic Nexus Legislation as it relates to a Connecticut income tax; however, the guidance does not address the application of the capital base tax to an out-of-state Internet retailer.
- **Transactions with Related Members.** The DRS guidance provides that, except for the licensing of intangible property, transactions between related members will not be treated as creating economic nexus. Accordingly, if an out-of-state headquarters corporation that otherwise is not subject to Connecticut income taxation provides legal and accounting services to its wholly-owned subsidiary



located in Connecticut, the provision of such services shall not constitute the conduct of “business” under the Economic Nexus Legislation.

The adoption of a bright line test, and the exemptions for passive investment activities and affiliated company transactions, will provide welcome relief to many parties who have waited anxiously for guidance to be issued related to the Economic Nexus Legislation. Nevertheless, the guidance leaves unanswered many other questions and raises some new issues on its own. By way of example, the guidance does not address the potential impact of the Economic Nexus Legislation on foreign (i.e. non-United States) corporations, pass-through entities and individuals who are not subject to Federal income taxation. The guidance furthermore restates the statutory mandate that a party’s “purposeful direction of business toward this state” be evaluated based upon the “frequency, quantity and systematic nature” of the party’s economic contacts with the state, but does not define what constitutes “active solicitation” and provides that

economic nexus can be based upon a single transaction involving the licensing of intangible property rights to a related party in Connecticut. The unfortunate result may be that many of these unanswered questions and unresolved issues will only be addressed through further legislation, additional administrative guidance or in the courts. In the interim, taxpayers are advised to consult with their tax advisors to determine how the Economic Nexus Legislation will impact their Connecticut tax reporting obligations.

Questions or Assistance?

The members of our State and Local Taxation Practice Group, as listed on page 1 of this alert, are available if you have any questions regarding the Economic Nexus Legislation or its impact on you and your business activities.

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