The Nuts and Bolts of Connecticut's New Passthrough Entity Tax

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In this installment of Noonan's Notes, the authors discuss Connecticut's new passthrough entity tax.

Since the Tax Cuts and Jobs Act (P.L. 115-97) passed late last year, there has been a flurry of activity in the states to enact conforming (or decoupling) legislation and — perhaps more importantly — implement new measures to counteract the cap on the individual state and local tax deduction for residents of high-tax states like Connecticut, New Jersey, and New York. Most of the fanfare has been around new potential charitable deductions in place of property taxes that are designed to circumvent the cap.[1] New York state also enacted a payroll tax designed to accomplish the same thing, shifting the burden of individual income tax to an employer to allow a deduction of state taxes at the employer level.[2] But that New York tax is voluntary, and based on what we are hearing, very few employers will sign up for it. Connecticut, Maryland, New Jersey, and New York have also filed a lawsuit against the federal government claiming that the SALT deduction cap is unconstitutional.[3]

In the midst of all this fanfare, the Connecticut legislature enacted a new, nonvoluntary tax on all passthrough entities doing business in the state. And the effective date is January 1, 2018 — retroactive from the date of passage, May 31! Entities subject to this tax should already be paying this estimated tax. In this article, we'll outline a lot of the questions associated with this new tax and provide some answers. Some of these answers are derived from recently issued guidance about the calculation of the tax as well as the computation of the individual income tax credit for such tax.[4]

I. Questions About Calculation of the Passthrough Entity Tax

Question: Who is subject to the passthrough entity tax?

Answer: The tax is imposed on partnerships, limited liability companies, and S corporations that do business in Connecticut or have income from Connecticut sources. Sole proprietorships,

[1] Amy Hamilton, "Treasury Receives More Than 1,500 Comments on Proposed SALT Regs," *State Tax Notes*, Sept. 21, 2018, p. 1300; Hamilton, "IRS Has Plan to Shut Down SALT Workarounds," *State Tax Today*, Aug. 24, 2018; Steve Wilson, "NJ Releases Regulations for SALT Deduction Charitable Contributions in Showdown With the IRS," *NJBIA*, Sept. 25, 2018; and Paul Jones, "SALT Cap Bypass Heads for Vote Despite IRS Regs," *State Tax Notes*, Aug. 29, 2018, p. 1013.

[2] TSB-M-18(1)ECEP, Employer Compensation Expense Program (July 3, 2018).

[3] Paige Jones, "States Sue IRS and Federal Government Over SALT Deduction Cap," *State Tax Today*, July 23, 2018, p. 401.

[4] Connecticut Department of Revenue Services, OCG-6, Pass-Through Entity Tax (June 19, 2018); and OCG-7, Pass-Through Entity Tax (Aug. 21, 2018).

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single-member LLCs, and publicly traded partnerships are *not* subject to this tax.

Question: How is the tax calculated?

Answer: Taxpayers can choose annually between two methods to calculate the tax. Both are designed to tax the passthrough entity only on income that, under prior law, would have been taxed to Connecticut individual taxpayers. The overall design of this tax is to shift the burden from the individual (who now can no longer deduct the tax) to the entity (which under federal law is allowed to deduct the tax). But because not all partners in Connecticut partnerships would pay Connecticut individual income tax, alternative calculations are needed to make this work.

Question: How is the standard base calculated?

Answer: This calculation is relatively straightforward. The passthrough entity takes its Connecticut-source income, using existing rules to determine the sourcing — customer-based sourcing since 2017! — and multiplies the total by the tax rate of 6.99 percent. Guaranteed payments are excluded from the tax base, as is any Connecticut-source income that flows up to the passthrough entity from a lower-tier passthrough entity that also files a Connecticut passthrough entity return, thus avoiding double taxation on that income.

For example:

> Partnership 1 is a 50 percent partner in Partnership 2. Partnership 1 has a total of $100,000 in net partnership income after the deduction of guaranteed payments. Of this amount, $20,000 is received from Partnership 2, all of which is from Connecticut sources. Half the remaining amount of net partnership income (that is, $40,000) is from Connecticut sources. Partnership 1 pays $2,796 in Connecticut tax on $40,000.

Question: How is the alternative base calculated?

Answer: This is way more complicated. Essentially this tax base is calculated by including only income that would flow through to individuals and only income that would be subject to Connecticut tax by the individuals. So under this tax base, all income that would flow to corporate or tax-exempt partners gets excluded. Also, all non-Connecticut-source income that would flow to nonresidents of Connecticut also gets excluded. Thus, only the income "creditable" in Connecticut is subject to the passthrough entity tax.

For example:

> LLC has three members: Member 1 is a corporation and owns 50 percent of LLC. Member 2 is a Connecticut resident individual and owns 40 percent of LLC. Member 3 is a nonresident individual and owns the remaining 10 percent. LLC has net income of $10,000 of Connecticut-source income and $50,000 of intangible income. If LLC chooses the alternative base, it would take the distributive share of the Connecticut-source income received by individuals (90 percent of $10,000 or $9,000) and add that to the distributive share of the intangible income received by a resident (40 percent of $50,000 or $20,000) for a total of $29,000 subject to tax.

Question: Can passthrough entities file combined returns to offset gains and losses among passthrough entities?

Answer: Yes, passthrough entities with common ownership (that is, more than 80 percent of the voting control is directly or indirectly owned by common owners) can file combined returns and must elect each year to do so. But all passthrough entities filing on a combined return must use the same tax base (standard or alternative).

Question: Are passthrough entities required to make estimated payments for 2018?

Answer: Yes! But don't worry, the Connecticut guidance indicates that the Department of Revenue Services will offer penalty relief because of how quickly this came up. But the fact remains that firms subject to this tax should be paying it already.

II. Guidance on the Passthrough Entity Credit

Again, don't tell the IRS, but the whole point to this tax is to shift the tax burden on passthrough income from the individual to the entity so that a federal deduction for the

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Connecticut tax paid is available. Part I addressed the shifting of that burden to the entity. But obviously, the income still flows through to the partner, so Connecticut needs a mechanism to eliminate the tax that would otherwise be paid by the partners. It does this through the passthrough entity tax credit.

Question: How does the credit work?

Answer: Partners and passthrough entities subject to the passthrough entity tax may take a credit equal to 93.01 percent of the partner's direct or indirect share of the passthrough entity's tax liability if the passthrough entity has actually paid the tax. Individual taxpayers can get a refund if the credit amounts exceed their Connecticut tax liabilities, whereas corporate taxpayers can carry forward any unused credits.

Question: Does the tax credit differ if the entity uses the standard base versus the alternative base?

Answer: Yes. Under the standard base, each partner's credit is based on the distributive share of partnership income. But under the alternative base, the credits flow only to the partners whose income is in the tax base.

Question: Why only 93.01 percent? Why won't they credit all of it?

Answer: This is just how the math works. Because the passthrough entity tax will be claimed as a federal tax deduction at the entity level, the partners' flow-through income gets reduced by the amount of this tax. Again, that's the whole point — to eliminate the Connecticut state tax from being subject to federal tax. This just prevents the partner from double-dipping. The example below shows how the tax and credit calculations are meant to be revenue neutral without increasing the overall tax burden of Connecticut resident individuals.

For example:

> S Corporation is wholly owned by a Connecticut resident and generates $5 million of unsourced income. Under old federal and Connecticut laws, the individual would pay $1.85 million ($5 million x 37 percent) in federal and $349,500 ($5 million x 6.99 percent) in Connecticut personal income tax for a total tax liability of $2,199,500.
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> Under new federal and Connecticut laws, the individual pays $1,720,685 ($4,650,500 x 37 percent) in federal and $325,070 ($4,650,500 x 6.99 percent) in Connecticut personal income tax for a total tax liability of $2,045,755. But the sole Connecticut resident shareholder is ultimately responsible for the $349,500 Connecticut passthrough entity tax paid by S Corporation and he receives a $325,070 credit ($349,500 x 93.01 percent) on his personal income tax return. So the passthrough entity tax is revenue neutral for Connecticut purposes ($325,070 + $349,500 - $325,070 = $349,500) but saves $129,315 in federal tax ($1,850,000 - $1,720,685).

Question: In what year can the partner claim the passthrough entity tax credit?

Answer: It doesn't matter if some of the tax is paid by the passthrough entity in calendar year 2018 or 2019. The partner can claim the tax credit against its tax due for its share of the income that created the passthrough entity tax liability. If all the tax paid by the passthrough entity in 2018 and 2019 related to 2018 income, the credit is available against the partner's 2018 Connecticut income tax liability.

Question: What happens to the credit when there are tiered partnerships?

Answer: Things can get a little funky. The subsidiary passthrough entity has to report to the parent passthrough entity the amount of the passthrough entity tax credit that the parent passthrough entity is allocated. But the parent passthrough entity cannot claim this credit because the parent passthrough entity is not subject to corporate or individual income taxes. Instead, the parent passthrough entity must flow through the passthrough entity tax credit to its partners, and Connecticut is calling these "indirect passthrough entity tax credits."

Question: How is the passthrough entity tax credit allocation calculated for combined filers?

Answer: The Connecticut guidance indicates that the combined group "may allocate the passthrough entity tax credit to the partners of the group's members in the manner it deems appropriate." Thus, in theory, the combined group could allocate all its credits to specific

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individual members who might benefit the most from the credits. This approach seems a little loosey-goosey given that the passthrough entity tax of a combined group is calculated by each member of the group separately calculating its tax base, but Connecticut's approach is to give maximum flexibility to the passthrough entity members.

Question: What if a nonresident's only source of Connecticut income is a distributed share of income from a passthrough entity that already pays the passthrough entity tax? Does that taxpayer have to file in Connecticut?

Answer: No. If I am a partner in a partnership that does business in Connecticut and my only income from Connecticut is that partnership's income, I am now relieved of my requirement to file Connecticut taxes. The nonresident might want to file a return to claim a refund, however, if the credit exceeds the individual's liability (for example, if the individual is subject to a personal income tax rate lower than 6.99 percent).

Question: If I'm a nonresident of Connecticut, will I be able to claim a credit in my home state for my share of the passthrough entity tax paid by my passthrough entity?

Answer: At this point, the answer to this question is not clear. And that is a *huge* problem. For example:

> I am partner in a law firm that does a little business in Connecticut. Every year I pay around $200 in Connecticut tax based on my firm's small amount of Connecticut-source income. And every year I claim a resident credit for this tax against my New York tax liability. But starting in 2018, instead of my paying the tax directly, my firm will pay the Connecticut passthrough entity tax. This will eliminate my need to pay Connecticut tax in 2018, but I'm still out-of-pocket the $200, since my passthrough income will be reduced because of this expense at the entity level. And since I didn't pay any Connecticut taxes, there's nothing for me to base a claim for a resident credit on.

So thanks, Connecticut! You've "fixed" the problem created by the loss of the SALT deduction by effectively doubling the amount of state tax the partner is paying. Under this new regime, the partner is still out $200 because of Connecticut taxes, but can't offset her New York tax liability by that amount anymore. Of course, there's nothing Connecticut can do about this. We need New York to make clear that such a credit will be allowed. Interestingly, Connecticut recently passed a law confirming that it would provide a credit for its residents to cover them if their employers pay the new New York employer compensation expense tax on their behalf.[5]

At present, there's been no guidance issued by the states on whether a resident credit would be allowed for taxes paid at the entity level. We believe there may be a position that taxes paid by partnerships are creditable, but since the issue has never really arisen in New York (since few if any states have an entity-level tax on partnerships), the answer is unclear. And at a minimum, it appears that S corporation shareholders are out of luck, particularly in New York. New York law already makes clear that resident S corporation shareholders are not allowed to claim a credit for corporate-level taxes paid by the corporation.[6]

Finally, to wrap this up, let's ask the $64,000 question:

Question: Will the IRS deny the federal deduction that the passthrough entity will take for the tax?

Answer: We know that the IRS is actively seeking to block state-level workarounds to the limitation on the individual SALT deduction. But denying an entity a deduction for state-level taxes it actually pays out might be more difficult when the state has created a new mandatory tax. A passthrough entity doing business in Connecticut is required to pay this tax. Regardless of why the tax is there, it's still a requirement that the tax be paid. So how could this not be an ordinary or necessary expense?

Nevertheless, consider a hedge fund that chooses the alternative base to calculate the Connecticut passthrough entity tax so that tax on the intangible income would be borne by the entity rather than the Connecticut resident

[5] Conn. Gen. Stat. section 12-704(a)(5). Applicable to tax years beginning Jan. 1, 2019.

[6] N.Y. Tax Law section 620(d).

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partners. Could the IRS deny the deduction (or part of it) on the basis that the entity could have chosen to pay less tax to Connecticut? Alternatively, if a partner claims a resident credit for the tax paid in her home state by the passthrough entity, does this give the IRS more basis to claim that the "tax" here was really on the partner, not the entity?

Our expectation is that the IRS will not go down this road, and instead focus its enforcement efforts on the charitable workarounds and other low-hanging fruit. This is how it has played out thus far, with the IRS issuing detailed proposed regulations in August attacking the charitable schemes without mention of entity-level tax workarounds. But for Connecticut taxpayers, this final question is kind of a moot point; they have to pay the tax regardless. And this, of course, is the ultimate irony: States have found ways to "help" taxpayers by creating new taxes! ■

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