2022 FTA Revenue Estimating Conference

Taxation of Pass-through Entities

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Connecticut Pass-Through Entity Tax Basics

CT Pass-Through Entity Tax ("PE Tax" or "PET").

- Effective: PE taxable years commencing on or after January 1, 2018.
- Affected Business Entities (PEs): Applicable to Partnerships, S corporations, and LLCs treated as partnerships (all types). Not applicable to Sole Proprietorships, SMLLCs, Publicly Traded Partnerships, or C corporations.
- Entity-level Income Tax: 6.99% flat tax rate
- PE Owner Tax Credit: 93.01% (2018) and 87.5% (2019 and after) credit for income and corporation business tax

Connecticut Pass-Through Entity Tax Basics

- This is a **mandatory** (not elective) entity level income tax imposed on PEs.
- PE owners receive a credit of the PE tax to claim on their individual income tax returns or corporation business tax returns.
- Nonresident individual owners are not required to file income tax returns if the credit satisfies their tax liability. The PE also has the option to make an additional composite payment on behalf of nonresidents if the PE credit does not satisfy the nonresidents' income tax liabilities.
- Estimated payments required at entity level.

Connecticut Pass-Through Entity Tax Basics

- PEs file Form CT-1065/CT-1120SI.

- Income apportionment, allocation and sourcing rules remain the same as they were under the prior composite income tax regime.

- PEs issue Schedule CT K-1s to PE owners.

Taxable Income Base

Taxable Income is Determined Under One of Two Methods:

- Connecticut Source Income Method (Default Method)
  - All of the PE's "Connecticut Source Income" is subject to tax.
- Alternative Base Method (Elective Method)
  - Only income attributable to PE owners who are individuals (including any PE owner subject to the personal income tax regime) is subject to tax.

Connecticut Source Income Method (Default – Standard Method)

Connecticut Source Income Method ("Standard Base")

- Taxable Income is Based on "Connecticut Source Income" as Determined Under the Personal Income Tax Rules.

- All Connecticut Source Income will be taxable regardless of the identity or type of PE owners.
  - Owners may be individuals (resident and nonresident), trusts, estates, C corporations, ESOPs, §501(c)(3) organizations, insurance companies, etc.

Alternative Base Method – Elective Method

Alternative Base Method

- Requires an Annual Affirmative Election – Check a Box on the Tax Return to Elect.
- Taxable income attributable to non-individual PE owners such as C Corporations, ESOPs, §501(c)(3) Organizations, Insurance Companies, etc., is not subject to the entity level income tax if the Alternative Base is elected. Only taxable income subject to tax under Chapter 229 (personal income tax rules) is taxable.
- Generally, must know who the PE owners are in order to properly compute the taxable income.

Alternative Base Method - Elective Method

The Alternative Base Taxable Income consists of

- CT Source Income (calculated under the default method *directly or indirectly* attributable to resident and non-resident individuals, trusts and estates); **and**

- Unsourced Income *directly* attributable to resident individual – natural persons (i.e., not resident trusts, resident estates, or resident private foundations founded by resident individuals; other than grantor trusts of a resident grantor).

Combined Returns

Entities can elect **annually** to file a Combined Return with one or more "*commonly-owned*" entities that are subject to the PE Tax and that have the same year-end.

- This election is made by making an election on the PE Tax return filed with the DRS.
  - Election is made on an annual basis by the due date or extended due date.
  - All members must use the same taxable income base, computed separately and then combined.

Combined Returns

Definition of a "Commonly-Owned" Entity

- PEs whereby more than 80% of the voting control is directly or indirectly owned by a common owner or owners, either corporate or noncorporate (w/ I.R.C. §318 attribution).
- You can pick and choose which entities to include in the combined return. It is not an all or no one election.
- The PEs do not have to have a unitary relationship or be in the same business line. Merely meting the > 80% ownership test is all that is needed.

PE Tax Credit

Personal Income (229) PE Tax Credit:

- For individual owners of PEs subject to the PE Tax, the law allows the PE owner to claim a *refundable credit* equal to their share of the PE Tax multiplied by 87.5% (2019 and after). The amount by which an owner's PE Tax credit exceeds the personal income tax liability is treated as a tax overpayment and refunded (it is not a carryforward credit).

PE Tax Credit

Corporation Business (Ch. 208) PE Tax Credit:

- Each corporation business tax taxpayer that is an owner of a PE may claim a credit equal to its share of the PE Tax multiplied by 87.5% (2019 and after). This will only apply if the Connecticut Source Income (Default) Method is used.
- The corporation must apply this credit after all other tax credits are applied.
- The credit is not subject to the corporation business tax credit cap.
- Unused credits may be carried forward indefinitely, until fully used (it is not a refundable credit).

Estimated Tax Payments

- The law requires PEs to make quarterly estimated tax payments equal to 25% of the “required annual payment,” which are due on the 15th day of the taxable year’s fourth, sixth, and ninth months, and on the 15th day of the first month of the next taxable year.
- Required Annual Payment
  - 90% of the Current years PE tax
  - 100% of the Previous years PE tax
- No estimates required if required annual payment is less than $1,000

Common Errors

- Inconsistent use of member identification numbers
- Claiming incorrect payments
- Claiming PE Credits from subsidiary PEs as payments (these credits should flow-through to the ultimate members of the parent PE)
- Apportionment issues
- Checking election boxes, but not including proper schedules (and vice-versa)

IRS Update

IRS issued Notice 2020-75 in November 2020

- Notice specifically blessed the use of an entity-level tax on pass-through entities to circumvent the $10,000 limit on the deductibility of state and local taxes.

Other States

- In 2018, Connecticut was the first state to enact a PE Tax in response to the $10,000 SALT deduction limitation. Since then, the following states have enacted similar, albeit optional, PE Taxes:
  - Alabama, Arkansas, Arizona, Colorado, Georgia, Idaho, Illinois, Louisiana, Maryland, Minnesota, New Jersey, New York, Oklahoma, Rhode Island, South Carolina and Wisconsin

DRS Guidance

- Pass-Through Entity Tax
  - DRS Portal: PE Tax home page link: https://portal.ct.gov/drs
  - Estimated Tax Payments DRS Guidance: SN 2018(4); SN 2019(6)
  - PE Tax Calculation DRS Guidance: OCG-6
  - PE Tax Credit DRS Guidance: OCG-7
- Connecticut Source Income and Apportionment
  - DRS Special Notice 2017(1)
- Economic Nexus
  - DRS Information Publication 2010(29.1)