PASS-THROUGH ENTITY TAXATION IN CONNECTICUT

For the Connecticut State Tax Panel

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Guiding Principles for Reform to Encourage Competitiveness

- Most Businesses Operate As a Pass-Through Entity
- Need to Eliminate Connecticut Anti-Competitive Tax Laws/Do Not Penalize Businesses for Being Based in Connecticut
- Need for Consistency in State Tax Treatment of Businesses Regardless of Legal Form Regarding Apportionment, Income Sourcing and Tax Credit Availability
- Predictability and Ease of Compliance

Types of Pass-Through Entities

- Limited Liability Companies (Single Member vs. Multiple Members)
- Partnerships, Limited Partnerships and Limited Liability Partnerships
- Subchapter S Corporations
- Disregarded Entities (Single Member LLCs, Qualified Subchapter S Subsidiaries)

Pass-Through Entity Taxation in Connecticut

Formation of Pass-Through Entities; Office of the Secretary of State

Year	Stock Corporations	LPs	LLPs	LLCs
2014	3165	228	69	22,950
2013	3413	167	88	22,506
2012	3317	190	75	22,824

N.B. "Stock corporations" include both Subchapter C corporations (taxable entities) and Subchapter S corporations (pass-through entities)

Pass-Through Entity Taxation in Connecticut

Most Common Attributes of Pass-Through Entities

- Small- and Medium-Sized Businesses (Often Owned by Individuals and Trusts)
- Corporate Joint Ventures
- Require Outsourced Services (Third Party Business Inputs)
- No or Limited In-House Tax/Compliance Services/Business Management Services

Federal and State Tax Treatment

- Federal Income Tax Treatment
  - No Federal Income Tax at Entity Level (Unless Check-the-Box Election Made)
    - Information Return: IRS Forms 1065 or 1120-S/Schedule C
  - Items of Income, Gain, Loss, Deduction and Credit Flow Through to Owners
  - Distributive Share of Income or Loss and of Certain Separately Stated Items

Pass-Through Entity Taxation in Connecticut

Federal and State Tax Treatment

- State Income Tax Treatment (Generally Follows Federal Income Tax Treatment)
  - Composite Tax Return Obligation (Form CT-1065/1120SI)
  - Foreign (non-Connecticut) Owner Withholding
- Other State Taxes (Separate Entity Treatment)
  - Sales and Use Tax
  - Conveyance Tax/Controlling Interest Transfer Tax
  - N.B. Conn. Gen. Stat. §34-113: LLC Taxation In Accordance With Federal Tax Classification (but see DRS Special Notice 99(3))

Connecticut Taxes Paid by Pass-Through Entities and Their Owners

- Personal Income Tax
  - State Composite Tax Return/Withholding
- Business Entity Tax
- Sales and Use Tax
- Local Property Tax
- Unemployment Insurance Tax

Anti-Competitive Connecticut Income Tax Issues for Pass-Through Entities

- Penalty Apportionment and Sourcing Rules
  - Favoring Out-of-State Businesses/Need for Market Sourcing
  - Lack of Consistency with Tax Treatment of Corporations
- Limited Availability of Credits
- History of Retroactive Tax Law Changes

Anti-Competitive Connecticut Income Tax Issues for Pass-Through Entities (cont'd)

- Business Tax Task Force Report (dated September 27, 2012), Chairs: Commissioners Smith and Sullivan
  - "Connecticut differentially & inequitably taxes similar enterprises solely on the basis of chosen forms of doing business . . . ."
  - "Consistent application of law, avoidance of retroactive changes, & reliable guidance are positive attributes of fair, effective & efficient business taxes."
  - Recommendation: "Standardize apportionment, factor weighting & sourcing."
  - Recommendation: "Phase out taxation of business-to-business computer & data processing services, analysis, management & management consulting services."

Penalty Apportionment/Sourcing Rules

- Scenario 1(a)
  - Connecticut-based pass-through entity (partnership, limited liability company or Subchapter S corporation) ("PE") sells services
  - All owners of PE are individuals
  - PE's only office is in Connecticut
  - PE has taxable nexus in Massachusetts
  - All of PE's customers are located in Massachusetts
  - Result:
    - PE sources 100% of income to Connecticut
    - PE sources 100% of income to Massachusetts
- Scenario 1(b)
  - Massachusetts-based PE sells services
  - All owners of PE are individuals
  - PE's only office is in Massachusetts
  - PE has taxable nexus in Connecticut
  - All of PE's customers are located in Connecticut
  - Result:
    - PE sources 0% of income to Connecticut
    - PE sources 0% of income to Massachusetts

Pass-Through Entity Taxation in Connecticut

Penalty Apportionment/Sourcing Rules (cont'd)

- Scenario 2
  - Pass-through entity ("PE") is a manufacturer
  - PE's owners are:
    - Individual ("I") who is a resident of Massachusetts
    - Corporation ("C") who is based in Massachusetts
  - All of PE's manufacturing facilities are located in CT; PE's sales office is located in MA; 80% of PE's payroll is located in Connecticut
  - All of PE's customers are located in Massachusetts
  - Result:
    - I sources 60% of its flow-through income from PE to Connecticut
    - C sources 0% of its flow-through income from PE to Connecticut

Pass-Through Entity Taxation in Connecticut

Limited Availability of Credits

There are approximately 25 Connecticut tax credits for which Subchapter C corporations can qualify, but pass-through entities and their owners cannot, including those tax credits for:

- Fixed Capital Investments (Conn. Gen. Stat. §§12-217o, 12-217w, 12-217mm)
- Employee Investments (Conn. Gen. Stat. §§12-217g, 12-217x)
- Research and Development Activities (Conn. Gen. Stat. §§12-217j, 12-217n)
- Enterprise Zone Investments (Conn. Gen. Stat. §12-217v)
- Neighborhood/Charitable Assistance (Chapter 228a)

N.B. Restriction on the eligibility of a corporate partner for tax credits (Bell Atlantic NYNEX Mobile, Inc. v. Commissioner, 273 Conn. 240 (2005)/OLR Research Report 2006-R-0206). Contra Conn. Gen. Stat. §§12-217gg (corporate partner in employment expansion project eligible for credit).

Penalty Credit Provisions

- Scenario 4(a)
  - Corporation ("C1") and Individual ("I") wish to form a joint venture to manufacture in Connecticut
    - C1 is based in Connecticut
    - I is a Connecticut resident
  - They form partnership ("P") to undertake the manufacturing and engage in research and development (R&D)
  - If P were subject to the Connecticut Corporation Business Tax, it would be entitled to a $100 R&D credit
  - Result:
    - P is not entitled to claim the R&D tax credit ($0)
    - C1 is not entitled to claim the R&D tax credit ($0)
    - I is not entitled to claim the R&D tax credit ($0)
- Scenario 4(b)
  - Corporation ("C1") and Individual ("I") wish to form a joint venture to manufacture in Connecticut
    - C1 is based in Connecticut
    - I is a Connecticut resident
  - They form corporation ("CORP") to undertake the manufacturing and engage in R&D
  - CORP is subject to the Connecticut Corporation Business Tax and is entitled to a $100 R&D credit
  - Result:
    - CORP is entitled to claim the R&D credit ($100)
    - C1 is not entitled to claim the R&D tax credit ($0)
    - I is not entitled to claim the R&D tax credit ($0)

Other Anti-Competitive Connecticut Tax Issues

- Sales and Use Tax on Business Inputs
  - Business Analysis and Management/Consulting Services
  - Computer and Data Processing
  - Personnel and Training Services
- Sales and Use Tax Complexity
- Property Tax Compliance in Multiple Towns/Multiple Rules
- Disregarded/Regarded Entities

Pass-Through Entity Taxation in Connecticut

Tax Policy Principles

- Revenue Stability and Sufficiency
- Balanced Revenue Sources
- Structural Stability
- Predictability
- Ease of Compliance
- Fair, Efficient and Cost-Effective Administration
- Consistent Application of Law and Timely Guidance
- Reflect the Global and Local Marketplace

Pass-Through Entity Taxation in Connecticut

Tax Policy Takeaways

- Eliminate Anti-Competitive Tax Rules/Do Not Penalize Connecticut-Based Businesses
  - Need for Market-Based Sourcing Rules
  - General Availability of Credits
  - Eliminate Sales and Use Taxes on Business Inputs
- Consistency in Application to All Businesses Regardless of Form of Tax Laws Regarding Apportionment, Sourcing and Tax Credit Availability
- Minimize Complexity