

Sweeping Connecticut Tax Reforms Passed by the General Assembly

June 5, 2015

Overview

On June 3, 2015, the Connecticut General Assembly passed in concurrence House Bill 7061 ("HB 7061"),¹ the Connecticut state budget bill for the biennium spanning July 1, 2015 through June 30, 2017. The bill is currently pending the signature of Governor Dannel Malloy. If enacted, this legislation would make several changes to Connecticut tax law.

In this Tax Alert we summarize these pending law changes, which would have various effective dates as specified below.

Changes to the Connecticut Corporation Business Tax

HB 7061 would make the following changes to the corporation business tax:

- Extend the 20% surtax on both the 7.5% tax rate on the income base and the 0.31% tax rate on the capital base for income years beginning prior to January 1, 2018. The surtax would be reduced to 10% for income years after January 1, 2018.
 - The 10% surtax on the capital base would be applicable only to calendar year taxpayers for the income year beginning on January 1, 2018, and would not apply to fiscal year taxpayers or to any tax period after January 1, 2018. We anticipate that this is a drafting error that would potentially be addressed as part of a technical corrections bill.
 - The surtax would apply to all companies with gross income of \$100,000,000 or more, all companies filing combined or elective unitary returns prior to 2015, and all companies filing unitary returns in 2015 through 2018.
- Extend the current film production tax credit limitations through June 30, 2017.
- Limit the deduction of Net Operating Losses ("NOLs") to 50% of Connecticut income effective January 1, 2015.
- Limit the application of tax credits to 50.01% of the amount of tax due effective January 1, 2015.
- Impose mandatory unitary taxation effective January 1, 2015:
 - The Connecticut combined group (referred to in this Tax Alert as the "CT unitary group") would be composed of all entities with common ownership (more than 50%, direct or indirect) that are engaged in a unitary business. CT unitary group members with nexus in Connecticut would be taxable members. CT unitary group members without nexus in Connecticut would be nontaxable members.
 - The "designated taxable member" would be either the parent of the CT unitary group or, if the parent of the CT unitary group is not a taxable member, the taxable member as selected by the CT unitary group.
 - The CT unitary group's income would be the aggregate income of every taxable and nontaxable member of the CT unitary group as reported on a federal return as if each member was filing a separate federal return or an adjusted profit and loss statement of a unitary foreign company that does not file a federal return.
 - The CT unitary group's income would include its distributive share from a pass through entity.
 - All inter-group dividends would be eliminated.
 - Inter-company gains would be deferred in a manner consistent with Treas. Reg. §1.1502-13.
 - Charitable contributions would be first deducted from the CT unitary group's income subject to IRC §170 limitations.

¹ H.B. 7061, 2015 Gen. Assemb., Reg. Sess. (Conn. 2015).

- Gains or losses under IRC §1231(a)(3) would be combined at the CT unitary group level and then apportioned to each member.
- Expenses related to income that Connecticut is prohibited from taxing under the U.S. Constitution would not be allowed as a deduction.
- Each taxable member would determine its separate apportionment percentage based on the otherwise applicable apportionment formula under Connecticut law.
- Taxable members would use the CT unitary group's denominator.
- Sourcing rules would depend on the apportionment formula applicable to the separate taxable or nontaxable entity.
- Receipts sourced to Connecticut for nontaxable members would be allocated to the numerators of the taxable members.
- Transactions between members would be eliminated for apportionment purposes.
- Every taxable member would have the right to apportion if any member is taxable outside Connecticut (*Finnigan* rule).
- CT unitary group NOL carryforwards from 2015 and forward would be shared with other taxable members of the CT unitary group, if such other members were members during the year the NOL was generated.
- Combined group NOL carryforwards from years prior to 2015 would be shared with other members of the CT unitary group that were included in the same pre-2015 combined group.
- NOLs from years prior to 2015 that were earned by a separate company would be available to that separate company on a Separate Return Limitation Year basis.
- The CT unitary group's capital base tax would be the aggregate capital bases of all taxable and non-taxable members. Intercorporate stockholdings would be eliminated.
- Financial services companies would be subject to the capital base tax at the \$250 minimum amount, would not be included in the CT unitary group's capital base calculation, and would not be included when calculating the capital base apportionment.
- The capital base apportionment denominator would be the aggregate denominator for all CT unitary group members.
- The aggregate capital base cap would be \$1M on the CT unitary group. If the CT unitary group's tax exceeds \$1M, then each member would pro-rate its separate capital base tax.
- The CT unitary group would compare its income tax liability on an aggregate basis to its capital base tax on an aggregate basis and pay the higher of the two.
- The tax credit ordering rules and tax credit limitation rules would apply separately to each taxable member.
- Tax credits earned on or after 2015 would be shared with other members of the CT unitary group, if such other members were members during the year the tax credit was earned.
- Tax credits carried forward from prior to 2015 would be shared with other entities that were included in the same pre-2015 combined return.
- The default CT unitary group would use a water's-edge basis. Optional elections would be available for filing on a federal affiliated group basis or a worldwide unitary basis. The affiliated election and worldwide unitary election would only be available if made on an originally filed return and would then be effective for the next 10 years.
- The water's-edge CT unitary group would (a) exclude U.S.-incorporated 80-20 companies, (b) include foreign incorporated companies with 20% or more of property and payroll in the U.S., and (c) include any companies incorporated in a tax haven at the discretion of the Commissioner, Department of Revenue Services ("Commissioner").
- Publicly traded companies in the CT unitary group would be entitled to the following deduction as stated in the pending statute:
 - For the seven-year period beginning with the unitary group's first income year that begins in 2018, a unitary group shall be entitled to a deduction from unitary group net income equal to one-seventh of the amount necessary to offset the increase in the net deferred tax liability or decrease in the net deferred tax asset, or the aggregate change thereof if the net income of the unitary group changes from a net deferred tax asset to a net deferred tax liability, as computed in accordance with generally accepted accounting principles, that would result from the

imposition of the unitary reporting requirements under . . . this act, but for the deduction provided under this section.²

- The former combined return rules would be inapplicable to years on and after 2015.
- The first 2015 estimate for a CT unitary group with an income year beginning in 2015 would be due at the time of the 2nd installment. For a CT unitary group with its income years beginning in January or February 2015, the 2nd installment would be due on July 15, 2015. For a CT unitary group with its income years beginning in March 2015, the 2nd installment would be due on August 15, 2015. The 2nd installment would be required to equal 70% of the required annual payment. A safe harbor would be created in 2015 if the CT unitary group's estimates equal 100% of the tax shown on the taxable member's aggregate separate returns or combined return filed in the previous year, without regard to tax credits under Conn. Gen. Stat. Title 12, Ch. 208 (Corporate Business Tax).
- Require the Commissioner to review the impact of alternative methods of apportionment and provide recommendations in a report delivered to the Finance, Revenue, and Bonding Committee of the General Assembly on or before February 1, 2016.

Changes to the Connecticut Personal Income Tax

HB 7061 would make the following changes to the personal income tax:

- Exempt U.S. military retirement income from the Connecticut income tax effective for income years beginning on and after January 1, 2015.
- Increase the top two marginal rates to 6.9% and 6.99% effective January 1, 2015. The 6.9% rate would apply to Connecticut taxable income over:
 - \$250,000, if filing Single or Married Filing Separately
 - \$400,000, if filing Head of Household
 - \$500,000, if filing Married Filing Jointly

The top 6.99% marginal rate would apply to Connecticut taxable income over:

- \$500,000, if filing Single or Married Filing Separately
 - \$800,000, if filing Head of Household
 - \$1,000,000, if filing Married Filing Jointly
- The new 6.99% rate would also apply to all trusts and estates.
- Delay by one year a scheduled \$500 increase in the personal exemption. The personal exemption for the income year beginning on January 1, 2016, would be \$14,500 and then would increase to \$15,000 for income years beginning on or after January 1, 2017.
 - Delay by one year a scheduled increase in the threshold for the credit for adjusted gross income. The various increases in the Connecticut gross income thresholds that were to occur for the income year beginning on January 1, 2015, would occur for the income year beginning on January 1, 2016.
 - Delay the increase of the earned income tax percentage to 30%. The percentage would remain at 27.5% for the 2015 and 2016 income years.
 - Decrease the amount of the 2016 credit for taxes paid on a primary residence or motor vehicle from \$300 to \$200 and reduce the income levels for the phase-out of the credit.

Changes to the Connecticut Sales and Use Tax

HB 7061 would make the following changes to the sales and use tax:

- Limit the sales tax holiday in the 3rd week of August to clothing and footwear under \$100 (previously \$300) effective July 1, 2015.
- Raise the luxury sales and use tax rate from 7% to 7.75% on (a) motor vehicles over \$50,000, (b) jewelry over \$5,000, and (c) clothing and footwear over \$1,000 effective July 1, 2015.
- Increase the sales and use tax rate on computer and data processing services from 1% to 2% effective October 1, 2015, and then to 3% effective July 1, 2016. Create an exemption from sales and use tax for sales of computer and data processing services between affiliates effective October 1, 2015.
- Extend the definition of computer and data processing to include services rendered in connection with the creation, development, hosting, and maintenance of an Internet web site effective July 1, 2015.

² H.B. 7061, §141(d), 2015 Gen. Assemb., Reg. Sess. (Conn. 2015).

- Expand the sales tax to parking services sold by certain government or tax exempt entities as well as some parking services sold by an employer to its employees effective July 1, 2015.
- Extend the sales and use tax to car wash services other than coin operated car washes effective July 1, 2015.
- Eliminate the use tax exemption, but not the sales tax exemption, for sales of Internet access services effective October 1, 2015.
 - If enacted, this would appear to raise constitutional issues and is presumed to be a drafting error.
- Clarify that the nursing home exemption does not include taxable sales of parking effective July 1, 2015.

Changes to the Connecticut Insurance Premium Tax

HB 7061 would make the following changes to the insurance premium tax:

- Extend the current limitation for tax credits through 2016. Tax credits are limited to 30%, 55%, or 70% of the amount of tax due depending on the type of tax credit.
- Rename the insurance reinvestment fund tax credit as the “Invest CT Fund” tax credit and expand the tax credit to apply to investments in cybersecurity businesses and businesses located in municipalities with a population greater than 80,000. The aggregate amount of tax credits available would be increased to \$350M. These changes would be effective July 15, 2015.

Changes to the Connecticut Hospital Gross Receipts Tax

HB 7061 would make the following changes to the hospital gross receipts tax:

- Limit the application of tax credits to 50.01% of the amount of tax due for quarters on or after July 1, 2015.
- Apply a gross receipts tax to ambulatory surgical centers effective October 1, 2015.

Changes to the Connecticut Estate and Gift Tax

HB 7061 would make the following changes to the estate and gift tax:

- Limit the amount of Connecticut estate tax for both residents and nonresidents to \$20M after allowing for a credit for Connecticut gift taxes paid by the decedent or the decedent’s spouse for deaths occurring on or after January 1, 2016.
- Limit the aggregate amount of gift tax to \$20M for all years after January 1, 2016.

Changes to the Connecticut Cigarette Tax

HB 7061 would make the following changes to the cigarette tax:

- Increase the cigarette tax to 182.5 mills per cigarette effective October 1, 2015.
- Increase the cigarette tax to 195 mills per cigarette effective July 1, 2016.
- Impose a cigarette excise floor tax at 12.5 mills per cigarette on distributors and dealers on September 30, 2015 at 11:59 and then again on June 30, 2016 at 11:59.

Changes to the Connecticut Admission Tax:

HB 7061 would exempt from tax admission charges to athletic events presented by a member of the Atlantic Professional Baseball League at Harbor Yard in Bridgeport from July 1, 2015 to June 30, 2017.

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If the income tax law changes discussed in this Tax Alert are enacted in June, 2015, any impact of these law changes would be treated as a second quarter event for financial statement purposes for calendar year taxpayers.

Considerations

If HB 7061 is enacted, Taxpayers subject to the Connecticut corporation business tax may need to consider these potentially significant changes to their Connecticut tax. CT unitary groups may need to adjust their second quarter estimates that could be due as soon as July 15, 2015, to take these changes into account. The increase in the highest marginal personal income tax rate would also apply for purposes of the Connecticut composite tax on pass-through entities. In addition, employers may be required to adjust the personal income tax withheld from high-income employees. Both sellers and purchasers of computer and data processing services may need to account for the expanded definition of the taxable services and the phased-in increase in the tax rate.

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