

# SALT WATCH

## Connecticut State Tax Updates

Connecticut enacts mandatory unitary combined reporting, imposes new limitations on net operating losses and tax credits, and makes sales and use and personal income tax changes.

### Summary

On June 30, 2015, Connecticut Governor Dan Malloy (D) signed into law House Bill 7061 and Senate Bill 1502, which together enact significant changes to the corporate income tax law, including the adoption of mandatory unitary combined reporting for tax years beginning after December 31, 2015, more restrictive limitations on the use of net operating loss carryforwards and tax credits for tax years beginning after December 31, 2014, the extension of the 20% corporate income tax surcharge through 2017, and the adoption of a 10% surcharge beginning in 2018. The enactment of these bills also causes several changes to: (i) the sales and use tax law (e.g., a change to the payment and return due date for monthly filers, and the expansion of taxable services to include creation, development, hosting, and maintenance of a website); and (ii) the personal income tax law (e.g., increases in tax rates, and delays to the increase in the personal exemption and the income thresholds used for purposes of reducing personal income tax credits).

### Details

#### Corporate Tax Changes

##### *Mandatory Unitary Combined Reporting*

Effective tax years beginning after December 31, 2015, a corporation with Connecticut nexus is required to report income on a unitary combined basis with its “combined group.” A “combined group” for these purposes, unless elected otherwise, is determined on a water’s-edge basis and is generally comprised of the following types of corporations that have “common ownership” and are engaged in a “unitary business”: (i) U.S. corporations with 80% or more of their property and payroll located in the U.S.; (ii) non-U.S. corporations with 20% or more of their property and payroll in the U.S. or that are incorporated in tax haven jurisdictions; and (iii) corporations that derive more than 20% of their income from payments for intangible property or service-related activities deductible from the income of other members of the combined group (but only to the extent of the related income and the apportionment factors).



## Connecticut State Tax Updates (cont.)

### Details (cont.)

#### ***Common Ownership and Unitary Reporting***

Two or more corporations are under “common ownership” where, when applying Section 318 of the Internal Revenue Code, more than 50% of the voting control of each corporation is directly or indirectly owned by the same owner or owners – whether corporate or non-corporate, and regardless of whether the owner or owners are members of the combined group. “Unitary business” for these purposes means a single economic enterprise, whether separate parts of a single business entity or a group of business entities, that is sufficiently independent, integrated or interrelated through activities so as to provide mutual benefit and produce a significant sharing or exchange of value among such entities, or a significant flow of value among the separate parts.

#### ***World-Wide and Affiliated Group Reporting Elections***

As an alternative to reporting on a water’s-edge basis, a combined group may make an election on a timely filed, original return to report on a world-wide basis (generally disregarding the entity restrictions imposed on a water’s-edge group) or as an “affiliated group.” Once made, the election is binding for the current and subsequent ten (10) taxable years. An “affiliated group” for Connecticut purposes is generally the same as a federal income tax affiliated group with certain modifications, including a requirement to include a corporation in the Connecticut affiliated group even if it is included in the federal consolidated return of a different group. A Connecticut affiliated group may even include a corporation formed in a tax haven jurisdiction.

#### ***Income Tax Liability***

The Connecticut corporate income tax applies only to a corporation that is subject to the corporate income tax (a “Taxable Member”). A taxable member’s tax liability is a product of the combined group’s net income, the taxable member’s Connecticut apportionment factor, and the applicable tax rate (currently 7.5%).

#### ***Combined Net Income***

A combined group’s net income is determined by adding the net income of every taxable and nontaxable member and deferring/eliminating intercompany transactions in a manner similar to the federal consolidated return rules. For this purpose, each member’s net income is its separate company federal taxable income, which is then subject to certain adjustments (in addition to the standard additions and subtractions). These adjustments include the elimination of intercompany dividends, removal of gain or loss from the sale or exchange of capital assets, property used in a trade or business (i.e., property described in Section 1231(a)(3) of the Internal Revenue Code), and property subject to an involuntary conversion. The net income (and apportionment) of a non-U.S. corporation that is not required to file a federal income tax return is determined on the basis of a profit and loss statement prepared in accordance with U.S. Generally Accepted Accounting Principles (“GAAP”). This amount is then adjusted to take into account any book-tax differences required by federal or Connecticut law.



## Connecticut State Tax Updates (cont.)

### Details (cont.)

#### ***Apportionment Formula***

A taxable member calculates its own apportionment percentage. The property, payroll, and sales factors of a taxable member are determined by dividing its Connecticut property, payroll, and sales by the combined group's everywhere property, payroll, and sales. The Connecticut sales of a taxable member includes its proportionate share of each nontaxable member's Connecticut sales factor as if the nontaxable member were subject to tax, which, in turn, is determined by the ratio of the taxable member's Connecticut sales to the Connecticut sales of the combined group. Transactions among combined group members are eliminated for purposes of determining the numerator and denominator of the apportionment factors.

#### ***Net Deferred Tax Liability Deduction***

Publicly traded companies participating in the filing of a publicly traded company's GAAP financial statements as of January 1, 2016, are eligible for a "net deferred tax liability" deduction if the new unitary combined reporting requirements result in an aggregate increase or decrease in the members' "net deferred tax liability" or "net deferred tax asset," respectively. The deduction may be claimed in equal amounts for a seven-year period beginning in the combined group's first income year that begins in 2018. Any unused amount may be carried forward until fully utilized. To claim the deduction, a combined group must file a statement with the Department of Revenue Services by July 1, 2017, that specifies the total amount of the deduction to be claimed.

#### ***NOLs and Credits***

Each taxable member of a combined group separately calculates its NOLs and credits, which it may carryforward to the extent allowed or share with another member of the combined group if the other member was a member of the combined group during the taxable year the NOL or credit was generated. A NOL or credit arising from a taxable year during which a corporation was not a member of the combined group may generally only be used by the corporation that generated it.

#### ***Capital Gains and Losses***

Capital gains and losses removed from the income of a member are aggregated, apportioned to each member, and added to each taxable member's income. A loss apportioned to a member that is limited by Section 1211 of the Internal Revenue Code must be carried forward and treated as a short-term capital loss apportioned and incurred by that member for the year for which the carryover applies.



## Connecticut State Tax Updates (cont.)

### Details (cont.)

#### ***Capital Base Tax***

Similar to the income tax, a combined group's capital base is the aggregate of the capital base of each taxable and nontaxable member. Intercorporate stockholdings are eliminated to avoid double counting. A taxable member's apportionment percentage is then applied to determine its apportioned capital base for purposes of computing its capital base tax. Also similar to the income tax, the numerator of a taxable member's capital base tax apportionment factor is comprised of its Connecticut property, and the denominator is comprised of the aggregated everywhere property of nontaxable and taxable members.

If the aggregate amount of tax calculated on each taxable member's capital base exceeds the \$1 million cap, each taxable member prorates its tax in proportion to the group's tax calculated without regard to the cap so that the group's aggregate additional tax equals \$1 million.

#### ***Designated Taxable Member***

The "designated taxable member" of the combined group makes all elections, files returns, and makes tax payments, including estimated tax payments, on behalf of the combined group. The "designated taxable member" is the common parent if it is a taxable member. If no such common parent exists, the "designated taxable member" is a taxable member selected by the combined group, notification of which must be made to the Department of Revenue Services by the due date (as extended) of the combined group's combined return for the initial taxable year that the return is required.

#### ***NOL and Tax Credit Limitations***

Effective for taxable years beginning after December 31, 2014, an NOL carryforward is subject to a new 50% of apportioned net income limitation, and the amount of tax credits that may be used may not exceed 50.01% of the amount of tax due. Under "old" law, the credit limitation was 70%.

A combined group with over \$6 billion in unutilized NOLs arising from taxable years beginning prior to January 1, 2013, may make a special election on its return for its taxable year beginning in 2015 regarding the utilization of NOLs.

#### ***Surcharge and Preference Tax***

The new law extends the 20% surcharge, which was previously set to expire for taxable years beginning before January 1, 2016, to taxable years beginning prior to January 1, 2018. For taxable years beginning after December 31, 2017, corporations will be subject to a 10% surcharge. A corporation with less than \$100 million in annual gross income during the taxable year will not be subject to the 10% surcharge, unless it files as part of a combined return.

Effective for taxable years beginning after December 31, 2015, the new law repeals the preference tax that is intended to recapture some or all of the tax benefit derived from the filing of a combined return under the elective combined return regime.



## Connecticut State Tax Updates (cont.)

### Details (cont.)

#### Sales and Use Tax Changes

Following are some of the more notable sales and use tax changes in the new law:

- Effective July 1, 2015, the tax rate on luxury goods, which applies to motor vehicles with a sales price exceeding \$50,000, jewelry with a sales price exceeding \$5,000, and clothing, footwear and certain accessories with a sales price exceeding \$1,000, increased from 7% to 7.75%.
- Effective July 1, 2015, car wash services, including coin-operated car washes, are subject to tax.
- Effective October 1, 2015, taxable computer and data processing services are defined to include services related to the creation, development, hosting and maintenance of a website, and are, therefore, taxable.
- Effective October 1, 2015, the deadline for remitting and filing monthly sales and use tax returns will change from the 20th day of the month to the last day of the month following the month covered by the return.

#### Personal Income Tax Changes

Following are some of the more notable personal income tax changes in the new law:

- Effective January 1, 2015, a 6.99% marginal tax bracket has been added for single filers with more than \$500,000 in Connecticut taxable income, head of household filers with more than \$800,000 in Connecticut taxable income, and joint filers with more than \$1 million in Connecticut taxable income.
  - Effective January 1, 2015, the 6.7% marginal rate increased to 6.9% and the flat income tax rate for trusts and estates increased from 6.7% to 6.99%.
  - The scheduled \$500 increase for the personal exemption from \$14,500 to \$15,000 has been delayed until January 1, 2017.
  - The scheduled increase for the income thresholds used for purposes of reducing personal income tax credits has been delayed until January 1, 2016.
  - The increase to the earned income tax credit percentage from 27.5% to 30% has been delayed until January 1, 2017.
  - Effective January 1, 2015, federally taxable military pay is fully exempt from Connecticut income tax.
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## Connecticut State Tax Updates (cont.)

### Insights

- Connecticut's change to mandatory combined reporting will likely present a significant departure from current law for many taxpayers since, Connecticut has historically required separate reporting, unless a taxpayer elected to file on a federal consolidated or unitary combined basis. Regardless, taxpayers should consider modeling the tax impact of filing combined returns on a water's-edge, worldwide or an affiliated group basis to ascertain which reporting method may be most advantageous. But do note that an election to file on a worldwide or affiliated group basis is binding for the current and subsequent 10 tax years.
- Connecticut has provided taxpayers that are publicly traded companies with a unique net deferred tax liability deduction to mitigate the financial statement impact of the law changes. However, the benefit of the deduction applies only to a combined group that has a taxable member in 2018.
- Since the new law was enacted on June 30, 2015, taxpayers should assess what, if any, impact these law changes would have on their existing deferred tax balances and adjust accordingly as of the enactment date.
- Due to the sales and use tax changes, taxpayers that have not historically charged sales tax on car wash services or services related to creation, development, hosting, and maintenance of a website should implement procedures to ensure the collection and remittance of sales and use tax on such services.
- The increases to the personal income tax rates, which were made retroactively effective to January 1, 2015, may impact employers and individuals who have likely been withholding taxes and making estimated tax payments based on "old" tax rates. These taxpayers will likely be required to make adjustments to their withholdings and estimated taxes to compensate for the differences resulting from the rate increases. Connecticut has exempted individuals from interest assessments due to an underpayment in estimated taxes created by the rate changes.

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