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May 16, 2018 - Tax Group News: Legislative Changes to the Connecticut Income Tax

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On May 9, 2018, the Connecticut legislature unanimously passed the “Act Concerning Connecticut’s Response to Federal Tax Reform” (the “Act”). The Act includes a series of Connecticut income changes that either diminish the impact that the recently passed federal Tax Cuts and Jobs Act of 2017 (the “TCJA”) may have on Connecticut taxpayers or reduce the tax benefits Connecticut taxpayers would otherwise receive under the TCJA. The Act is expected to be sent to Governor Dannel Malloy by mid-June and he is expected to sign the Act into law.

Highlights of some of the significant Connecticut income tax changes imposed by the Act include:

Pass-Through Entity Tax: The Act imposes a new 6.99% income tax on most pass-through businesses (e.g., partnerships, S-corporations and LLCs treated as partnerships) at the entity level. Individual and corporate owners of an affected business will be entitled to a credit against their income tax equal to 93.01% of the owner’s pro rata share of the entity tax paid by the pass-through business. The owner of a pass-through entity will also be entitled to a credit for any entity-level tax imposed by other states that the Department of Revenue Services determines is substantially similar to the Connecticut pass-through entity tax. Pass-through businesses subject to the tax are required to make quarterly estimated tax payments.

The purpose of the pass-through entity tax is to mitigate the \$10,000 cap on state and local income, sales and property tax (“SALT”) deductions under the TCJA. By imposing the tax on the entity rather than the individual, the tax becomes a fully deductible business expense for federal income tax purposes. The almost dollar-for-dollar credit at the owner-level circumvents the SALT cap with little to no effect on Connecticut tax revenues (Testimony supporting the Act stated that if all of the income subject to the pass-through entity tax was taxed at the maximum federal rate of 37%, the pass-through entity tax would shield an estimated \$600 million from federal taxation and would thereby return an estimated \$220 million to Connecticut taxpayers).

Property Tax Credit: The Act permits municipalities to provide a property tax credit to eligible taxpayers who make voluntary, unrestricted and irrevocable contributions to a community supporting organization approved by the municipality. A “community supporting organization” is essentially a charitable organization that supports town programs and services, such as public education. The credit amount is determined by the municipality and only applies to residential property.

Like the pass-through entity tax, the purpose of the property tax credit is to mitigate the SALT cap. This provision causes the payment to be treated as a “charitable contribution” for federal income tax purposes which is not subject to the SALT cap.

Bonus Depreciation: The TCJA permits a first-year bonus depreciation deduction of 100% of qualified new and used property placed in service after September 17, 2017 and before January 1, 2023. Rather than adopting this change, the Act requires individuals receiving income from pass-through businesses to add back the federal bonus depreciation deduction when calculating their Connecticut adjusted gross income for the state personal income tax. The individuals are permitted to deduct 25% of the add-back in each of the four succeeding years.

Asset Expensing Deduction: Federal law permits businesses to elect to treat the cost of qualifying property



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as a deductible expense (“Section 179 deduction”) rather than a capital expenditure, subject to maximum deduction and investment limitations. The Act does not adopt this change. The Act requires individuals and corporations to apportion the Section 179 deduction over a five-year period. Eighty percent (80%) of the deduction must be added back in the first year and then deducted over the next four years (e.g., 20% per year for five years) for Connecticut income tax purposes.

Interest Expense: Under the TCJA, the deduction for business interest expense is limited to the sum of the taxpayer’s business interest income plus 30% of a taxpayer’s adjusted taxable income. The Act states that this limitation does not apply for Connecticut income tax purposes.

Dividends Received Deduction: Under current Connecticut law, dividends a corporation receives from another corporation in which it has an ownership interest are not taxable. A corresponding provision prohibits expenses relating to these dividends from being deductible. However, before the Act, there was no guidance as to how to determine when an expense is related to dividends. The Act provides that expenses related to dividends generally equal 5% of all dividends received by a company during an income year.

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