

Navigating the New Pass-Through Entity Tax

Connecticut Business and Industry Association

July 24, 2018

Tony Switajewski

Tax Partner
BlumShapiro

Alan Lieberman

Shipman & Goodwin LLP

David Bigger

Shipman & Goodwin LLP

BlumShapiro

Accounting | Tax | Business Consulting

 **SHIPMAN &
GOODWIN** [®] _{LLP}
COUNSELORS AT LAW

Disclaimer

- This presentation is intended to provide general information and no tax advice is intended to be given.
- Any written tax content, comments, or advice contained in this presentation is limited to the matters specifically set forth herein. Such content, comments, or advice may be based on tax statutes, regulations, and administrative and judicial interpretations thereof and we have no obligation to update any content, comments or advice for retroactive or prospective changes to such authorities. This communication is not intended to address the potential application of penalties and interest, for which the taxpayer is responsible, that may be imposed for non-compliance with tax law.
- **NOTE: As the interpretation of the law that is presented here is developing, please refer to the law for your own interpretation as well as the Connecticut Department of Revenue Services guidance that has been issued.**

Agenda

- Tax Cuts and Jobs Act Limitation on State Tax Deduction
- Connecticut's Response – PET
- PET Taxable Income Base and Methods
- Standard Method
- Alternative Base Method
- Investment Income and Investment Partnerships
- Tiered Pass-Through Entities
- Combined Returns
- Net Losses

Agenda (Continued)

- PE's Owner Credit for PET
- Allocation of PET Deduction and PET
- PET Estimated Tax Payments
- PE Owner "Recharacterization" of Estimated Tax Payments
- Resident Credit for Entity Level Taxes Paid in Other States
- Non-Resident Credit for PET in Resident State—Applicability
- PE Tax Enforcement
- Financial Statement Impact
- Connecticut Tax Guidance

Tax Cuts and Jobs Act of 2017

**Bloomberg
Tax**

Tax Reform Roadmap

| Individual | | | | |
|--------------------------------------|--|--|------------------------|-------------------------|
| Topic | Prior Law | 2017 Tax Act, as Amended | Act Sections | I.R.C. Sections |
| State and Local Tax Deduction | Individuals may claim itemized deductions for state and local government income and property taxes paid. In lieu of the itemized deduction for state and local income taxes, individuals may claim an itemized deduction for state and local government sales taxes. | <p>The Act provides that individual taxpayers may elect to deduct state and local sales, income, or property taxes up to \$10,000 (\$5,000 for a married taxpayer filing a separate return) for tax years beginning after Dec. 31, 2017, and beginning before Jan. 1, 2026.</p> <p>For amounts paid in a tax year beginning before Jan. 1, 2018, with respect to state or local income taxes, beginning after Dec. 31, 2017, the payment is treated as if paid on the last day of the tax year for which such tax is imposed for purposes of applying the limitation of the deduction.</p> <p>The Act also provides that individuals may deduct state, local, and foreign property taxes and state and local sales taxes when paid or accrued in carrying on a trade or business and generally disallows a deduction for individual state and local income, war profits, and excess profits taxes.</p> | §11042 | §164(b) |

BlumShapiro

Accounting | Tax | Business Consulting

**SHIPMAN &
GOODWIN** ^{LLP}
C O U N S E L O R S A T L A W

Tax Cuts and Jobs Act of 2017

- Lawsuit filed by Connecticut, Maryland, New Jersey and New York
 - Challenge to limitation on the state and local tax deduction
 - Unconstitutional exercise of federal authority to impose tax
 - Interferes with state fiscal decisions
 - Increases federal tax liability of their residents

Pass-Through Entity Tax

- SALT Deduction Example (PRE-TCJA):
 - Assume a Connecticut resident with \$500,000 of adjusted gross income
 - Assume that the individual pays annual property taxes of \$20,000 and annual Connecticut personal income tax of \$35,000
 - A very simplistic computation of that individual's federal taxable income:

| |
|---------------------------------|
| \$500,000 |
| <20,000 > property tax |
| <35,000 > CT income tax |
| <u>\$445,000</u> taxable income |
 - The \$55,000 SALT deduction had a significant downward impact on individual federal tax liability

Pass-Through Entity Tax

- SALT Deduction Example (PRE-TCJA):
 - Assume facts described on previous slide
 - Under the TCJA, the individual's federal taxable income will rise dramatically because of the SALT cap:

\$500,000
<10,000 > SALT deduction
\$490,000 taxable income

- As a result of SALT deduction limitation, taxable income is increased by \$45,000
- At a top bracket of 37%, that could result in potential additional federal tax liability of \$16,650

Pass-Through Entity Tax

- Conference Report, Footnote 172

“...Additionally, taxes imposed at the entity level, such as a business tax imposed on pass-through entities, that are reflected in a partner’s or S corporation shareholder’s distributive or pro-rata share of income or loss on a Schedule K-1 (or similar form), will continue to reduce such partner’s or shareholder’s distributive or pro-rata share of income as under present law.”

Connecticut's Response

- CT Pass-Through Entity Tax (PET)
 - Public Act 18-49: Signed by the Governor on May 31, 2018
 - 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. **PLANNING POINT.**
 - Due Date: On or before the 15th day of the third month following the close of each taxable year (i.e., March 15)
 - Entity-level Income Tax: 6.99% flat tax rate
 - PE Owner Tax Credit: PET 93.01% credit offset for personal income and corporation business tax

Connecticut's Response

CT Composite Tax (OLD)

-Individual level tax
-Deductible on Fed
Form 1040 Sch. A
(Subject to \$10,000
limit)



CT PET (New)

-Entity level tax
-Deductible on Fed
Form 1040 Sch. E
(Not subject to
\$10,000 limit)

Pass-Through Entity Tax (“PET”)

- PET is mandatory it is not elective (can’t opt-out of it). Every PE doing business in CT will be subject to the PET (with some exceptions – Elective ATB Method with nonindividual owners). There is no *de minimis* income level.
- Annual payment by the PE “on behalf of nonresident individuals” is no longer applicable. The tax must be paid as an entity level income tax. This will accelerate cash flow into the state.
- There is no composite return election for nonresident individuals. There is no composite return option. Nonresidents cannot opt out of this taxing regime. Nonresidents may now have to file CT tax returns.
- Quarterly Estimated Tax Payments are now **REQUIRED** starting in 2018.

Pass-Through Entity Tax

- The tax is INTENDED to be revenue neutral for the state. PE tax is imposed but the owner gets a credit for the PE tax.
- The tax is INTENDED to provide a favorable *federal income tax benefit* to *individual owners* of passthrough entities. When we use the term “individuals” in this presentation, we mean anyone subject to the personal income taxation regime – such as Trusts and Estates.
- The tax is INTENDED to be a wash for RESIDENT individual owners of PEs.
- The tax MAY BE UNFAVORABLE to NONRESIDENT individual owners of PEs (they may be subject to double state taxation), albeit they will get the federal income tax benefit of deducting CT income taxes on their federal income tax return.

PET Taxable Income Bases

- Taxable Income is Determined Under One of Two Methods:
 1. Connecticut Source Income Method (Default Method)
 2. Alternative Tax Base Method (Elective Method)

PET Taxable Income

1. Connecticut Source Income Method (“Standard Method”)

- DRS calls this the “Standard Method”
- Taxable Income is Based on Connecticut Sourced Income as Determined Under the Personal Income Tax Rules (Not the C Corporation Apportionment Rules)
- **All Connecticut Sourced Income will be taxable regardless of the identity or type of owners.** Owners may be individuals (resident and nonresident), trusts, estates, C corporations, ESOPs, §501(c)(3) organizations, insurance companies, etc.
- Generally, you DO NOT want to use this method if you have nonindividual owners. You want to elect the Alternative Tax Base Method.

Alternative Tax Base

2. Alternative Tax Base Method (“ATB Method”)

- Requires an Annual Affirmative Election – Check a Box on the Tax Return to Elect
- Will be applicable in the vast majority of situations
- When Electing this Method – Taxable income that is attributable to *non-individual PE owners* will not be subject to the entity level PE Tax. Only taxable income subject to Chpt. 229 is taxable.
- Generally, must know who the PE owners are in order to properly compute the taxable income.
- Taxable Income attributable to PE owners which are C Corporations, ESOPs, §501(c)(3) Organizations, Insurance Companies, etc. is not subject to the entity level income tax if the ATB Method is elected

Standard Method

- **Taxable Income:**
 - Partnerships: The separately stated and non-separately stated federal items in §702(a), to the extent considered Connecticut Sourced Income (under the PIT sourcing rules).
 - S Corporations: The separately stated and non-separately stated federal items in §1366, to the extent considered Connecticut Sourced Income (under the PIT sourcing rules).
 - Connecticut Modifications must be taken into account.
- In other words, the federal taxable income of the PE sourced to CT, including CT modifications.

Standard Method - Example

- Example: Assume 3 Equal Partners - Non-Resident Individual (NI); Resident Individual (RI); C Corporation.
 - It does not matter who the owners are to calculate the taxable income under the standard method.
- Connecticut Source Income is \$150,000 (but total income is \$200,000)
 - The PE Tax is \$10,485 ($\$150,000 \times 6.99\%$)
 - Taxable Income of Passthrough is \$189,515 (per K-1 = \$63,172)

Federal K-1s:

- Non-Resident Individual: \$63,172 / \$3,495 PE Tax (w/ 93.01% Credit)
- Resident Individual: \$63,172 / \$3,495 PE Tax (w/ 93.01% Credit)
- Corporation: \$63,172 / \$3,495 PE Tax (w/ 93.01% Credit)

Note: For purposes of the credit on the owner's tax return, the PE Tax is allocated based on the PE owners *pro rata share* to each owner.

Alternative Base - Needs to Be Elected

- Alternative Tax Base:
 - I. Modified Connecticut Source Income (MCSI)
 - +
 - II. Resident Portion of Unsourced Income (RPUI)
 - (Unsourced Income x Resident Ownership %)

I. Modified Connecticut Source Income

- MCSI means the Connecticut source income x the individual ownership % or PE% owners to the extent owned by individuals. The presumption is that an owner is an individual unless you know otherwise.
- For example, *if the PE's CT source income (as would be computed under PIT) is determined to be \$100,000 and it is owned 25% by a NI, 25% by a RI, 25% by a Corporation, and 25% by an ESOP - then, the MCSI is \$50,000 [\$100,000 x 50% (owned by Individuals)]*

II. Unsourced Income – To Get RPUI

- USI means the total separately and non-separately stated items of §702 (partnerships) and §1366 (S Corporations) *plus/minus* CT modifications *minus* CT Sourced Income *minus* Other State Source Income.
- **NOTE**: The Other State Source Income subtraction is based on a “**jurisdiction to tax**” and not a “subject to tax” standard and is based on Connecticut’s Nexus (including economic nexus threshold) and Sourcing Rules (e.g., single sales factor, market-state).

Resident Portion of Unsourced Income

Formula:

$$\begin{aligned} & \text{Total } \S 702/\S 1366 \text{ federal taxable income} \\ +/ - & \text{ CT Modifications} \\ - & \text{ CT Sourced Income (w/o adjustment for tiered business entities)} \\ - & \underline{\text{Other State Source Income}} \text{ (w/ CT Modifications)} \\ & \text{Unsourced Income} \\ \times & \underline{\text{Resident Owners Percentage}} \\ = & \underline{\text{Resident Unsourced Income}} \end{aligned}$$

Resident Portion of Unsourced Income

- The PE's total income is \$900,000, its CT modifications are \$100,000 and it is determined that the income sourced to other states (using CT's PIT nexus and sourcing rules) is determined to be \$400,000 (based on a jurisdiction to tax nexus standard). The PE files a tax return in CT and MA, but NYS has jurisdiction to tax under CT's nexus rules.

| | | |
|---------------------------|--------------------|--|
| Total §702/§1366 | \$900,000 | |
| CT Modifications | \$100,000 | |
| CT Sourced Income | (\$100,000) | — See Prior Slide |
| Other State Source Income | <u>(\$400,000)</u> | — (e.g., NYS and MA , using CT sourcing rules) |
| Unsourced Income | \$500,000 | |
| Resident Ownership % | <u>25%</u> | |
| RPUI | <u>\$125,000</u> | |

Alternative Tax Base

- Alternative Tax Base:

| | | |
|--------------------------------------|---|------------------|
| Modified Connecticut Source Income | = | \$ 50,000 |
| Resident Portion of Unsourced Income | = | <u>\$125,000</u> |
| Alternative Tax Base | | \$175,000 |
| PE Tax Rate | | <u>6.99%</u> |
| ■ PE Tax | | <u>\$ 12,233</u> |

This PE Tax then gets allocated to the owners for credit purposes.

Alternative Tax Base

Example: An S corporation is owned 75% by an ESOP and 25% by individuals.

- If the Alternative Tax Base Election is not made the PE will be subject to tax under the Standard Method on its CT sourced income at 6.99%.
 - Query: Can the PE tax paid be allocated all to the individual and none to the ESOP or does the ESOP have to file a tax return and obtain a refund?
- If the *Alternative Tax Base Election* is made, only 25% of the PE's taxable income will be subject to tax based on the formula.

Alternative Tax Base

Example: A partnership is owned by a C corporation, §501(c)(3) organization, and an insurance company. The PE owners are all entities that are not subject to the personal income tax.

- If the Alternative Tax Base election is made, since there are no owners subject to the individual income tax provisions (Chpt. 229) there is no taxable income base and thus no PE Tax.

Effect of Separately Stated Items

- For purposes of the netting to determine taxable income under §702 and §1366, there are no provisions to disallow charitable contributions or limit capital losses to capital gains (or to \$3,000).
Warning – However, since Connecticut is an AGI taxable base state, must consider this for the PE owner's estimated tax payments.
- Guaranteed Payments although deducted in arriving at ordinary income for partnerships are not considered part of the taxable PET income base although they are reported on Schedule K.
 - Therefore, *resident and nonresident partners* who receive guaranteed payments will need to consider these for Connecticut estimated tax purposes.

Investment Partnerships – Hedge Funds

- Standard Method: There should not be any PE Tax as there should generally not be any CT sourced income whether the PE is owned by RIs, NIs, Corporations or any other type of entity. An investment partnership is generally deemed under Conn. Gen. Stat. §12-711(f) not to be carrying on a trade or business in Connecticut and has no CT sourced income [i.e., “trading for own account” of the investors – but see *Sobel* (Superior Court, (3/7/2017), appeal pending, where it was held that a investment type partnership was engaged in a trade or business)].
- ATB Method: If the PE has resident individuals, the PE tax should generally only apply to the resident portion (%) of the investment income (i.e., resident portion of unsourced income – however see *Sobel* if have nonresident individuals – is there any CT sourced income?). Query: Is the PE tax a §162 business deduction or a §212 investment expense (itemized deduction). Section 162 requires that a deductible expenditure be incurred in carrying on business (§162(a); T.C. Memo 1976-359).

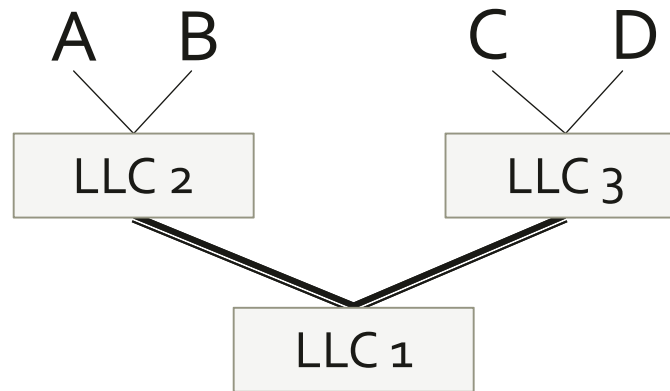
Investment Income

- What is the Connecticut Source Income treatment of an Operating PE that has significant investment income? Is it Connecticut Sourced Income for purposes of the PE taxable income bases?
- Example:
 - CT PE, operating a business, has significant investments that are not be utilized as “working capital” in the business.

Tiered Pass-Through Entities

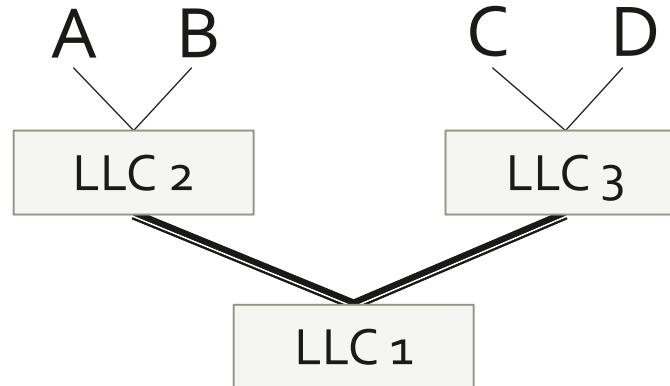
- Tiered Pass-Through Entities - Concepts:
 - **Generally**, the Subsidiary PE pays the tax on its separately determined taxable income and the Parent PE subtracts out the taxable income that was taxed at the Subsidiary PE Level. The Parent PE pays the tax based on its own separately determined taxable income.
 - Modified Connecticut Source Income - Under the ATB Method: if you don't know who the ultimate owners are of the ultimate Parent PE, all (100%) of the PE's *Modified Connecticut Sourced Income* is subject to taxation (i.e., you assume everyone is an individual owner of the Parent PE). If you do know who the ultimate owners are of the ultimate Parent PE, you can consider indirect ownership when determining the individual ownership percentage to be applied against Connecticut Sourced Income. For example, if you know who all the ultimate owners of the Parent PE are and that one of the ultimate PE owners is a Corporation (i.e., not subject to the personal income tax), the Subsidiary PE would not have MCSI associated with that corporate owner.
 - Resident Portion of the Connecticut Source Income - Under the ATB Method: If the PE is owned by another PE, the PE does not have any *Resident Unsourced Income* (\$0), because it is not owned **directly** by a resident individual. You cannot look at indirect ownership like you can (assuming you know who the ultimate Parent PE owners are) when determining Modified Connecticut Sourced Income.

Treatment of Multi-Tier Entities



- LLC 1 computes the PET and allocates it to LLC 2 and LLC 3. Each of LLC 2 and LLC 3 will subtract its distributive share of income from LLC 1 (or add its distributive share of loss) in computing its Connecticut source income

Treatment of Multi-Tier Entities



- What happens in the event of the following?
 - A is a Connecticut resident individual
 - B is a non-resident individual
 - C is a corporation
 - D is a tax-exempt entity

PET Combined Returns

- Entities can elect annually to file a Nexus Combined Return with one or more “*commonly-owned*” entities that are subject to the PET.
 - Provision is important to the real estate industry whereby a PE management company PE that is commonly owned with real estate PEs can elect to file a combined return so that net losses from the real estate PEs could offset the taxable income of the PE management company.
- This election is made by filing a written notice (separate form) with the DRS
 - Election is made by due date or extended due date
 - Combined Taxable Income determined under the standard method unless elect ATB method
- 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/ §318 attribution)
 - Entities that elect to file a combined return must net their taxable income or alternative tax bases, and each entity is jointly and separately liable for the PET due. Combined Taxable Income is based on separate company sourcing.

Combined Return

- **Example:**
 - PE1 and PE2 are 100% owned by a Nonresident Individual.
 - PE1 generates CT sourced taxable income of \$100,000
 - PE2 incurs CT sourced taxable loss of **(\$75,000)**
 - IF PE1 and PE2 elect to file a combined return, then the PE Tax is based on \$25,000. The combined group pays PE tax of \$1,748 and reports this to NI. Otherwise, PE1 would be subject to the PE tax on \$100,000 of taxable income and \$6,990 of PET; even though NI reports CT sourced income of \$25,000 (and pays tax of \$1,748). Overpayment will be refunded to NI.

Net Losses

- Standard Method: If a net loss results from the use of the Standard Method it may be carried forward indefinitely until fully utilized.
- ATB Method: There is seemingly no net operating loss carryforward provisions with respect to the Resident Portion of Unsourced Income component under the ATB Method.

PET 93.01% Credit

- Personal Income (229) PET Credit:
 - For individuals owners of PEs subject to the PET, the law allows the person to claim a *refundable credit* equal to the direct and indirect pro rata share of the PET (reported on the K-1) multiplied by 93.01%
 - The amount by which a person's PET credit exceeds the personal income tax liability is treated as a tax overpayment and refunded (it is not a carryforward credit)
- Corporate Income (208) PET Credit:
 - Each corporation business member that is a member of a PE may claim a credit equal to its direct and indirect pro rata share of the PET multiplied by 93.01%.
 - 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)

“Pro Rata” Share of PET x 93.01% = PET Credit

- What about Special Allocations of deduction and credit?
- Can you allocate the PET credit other than pro rata?

Why 93.01%

Is 93.01% Correct?

Example:

- PE has taxable income of \$100,000.
- PET is \$6,990.
- PE CT K-1 Taxable income passthrough is thus \$93,010.
- CT Tax on \$93,010 (at 6.99%) is **\$6,501**.

Credit is equal to 93.01% of the PET (reported on the CT K-1)

$$93.01\% \times \$6,990 = \text{\textbf{(\$6,501)}}$$

- CT DRS indicated in OCG-6 that there is no state income tax addback at the PE owner level. That is, CT AGI does not have to be increased to \$100,000, even though CT income taxes have been deducted at the PE level.

Allocation of CT PE Tax Deduction

- How does the PE state tax deduction get allocated to the PE Owners?
 - Generally, in accordance with how federal ordinary income is allocated.
- Example:
 - S Corporation is owned 25% by a RI and 75% by an ESOP. Total Net Income before PE taxes is \$10,000,000 and the PE Tax determined under the elective ATB Method is \$174,750. Schedule K ordinary income is determined to be \$9,825,250 which gets allocated 25% (RI - \$2,456,313) and 75% (ESOP - \$7,368,937). (Planning opportunity: allocation of expense among owners.)
 - CT PE Tax Deduction Allocation: Therefore, of the \$174,750 PE tax paid, RI gets an allocation of \$43,688 (25%) to reduce RI's federal (and CT) taxable income, the remaining PE tax paid, \$131,062 (75%), provides no federal income tax benefit to any person. (Planning opportunity: allocation of expense among owners.)

Allocation of Tax Credit

- How does the PE tax credit get allocated to the PE owners?
- If pro rata method:
 - RI: $\$2,456,313 \times 6.99\% = \$171,696 - \$40,634$ ($\$174,750 \times 25\% \times 93.01\%$) = $\$131,062$ Due
 - ESOP: $\$7,368,938 \times 0\% = \$0 - \$121,901$ ($\$174,750 \times 75\% \times 93.01\%$) = $(\$121,901)$ Refund
- If specifically allocated all to RI:
 - RI: $\$2,456,313 \times 6.99\% = \$171,696 - \$162,535$ ($\$174,750 \times 100\% \times 93.01\%$) = $\$9,161$ Due

PE 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. The “required annual payment” is the lesser of:
 1. 90% of the PET reported or due for the current taxable year, or
 1. 22.5%; 2. 45%; 3. 67.5%; 4. 90%
 2. 100% of the PET reported on the PET return for the preceding taxable year (N/A for 2018)
 3. There is no prior-facts/taxable income this year’s tax law safe harbor
 4. Short-Years: Look to PIT Regulations

PE Estimated Tax Payments

- Alternatively, entities may make payments using the “annualized income installment” method:
 - Annualization looks to the taxable income for the months in the taxable year ending before the due date of the installment. That tax is calculated and the following percentages are applied for each quarter.
 1. 22.5%; 2. 45%; 3. 67.5%; 4. 90%.

PE Estimated Tax Payments

- DRS Special Notice 2018(4): 2018 Estimated Payments
 - Make “catch-up” payment with June 15, 2018 estimated payment
 - Make three estimated payments (6/15/18, 9/15/18, 1/15/19) equal to 22.5% of tax liability and remainder by due date
 - Annualize estimated payments for taxable year
 - Query: Will the DRS allow annualization using only the 2nd quarter’s income – April 1 – May 31, 2018?
 - Penalty Relief Request: Due on or before December 31, 2018 (OCG-6)

PE Estimated Tax Payments

- Payment Form: For calendar year PEs (i.e., with a tax year beginning January 1, 2018), the first 2018 estimated tax payment is scheduled to be due on June 15, 2018
 - Catch-Up Payment 45% or 22.5% (three equal payments)
 - The Payment Form was posted on the CT DRS website (not ProFx)
 - Pay by Check
 - The payment is not allocated to the PE owners at this time (i.e., the PE does not have to identify with the payment form to whom the PE tax will be allocated).

Pass-Through Entity Tax

[Reset Fields](#)

[Print Coupon](#)

Department of Revenue Services
PO Box 2965
Hartford CT 06104-2965
10651120SI ES 0618W 01 9999



CT-1065/CT-1120SI ES
2018 Estimated Connecticut
Pass-Through Entity Tax
Payment Coupon

2018
(Rev. 06/18)

| | | |
|-----------------------------|--|-----------------------------------|
| For Taxable Year Ending | Connecticut Tax Registration Number (if any) | Federal Employer ID Number (FEIN) |
| <input type="text"/> | <input type="text"/> | <input type="text"/> |
| Pass-through entity name | | |
| <input type="text"/> | | |
| Address (number and street) | PO Box | |
| <input type="text"/> | <input type="text"/> | |
| City, town, or post office | State | ZIP code |
| <input type="text"/> | <input type="text"/> | <input type="text"/> |
| | | Payment amount due |
| | | <input type="text"/> .00 |

CT-1065/CT-1120SI ES - Tax Payment Coupon Instructions

- Complete payment coupon in blue or black ink only.
- Print all information. Include your FEIN.
- Cut along dotted line and mail coupon and payment to the address below.
- Make your check payable to **Commissioner of Revenue Services**.
- DRS may submit your check to your bank electronically.
- To ensure proper posting, write your FEIN and "2018 CT-1065/CT-1120SI ES" on your check.

Send completed coupon and payment to:

Department of Revenue Services
PO Box 2965
Hartford CT 06104-2965

BlumShapiro

Accounting | Tax | Business Consulting

SHIPMAN & GOODWIN ^{LLP}
C O U N S E L O R S A T L A W

Owner Estimated Tax Payments

- If the PE credit does not cover the full CT tax liability of the owner, the owner is required to make estimated tax payments.
 - This will be the case if the owner is a Resident individual with other income (e.g., W-2, investment income, spouse income) or a Nonresident Individual with other CT sourced income (e.g., CT Rental Property).

Estimated Tax Payments - Recharacterization

- PE **MUST** make estimated tax payments. If elect to recharacterize, PE is deemed to have made estimated tax payments.
- Estimated Tax Payments made have been paid by PE owners already or set up to be made. Therefore, double payments could occur.
 - DRS will allow PE owners (e.g. individuals) to ELECT to “**Recharacterize**” all or a portion of their April, 15; June 15; and September 15 (not January 15) income tax estimated tax payments so that their payments are *transferred* to the PE and applied against the PE 2018 estimated tax payment requirements for these quarters. Recharacterization must be done by December 31, 2018. The recharacterized amounts will be deemed to have been made by the PE as of the date that the owner remitted the payment to the DRS.
 - Continue with Double Payments with PE owner obtaining refund when PE owner files tax return.
 - May want to cancel automatic estimated tax payments.
 - PE Distributions to PE Owners: Continue Distributions and Recharacterize OR Stop Distributions and pay the PE Tax.

Estimated Tax Payments - Recharacterization

- A Recharacterization Form will be filed with the DRS and must be signed by the PE and Owner(s) who want such recharacterization. This form will be available by September 30th. The form will be utilized by the DRS to transfer payments made by owners to the PE.
- Presumably, the deemed transfer will be treated as a contribution to the capital of the PE and presumably will need to be accounted for tax purposes (i.e., does it provide tax basis in the PE interest?).
- If the PE and the Owner both make estimated tax payments, with respect to the PE passthrough taxable income, (i.e. double pay the tax) the Owner should get a refund of the overpaid tax.

Estimated Tax Payments - Recharacterization

- Generally, the recharacterization will be made mostly by residents as nonresidents were not required to make estimated tax payments (unless the nonresidents had other CT sourced income).

Resident Credit for Taxes Paid

- Resident individuals will now be able to obtain a tax credit for certain entity level PE income taxes imposed by other states. Prior to this, resident individuals only received a credit for taxes paid to other states if the individual was directly taxed.
- The tax that is imposed by the other state must be “*substantially similar*” to CT’s PE tax, as determined by the Commissioner. What does this mean?
 - MA and CA S Corporation Income Tax?
 - NYC and DC UBT? (Only states?)
 - NYS C Corporation Income Tax (if S Election not made)?
 - TX Margin Tax?
 - OH CAT?

Nonresidents Individuals

- Generally, a nonresident individual does not have to file a Connecticut income tax return if the NI's only CT sourced income is from the PE and the tax was paid by the PE
 - The NI can file a CT return to potentially get a refund if not at the 6.99% rate
 - However, a NI must file a return if the PE files a combined return and the NI's personal income tax liability would not be entirely satisfied by the offsetting PE credit.

Nonresident Individuals

- **WARNING:** A nonresident may or may not get a credit for the Connecticut PE level income taxes paid, because most states only allow a credit for taxes paid that are directly imposed on the individual
 - This results in double state taxation – NOT GOOD
 - Queries:
 - Can NIs elect out of the PE Tax? NO (the PE tax must be paid by the PE)
 - Can NIs elect to file a Composite Tax Return? NO (there is no such thing)
 - Can NIs pay estimated tax payments on the PE income? YES (double paid)
 - Will their Resident State give them a credit for those taxes paid? Don't Know

PE Tax Enforcement

- Tax Due From PE (have individuals paid it?)
- Late Tax: 1% per month interest rate
- Underpayment of Estimated Taxes – 1% per month
- Penalties (Late Filing and Late Payment)
- Liens Against CT Real Estate
- Warrant to Take Control of the Business
- Civil Proceeding to Collect

Financial Statement Impact

- The law was signed into law by the Governor during the 2nd Quarter of 2018 (e.g., Signed Public Act 18-49).
- S corporations and Partnerships will now be required to accrue (if on the accrual basis) a tax provision for Connecticut income taxes (Current and Deferred Taxes will be required with respect to the PE tax).
- PE Tax Payments will be booked to a current tax payable account and no longer treated as distributions (as was the case under the prior tax regime).
- If a recharacterization election is made, then, presumably treat as contribution to capital and as a tax payment to CT.
- Footnote disclosure on financial statements.

IRS's Reply

- Notice 2018-54:
 - Was IRS Notice 2018-54 a warning that affects the deductibility of the CT PE Tax? Or is the IRS solely focusing in on property tax provisions that “allow property taxes” to be deducted as charitable contributions?
 - Does it look like PE is just paying the tax on behalf of the owners, considering the credit mechanism?
 - Recharacterization – Does it look like the individual really paid the tax?

Department of Revenue Service Guidance

- Pass-Through Entity Tax
 - Estimated Tax Payments Guidance: SN 2018(4)
 - PE Tax Calculation Guidance: OCG-6
 - PE Tax Credit Guidance: To Be Issued
- Connecticut Source Income
 - Special Notice 2017(1)
- Economic Nexus
 - Information Publication 2010 (29.1)