Comparison of Business Tax Structures in Surrounding States

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Issue

Briefly compare the business tax structures for corporations and pass-through businesses in Connecticut and surrounding states.

Summary

Connecticut and its three surrounding states, Massachusetts, New York, and Rhode Island, impose a corporation tax on businesses organized as C corporations and personal income tax on the income generated by pass-through businesses. Attachments 1 and 2 compare the major features of these taxes, which we briefly describe below.

Pass-Through Businesses

Businesses organized as pass through-entities (e.g., limited liability corporations, partnerships, and S corporations) are not subject to corporation tax. Rather, their profits are passed through to the owners and taxed as part of the owners' personal income tax returns.

Attachment 3 compares several other state and local taxes that apply broadly to businesses in the four selected states, including taxes on the property they own, use, or transfer (i.e., personal property tax and conveyance taxes) and the goods and services they purchase (i.e., sales and use tax). It also includes the entity-level taxes or fees that pass-through businesses must pay to operate in each state. For purposes of this report, we excluded taxes that apply only to specific types of businesses (e.g., hospitals, utilities, and insurance companies).

Corporation Tax

Attachment 1 compares the major features of the corporation taxes in Connecticut and its surrounding states. We briefly explain each of the features below.

Rate and Base

Both Connecticut and New York require corporations to pay the greater of a net income base tax, capital base tax, or a minimum tax amount. Massachusetts requires corporations to pay a net income tax and an additional tax on their net worth or tangible personal property, depending on whether a corporation is classified as a tangible or intangible property corporation. Rhode Island requires corporations to pay a net income tax. All four states use net income for purposes of the federal corporation tax as the starting point for determining state corporate net income.

Mandatory Combined Reporting

All four states require combined reporting for companies that consist of affiliated businesses. Combined reporting requires the company's affiliates to determine their total income as though they were one entity and apportion it to the state according to the state's apportionment formula.

Apportionment Formula

Apportionment formulas are designed to allocate to a taxing state, for tax purposes, a share of a company's income that corresponds to its business activity in the state. State formulas use one or more factors to determine what percentage of a company's overall income is taxable in the state. Connecticut, New York, and Rhode Island use a single-factor formula based only on a company's sales in the state. Massachusetts uses a three-factor formula based on a company's share of property, payroll, and sales in the state, with double weight given to the sales factor.

Sourcing Rules

All four states require companies to use market-based sourcing rules to determine where their sales of services are made in order to apportion their income to the state. Under market-based sourcing, companies source sales based on where their customers are located or receive the service's benefit. This is in contrast to cost of performance-based sourcing, under which companies source their sales based on where the business performed the service.

Throwout/Throwback

The sales factor described above requires corporations to compare their sales or receipts in the taxing state to their sales nationwide. Some of these sales, though, are made to government agencies and other tax-exempt organizations or to purchasers in jurisdictions that do not levy corporation business taxes or in which the corporation has no taxable nexus. Adding these sales to the total nationwide sales decreases the share of sales made in the taxing state and, consequently, reduces the amount of taxes owed to that state. Some states offset this effect by requiring businesses to subtract these "nowhere sales" from their nationwide total (throwout) or add them to its sales in the state (throwback). Both adjustments increase the relative weight of in-state sales and, consequently, the taxable income apportioned to the taxing state.

Connecticut requires companies to subtract sales of property that is not held primarily for sale to customers in the ordinary course of trade or business, while Massachusetts requires companies to subtract certain sales of intangible property. Massachusetts and Rhode Island require companies to add back certain sales of tangible personal property.

Net Operating Loss Carryback and Carryforward

All four states allow companies to carry forward deductions that exceed their gross income for a particular year (i.e., net operating loss (NOL)). The number of years ranges from five years in Rhode Island to 20 years in Connecticut, Massachusetts, and New York. New York is the only state that allows a company to carry an NOL back.

Dividends Received

All four states allow companies to subtract from their net income some or all of the dividends they receive from stock held in other corporations. It typically benefits conglomerates, holding companies, and corporate groups that own shares in subsidiary or affiliated companies.

Federal Bonus Depreciation and Asset Expense Election

All four states generally disallow the federal bonus depreciation deduction and allow the federal asset expense election for corporation tax purposes, although New York has certain narrow exceptions. Federal bonus depreciation allows companies to take a first-year bonus depreciation deduction for certain qualified property. Asset expense election allows them to treat the cost of qualifying property as a deductible expense, rather than a capital expenditure, subject to a dollar and investment limitation.

Personal Income Tax

Rather than pay corporate income tax, the owners, members, shareholders, and partners of pass-through entities doing business in the four selected states pay personal income tax on their share of income the business generates. Attachment 2 compares the major features of the personal income tax in the four selected states. As it shows, three of the states, including Connecticut, have a graduated tax that imposes higher tax rates on higher incomes. Massachusetts has a flat tax but varies the rate by income type.

As with corporation tax, the states establish apportionment formulas and sourcing rules for business income for personal income tax purposes. Both Connecticut and Massachusetts apply the same apportionment formula and sourcing rules to personal income tax as they do to corporation tax (i.e., single sales factor apportionment in Connecticut and a three-factor formula, with double-weighted sales, in Massachusetts; both require market-based sourcing for sales of services). New York and Rhode Island, however, both require single sales factor apportionment and market-based sourcing for corporation tax purposes, but apply different apportionment formulas and sourcing rules for personal income tax purposes. New York requires single sales factor apportionment for S corporations, but an evenly weighted three-factor formula for other pass-through entities. Rhode Island requires an evenly weighted three-factor formula. Both require a cost of performance method for sourcing sales of services under the personal income tax.

Connecticut is the only one of the four states that allows the federal bonus depreciation deduction; the other three generally disallow it. All four allow the federal asset expense election, with certain narrow exceptions in New York.

Attachment 1: Corporation Taxes in the Selected States

Feature	Connecticut	Massachusetts	New York	Rhode Island
General Rate and Base	Greater of: • 7.5% of net income and • 0.31% of capital base (up to $1 million) $250 minimum tax Additional 10% surcharge applies for the 2018 income year for companies whose gross income exceeds $1 million and tax liability exceeds the minimum tax	Sum of: • 8% of net income and • 0.26% of tangible property or net worth $456 minimum tax	Greater of: • 6.5% of net income and • 0.075% of business capital base (up to $5 million for most taxpayers) Minimum tax between $25 and $200,000, depending on amount of New York receipts Additional surcharge applies to businesses with activity or property attributable to the Metropolitan Commuter Transportation District	7% of net income $400 minimum tax
Mandatory Combined Reporting	Yes	Yes	Yes	Yes
Apportionment Formula	Single sales factor	Three-factor formula with double-weighted sales	Single sales factor	Single sales factor
Sourcing Rules	Market-based	Market-based	Market-based	Market-based
Throwout/ Throwback	Throwout applies if the property is not held primarily for sale to customers in the ordinary course of trade or business; No throwback	Throwback applies to certain sales of tangible personal property; Throwout applies to certain sales of intangible property	No throwback or throwout	Throwback applies to certain sales of tangible personal property; No throwout
Net Operating Loss Carryback/Carryforward	0 back/ 20 forward	0 back/ 20 forward	3 back/ 20 forward	0 back/ 5 forward

Feature	Connecticut	Massachusetts	New York	Rhode Island
Dividends Received	Subtraction allowed, less related expenses, equal to: • 100% of dividends received from 20% or more owned corporations and • 70% of dividends received from less than 20% owned domestic corporations	Subtraction allowed for 95% of dividends received from 15%-or-more-owned domestic and foreign corporations	Subtractions allowed for investment income and other exempt income, including exempt unitary corporation dividends	Subtraction allowed equal to: • 100% of dividends received from 100%-owned corporations; • 80% of dividends received from more-than-20%-owned; and • 70% of dividends received from less-than-20%-owned corporations
Bonus Depreciation (IRC § 168(k))	Disallowed	Disallowed	Disallowed, with certain exceptions	Disallowed
Asset Expense Election (IRC § 179)	Allowed	Allowed	Allowed, except for deductions relating to certain sport utility vehicles	Allowed

Source: CCH AnswerConnect

Attachment 2: Personal Income Taxes in the Selected States

Feature	Connecticut	Massachusetts	New York	Rhode Island
Rates	Marginal rates range from 3% to 6.99%, depending on taxable income and filing status	Flat 5.1% (12% on certain capital gains)	Marginal rates range from 4% to 8.82%, depending on taxable income and filing status	Marginal tax rates range from 3.75% to 5.99%
Number of Brackets	7	1	8	3
Income Threshold Applicable to Highest Bracket	$500,000 for single filers; $1 million for joint filers	N/A	$1,077,550 for single filers; $2,155,350 for joint filers	$142,150 for all filers
Apportionment Formula	Single sales factor	Three-factor formula with double-weighted sales	Single sales factor for S corporations; Evenly weighted three-factor formula for partnerships, LLPs, and LLCs	Evenly weighted three-factor formula
Sourcing Rules	Market- based	Market-based	Cost of performance	Cost of performance
Bonus Depreciation (IRC § 168(k))	Allowed	Disallowed	Disallowed, except for qualified resurgence zone and New York Liberty Zone property	Disallowed
Asset Expense Election (IRC § 179)	Allowed	Allowed	Allowed, except for deductions relating to certain sport utility vehicles	Allowed

Source: CCH AnswerConnect and state tax department websites

Attachment 3: Other Business Taxes in the Selected States

	Connecticut	Massachusetts	New York	Rhode Island
Entity-Level Tax or Fee	Business entity tax of $250 due every other year	None	Annual filing fee, based on New York-source gross receipts, ranges from $25 (for gross income between $0 and $100,000) to $4,500 (for gross income greater than $25 million)	Annual filing fee of $400
Sales and Use Tax	6.35% on sales of most goods and specified services	6.25% on sales of most goods and specified services 0.75% local option meals tax	7 to 8.875% (combined rate), depending on jurisdiction, on most goods and some services Combined rate includes (1) a 4% state rate; (2) any local tax rate imposed by a city, county, or school district; and, if applicable, (3) a 0.375% state rate imposed in the Metropolitan Commuter Transportation District	7% on sales of most goods and specified services Additional 1% local tax on meals and beverages
Property Tax on Tangible Personal Property	Taxable, unless a specific exemption applies	Taxable, unless a specific exemption applies	Exempt	Taxable, unless a specific exemption applies
Real Estate Conveyance Tax	0.75% to 1.25% of sales price, depending on property type Municipal transfer tax of 0.25% to 0.5% also applies	0.456% of sales price 0.648% in Barnstable County	0.4%; 1.4% of total sales price for residential sales exceeding $1 million Additional mortgage recording tax also applies Local taxes may also apply	0.46% of sales price

Source: *State Tax Notes*, "An Update on the State Tax Treatment of LLCs and LLPs." January 8, 2018; State tax department websites; CCH AnswerConnect

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