PASS-THROUGH ENTITY TAXATION IN CONNECTICUT

For the Commission on Connecticut’s Leadership in Corporation and Business Law

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Pass-Through Entity Taxation in Connecticut

Guiding Principles for Reform to Encourage Competitiveness

- Most Businesses Operate As a Pass-Through Entity
- Need to Eliminate Connecticut Anti-Competitive Tax Laws/Do Not Penalize Businesses for Being Based in Connecticut
- Need for Consistency in State Tax Treatment of Businesses Regardless of Legal Form Regarding Apportionment, Income Sourcing and Tax Credit Availability
- Predictability and Ease of Compliance
Pass-Through Entity Taxation in Connecticut

Types of Pass-Through Entities

- Limited Liability Companies (Single Member vs. Multiple Members)
- Partnerships, Limited Partnerships and Limited Liability Partnerships
- Subchapter S Corporations
- Disregarded Entities (Single Member LLCs, Qualified Subchapter S Subsidiaries)
Formation of Pass-Through Entities; Office of the Secretary of State

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N.B. “Stock corporations” include both Subchapter C corporations (taxable entities) and Subchapter S corporations (pass-through entities)
Pass-Through Entity Taxation in Connecticut

Most Common Attributes of Pass-Through Entities

- Small- and Medium-Sized Businesses (Often Owned by Individuals and Trusts)
- Corporate Joint Ventures
- Require Outsourced Services (Third Party Business Inputs)
- No or Limited In-House Tax/Compliance Services/Business Management Services
Pass-Through Entity Taxation in Connecticut

Federal and State Tax Treatment

- Federal Income Tax Treatment
  - No Federal Income Tax at Entity Level (Unless Check-the-Box Election Made)
    - Information Return: IRS Forms 1065 or 1120-S/Schedule C
  - Items of Income, Gain, Loss, Deduction and Credit Flow Through to Owners
  - Distributive Share of Income or Loss and of Certain Separately Stated Items
Federal and State Tax Treatment

- **State Income Tax Treatment (Generally Follows Federal Income Tax Treatment)**
  - Composite Tax Return Obligation (Form CT-1065/1120SI)
  - Foreign (non-Connecticut) Owner Withholding

- **Other State Taxes (Separate Entity Treatment)**
  - Sales and Use Tax
  - Conveyance Tax/Controlling Interest Transfer Tax
  - **N.B.** Conn. Gen. Stat. §34-113: LLC Taxation In Accordance With Federal Tax Classification (but see DRS Special Notice 99(3))
Pass-Through Entity Taxation in Connecticut

Connecticut Taxes Paid by Pass-Through Entities and Their Owners

- Personal Income Tax
  - State Composite Tax Return/Withholding
- Business Entity Tax
- Sales and Use Tax
- Local Property Tax
- Unemployment Insurance Tax
Pass-Through Entity Taxation in Connecticut

Anti-Competitive Connecticut Income Tax Issues for Pass-Through Entities

- Penalty Apportionment and Sourcing Rules
  - Favoring Out-of-State Businesses/Need for Market Sourcing
  - Lack of Consistency with Tax Treatment of Corporations
- Limited Availability of Credits
- History of Retroactive Tax Law Changes
Anti-Competitive Connecticut Income Tax Issues for Pass-Through Entities (cont’d)

  
  - “Connecticut differentially & inequitably taxes similar enterprises solely on the basis of chosen forms of doing business . . . .”
  
  - “Consistent application of law, avoidance of retroactive changes, & reliable guidance are positive attributes of fair, effective & efficient business taxes.”
  
  - Recommendation: “Standardize apportionment, factor weighting & sourcing.”
  
  - Recommendation: “Phase out taxation of business-to-business computer & data processing services, analysis, management & management consulting services.”
Pass-Through Entity Taxation in Connecticut

Penalty Apportionment/Sourcing Rules

- Scenario 1(a)
  - Connecticut-based pass-through entity (partnership, limited liability company or Subchapter S corporation) ("PE") sells services
  - All owners of PE are individuals
  - PE’s only office is in Connecticut
  - PE has taxable nexus in Massachusetts
  - All of PE’s customers are located in Massachusetts
  - Result:
    - PE sources 100% of income to Connecticut
    - PE sources 100% of income to Massachusetts

- Scenario 1(b)
  - Massachusetts-based PE sells services
  - All owners of PE are individuals
  - PE’s only office is in Massachusetts
  - PE has taxable nexus in Connecticut
  - All of PE’s customers are located in Connecticut
  - Result:
    - PE sources 0% of income to Connecticut
    - PE sources 0% of income to Massachusetts
Pass-Through Entity Taxation in Connecticut

Penalty Apportionment/Sourcing Rules (cont’d)

• Scenario 2
  ➢ Pass-through entity (“PE”) is a manufacturer
  ➢ PE’s owners are:
    ➢ Individual (“I”) who is a resident of Massachusetts
    ➢ Corporation (“C”) who is based in Massachusetts
  ➢ All of PE’s manufacturing facilities are located in CT; PE’s sales office is located in MA; 80% of PE’s payroll is located in Connecticut
  ➢ All of PE’s customers are located in Massachusetts
  ➢ Result:
    ➢ I sources 60% of its flow-through income from PE to Connecticut
    ➢ C sources 0% of its flow-through income from PE to Connecticut
Limited Availability of Credits

There are approximately 25 Connecticut tax credits for which Subchapter C corporations can qualify, but pass-through entities and their owners cannot, including those tax credits for:

- Fixed Capital Investments (Conn. Gen. Stat. §§12-217o, 12-217w, 12-217mm)
- Employee Investments (Conn. Gen. Stat. §§12-217g, 12-217x)
- Enterprise Zone Investments (Conn. Gen. Stat. §12-217v)
- Neighborhood/Charitable Assistance (Chapter 228a)

Pass-Through Entity Taxation in Connecticut

Penalty Credit Provisions

1. Scenario 4(a)
   - Corporation ("C1") and Individual ("I") wish to form a joint venture to manufacture in Connecticut
     - C1 is based in Connecticut
     - I is a Connecticut resident
   - They form partnership ("P") to undertake the manufacturing and engage in research and development (R&D)
   - If P were subject to the Connecticut Corporation Business Tax, it would be entitled to a $100 R&D credit
   - Result:
     - P is not entitled to claim the R&D tax credit ($0)
     - C1 is not entitled to claim the R&D tax credit ($0)
     - I is not entitled to claim the R&D tax credit ($0)

2. Scenario 4(b)
   - Corporation ("C1") and Individual ("I") wish to form a joint venture to manufacture in Connecticut
     - C1 is based in Connecticut
     - I is a Connecticut resident
   - They form corporation ("CORP") to undertake the manufacturing and engage in R&D
   - CORP is subject to the Connecticut Corporation Business Tax and is entitled to a $100 R&D credit
   - Result:
     - CORP is entitled to claim the R&D credit ($100)
     - C1 is not entitled to claim the R&D tax credit ($0)
     - I is not entitled to claim the R&D tax credit ($0)
Pass-Through Entity Taxation in Connecticut

Other Anti-Competitive Connecticut Tax Issues

- Sales and Use Tax on Business Inputs
  - Business Analysis and Management/Consulting Services
  - Computer and Data Processing
  - Personnel and Training Services

- Sales and Use Tax Complexity

- Property Tax Compliance in Multiple Towns/Multiple Rules

- Disregarded/Regarded Entities
Pass-Through Entity Taxation in Connecticut

Tax Policy Principles

- Revenue Stability and Sufficiency
- Balanced Revenue Sources
- Structural Stability
- Predictability
- Ease of Compliance
- Fair, Efficient and Cost-Effective Administration
- Consistent Application of Law and Timely Guidance
- Reflect the Global and Local Marketplace
Pass-Through Entity Taxation in Connecticut

Tax Policy Takeaways

- Eliminate Anti-Competitive Tax Rules/Do Not Penalize Connecticut-Based Businesses
  - Need for Market-Based Sourcing Rules
  - General Availability of Credits
  - Eliminate Sales and Use Taxes on Business Inputs
- Consistency in Application to All Businesses Regardless of Form of Tax Laws Regarding Apportionment, Sourcing and Tax Credit Availability
- Minimize Complexity