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## INSIGHT: Legislative Changes Affecting Connecticut Pass-Through Entity Tax

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Effective Jan. 1, 2018, a new Connecticut 6.99% entity-level income tax was imposed on most businesses that are structured as pass-through entities (e.g., partnerships, S corporations and limited liability companies (LLCs) treated as partnerships). The primary motivation for enacting the pass-through entity tax (PET) was to mitigate the \$10,000 cap on personal state and local income, sales, and property tax (SALT) deductions under the federal Tax Cuts and Jobs Act by imposing the tax at the entity level thereby making the tax a fully deductible business expense for federal income tax purposes.

As originally enacted, individual and corporate owners of an affected pass-through entity business were entitled to a credit against their Connecticut income tax equal to 93.01% of the owner's pro rata share of the entity tax paid by the pass-through entity. This credit percentage provided an almost dollar-for-dollar credit at the owner-level which circumvented the SALT cap with little to no effect on Connecticut tax revenues. However, legislation passed by the Connecticut General Assembly during the 2019 legislative session made certain amendments to the PET.

For example, the pass-through entity credit percentage was reduced from 93.01% to 87.5% effective for tax years beginning on or after Jan. 1, 2019. This reduction effectively increases the Connecticut income tax on Connecticut source income of the owners of pass-through entities by 0.385%. In addition, guaranteed payments received from a partnership (and an LLC treated as a partnership) are now required to be included in the pass-through entity's Connecticut income base upon which the PET is calculated.

### Special Notice

On Aug. 16, 2019, the Connecticut Department of Revenue Services issued [Special Notice 2019\(6\)](#) to help taxpayers better understand certain aspects of the PET amendments. Consistent with the 2019 PET legislation, the special notice reiterates that for taxable years beginning on or after Jan. 1, 2019, the PET credit percentage is reduced from 93.01% to 87.5% and that guaranteed payments are included in the pass-through entity's Connecticut income base upon which the PET is calculated.

The special notice also states that the department will waive any late payment penalty and related interest imposed on the year 2018 PET liability so long as the full amount (excluding penalties and interest) is paid within one year of the original due date of the return (March 15, 2020, for calendar year filers). For non-corporate taxpayers, the waiver request is made by submitting a completed [Form CT-CWPI \(Request for Waiver of 2018 Penalty and Interest Due to the Enactment of the Pass-Through Entity Tax\)](#).

In addition, for taxable years beginning on or after Jan. 1, 2019, the department will permit pass-through entities to make an annual election to remit composite income tax on behalf of its nonresident members. If the pass-through entity makes this election, its nonresident members will be excused from filing their own Connecticut personal income tax returns if they have no Connecticut-source income other than from the electing pass-through entity.

The pass-through entity makes the election by checking a box on the PET return and attaching a schedule to the return. This composite filing option alleviates the concern that a nonresident pass-through entity owner could be required to file a Connecticut personal income tax return in a situation where the reduced credit percentage does not completely offset the nonresident owner's entire Connecticut personal income tax liability.

The special notice concludes by stating that DRS is in the process of updating related department guidance to reflect the legislative changes made to the PET.

### Federal Actions

On a related note, the Internal Revenue Service has already issued guidance eliminating another effort by states, including Connecticut, to circumvent the SALT cap. Legislation passed by these states would offer property tax credits in exchange for contributions to municipality-sponsored charitable funds. Recently issued IRS regulations state that any contribution to these funds for which a taxpayer could otherwise take a charitable contribution deduction for federal income tax purposes must be reduced by the amount of the tax credit.

The IRS is well aware of the efforts by states to enact pass-through entity taxes as a workaround to the new SALT cap but has not yet issued any guidance specifically directed at pass-through entity taxes. While it is still unclear whether the IRS will respect the expense deduction taken for the payment of these entity-level taxes for federal income tax purposes, the IRS's priority plan guidance states that the IRS plans to address how to apply the SALT cap to pass-through entities.

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