Connecticut issues Pass-Through Entity Tax guidance; questions remain

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In brief
On August 21 and June 19, the Connecticut Department of Revenue Services issued guidance regarding the Pass-Through Entity Tax (PE Tax), applicable to tax years beginning on or after January 1, 2018. The August and June documents discuss the alternative tax bases, the combined return election, estimated payments, and mechanics around the tax credit.

[OCG-7, Office of the Commissioner Guidance Regarding the Pass-Through Entity Tax Credit (8/21/18);
OGC-6, Office of the Commissioner Guidance Regarding the Calculation of the Pass-Through Entity Tax (6/19/18)]

In detail - PE Tax generally
Enacted on May 31, 2018, S.B. 11 created the PE Tax, which requires certain pass-through entities (PEs) — generally a partnership, LLC treated as a partnership for federal tax purposes, or an S corporation, but not a publicly traded partnership — to pay an entity-level tax at the rate of 6.99% on one of two bases. The PE Tax is applicable to tax years beginning on or after January 1, 2018. Click here for our summary of S.B. 11.

Prior to S.B 11, PEs were not subject to tax on their income. Instead, the partners, members, or shareholders (collectively, partners) were required to pay tax on their distributive shares of the PE’s income. As a general rule, partners were responsible for paying tax on their distributive share of income from a PE and typically made estimated payments for that liability.

For tax years beginning on or after January 1, 2018, a pass-through entity is subject to tax on its own income. To account for the fact that the pass-through entity must pay tax on its own income (which remains includible in the distributive share income of the partners), a tax credit is available for the partners to claim on their Connecticut tax returns.

The following summarizes the key points from the PE Tax guidance issued by the Department of Revenue Services on August 21 and June 19.

There are two methods that PEs may utilize to calculate the PE tax. The ‘standard base’ is the default method unless the PE elects the ‘alternative base.’ PEs may elect to use the alternative tax base on or before the extended due date of the PE Tax. The election is available annually.
**Standard base**
The standard base equals:

- The PE’s Connecticut source income — i.e., the PE’s separately and nonseparately computed items under IRC Secs. 702(a) or 1366, to the extent derived from or connected with sources within Connecticut.

**Less**

- Connecticut source income from subsidiary PEs that filed a Connecticut PE Tax return.

**Alternative base**
The alternative base equals:

The sum of **Modified Connecticut source income** and the **Resident portion of unsourced income**.

**Modified Connecticut source income**
Modified Connecticut source income equals:

- The standard base (as calculated above) multiplied by

- The cumulative percentage of direct or indirect distributive shares owned by partners that are subject to tax under Chapter 229 (Connecticut’s individual income tax).

**Resident portion of unsourced income**
The ‘resident portion’ is the cumulative percentage of direct distributive shares owned by Connecticut resident individual partners. This percentage is multiplied by ‘unsourced income’ (defined below).

Unsourced income is a PE’s income that is not sourced to Connecticut or to another state where the PE has nexus (regardless whether the other state actually subjects the PE to tax). This amount equals:

- The PE’s total income, which is equal to its separately and nonseparately computed items under IRC Secs. 702(a) or 1366, regardless of where derived or connected.

**Less**

- The PE’s Connecticut source income. As calculated under the standard base, this amount is equal to the PE’s separately and nonseparately computed items under IRC Secs. 702(a) or 1366, to the extent derived from or connected with sources within Connecticut. Note that there is no subtraction for amounts received from a subsidiary PE.

**Guaranteed payments**
Under both the standard and alternative tax bases, the starting point in computing the PE Tax is the PE’s separately and nonseparately computed items under IRC Secs. 702(a) or 1366. As noted in OCG-6, under federal law, guaranteed payments are deducted on Line 10 of Form 1065 when determining a PE’s ordinary income. Therefore, under either the standard base or the alternative base method for PE Tax purposes, guaranteed payments are not included when determining the amount of a PE’s income subject to PE Tax.

Nonresident individual partners who receive guaranteed payments are required to file Form CT-1040NR/PY to report all their Connecticut source income, including the Connecticut source portion of their guaranteed payments. The Connecticut source portion of a guaranteed payment is determined at the PE level. The Connecticut portion generally is calculated by multiplying the amount.
of the partner's guaranteed payments by the PE's apportionment fraction.

**Observation:** Similar to the approach to evaluating the inclusion of guaranteed payments in the tax base, taxpayers should evaluate their particular income and deduction items (e.g., special allocation items) to determine which items are properly includible in the IRC Sec. 702(a) starting point.

**Estimated payments**
Estimated payments are required. For calendar-year filers, estimated payments are due on April 15, June 15, September 15, and January 15. Recognizing that the PE Tax was enacted after April 15, Special Notice 2018-4 provides alternatives for PEs to pay their 2018 estimates.

**In detail - PE Credit**
PE partners are entitled to a credit equal to 93.01% of the partner's direct and indirect share of a PE's tax liability. The PE must have paid the tax prior to the partner claiming the credit. The credit is applicable against the corporation business tax (Chapter 208) or individual income tax (Chapter 229). S.B. 11 did not list taxpayers that are subject to tax under Chapter 207 (insurance companies and health care centers) as taxpayers that qualify for the credit.

**Credit calculation**
A partner's share of the PE Tax liability is determined based upon the percentage of the partner's distributive share of income that is included in the PE's income subject to the PE Tax.

If a partner is allocated a net loss, the partner's share of the PE Tax is zero and, therefore, the partner is not entitled to any PE Tax Credit. The PE Tax should be prorated among the remaining partners based upon their relative distributive shares of income included in the PE's income subject to PE Tax.

**OCG-7** provides several examples regarding the credit calculation. Under the alternative tax base calculation, the examples demonstrate how resident (but not nonresident) individuals are allocated PE Tax based on the entire amount of Connecticut unsourced income (plus Connecticut sourced income), while nonresident individuals are subject to tax only on Connecticut sourced income. In addition, the alternative tax base examples illustrate how corporate partners are not allocated any portion of the PE Tax.

**Indirect PE tax credits**
Credits allocated from a subsidiary PE to a parent PE will flow through to the parent PE's partners. Such credits are called 'indirect PE tax credits.' Indirect credits should be allocated to each partner in a ratio that reflects the portion that the partner's share of the distributive share of income contributes to the PE's standard base (for standard base filers) or modified source income (for alternative base filers). OCG-7 provides several examples regarding the indirect credit calculation.

**Excess credits**
Credits that exceed a taxpayer's individual tax liability (under Chapter 229) are treated as overpayments and will be refunded (provided the taxpayer has no other debts or obligations to the state) without interest.

Credits that exceed a corporate taxpayer's corporation business tax liability (under Chapter 208) may be carried forward until used.

**Nonresident individuals**
Nonresident individuals generally are not required to file a Connecticut income tax return when their only source of Connecticut income is a distributive share of income from one or more PEs that file PE Tax returns and pay the PE Tax.

Such nonresidents are be required to file a Connecticut income tax return if they:
- receive Connecticut-source guaranteed payments from one or more PEs
- are members of a PE that files a combined PE Tax return and the PE Tax Credit allocated by the combined group to the nonresident individual does not fully offset their Connecticut income tax liability
- receive a Schedule CT K-1 reporting Connecticut source income and do not report a PE Tax Credit.

**Due date**
The PE Tax return is due on or before the 15th day of the third month following the close of the PE's tax year.

**Observation:** It would appear that the return can be extended until the 15th day of the ninth month following the close of the PE's taxable year, following the same extension provisions that are currently in effect for partnership return purposes.

Additionally, for tax years commencing on or after January 1, 2018, S.B. 11 changes the due date of partnership returns generally in Ct. Stat. Sec. 12-726(b) from the 15th day of the fourth month following the close of the taxable year to the 15th day of the third month following the close of the taxable year.

**Open questions**
As noted above, a threshold question is whether particular income or deduction items fall within the PE Tax starting point, which includes...
separately and nonseparately stated items under IRC Secs. 702(a) or 1366. For example, IRC Sec. 702(a) includes certain dividends, and would appear to include IRC Secs. 965 and 951A income of US shareholders as ‘dividends’ for this purpose.

The PE Tax is an element of legislation Governor Malloy advocated as a method to “protect Connecticut residents from negative effects” of federal tax reform. He referred to the tax as “[a] new revenue-neutral tax on pass-through entities, fully offset by a personal income tax credit, [that] will prevent Connecticut’s small business owners from being targeted by the federal tax law.”

**The takeaway**

Taxpayers should consider the impact of the above provisions in determining their PE Tax as well as the impact on estimated payment requirements at the partner level. Partnerships with corporate partners, in particular, should evaluate the alternate tax base so as to potentially eliminate the PE Tax and credit flow through issues that would otherwise apply to the corporate partners.

**Let’s talk**

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