PULLMAN & COMLEY

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ARE CONNECTICUT INCOME TAXES NOW TAX DEDUCTIBLE FOR THE OWNERS OF PASS-THROUGH ENTITIES?

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The Tax Cuts and Jobs Act, which was passed by Congress last year, imposed a $10,000 limit on state and local tax ("SALT") deductions. On May 31, 2018 Governor Dannel Malloy signed into law Connecticut Public Act No. 18-49 (the "Act"), which may have the effect of restoring a federal income tax deduction for those taxpayers who conduct their businesses in the form of partnerships, limited liability companies, and s-corporations ("pass-through entities").

The Act imposes a Connecticut income tax on pass-through entities at a 6.99% rate, which is the highest marginal rate for the Connecticut income tax on individuals. The tax is offset by a tax credit at the personal income tax level equal to 93.01% of the pass-through entity's owner's pro rata share of the tax paid by the pass-through entity.

For example, assume A and B are equal members of AB LLC, and that AB LLC has net income of $200,000. A tax is now imposed on AB LLC at a 6.99% rate, for a tax of $13,980. AB LLC will deduct that amount on its federal income tax return, as it would any other expense, and the net income of ABC LLC is reduced to $186,020. A and B therefore will each report one-half of that lower amount, or $93,010, as income on their federal and Connecticut income tax returns. The pro rata share of this new Connecticut tax for each of A and B will be one-half of $13,980, or $6,990. That credit and the reduced income being reported by A and B will leave them in the same economic position they would have been under pre-2018 law when the SALT deductions were not limited to $10,000.

The Act is applicable to tax years of pass-through entities beginning on or after January 1, 2018. The Act requires each pass-through entity to make estimated tax payments, similar to those which the owners of the entity previously paid.

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These owners will now need to make corresponding reductions to their estimated tax payments.

The Act also allows municipalities to create “community supporting organizations” to which taxpayers can make donations. These donations will be in lieu of paying part of their property taxes to the municipality in which the taxpayer resides. This, too, was an attempt to create a work-around for the SALT deductions that were limited by the Tax Cuts and Jobs Act. However, the IRS recently issued Notice 2018-54, which indicates that the IRS will soon issue proposed regulations that deny a deduction for a payment to such a community organization in lieu of real estate taxes.

Notice 2018-54, however, does not address the approach taken by the Act to give Connecticut pass-through entity owners, in effect, most of the benefit of what would have been a deduction for Connecticut income tax paid by those owners. Will the IRS challenge this novel approach? Time will tell.

This is by no means a comprehensive explanation of the changes made in the Act. If you have any questions regarding the content of this alert, please contact Rob Morris, Keinan Meginniss or any of the attorneys in our Tax Law Practice.

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