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Connecticut budget bill raises taxes for individuals and businesses

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James R. Brockway
PARTNER | US

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On June 4, 2015, following extensive negotiations between the legislature and the Governor's office, the Connecticut General Assembly passed H.B. 7061 (the "Budget Bill") into law. The controversial two-year Budget Bill is expected to generate $40.3 billion in revenue and includes significant tax increases for Connecticut businesses and individuals. Governor Malloy has proposed trimming $224 million from the Budget Bill's tax hikes by cutting state spending by 1.5%. The Governor's proposed changes, the details of which remain unclear, will be considered by the legislature in its upcoming special session, but it is expected that the Governor will sign some version of the Budget Bill before the July 2, 2015 deadline.

For Connecticut individuals, the Budget Bill increases income taxes for high-earners, trusts and estates, decreases the available property tax exemption and increases the sales and use tax on certain items. For Connecticut businesses, the Budget Bill imposes a mandatory unitary combined reporting regime, extends the corporate income tax surcharge, limits the availability of net operating loss carryforwards to offset income in future years and limits the availability of tax credit offsets.

Changes for Connecticut Individuals

Income Tax Increase. Effective for the 2015 tax year, the Budget Bill increases the marginal income tax rate for individuals with annual taxable incomes over $250,000 (or $500,000 for couples) from 6.7% to 6.9%. It also adds a 6.99% marginal tax bracket applicable to individuals with annual taxable incomes over $500,000 (or $1,000,000 for couples). The Budget Bill also increases the flat income tax rate applicable to Connecticut resident trusts and estates from 6.7% to 6.99%.

Property Tax Credit Reduction. Effective for the 2016 tax year, the Budget Bill reduces the maximum property tax credit allowed against Connecticut personal income tax from $300 to $200. It also reduces the income threshold at which the property tax credit begins to phase-out from $64,500 for individuals (or $100,500 for couples) to $49,500 for individuals (or $70,500 for couples).

Sales and Use Tax Increases. Effective July 1, 2015, the Budget Bill increases the sales and use tax rate from 7% to 7.75% on three categories of "specified luxury items": (i) motor vehicles with value in excess of $50,000; (ii) jewelry with value in excess of $5,000; and (iii) clothing, footwear, handbags, luggage, umbrellas, wallets and watches with value in excess of $1,000. The Budget Bill also increases the sales and use tax rate applicable to computer and data processing services from 1% to 2% beginning October 1, 2015 and from 2% to 3% beginning July 1, 2016, subject to an exception for services performed for or on behalf of an affiliated entity.

Changes for Connecticut Businesses

Mandatory Unitary Combined Reporting. Under current law, companies doing business in Connecticut may elect to compute their Connecticut corporation tax liability separately or together with a group of affiliated companies. The Budget Bill requires any company that is subject to the Connecticut corporation tax and is part of a group of related companies to determine its Connecticut corporation tax liability with reference to the net income or capital base of the entire "combined group." A "combined group" is a group of companies that (i) share common ownership, and (ii) are engaged in a "unitary business." A "unitary business" is defined as a single economic enterprise that is interdependent, integrated or interrelated and produces significant exchanges of value among its constituent members. Companies share "common ownership" if the same entity or entities directly or indirectly own 50% or more of their respective voting stock. Combined groups must designate a Connecticut taxable member to file their unitary return and pay the required tax on behalf of the entire group. Each taxable member of the group, however, will be jointly and severally liable for taxes, penalties and interest due by the combined group.

Corporation Tax Surcharge Extended. The Budget Bill extends the 20% corporation income tax surcharge through the end of the 2017 tax year and imposes a 10% surcharge for the 2018 tax year. The corporation tax surcharge generally applies to Connecticut businesses that have more than $250 in corporation tax liability. However, companies that have less than $100 million in annual gross income are exempt from the surcharge, unless they file combined or unitary returns.

Net Operating Loss Limitation. Under current law, Connecticut corporations may reduce their tax liability by deducting net operating losses. Unused net operating losses may be carried forward and used to offset future income for up to 20 years. Under the Budget Bill, the amount of net operating loss carryforwards a corporation may utilize to offset income in a future year is limited to 50% of the corporation's Connecticut source income. The excess of the net operating loss carried forward from prior years, which is not used to offset the other 50% of the corporation's

Connecticut source income, may be carried forward.

Tax Credit Limitation. Under current law, Connecticut businesses may reduce their tax liability by up to 70% in any tax year through the use of applicable tax credits. Under the Budget Bill, this limit would be reduced to 50.01% of a business's tax liability. Governor Malloy has proposed increasing this threshold to 55%, but the end result will be an effective corporation tax increase for many Connecticut businesses.

Conclusion

The legislature's special session at the end of June may result in some development or refinement to the Budget Bill. However, it is anticipated that Governor Malloy will sign some version of H.B. 7061 into law before the July 2, 2015 deadline. While the Connecticut business community has expressed strong opposition to the changes, it is likely that Connecticut individuals and businesses will see an increase in their state tax liability for tax year 2015. Accordingly, it is important to consult with Connecticut tax counsel to understand the impact of these tax increases and to develop strategies to mitigate their effects.

Update

On June 30, 2015, Governor Malloy signed the Budget Bill into law, as amended by S.B. 1502, a budget implementation bill passed by a special session of the Connecticut General Assembly on June 29, 2015 (the “Implementation Bill”). The Implementation Bill made the following changes to the Budget Bill:

Delay for Mandatory Unified Combined Reporting. The Implementation Bill provides a one-year delay to the implementation of the new mandatory combined reporting rules applicable to groups of Connecticut companies engaged in a “unitary business” and subject to the Connecticut corporation tax. Instead of being subject to the new combined reporting requirement for tax year 2015, Connecticut businesses now have until January 1, 2016 to prepare for the impact of the new rules.

Computer and Data Processing Services. The Implementation Bill eliminates provisions of the Budget Bill, discussed above, that increase the sales and use tax rate applicable to computer and data processing services. However, the Implementation Bill also eliminates provisions of the Budget Bill that provide exemptions from sales and use tax for computer and data processing services performed for affiliated entities and eliminates the use tax exemption for internet access services, effective October 1, 2015.

_Net Operating Loss Relief. _ The Implementation Bill also provides some relief to large Connecticut businesses with accrued net operating losses. For corporations that are part of a combined group with over $6 billion in pre-2013 unused net operating losses, such losses can now be carried forward to the extent of the combined group's net income until it has used 50% of its pre-2015 net operating losses to offset its Connecticut taxable income. Once the combined group reaches the 50% threshold, it is subject to the limitations set forth in the Budget Bill, described above.

While the Implementation Bill provides limited relief to some Connecticut taxpayers affected by the Budget Bill's numerous tax increases, particularly those businesses subject to the new mandatory combined reporting rules, the new provisions signed into law by Governor Malloy will still result in an eventual increase in the state tax liability of many Connecticut businesses and individuals.

Authors

James R. Brockway

PARTNER | NEW HAVEN

Private client and tax

+1 203 974 0309

james.brockway@withersworldwide.com