Tax Legal Update

Connecticut's Budget Act

After months of wrangling that left Connecticut without a budget well into the 2010-2011 biennium, Governor Rell permitted Public Act 09-3 (June Special Session) to become law without her signature. The act raises revenue by making some fairly significant tax increases but also provides for tax relief in some specific areas. Dark clouds on the economic horizon, however, portend continuing deterioration of the state's fiscal condition and the potential for future tax increases or a scaling back of some of the reductions adopted this year.

Personal Income Tax Increases

The most significant revenue raiser in the act is an increase in the personal income tax rates from 5 percent to 6.5 percent for joint filers whose Connecticut taxable income is more than $1 million ($800,000 for heads of household and $500,000 for single filers). The increase in the top rate is retroactively effective to January 1, 2009, and is projected to result in $594 million of additional revenue in the current fiscal year.

The act also delays the scheduled income tax reductions for single filers for three years by postponing increases in adjusted gross income exempt from tax and the income thresholds for phasing out personal exemptions and credits.

Business Tax Increases

The principal business tax increase is a 10 percent surcharge on the corporation business tax rates applicable to income and the capital base for income years beginning in 2009, 2010 and 2011, except for companies with less than $100 million in gross revenues for any such year. The surcharge is projected to increase revenue by $74.1 million in the current fiscal year.

The act also bars companies and individuals from using the federal tax deduction for income derived from qualified domestic production activities under Internal Revenue Code §199, effective for tax years starting on or after January 1, 2009.

The benefits of filing a combined return by companies subject to the corporation business tax are also reduced by the act, which increases the maximum tax for filing a combined return from $250,000 to $500,000. This increase places the tax efficiencies provided under the Connecticut combined return rules even further beyond the reach of smaller corporate taxpayers.

The act extends from 15 to 25 years the carryforward period for the 50 percent tax credit for donations of open space land.

Finally, the act makes several changes to the film and digital animation production tax credits and the related infrastructure tax credit. It transfers administrative responsibility for these credits from the Commission on Culture and Tourism to the Department of Economic and Community Development (DECD). At this point, we are awaiting word regarding the extent to which the personnel who have administered these credits will assume similar responsibilities at DECD and operate under similar rules as they have with the commission. Among other changes to these credits are elimination of the ability to obtain interim film production credits, requirement of an audit for companies applying for the credits, provision for an administrative fee, elimination of a graduated credit regime for the infrastructure credit, acceleration of the phaseout for costs incurred outside of Connecticut, and increase of the annual "star cap" to $20 million.

Expansive Economic Nexus Rules

The act adopts one of the broadest "economic nexus" rules seen around the country, effective for tax years beginning in 2010 and t fter. Initially proposed as a measure aimed at out-of-state credit card issuers, the measure morphed into one that imposes the corporation business tax upon any company that

> derives income from sources within this state, or has a substantial economic presence within this state, evidenced by a purposeful direction of business toward this state, examined in light of the frequency, quantity and systematic nature of a company's economic contacts with this state, without regard to physical presence, to the extent permitted by the Constitution of the United States...

A similar rule was adopted for passthrough entities such as partnerships, limited partnerships, LLCs and S corporations that have the prescribed economic presence in Connecticut and have nonresident owners not otherwise subject to the Connecticut personal income tax (corporate partner/owners appear to be unaffected).

The breadth of the statutory language and, in particular, the absence of any minimum amount of income derived from Connecticut that triggers nexus will likely spawn numerous disputes with the Connecticut Department of Revenue Services (DRS) if it chooses to take an expansive approach to administering these provisions.

The initial revenue projections ($10 million for fiscal 2011) are relatively modest, in keeping with the original purpose of targeting credit card issuers. However, informal indications from DRS regarding the potential for much broader application of these provisions suggest that we face years of uncertainty, both with respect to audits and the need for companies subject to FIN 48 to handicap their positions regarding provisions for nexus issues. Further, DRS officials have informally suggested that they may apply these provisions to non-U.S. corporations, with the focus either on income derived from U.S. markets or from U.S. affiliates.

We believe that, at least initially, the principal losers with such a nexus regime will be companies subject to special apportionment regimes in Connecticut that focus on the market rather than on the location of property and payroll. Financial service companies and broadcasters fall into this category.

Sales and Use Tax

Effective January 1, 2010, the act reduces the current 6 percent sales and use tax rate to 5.5 percent. However, this reduction will not take effect if, before that date, the Comptroller's monthly statement shows a revenue shortfall of 1 percent below the estimate adopted by the Joint Committee on Finance, Revenue, and Bonding. A restoration of the 6 percent rate will occur if any of the Comptroller's monthly statements issued between January 1 and June 20, 2010 show revenue at least 1 percent below the budgeted estimate, effective on July 1, 2010.

Items currently taxed at a rate other than 6 percent, such as hotel occupancy and computer services, will not be affected.

New Tax Settlement Initiative

Coming on the heels of an earlier tax amnesty program that ended on June 25 of this year, the act requires DRS to implement a tax settlement initiative program for anyone owing state taxes, interest or penalties for any taxable period for which the DRS has assessed a liability. The program extends from October 1, 2009 through December 31, 2009 and taxpayers who are notified of their eligibility for the program and elect to participate in it are relieved of all civil penalties and 50 percent of accrued interest. Participation requires payment in full of the entire amount of the assessment and the reduced interest amount. Partial payments are applied to the assessed liability but do not operate to reduce interest or penalty.

At this writing, details regarding implementation of the settlement initiative are being developed internally within DRS. What we know at this point is that taxpayers must be "invited" to participate in the program, but we cannot identify the criteria by which such invitations will be extended or the extent to which the program will accommodate compromise settlements of disputed tax

liabilities. It appears, however, that the existence of the program, which is aimed at generating $75 million of revenue, will be a factor in resolving pending tax disputes with DRS.

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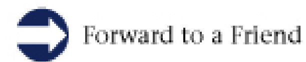

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