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FRIDAY FOCUS

What the new state tax changes mean

Michael D'Addio, left, and Andrew Ebneter from Marcum LLP

For this week's Friday Focus, we feature a Q&A on tax changes coming starting July 1 because of the new state budget. We spoke with Andrew Ebneter, CPA, Tax & Business Services Partner, State & Local Tax Practice Group, and, Michael D'Addio, JD, Tax & Business Services Principal at Marcum LLP.

Q. The revised state budget taking place July 1 has some major changes in the corporate income tax, personal income tax, and sales tax. What are the most important changes for businesses?

Andrew Ebneter - While these changes promote apportionment uniformity among several types of business entities, pass-through entities will need to adjust their internal controls for tracking service revenue. If, for example, 100% of a company's services were performed in Connecticut for customers that were located outside of the state, the company's 2017 Connecticut apportionment percentage could be much less than in previous years.

Q. What's your view of these revisions to the tax code? Will they be effective in solely generating new revenue or can they also be perceived as being business friendly?

Andrew Ebneter - The trend over the past decade has been for states to adopt a single-sales factor for apportionment and market-based sourcing for service revenue. The prevailing sentiment is that capital-intensive businesses like manufacturing benefit by the elimination of both property and payroll factors because both factors would be high for these types of businesses located in-state. Similarly, including service revenue in the sales factor based on customer location does not penalize an in-state service business with customers located outside the state. In continuance of this trend, North Carolina, currently a "cost of

performance" state, recently required certain taxpayers to complete forms containing information that would allow the state legislature to analyze whether market-based sourcing would generate more revenue for that state.

Michael D'Addio - When dealing with changes to apportionment formulas, there are always winners and losers. However, the single factor formula should benefit Connecticut businesses, which have significant interstate and international sales. Last year, Connecticut repealed the state's three factor apportionment formula for entities taxed as C corporations and replaced it with a single factor approach based on sales. However, this change was not extended to the apportionment rules for personal income tax returns (which affects partnerships and S corporations). The new rule will apply to all business entities.

The market sourcing rules will impact all taxpayers, since Connecticut did not previously amend its rules regarding the apportionment of receipts for sales of other than tangible personal property.

The proposal would conform (with limited exceptions) the apportionment methods for corporations, partnerships, S corporations and individuals. This provides some simplicity and reduces the confusion and potential for error where different business entities must use different methods to determine its Connecticut taxable income.

Connecticut businesses tend to have most of their employees and capital employed in Connecticut. Under a multiple factor approach, this causes a larger apportionment of taxable income to Connecticut than an out-of-state business (which would have most of its employees and capital employed outside of Connecticut). The change to a single factor should increase the income allocated to Connecticut by out-of-state businesses and reduce this allocation for Connecticut businesses which have out-of-state sales. Additionally, the change to market-based sourcing will cause sales made by Connecticut businesses to a client or customer located out-of-state to be allocated away from Connecticut, even though the work done in connection with such sales is done in Connecticut. For these reasons, the proposed changes can be seen as friendly to Connecticut businesses. Connecticut should experience an increase in taxes paid by out-of-state businesses as a result of these changes.

Q. How significant is the market-based sourcing of gross receipts for both corporate and personal income tax purposes? How does this differ from past tax practices and how does it help or hurt taxpayers?

Andrew Ebneter - Market based sourcing works to shift a tax burden outside the state from where the services are performed. I think there will be a continued uptick around the issue of "nexus", or whether businesses are taxable in states where revenue is sourced but services are not performed. Some states now have bright-line rules regarding certain amounts of sourced revenue automatically creating nexus in these states. In addition, states may require the "throwback" of service revenue from market-based states if nexus is not established where revenue is originally sourced based on customer location.

Michael D'Addio - Market-based sourcing deals with how sales are allocated in the sales factor of an apportionment formula to Connecticut.

For C corporations, sales of tangible property are generally sourced to the state where the property is delivered, regardless of its F.O.B. point. This was not always the rule applied to personally-owned businesses, S corporations or partnerships for many years. Prior to 2014, these sales were sourced based on where the sales activity occurred. This difference in the rules caused many adjustments on audit by Connecticut Department of Revenue Services for a partnership or S corporation which was incorrectly using the corporate rule. For sales of tangible property in 2014 and later, individuals, partnerships and S corporation were subject to the sourcing rule that applied to corporation. Sales of services were sourced for all entities based on the place the service was performed.

Under the proposal, all sales will be based on delivery. For tangible personal property, it depends on whether delivery is in this state. For services, it depends on whether the service is used in this state. The DRS will need to issue rules to detail how these rules apply.

Q. How complex is the new tax structure with regards to personal income taxpayers? Has the state set up a system that might be hard for average taxpayers to fathom?

Andrew Ebneter – There will be challenges for certain individuals, depending upon the number and type of income streams an individual has. If larger corporations face internal control challenges from a revenue-tracking standpoint when analyzing this issue, then it's fair to say that individuals will need to either endeavor to grasp the new law or rely on a tax advisor for assistance.

Michael D'Addio – The average taxpayer will not be subject to the market based sourced or single factor rules unless he or she is operating a multi-state business. Consequently, most will not be affected by these changes. The experience of other states using market-based sourcing of sales suggests that businesses will need guidance in particular circumstances.

Q. There's a new a new estate tax deduction beginning in 2021. What are the odds it is implemented as is? And, assuming it is implemented, what should people be doing in terms of planning now for it?

Andrew Ebneter – Investments made qualifying for the reduction will fund entrepreneurship in the state. To that end, the estate tax reduction appears to be an attempt at a "win-win" for estates and Connecticut though encouraging long-term investment in a state-affiliated program. Individuals with the wherewithal to contribute should discuss the reduction with their tax advisor.

Michael D'Addio - It is difficult to assess the odds of this provision passing. The estate tax is an area of great debate among Connecticut legislators. It probably makes sense to see what passes before doing any planning.

Q. One of the changes in the law revolves around sales & use tax (and cigarette tax) licenses, effective Jan. 1, 2017. Seller's permits will not be renewed if the applicant has failed to file any required returns. Previously, such licenses would not be renewed only if the applicant had outstanding taxes due. How prevalent a concern is this going to be? Wouldn't not filing a return dovetail with not paying required returns?

Andrew Ebneter – In the past, if a business did not have a sales tax liability, its management might not have filed returns showing zero tax, as doing so might have been construed as an administrative burden and unnecessary cost. With the passage of this law, however, compliance is mandated even if no tax is due. The submission of "zero" returns puts Connecticut on notice and gives the state an opportunity to audit a business to assess whether remitting no tax is appropriate.

Michael D'Addio - This can be a significant penalty for failure to file a return. The loss of license does not apply only where there is a tax due. A taxpayer not filing a zero tax return would also be subject to the new rule.

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