ROBINSON & COLE LLP
ATTORNEYS AT LAW


UPDATE
Tax Planning and Representation

MAY 2011

Connecticut Budget Act and Pending Tax Legislation

Facing an estimated $3.5 billion budget deficit, both chambers of the Connecticut General Assembly recently approved a modified version of Governor Dannel Malloy's original budget proposal. The $40.2 billion budget for fiscal years (FY) 2012 and 2013, signed into law by Governor Malloy on May 4, 2011, seeks to address the budget deficit, in part, by increasing a variety of taxes, including the individual income tax, the sales and use tax, and the corporation business tax. The legislative Office of Fiscal Analysis projects these measures will generate approximately $4 billion in additional revenue for the FY 2012-2013 biennium, representing the largest tax increase in state history. The administration has recently announced an agreement with state employee union negotiators that would produce an additional $1.6 billion in savings over the next two fiscal years. While this falls short of the $2 billion in savings the governor had sought, Governor Malloy reports that he will eliminate the remaining $400 million deficit without further raising taxes.

The new tax increases enacted as part of the governor's budget proposal (Bill) will impact virtually all types of taxpayers throughout the state. The changes to the individual income and corporation business tax rates are effective retroactive to January 1, 2011, while most of the other provisions take effect on July 1, 2011. The changes to the individual income and corporation business tax rates are effective retroactive to January 1, 2011, while most of the other provisions take effect on July 1, 2011. This legal update summarizes the tax-related measures found in the Bill and highlights the status of pending tax legislation not included in the Bill.

Individual Income Tax

- *Adoption of New Individual Income Tax Rates and Bracket Thresholds.* The Bill increases the marginal individual income tax rate for single taxpayers making over $50,000 and married couples making over $100,000 by creating a new six-bracket system as follows:

TAX RATES		Connecticut Taxable Income							
		Married Filing Jointly		Single		Head of Household		Married Filing Separately	
Current	The Bill	Over	But Not Over	Over	But Not Over	Over	But Not Over	Over	But Not Over
3.0%	3.0%	$0	$20,000	$0	$10,000	$0	$16,000	$0	$10,000
5.0%	5.0%	$20,000	$100,000	$10,000	$50,000	$16,000	$80,000	$10,000	$50,000

	5.5%	$100,000	$200,000	$50,000	$100,000	$80,000	$160,000	$50,000	$100,000
	6.0%	$200,000	$400,000	$100,000	$200,000	$160,000	$320,000	$100,000	$200,000
	6.5%	$400,000	$500,000	$200,000	$250,000	$320,000	$400,000	$200,000	$250,000
	6.7%	$500,000	$1,000,000	$250,000	$500,000	$400,000	$800,000	$250,000	$500,000
6.5%		Over $1,000,000		Over $500,000		Over $800,000		Over $500,000	

- *Phase-Out of Three Percent Tax Bracket and Recapture of Income Taxed at Lower Marginal Rates.* The Bill phases out the amount of income subject to the three percent income tax bracket, which is fully phased out for single taxpayers making over $101,500, married filing jointly taxpayers making over $145,000, head of household taxpayers making over $114,500, and married filing separately taxpayers making over $72,250. In a related measure, taxpayers must now pay an additional amount of tax based on a sliding scale to eliminate the benefits received from having a portion of their income taxed at the three percent and five percent marginal tax rates. For a taxpayer who is married filing jointly, the recapture amount is equal to $150 for each $10,000 earned over $400,000. The maximum amount that can be recaptured is $4,500, which represents the point at which 100 percent of the taxpayer's income is taxed at the highest 6.7 percent marginal tax rate.
- *Reduction of Property Tax Credit.* The Bill reduces the property tax credit from $500 to $300 and phases out the credit for high-income taxpayers. Under the terms of the Bill, joint filers making over $160,500 are not entitled to any property tax credit (as opposed to $190,500 under current law).
- *Creation of State-Earned Income Tax Credit.* The Bill creates a state-earned income tax credit equal to 30 percent of the federal credit.

Corporation Business Tax and Other Related Taxes

- *Corporation Tax Surcharge.* The Bill imposes a 20 percent corporation tax surcharge for the 2012 and 2013 income years. Set to expire for tax years beginning on or after January 1, 2014, this new 20 percent surcharge replaces the 10 percent surcharge that expires at the end of the 2011 income year. The surcharge applies only to companies with at least $100 million in annual gross income and a tax liability in excess of $250.
- *Credit Offset.* For income years 2011 and 2012, the Bill allows a corporation to offset an additional tax liability beyond the 70 percent limit when it experiences an average net monthly increase in employees. The amount of the offset is equal to the taxpayer's average net monthly increase in employees multiplied by $6,000. Under this measure, a company is eligible to offset no more than 100 percent of its total tax liability.
- *Limitation on Transfer of Film Production Tax Credit.* The Bill limits the amount of the Film Production Tax Credit (Conn. Gen. Stat. § 12-217jj) that a film production company may transfer to 50 percent of the credit in 2011 and 25 percent of the credit in 2012 and beyond.
- *Increase in Job Creation Tax Credit Limits.* The Bill increases the total amount of business and insurance premiums tax credits available for creating new jobs. Under existing law, the Creating New Jobs Credit (Conn. Gen. Stat. § 12-217ii), the Small Business Creating Jobs Credit (Conn. Gen. Stat. § 12-217nn), and the Vocational Rehabilitation Job Creation Tax Credit (Conn. Gen. Stat. § 12-217oo) were collectively capped at $11 million per year. The Bill increases the collective cap to $20 million.
- *Reduction of Credit.* For tax years 2011 and 2012, the Bill lowers the amount by which an insurer can utilize credits to reduce its insurance premium tax liability from 70 percent to 30 percent. The insurance reinvestment fund tax credit is exempted from this new 30 percent cap.

Sales and Use Taxes

- *Increase in Tax Rate.* The Bill increases the general sales and use tax rate from 6 percent to 6.35 percent and the hotel tax rate from 12 percent to 15 percent. The increase in tax rate does not affect the special rate for sales of computer and data processing services, currently taxed at one percent.
- *Luxury Goods Tax.* The Bill imposes a seven percent sales and use tax on the full price of the following items:
  - Motor vehicles costing more than $50,000, excluding vehicles with a gross vehicle weight rating of over 12,500 pounds and all qualifying commercial vehicles
  - Boats costing more than $100,000
  - Jewelry costing more than $5,000
  - Clothing or footwear (including handbags, watches, and luggage) costing more than $1,000
- *New Services to Be Taxed.* The Bill extends the sales and use taxes to the following services:
  - Motor vehicle storage
  - Packing and crating
  - Motor vehicle towing and road services (excluding repairs, which are otherwise taxable)
  - Intrastate transportation via livery services (excluding taxi, bus, funeral, and ambulance)
  - Pet grooming, pet boarding, and pet obedience classes
  - Cosmetic medical procedures (except reconstructive surgery)
  - Manicure and pedicure
  - Spa
- *Existing Exemptions Eliminated.* The Bill eliminates the tax exemptions currently in place for the following items:
  - Clothing and footwear costing less than $50
  - Nonprescription drugs and medicine
  - Containment or removal of hazardous waste
  - Airport valet parking
  - Yoga instruction
  - Cloth or fabric for noncommercial sewing
  - Property or services used in operating a solid waste-to-energy facility
  - Yarn
  - Smoking cessation products
- *Imposition of Amazon Tax.* The Bill requires certain remote sellers who have no physical presence in Connecticut to collect sales tax on their taxable sales in the state. A remote seller is presumed to be a retailer with a Connecticut nexus if it sells more than $2,000 worth of taxable items or services in Connecticut during the preceding four quarters. The remote seller acquires nexus with Connecticut if it has an agreement with an affiliate under which the affiliate receives a commission for referring potential customers to the seller. Connecticut joins other states, including New York, Rhode Island, and Illinois in passing this type of legislation. Connecticut's $2,000 threshold, however, is significantly lower compared to New York and Illinois ($10,000 threshold) as well as Rhode Island ($5,000 threshold).
- *Imposition of Rental Car Surcharge.* The Bill imposes an additional three percent sales and use tax on short-term car rentals, resulting in a total levy of 9.35 percent. This three percent addition is independent of the rental car surcharge under Conn. Gen. Stat. § 12-692(b).
- *New Municipal Revenue-Sharing Account Created.* The Bill requires the commissioner of Revenue Services to deposit certain allocated amounts from the increased taxes to

the Municipal Revenue-Sharing Account. The funds are used to make manufacturing transition grants to municipalities.

Estate and Gift Tax

- *Lowering of Estate and Gift Tax Threshold.* The Bill lowers the estate and gift tax threshold from $3.5 million to $2 million and applies the existing 7.2 percent rate to estates and gifts valued between $2 million and $3.5 million.

Other Taxes

- *Increases to the Real Estate Conveyance Tax.* The Bill increases the state real estate conveyance tax by 0.25 percent and makes permanent the 0.25 percent base municipal real estate conveyance tax, which was scheduled to expire on June 30, 2011. Currently, a 0.5 percent state tax is imposed upon residential property under $800,000 and the sales price of unimproved land and certain bank foreclosures, while sales of nonresidential property and any portion of the sales price of a residential property exceeding $800,000 are taxed at one percent. The Bill increases these state rates to 0.75 percent and 1.25 percent respectively, with the result that the combined state and municipal rate for sales of nonresidential property and residential property exceeding $800,000 will be 1.5 percent, effective July 1, 2011.
- *Temporary Tax on Electric Generation Facilities.* The Bill imposes a temporary tax on electric generation facilities at a rate of $0.0025 per net kilowatt hour of electricity generated and uploaded into the regional power grid at a Connecticut facility. The tax applies to all electricity, except electricity generated through use of a fuel cell or an alternative energy system (e.g., solar or wind system). The tax expires on June 30, 2013.
- *Establishment of Tax on Hospital Net Revenue.* The Bill eliminates the tax on hospitals' gross earnings and replaces it with a 4.6 percent tax on net patient revenue. A hospital's net patient revenue is the amount of its gross revenue, including amounts it receives from the federal government for Medicare patients. The Malloy administration claims that this new tax, projected to raise $350 million in revenue, will increase Connecticut's share of federal reimbursement funds. It is unclear, however, what the net effect will be for each hospital subject to the tax.
- *Increase in Cigarette and Tobacco Products Taxes.* The Bill increases the cigarette tax from $3.00 to $3.40 per pack, resulting in an increase of $4.00 per carton. It increases the tobacco products tax on snuff tobacco from $0.55 to $1.00 per ounce and all other tobacco products (e.g., cigars, cheroots, pipe tobacco, and similar products) from 27.5 percent of wholesale price to 50 percent.
- *Increase in Alcoholic Beverages Tax.* The Bill increases the excise tax on alcoholic beverages by 20 percent.
- *Increase in Diesel Fuels Tax.* The Bill increases the base tax on diesel fuel from $0.26 to $0.29 per gallon.
- *Elimination of Admissions Tax Exemptions.* The Bill eliminates the exemption from the 10 percent admissions tax for events held at many of the largest entertainment facilities in Connecticut.
- *Imposition of Cabaret Tax.* The Bill resurrects the cabaret tax, which was repealed in 1999. In its new incarnation, the tax is imposed at a rate of three percent on admissions, food, drink, service, and merchandise at any place offering live music, dancing, or other entertainment. The State is required to disburse such tax revenues to the municipality where the event occurred.

Not all proposed tax law changes are dealt with in the Bill. Some changes proposed by the

Department of Revenue Services (DRS Package) remain pending after being reported favorably out of the Joint Committee on Finance, Revenue, and Bonding. The DRS Package includes the following proposals:

- *Changes to Reciprocal Tax Refund Agreements.* Under existing law, the commissioner may withhold all or part of a taxpayer's Connecticut tax refund if another state requests the commissioner to withhold that amount. For Connecticut to withhold, the other state must make similar accommodations in the case of a taxpayer who owes Connecticut taxes. As part of the DRS Package, the commissioner is no longer required to give notice to the taxpayer when receiving a certification from the other state. The commissioner notifies the taxpayer only if the taxpayer is otherwise entitled to a refund (effective upon passage).
- *Economic Nexus for Corporation Business Tax.* Under existing law, a company is subject to the Connecticut corporation business tax, regardless of physical presence, either if it has a substantial economic presence in Connecticut or derives income from sources within the state. The DRS Package changes the economic nexus standard to require both substantial economic presence *and* a derivation of income from sources within Connecticut. Also, the DRS Package exempts from tax any company treated as a foreign corporation under the Internal Revenue Code of 1986, as amended, that has no income effectively connected with a U.S. trade or business (effective upon passage and applicable to income years beginning on or after January 1, 2011),
- *Extension of Time for DRS to Issue Withholding Tax Deficiency Assessment.* In addition to taxpayers who omit more than 25 percent of their income from their tax return, the DRS Package extends the six-year period of assessment to situations in which employers omit more than 25 percent of Connecticut wages from their withholding tax return or pass-through entities omit more than 25 percent of Connecticut-sourced adjusted gross income from withholding taxes of their nonresident members (effective upon passage and applicable to tax years staring January 1, 2011).
- *Reduced Penalty Framework Related to Electronic Funds Transfer.* In the case of taxpayers who make a timely payment but submit such amounts by a method other than electronic funds transfer, the commissioner is required to impose a penalty equal to the lesser of 10 percent of the tax payment or $100 for the first offense. For the second offense, the penalty is the lesser of 10 percent of the tax payment or $10,000 (effective upon passage and applicable to payments for tax periods beginning on or after January 1, 2012).
- *Payment of State Taxes as a Condition of Issuing State License.* The DRS Package gives the commissioner of Revenue Services the authority to enter into an agreement with the head of an agency that issues professional, occupational, or business licenses to require the payment of all state taxes that may be due and owing before issuance of the applicant's license (effective July 1, 2011).
- *Electronic Funds Transfer for Withholding Tax Payments for Nonpayroll Amounts.* The DRS Package requires an employer with more than $2,000 in income tax withholding liability from nonpayroll amounts to pay the taxes electronically (effective July 1, 2011).
- *Successor Liability for Withholding Taxes.* The DRS Package requires the purchaser of a business to withhold from the purchase price an amount equal to any unpaid withholding taxes, penalties, or interest until the employer provides a DRS receipt or clearance certificate. This concept is identical to successor liability with respect to sales and use taxes (effective July 1, 2011).
- *Revisions to Nonresident Contractor Bond Provisions.* The DRS Package makes significant administrative changes to provisions relating to nonresident contractors. Under the proposal, resident contractors who have registered with the DRS and have filed all required tax returns are "verified" contractors and not required to post a bond. DRS is required to provide upon request information whether a nonresident contractor

either is a verified contractor or has posted a bond. Withholding is required only in the case of contractors or subcontractors who either are not verified or have not posted a bond. The proposed legislation also exempts from bonding and withholding provisions contracts with a total contract price of less than $250,000 (effective October 1, 2011).

- *Corporation Business Tax Overpayments.* In the case of a corporation that has overpaid its estimated tax liability, the existing law requires the DRS to issue a refund. As part of the DRS Package, a corporation that has overpaid its estimated tax liability for the year must apply such excess to its estimated taxes in the following year (effective October 1, 2011, and applicable to estimated tax payments for income years starting January 1, 2012).

If you have any questions regarding the recently enacted budget or the DRS Legislative Package, please contact one of the following attorneys:

Richard W. Tomeo
(860) 275-8278
rtomeo@rc.com

John R. Shaughnessy, Jr.
(860) 275-8314
jshaughnessy@rc.com

Felicia S. Hoeniger
(860) 275-8309
fhoeniger@rc.com

Christine E. Bromberg
(860) 275-8353
cbromberg@rc.com

Scott E. Sebastian
(860)275-8386
ssebastian@rc.com
