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Pro-Business Tax Legislation in Connecticut; Yes, You Heard It Right

In the recently executed implementer bill, Governor Malloy signed into law two favorable income tax changes for Connecticut businesses. First, Connecticut has now joined the ranks of many other states, including neighboring New York and Massachusetts, in using a single sales factor to determine Connecticut taxable income. Second, for service businesses, services will now be sourced based on the destination of the service. The implementer finished work that began last year so that for the tax period beginning in 2018 all business entities, from C corporations to pass-throughs, will be subject to the same apportionment methodology.

Single Sales Factor Apportionment

Beginning for the tax years after 2016 for C corporations and after 2017 for pass-throughs (collectively, the “Tax Periods”), business entities will now be able to determine the portion of their taxable income subject to Connecticut income tax based solely on a single sales factor (“SSF”). The SSF replaces the historic three factor test where Connecticut-based property and payroll were also determining factors in the amount of taxable income subject to Connecticut income taxes. The SSF is typically enacted for two reasons: (1) it makes the state more attractive for businesses to expand their physical footprint and number of employees; and (2) it incentivizes existing businesses not to decrease their physical footprint or number of employees. For Connecticut-based businesses, the change to the SSF to calculate taxable income should result in a substantial reduction in the business entity’s Connecticut income tax liability.

Market-State Sales Factor Apportionment

For the Tax Periods, the sale of services (and income derived from intangible assets) will now be sourced where the customer is located (*i.e.*, the destination of the services). In the past, the taxation of services was based on where the activity was performed. As with the SSF, the market-state sales factor (“MSSF”) has Connecticut now coming to the table with an apportionment factor for services to counter legislation enacted throughout the country, including in New York and Massachusetts. This sourcing makes the apportionment of services similar to the sourcing of the sales of goods: generally, where the customer who receives the service is located. The rationale for enacting the MSSF typically includes: (1) attracting service companies looking to establish branches or offices within the state; and (2) increasing tax revenue since the pie of taxable sales is bigger by including out-of-state service providers. For Connecticut-based service businesses, the change to the MSSF should, like the SSF, result in favorable income tax consequences.

Conclusion

The goal of all apportionment methods is to provide a “reasonable approximation” of the business entity’s in-state level of activity. Based on this level of activity, states can then sufficiently calculate the business entity’s “fair share” of multistate income that a state may collect in taxes. In the context of “reasonable” and “fair” with any SSF and MSSF lie the opportunity of zero taxation and the real risk of double taxation. With the Tax Periods on the horizon, now may be the right time to consider with your tax advisor the effect of the SSF and MSSF on your taxable income subject to Connecticut’s (and potentially other states’) income tax.

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