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Connecticut General Assembly Approves Budget for the Biennium

The Connecticut General Assembly has adopted, and Governor Malloy yesterday signed, Senate Bill No. 1239, “An Act Concerning the Budget for the Biennium Ending June 30, 2013” (the “Act” or “Budget”).

The Act is projected to increase state tax revenues by approximately \$1.5 billion, principally through increases in the income tax, corporation business tax, sales and use tax and other miscellaneous taxes and fees. The tax increases are likely to impact every taxpayer and will require most businesses to implement quickly new sales tax rates, revised withholding tax tables and other new tax-related requirements.

In this Alert, we summarize the principal tax provisions in the Budget so that our clients can begin immediately to address the new compliance requirements. Hopefully, administrative guidance will be published promptly as many of the tax law changes are retroactive to January 1, 2011, or are scheduled to be effective as early as July 1, 2011. Please note, however, that the Budget contemplates significant concessions from state employees, totaling approximately \$2 billion over two years. If an agreement with the state employees achieves less than \$2 billion in savings, the Governor is to submit to the General Assembly recommendations for budget adjustments to achieve the difference. Although such adjustments are intended to be in the form of reduced expenses, there is nothing to prevent the legislature from adopting additional tax increases. In addition, the Connecticut General Assembly is still in session until June 8, 2011, and additional tax legislation may be enacted. As in prior years, we will publish our legislative review once the legislative session has concluded.

Please contact a member of our State and Local Tax Practice Group if you have any questions regarding the Budget or how its provisions will affect you or your business.

INDIVIDUAL INCOME TAX

As originally proposed, the Budget eliminated the property tax credit of \$500 and provided for a schedule of eight marginal tax rates with the new top rate of 6.7% effective for Connecticut taxable income in excess of \$1 million for joint filers. The final Budget partially restores the property tax credit, but meaningfully increases the taxes on more affluent taxpayers by cutting in half the income levels at which the higher marginal tax rates apply and by phasing out the benefit of the lower marginal rates as a taxpayer's income increases over a certain income threshold.

New and Increased Marginal Tax Rates. The prior schedule of three marginal tax rates of 3.0%, 5.0% and 6.5% is replaced, retroactively to January 1, 2011, with a schedule of six marginal tax rates, including a top rate of 6.7%. The new rates for single taxpayers (including married individuals filing separately), joint filers and heads of households, and the income levels after which each rate would apply, are as follows:

	3.0%	5.0%	5.5%	6.0%	6.5%	6.7%
Single	\$0	\$10,000	\$50,000	\$100,000	\$200,000	\$250,000
Joint	\$0	\$20,000	\$100,000	\$200,000	\$400,000	\$500,000
HOH	\$0	\$16,000	\$80,000	\$160,000	\$320,000	\$400,000

Phase Out of Lowest Marginal Tax Rate. The amount of a taxpayer's Connecticut taxable income that will be subject to the 3.0% tax rate will begin to phase out when the Connecticut adjusted gross income of the taxpayer exceeds \$56,500 in the case of a single filer, \$100,500 in the case of a joint filer, \$78,500 in the case of a head of household filer, and \$50,250 in the case of a married individual filing separately. Income subject to the phase-out will be taxed at the 5.0% rate.

Recapture of Marginal Rate Benefits. The final Budget includes a "recapture" provision whereby a taxpayer will lose the benefit of the lower marginal rates once the taxpayer's Connecticut adjusted gross income exceeds a certain income threshold (\$400,000 for joint filers, \$320,000 for head of household filers, and \$200,000 for single and married filing separately filers). By way of example, joint filers are required to recapture \$150 in tax benefits (*i.e.*, pay an additional tax of \$150) for every \$10,000, or fraction thereof, in Connecticut adjusted gross income they earn over \$400,000 (up to a maximum recapture amount of \$4,500). The result is that a couple filing a joint tax return will lose any benefit of the lower marginal tax rates once their Connecticut adjusted gross income reaches \$700,000.

Reduction of Property Tax Credit. The tax credit for property taxes paid with respect to a primary residence or motor vehicle, that currently can be up to \$500, is reduced to a maximum of up to \$300. Prior law reduced the maximum credit by 10% for every \$10,000 (\$5,000 for married filing separately filers) in additional Connecticut adjusted gross income earned over certain thresholds. The proposal provides for a steeper phase-out by increasing the percentage reduction to 15%.

Trusts and Estates. The tax rate applicable to the Connecticut taxable income of trusts and estates is increased from 6.5% to 6.7% as of January 1, 2011.

Estimated Tax Payments. Any taxpayer required to make an estimated tax payment in September of 2011 is required to make a catch-up estimated tax payment in such month to account for any change in the rate of tax applicable to their 2011 Connecticut taxable income.

Income Tax Withholding. The Department of Revenue Services is to issue new withholding tables for 2011 Connecticut income tax withholding to account for the new and increased marginal tax rates.

Nonresident Partner/Member/Shareholder Withholding. Since the required rate of withholding on the Connecticut source income of nonresident partners of a partnership, members of a limited liability company and shareholders of a Subchapter S corporation is the highest marginal income tax rate, the new marginal tax rate schedule increases the rate of withholding from 6.5% to 6.7%.

Earned Income Tax Credit. Applicable to tax years commencing on or after January 1, 2011, a Connecticut resident subject to the Connecticut personal income tax generally is entitled to claim a tax credit against the taxpayer's Connecticut tax equal to 30% of the amount of the taxpayer's federal earned income credit. The credit is refundable to the extent that the credit exceeds the taxpayer's liability for Connecticut income tax, but would not earn interest in the event of a late payment of the refund.

CORPORATION BUSINESS TAX

The initial Budget proposal contemplated an extension of the existing 10% surcharge and the implementation of a "throwback" rule for corporate sellers of tangible personal property. The "throwback" rule fortunately was deleted from the final Budget, but the "cost" seemingly was an increase in the surcharge from 10% to 20% for the 2012 and 2013 tax years.

Surcharge Continued and Increased for Two Years. The 10% surcharge on the corporation business tax, that was to be applicable only to income years commencing prior to January 1, 2012, is extended for two additional years, through income years commencing prior to January 1, 2014, and is increased to 20% for each of those two additional years. As under current law, the surcharge is calculated based upon the tax liability of the Subchapter C corporation, excluding any credits, whether calculated based upon the corporation's net income or capital base, and is imposed on the corporation unless either (i) the tax liability of the corporation is equal to \$250 (i.e. the minimum tax) or (ii) the annual gross income of the corporation is less than \$100 million. The \$100 million annual gross income exemption is not available to a corporation that files a combined or unitary return.

TAX CREDITS

Credit Cap Reduction and Relief. Under prior law, the amount of tax credit or credits allowable against the corporation business tax or the insurance premium/subscriber charge tax generally could not exceed 70% of the amount of tax due. After the insurance industry successfully protested the Governor's proposed increase of the insurance premium/subscriber charge tax, the Budget was amended to lower the cap on credits to 30% of the amount of tax due for taxpayers subject to the insurance premium/subscriber charge tax for the 2011 and 2012 tax years (with the exception of the Connecticut insurance reinvestment fund tax credit provided in Conn. Gen. Stat. § 38a-88a). The Act does, however, permit a taxpayer to exceed the 70% cap or 30% cap, as applicable, by an amount equal to \$6,000 multiplied by the taxpayer's "average monthly net employee gain" for the year, which is determined by adding the total increase in employees for the applicable year and dividing by 12. In the case of a taxpayer subject to the corporation business tax, the relief from the 70% cap is available for an income year commencing on or after January 1, 2011, and prior to January 1, 2013, and would be based upon the average monthly net employee gain for the income year. In the case of a taxpayer subject to the insurance premium/subscriber charge tax, the new, two-year 30% cap limit would be applied on a calendar

year basis, and the cap relief would be available during, and based upon the average monthly net employee gain for, the 2011 and 2012 calendar years. In both cases, the aggregate credits allowed may not exceed the total tax liability of the taxpayer. For purposes of determining whether there has been a “net employee gain,” only employees who are required to work at least 35 hours per week and who were not employed in Connecticut by a related party within 12 months before the applicable calendar year will be counted.

Film Production Tax Credit. The ability of a taxpayer to transfer film production tax credits generally will be limited if the transferring taxpayer is neither subject to the corporation business tax nor to the insurance premium/subscriber charge tax. The limitation would prevent such a taxpayer from transferring more than 50% of its film production tax credits in any one year in the case of credits allowed for the 2011 income year, and more than 25% of any such credits in any one year in the case of a credit allowed for any subsequent year. The new limitation will not apply to credits issued for any qualified production that is created in whole or in significant part, as determined by the Department of Economic and Community Development (“DECD”), at a “qualified production facility.” A “qualified production facility” means a facility: (i) located in Connecticut; (ii) intended for film, television or digital media production; and (iii) that has a minimum investment of \$3 million (or less if approved by the DECD). The Act also increases, from 25% to 50%, the minimum share of principal photography days that a production company must spend in Connecticut in order to qualify for the film production tax credit.

Job Creation Tax Credit Programs. Effective July 1, 2011, the aggregate limit on tax credits granted under the jobs creation tax credit program, the qualified small business job creation tax program and the vocational rehabilitation job creation tax credit program is increased from \$11 million to \$20 million in any one fiscal year.

SALES AND USE TAX

Rate Increases. The Budget increases the following base sales tax rates:

- **General Sales and Use Tax Rate.** The general sales and use tax rate is increased from 6.0% to 6.35% for sales occurring on or after July 1, 2011.
- **Room Occupancy Tax Rate.** The room occupancy tax rate is increased from 12% to 15% as of July 1, 2011.
- **Motor Vehicle Rental or Lease Tax Rate.** As of July 1, 2011, the sales and use tax rate for the rental or lease of a passenger motor vehicle for a period of 30 days or less is increased from 6.0% to 9.35%.
- **Luxury Item Sales and Use Tax Rate.** Commencing July 1, 2011, the sale of the following “luxury” items are subject to a tax of 7.0% on the full purchase price: (i) a motor vehicle with a sales price exceeding \$50,000 (excluding motor vehicles purchased by nonresident members of the armed forces, motor vehicles having a gross vehicle weight rating over 12,500 pounds or having a gross vehicle weight rating of 12,500 pounds or less that is not used for private passenger purposes, but is designed or used to transport merchandise, freight or persons in connection with any business enterprise and issued a commercial registration or more specific type of registration by the Department of Motor Vehicles); (ii) a vessel with a sales price exceeding \$100,000; (iii) jewelry with a sales price exceeding \$5,000; and (iv) an article of clothing or footwear, a handbag, an article of luggage, umbrella, wallet or watch for a sales price exceeding \$1,000.
- **Municipal Revenue Sharing Account.** For calendar quarters ending on or after September 30, 2011, the Commissioner of Revenue Services is to deposit into a new “municipal revenue sharing account” an amount equal

to the sum of (i) 1.57% of the amounts received by the State from the general 6.35% sales and use tax; and (ii) 1.43% of the amounts received by the State from the sales and use tax on luxury items. The money in the account is to be expended by the Secretary of OPM for “manufacturing transition grants” to municipalities. The grants are to equal the amount each municipality received (or estimated would have received if timely requested) in the 2011 fiscal year as a payment in lieu of taxes (PILOT) for eligible commercial vehicles, manufacturing machinery and equipment, and certain real property in enterprise zones. Any remaining funds are to be disbursed to municipalities according to a statutory formula.

- **Regional Performance Incentive Account.** For calendar quarters ending on or after September 30, 2011, the Commissioner of Revenue Services is to deposit into a new “regional performance incentive account” an amount equal to the sum of: (i) 6.7% of the amounts received by the State from the occupancy tax; and (ii) 10.7% of the amounts received by the State from the sales and use tax on rental or leased motor vehicles. The money in the account is to be expended by the Secretary of OPM for grants to regional entities to provide a local service on a regional basis.

Numerous Sales Tax Exemptions Repealed. The following exemptions from the Connecticut sales and use tax are repealed, thereby rendering sales or use of these services or property subject to sales tax, effective for sales occurring on or after July 1, 2011:

- Voluntary evaluation, prevention, treatment, containment or removal of hazardous waste or other contaminants of air, water or soil when rendered to industrial, commercial or income-producing property
- Valet parking provided at any airport
- Yoga instruction provided at a yoga studio
- Articles of clothing or footwear costing under \$50 (thereby rendering clothing and footwear generally subject to tax)
- Nonprescription drugs and medicines
- Cloth or fabric purchased for noncommercial sewing
- Services or tangible personal property used or consumed in operating solid waste-to-energy facilities
- Yarn for noncommercial use
- Products that aid in the cessation of smoking

New Taxable Services. The following new services are subject to the sales and use tax effective July 1, 2011:

- Motor vehicle storage services (including motor homes, campers and camp trailers)
- Packing and crating services (to the extent not already subject to the tax in connection with the sale of tangible personal property)
- Motor vehicle towing and road services

- Intrastate transportation services provided by livery services (but not including transportation by taxicab, motorbus, ambulance or ambulette, scheduled public transportation or services provided in connection with funerals)
- Pet grooming and pet boarding services, except when such services are provided as an integral part of professional veterinary services, and pet obedience services
- Services in connection with a cosmetic medical procedure [N.B. Reconstructive surgery is expressly excluded from the definition of “cosmetic medical procedures.”]
- Manicure and pedicure services and all other nail services
- Spa services, regardless of where performed, including body waxing and wraps, peels, scrubs and facials

Sales and Use Tax Collection by Remote Sellers (the “Amazon” Rule). The Budget establishes a new presumption that a retailer that does not have a physical presence in Connecticut must collect and remit sales tax on its taxable sales to Connecticut if the retailer annually sells more than \$2,000 worth of taxable items or services in Connecticut through an independent contractor or other representative who is a resident of Connecticut, if the retailer enters into an agreement with the resident under which the resident, for a commission or other consideration, directly or indirectly refers potential customers, whether by a link on an Internet website or otherwise, to the retailer. The retailer will be presumed to be soliciting business through such contractor or representative, which presumption may be rebutted by proof that the resident with whom the retailer has an agreement did not engage in any solicitation in Connecticut on behalf of the retailer that would satisfy the nexus requirement of the United States Constitution. [Ed. note. Similar legislation has been enacted in other jurisdictions and is the subject of a constitutional challenge in a case brought by Amazon.com in New York.]

ESTATE AND GIFT TAXES

Taxable Estate Threshold. Effective for the estates of decedents dying on or after January 1, 2011, the taxable estate threshold is lowered from \$3.5 million to \$2.0 million.

Taxable Gift Threshold. Effective for Connecticut taxable gifts made by a donor on or after January 1, 2011, including the aggregate amounts of all Connecticut taxable gifts made by the donor during all calendar years commencing on or after January 1, 2005, the taxable threshold is lowered from \$3.5 million to \$2.0 million.

MISCELLANEOUS TAXES

Hospital Provider Tax. Effective July 1, 2011, each hospital in Connecticut will be required to pay a tax at the rate of 4.6% on its net patient revenue each calendar quarter. “Net patient revenue” is defined as the hospital’s gross revenue including the amount received by the hospital from the federal government for Medicare patients. In the case of a delinquency which has been reported by the Commissioner of Revenue Services to the Commissioner of Social Services, the Commissioner of Social Services shall deduct and withhold the delinquent amount from amounts otherwise payable by the Department of Social Services to the hospital. Returns must be filed electronically and payment made by electronic funds transfer irrespective of the general requirements pertaining to electronic filing and fund transfers set forth in Chapter 228g of the Connecticut General Statutes.

Nursing Home Resident User Fee. The nursing home user fee cap is increased to the maximum allowed under federal law, which currently is 5.5%, and is to be 6.0% effective October 1, 2011.

New User Fee for Intermediate Care Facilities for the Mentally Retarded. Effective July 1, 2011, a new user fee is imposed on residential facilities for the mentally retarded. Before October 1, 2011, the fee can be as high as 5.5%; on or after October 1, 2011, the fee is capped at the maximum amount allowed by federal law (currently 6%). Similar to the Hospital Provider Tax discussed above, the Commissioner of Social Services is to deduct and withhold any delinquent user fee amount from amounts otherwise payable by the Department of Social Services to the intermediate care facility. [N.B. The user fee is not to be collected until the Commissioner of Social Services informs the Commissioner of Revenue Services that all necessary federal approvals are in effect to secure federal financial participation matching funds associated with any authorized facility rate increases.]

Real Estate Conveyance Tax. The state conveyance tax rate currently is (i) 0.5% of (A) the first \$800,000 of the sale price of a residential property and (B) the full sale price of unimproved land and certain bank foreclosures for mortgage delinquencies; and (ii) 1% of (A) any portion of the sales price of a residential dwelling that exceeds \$800,000 and (B) sales of nonresidential property other than unimproved land. Effective July 1, 2011, both state rates are increased by 0.25% to 0.75% and 1.25%, respectively. (The tax revenue attributable to the 0.25% increase is to be deposited in the municipal revenue sharing account.) The "temporary" increase in the municipal portion of the real estate conveyance tax from 0.11% to 0.25% is made permanent as of the same date. Note that certain targeted investment communities can further increase the municipal portion of the real estate conveyance tax to 0.50%. Currently, there are 18 municipalities that have done so.

Cigarette and Tobacco Products Tax. The tax on each cigarette pack is increased from 150 mills to 170 mills (representing an increase from \$3.00 to \$3.40 per pack) effective July 1, 2011, and a dealer or distributor will be required to pay a floor tax of 20 mills (40 cents) per cigarette pack in the dealer's inventory as of the close of business on June 30, 2011. Failure to file a report and pay the floor tax by August 15, 2011 may result in substantial penalties and/or revocation of such cigarette dealer's or distributor's license and any other Department of Revenue Services-issued license or permit the person or entity holds. Also effective July 1, 2011, the tax on snuff is increased from 55 cents to one dollar per ounce. The tax on all other tobacco products, as of the same date, is increased from 27.5% to 50% of the wholesale sales price of such products.

Alcoholic Beverages Tax. Effective for sales occurring on or after July 1, 2011, the tax on alcoholic beverages is increased generally by 20% as follows: (i) beer, and cider containing not more than 7% of absolute alcohol: from \$6.00 to \$7.20 for each barrel; \$3.00 to \$3.60 for each half barrel; \$1.50 to \$1.80 for each quarter barrel; \$0.20 to \$0.24 for each wine gallon or fraction under a quarter barrel; (ii) liquor: from \$4.50 to \$5.40 per wine gallon; (iii) still wines of not more than 21% absolute alcohol: from 60 cents to 72 cents per wine gallon; (iv) other still wines and sparkling wines: from \$1.50 to \$1.80 per wine gallon; (v) alcohol in excess of 100 proof: from \$4.50 to \$5.40 per proof gallon; (vi) liquor coolers containing not more than 7% alcohol: from \$2.05 to \$2.46 per wine gallon; and (vii) certain still wine produced by small producers: from 15 cents to 18 cents per wine gallon. A floor tax is imposed on alcohol inventories as of the effective date of the new tax rates. Failure to file a report and pay the floor tax by August 15, 2011 may result in substantial penalties and/or revocation of any Department of Revenue Services-issued license or permit the person or entity holds.

Motor Vehicles Fuels Tax. Effective July 1, 2011, the base tax on diesel fuel is increased from 26 cents to 29 cents per gallon. A floor tax of 3 cents is imposed on inventories of diesel fuel as of the close of business on June 30, 2011. Failure to file a report and pay the floor tax by August 1, 2011 may result in substantial penalties and/or revocation of any Department of Revenue Services-issued license or permit the person or entity holds.



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Electric Generation Tax. Commencing July 1, 2011, and effective only through June 30, 2013, a new tax is imposed on any person providing electric generation services and uploading electricity generated at such person's electric generation facility in this state to the regional bulk power grid. The tax is the product of one-quarter of one cent multiplied by the net kilowatt hours of electricity generated by such person and uploaded to the regional bulk power grid. The tax does not apply to any net kilowatt hours of electricity generated exclusively through the use of fuel cells or an alternative energy system, such as a solar or wind system. The Department of Revenue Services audit, collection, and other tax administration procedures applicable to the admissions and dues taxes apply to the generator tax except where inconsistent.

Admissions Tax Exemptions Repealed. Effective January 1, 2012, the exemption from the admissions tax would be repealed for any event held at a number of venues, including, amongst others, the Hartford Civic Center, Connecticut Convention Center, New Britain Veterans Memorial Stadium, New Britain Beehive Stadium, Bridgeport Harbor Yard Stadium, the Arena at Harbor Yard and Lime Rock Park.

Cabaret Tax. Effective July 1, 2011, a tax equal to 3% is imposed on all amounts charged for admissions, food and drink, service or merchandise at any cabaret or similar place furnishing music, dancing privileges or any other entertainment for profit. The taxes collected by the State are to be disbursed to the municipality where the transactions occurred. The administrative, enforcement, liability and appeal process requirements applicable to the admissions tax will be applicable to the cabaret tax.

Our State and Local Tax Practice

The attorneys in the **State and Local Taxation Practice** at Shipman & Goodwin LLP are regularly called upon to advise businesses, executives and individual clients on all aspects of state and local tax matters. Additionally, our tax lawyers represent clients in connection with state and local tax audits, refund requests and appeals from state or local assessments.

This newsletter is for informational purposes only. It is not intended as legal advice. How the laws and principles described here will apply in a particular matter depends on the facts of that situation.

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