Tax Reform

Connecticut Mulls State, Local Tax Deduction Cap Workarounds

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- Bill would create "revenue neutral" tax, corresponding state credit on pass-through entities
- Cities, towns could create charitable organizations to support town services
- Moody's says Connecticut has second-highest percentage of filers who claim state, local tax deduction

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By Aaron Nicodemus

Connecticut legislators and tax officials continue to wrestle with provisions of the new federal tax law--particularly its cap on state and local tax deductions.

Gov. Dannel Malloy (D) has proposed a bill (S.B.11) that would create a new "revenue-neutral" state tax on pass-through entities, which would be fully offset by a corresponding state income tax credit. The amount of the new state tax would be fully deductible as a new expense on a business's federal income tax return. That would help offset the $10,000 state and local tax (SALT) deduction cap in the 2017 federal tax act (Pub. L. No. 115-97), Malloy said.

Louis Schatz, partner with Shipman & Goodwin LLP in Hartford, called Malloy's proposal "encouraging," but told Bloomberg Tax in an April 18 email the success of the legislation "will depend on the implementation of the new provisions."

The business community would prefer that the state respond to the federal tax changes by lowering taxes, said Eric Gjede, counsel with the Connecticut Business and Industry Association. In March 2 testimony before the Senate Committee on Finance, Revenue & Bonding, he said the proposal "certainly merits further review."

"However, we urge the committee to look at whether corporate partners should be required to pay this new tax, especially given that due to their structure and liability, corporate partners may be unable to realize the state tax credit," he wrote.

Moody's Assessment

An April 11 report by Moody's Investors Service laid out how the SALT deduction cap will have "an adverse credit effect" on state governments in Connecticut, New Jersey, and New York.

The report noted that Connecticut has the second highest percentage (41 percent) of tax filers who claim a SALT deduction, trailing only Maryland (46 percent) and tied with New Jersey. Connecticut also had the second highest average SALT deduction, trailing only New York.

The report said that the SALT deduction cap will slow the growth in housing prices in those states, especially among high-value properties, curbing property value and property tax revenue growth.

"In the event that growth in property taxes slows, local governments with high fixed costs--pension obligations, debt service and retirement health benefits--will have more difficulty reducing expenditures because they have less discretionary spending in their budgets," the report said. "Also, the tax legislation's elimination of advanced refundings will make it more difficult for local governments to generate additional cash flow savings by taking advantage of lower interest rates."

Local Charitable Organizations

S.B. 11, which is under review by the state's Office of Legislative Research and Office of Fiscal Analysis, also proposes allowing Connecticut municipalities to create charitable organizations that support town services, in conjunction with a local property tax credit.

This proposal may be more problematic, Schatz said.

"The plan could conceivably work, but the issue that will be faced by taxpayers seeking the federal charitable deduction is whether they can show the requisite donative intent," Schatz said.

New York recently enacted a similar plan. The state became the first to substantially overhaul its tax code in response to the new federal tax law when Gov. Andrew M. Cuomo (D) signed an omnibus budget bill (S. 7509) April 12 that creates a payroll tax and new charitable funds to offset the impact of the SALT deduction cap.

New Jersey lawmakers also passed legislation (S.1893) that would allow a municipality, county, or school district to establish charitable funds for specific purposes and would permit property tax credits for certain donations. Gov. Phil Murphy (D) hasn't signed the bill, but has voiced support for the proposal.

Some have questioned whether the charitable funds idea will pass muster with the IRS, which could potentially consider it an abusive tax shelter. U.S. Treasury Secretary Steven Mnuchin has cast doubt on such workarounds and has threatened to audit taxpayers who use them. IRS Publication 526 says that taxpayers can't deduct as a charitable contribution any payment for which they receive a benefit in return.

Repatriation Income

Meanwhile, the Connecticut Department of Revenue Services (DRS) issued guidance (OGC-4) April 9 explaining how repatriated income is to be treated by Connecticut corporate and individual taxpayers under Internal Revenue Code Section 965.

In its guidance, the DRS noted that deferred foreign income, also known as "Section 965 income," must be reported in its entirety on 2017 Connecticut tax returns, and that Connecticut treats deferred foreign income as dividend income. The guidance further said that corporations are entitled to a full deduction of such dividend income under Connecticut state tax law, but that each corporation must "add back its expenses that are related to its dividend income."

That could prove administratively difficult, the guidance said. S.B.11 would simplify the calculation "by setting the amount of expenses related to dividend income at 10% of the dividend income. Thus, a corporation would multiply its Section 965 income by 10% to determine its expenses related to dividend income," according to the guidance.

The guidance also said that the 10 percent figure "historically has been found to reasonably approximate a corporation's expenses related to dividend income and would be accepted by DRS as the appropriate expense addback amount."

Phasing Out Capital Stock Tax

Connecticut is also considering S.B. 5581, which proposes to phase out the state's capital stock tax over three years and would allow bonus depreciation and asset expensing deductions to be taken over two years.

The federal tax law increased the bonus depreciation and asset expense deductions for federal taxpayers.

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Text of the Moody's report is at http://src.bna.com/x32.
Text of S.B11 is at visit http://src.bna.com/x1r.
Text of the DRS guidance is at http://src.bna.com/x1h.