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In this article, Schatz examines recent legislative revisions to the Connecticut passthrough entity tax.

Shortly following the adoption of the federal Tax Cuts and Jobs Act of 2017, Connecticut adopted its passthrough entity (PTE) tax (also known as PET).[1] Connecticut was the first state in the country to adopt a PET, which was effective with the 2018 tax year. The purpose of the PET was to provide the owners of certain passthrough entities, such as limited liability companies, partnerships, and S corporations (referred to herein as PTEs[2]), with a way to mitigate the negative tax consequences of the $10,000 limitation imposed by the TCJA on the deduction of certain state and local taxes (the SALT limitation).[3] Connecticut was the first state in the country to impose an income-based tax directly on PTEs that was designed to provide a workaround to the SALT limitation.

In brief, the main objective of the 2018 Connecticut PET legislation was to provide the owners of the PTE with the economic effect of a federal income tax deduction resulting from the movement of the tax burden for state and local income taxes from the owners of the PTE to the PTE, in which case such income taxes would be deductible by the PTE. Without the 2018 Connecticut PET legislation, the state tax burden on the income earned by the PTE would be on the individual owners of the PTE, and the state income tax would generally not be fully deductible for federal tax purposes because of the SALT limitation.

When the 2018 Connecticut PET legislation was adopted, there was some concern that the IRS would challenge the PET deduction taken by the PTE on the federal tax return filed by the PTE on the theory that the PET expense was an expense paid on behalf of the owners of the PTE, and not a direct tax imposed on the income of the PTE; therefore, not an expense of the PTE. However, the IRS announced in November 2020[4] that it would not challenge the PET expense deduction taken by the PTE. Following the release by the IRS of its November 2020 notice, many other states adopted their own versions of a PET; however,

[1] 2018 Conn. P.A. No. 18-49, section 1 (effective May 21, 2018, added 12-699) (the 2018 Connecticut PET legislation).

[2] Single-member LLCs are not included within the definition of PTEs, unless the single-member LLC has elected under federal tax law to be taxed as an S corporation. Sole proprietorships also are not considered PTEs.

[3] IRC section 164(b)(6), as amended by the TCJA.

[4] IRS Notice 2020-75. No further guidance has been issued by the IRS on this topic since 2020.

Connecticut's PET remained the only PET in the country that was mandatory, not optional.

On June 12, 2023, Connecticut Gov. Ned Lamont (D) signed P.L. 23-204 (H.B. 6941) (the Act) into law. Among its many provisions, the Act makes significant changes to the 2018 Connecticut PET legislation.[5] While the changes are not effective until tax years beginning on or after January 1, 2024, they will affect every PTE that has been filing a Connecticut PET return. Accordingly, it is not too early for PTEs that have been subject to the Connecticut PET to begin considering how the new changes to Connecticut's PET will impact these PTEs.

Overview of the 2018 Connecticut PET Legislation

Before the enactment of the 2018 Connecticut PET legislation, PTEs in Connecticut were not subject to an entity-level tax on their net income. Instead, the PTE's net income would pass through to the owners of the PTE and be subject to the Connecticut personal income tax (if the owner was an individual, trust, or estate) or subject to the Connecticut corporate business tax (if the owner was a corporation). However, each PTE was required to file a Connecticut tax return and pay Connecticut personal income tax on behalf of its nonresident owners.[6]

Effective for tax years beginning on or after January 1, 2018, Connecticut adopted the PET. The PET was made a mandatory tax and was imposed on PTEs at the entity level.[7] The tax rate for the PET was set at the then-existing highest marginal rate for the personal income tax, which at that time was (and continues to be) 6.99 percent.[8] In determining a PTE's PET liability, each PTE could elect to use one of two methods to determine the base of taxable income against which the tax rate was applied.[9] The first method is called the "standard base," which is the default method under the law. The second method is the so-called alternative base. If a PTE desired to use the alternative base method, it would have to elect to do so on its PET return; otherwise, the standard base method was to be used. While the alternative base presents more complexities than the standard base method, it often provides a much more desirable result (in the form of a larger PET expense deduction) to a PTE with owners residing in Connecticut. If the alternative base was not elected on the original PET return, a taxpayer would not thereafter be permitted to elect to use the alternative base.[10]

Because the PET is an expense of the PTE, the impact of the tax is to lower the federal taxable income that is allocated to the owners. In addition to being allocated net income of the PTE that has been reduced by the PET expense paid by the PTE, each owner of the PTE is entitled to a credit (the PET credit) against that owner's Connecticut income tax[11] (or its Connecticut corporation business tax[12]) equal to 87.5 percent[13] of the owner's direct and indirect[14] share of a PTE's PET liability, provided the PTE has paid such liability

[5] *See* Conn. P.A. No. 23-204, sections 360-364.

[6] Conn. Gen. Stat. section 12-699(a); Conn. Gen. Stat. section 12-719 (before amendment by the 2018 Connecticut PET legislation).

[7] 2018 Conn. P.A. No. 18-49, section 1 (effective May 21, 2018, adding Conn. Gen. Stat. section 12-699). As part of the adoption of the PET, the 2018 Connecticut PET legislation also repealed the tax payment and return requirement that was then applicable to all PTEs with nonresident owners (effective for tax years beginning on or after January 1, 2018).

[8] Conn. Gen. Stat. section 12-699(c). The 6.99 percent marginal tax rate, the highest current rate, applies to taxable income over (1) $1 million for married filing jointly, (2) $500,000 for single and married filing separately, and (3) $800,000 for heads of household. *See* Conn. Gen. Stat. section 12-700(a)(9).

[9] Conn. Gen. Stat. section 12-699(k).

[10] The decision to file the PET return using the standard base or alternative base is made annually with the filing of the tax return and is irrevocable. *See* Form CT-1065/CT-1120SI, "2022 Connecticut Pass-Through Entity Tax Instructions."

[11] The income tax is imposed by chapter 229 of the Connecticut General Statutes. The PET credit may be claimed against all taxes imposed under chapter 229 of the Connecticut General Statutes, other than income tax withholding imposed under Conn. Gen. Stat. section 12-707. *See* Conn. Gen. Stat. section 12-699(g)(1)(A), (2); Connecticut Office of the Commissioner Guidance OCG-7 (last updated Aug. 16, 2019).

[12] The corporate tax is imposed by chapter 208 of the Connecticut General Statutes.

[13] The 87.5 percent credit percentage applies to tax years beginning on or after January 1, 2019. For tax years beginning on or after January 1, 2018, but before January 1, 2019, the credit percentage was 93.01 percent. In effect, the 93.01 percent PET credit was intended to make the imposition of the PET revenue neutral for Connecticut taxation purposes (the neutrality was achieved by adding together the 6.99 percent income tax rate to the 93.01 percent credit percentage to get to 100 percent). By lowering the PET credit percentage from 93.01 percent to 87.5 percent, Connecticut, without raising tax rates, was able to raise additional state revenue from the mandatory PET regime by approximately $3.85 for each $1,000 of PTE income subject to the PET.

[14] The use of the term "indirect" in this context generally refers to a PET credit that is being passed through to the owner from a lower-tier PTE.

before the owner claimed the PET credit.[15] An owner's direct and indirect share of a PTE's PET liability is generally determined based upon the percentage of the owner's distributive share of income that is included in the PTE's income subject to the PET.

If the amount of the PET credit exceeds the owner's Connecticut personal income tax liability, the excess is treated as an overpayment and is used to offset other tax obligations or could be refunded without interest (that is, the PET credit is a refundable credit).[16] If the amount of the PET credit exceeds the owner's Connecticut corporation tax liability, any PET credit that is not used in a tax year is not treated as a refundable credit but rather is to be carried forward to each succeeding tax year by the corporate owner until such credit is fully taken against the owner's Connecticut corporate tax liability.[17] If the PET credit is less than the corporate owner's Connecticut tax liability, the owner must pay the remaining tax due.[18]

Also, under Connecticut law, individual resident and part-year resident taxpayers are entitled to a credit on their Connecticut personal income tax returns for "PET type" taxes paid to other states, the District of Columbia, or the United States that the commissioner of the Department of Revenue Services (the DRS) "determines" are "substantially similar" to the Connecticut PET.[19] To date, the commissioner has not published a listing of states with PTE tax provisions that are substantially similar to the PET.

The standard base component of the PET is relatively easy to compute. It is equal to the PTE's Connecticut-source income, determined under Connecticut personal income tax rules, excluding any distributive share of Connecticut-source income that the PTE received from a subsidiary (lower tier) PTE that filed a Connecticut passthrough tax return (that is, distributive share of income received from a lower-tier PTE).[20] The standard base does not include any of the PTE's "unsourced income," nor does it include any income of the PTE that is sourced to any state other than Connecticut. Accordingly, for an apportioning PTE, it is not unusual for a PTE's standard base to result in taxable net income that is significantly lower than the federal taxable net income of the PTE for the particular year. Also, the determination of the standard base component is not affected by the types of owners of the PTE (that is, the base is the same irrespective of whether the owners are residents or nonresidents of Connecticut and irrespective of whether the owners are subject to the Connecticut personal income tax). The effect of the PET using the standard base is demonstrated in Example 1.

Example 1 — The Standard Base

Partnership ABC has three equal partners: a resident individual (A), a nonresident individual (B), and a corporation (C). Partnership ABC does not elect to use the alternative base and, therefore, is subject to the standard base in computing its PET liability. For tax year 2022 Partnership ABC has $200,000 of operating net ordinary income, $100,000 of which is from Connecticut sources. Accordingly, ABC's standard base for tax year 2022 will simply be the $100,000 of Connecticut-source income (the $100,000 of operating income that is not from Connecticut sources is not taken into account in determining the standard base). Partnership ABC will be subject to a PET of $6,990 ($100,000 of Connecticut-source income multiplied by 6.99 percent). Assume the PET liability of $6,990 is paid to Connecticut in 2022. In determining its 2022 federal taxable income, Partnership ABC will deduct the PET from its ordinary income, resulting in net income of $193,010 ($200,000 reduced by the $6,990

[15] Conn. Gen. Stat. section 12-699(g)(1). The PTE is required to report the amount of the PET credit that is allocated to each of its owners on Schedule CT K-1.

[16] Conn. Gen. Stat. section 12-699(g)(1)(A). Connecticut Office of the Commissioner Guidance OCG-7 (last updated Aug. 16, 2019).

[17] Conn. Gen. Stat. section 12-699(g)(2). Connecticut Office of the Commissioner Guidance OCG-7 (last updated Aug. 16, 2019).

[18] Connecticut Special Notice SN 2018(9.1) (Mar. 1, 2019).

[19] Conn. Gen. Stat. section 12-699(g)(1)(B); Connecticut Special Notice SN 2018(9.1) (Mar. 1, 2019).

[20] Conn. Gen. Stat. section 12-699(c). In general, the Connecticut PET is calculated at each tier of a PTE entity structure.

PET), which amount will be allocated pro rata among the partners (this has the effect of a deduction at the federal level for the PET paid by the PTE).

For purposes of determining the Connecticut PET credit, the $6,990 in PET paid by Partnership ABC will be allocated to partners A, B, and C based on their distributive share of income of the PTE. Since each partner has a one-third share, each partner's share of the PET credit will be one-third of $6,990, or $2,330 of the PET paid by ABC. Each partner will be allowed to take a credit of 87.5 percent of $2,330, or $2,039 against either their Connecticut personal income tax liability (for Partners A and B) or corporate income tax liability (for Partner C).

Instead of using the standard base, which calculates the PET based solely on the PTE's own Connecticut-source income, the PTE may elect to calculate the PET using the alternative base.[21] The alternative base is determined by adding two separate taxable income components.

The first taxable income component of the alternative base is called the "resident portion of unsourced income." "Unsourced income" for these purposes is a PTE's income that is not sourced to Connecticut or to any other state with which the PTE has nexus (that is, in which another state has "jurisdiction to subject" the PTE to tax), *regardless* of whether the other state subjects the PTE to tax.[22] Whether income is sourced to Connecticut or to another state, or whether a PTE has nexus in another state, is determined under Connecticut nexus (including economic nexus) and personal income tax sourcing and apportionment rules.[23] Unlike the standard base, unsourced income may include the distributive share of unsourced income a PTE receives from a subsidiary PTE (in other words, an adjustment is made for a lower-tier PTE's Connecticut-source income/loss).[24]

The resident portion of unsourced income equals the unsourced income of the PTE multiplied by the percentage of ownership interests of the PTE that are directly held by Connecticut resident individual owners of the PTE. Accordingly, any ownership interests held by nonresident individuals, trusts, estates or any entity types are not considered for this purpose.[25] A resident owner's "ownership percentage" is based upon the owner's direct distributive share of the PTE's income.[26]

In sum, the resident portion of unsourced income component of the alternative base brings into the base and subjects to the PET the unsourced income of the PTE that is attributable to resident individual owners. Of note, this income is not picked up by the standard base. By doing so, PTEs with both resident individual owners and unsourced income will generally pay a larger PET under the alternative base than under the standard base.

The second taxable income component of the alternative base is called the "modified Connecticut-source income" component. Modified Connecticut-source income for these purposes is the Connecticut-source income of the PTE (as determined by using the standard base) multiplied by the percentage of ownership interests of the PTE that are *directly* or *indirectly*[27] held by owners subject to the Connecticut personal income tax (such as individuals, trusts, estates, or in certain situations another PTE owner). For purposes of this calculation, an owner's ownership percentage is based upon the owner's direct or indirect distributive share of the PTE's income.[28] In determining indirect ownership, if an owner of a PTE is another PTE, you are permitted to look through to the owners of that other PTE when calculating the PTE's

[21] Conn. Gen. Stat. section 12-699(k).

[22] Connecticut Office of the Commissioner Guidance OCG-6 (last updated Aug. 16, 2019). For example, if a PTE has income tax nexus activities in Florida (Florida has jurisdiction to tax the PTE or its owners), income sourced to Florida would not be treated as "unsourced income" for purposes of the application of the alternative base even though Florida does not impose an income tax on such income. That is, income sourced to Florida, using Connecticut's sourcing rules, would be subtracted from the taxable base and would not be subject to PET.

[23] *Id.*

[24] Conn. Gen. Stat. section 12-699(d); *id.*

[25] Conn. Gen. Stat. section 12-699(l)(2).

[26] *Id. See also* Form CT-1065/1120SI — Schedule CT-AB.

[27] A shareholder in a C corporation, which C corporation is a partner in a PTE, is not an indirect partner.

[28] Conn. Gen. Stat. section 12-699(l)(2); Connecticut Office of the Commissioner Guidance, *supra* note 22.

modified Connecticut-source income. However, based on published guidance, if a PTE (Parent PTE) is a partner in another PTE (Sub PTE) that is subject to the PET, and Sub PTE does not have information on Parent PTE's partners, Sub PTE must assume for these purposes that all of Parent PTE's partners are subject to the Connecticut personal income tax.[29]

In summary, the modified Connecticut-source income component of the alternative base is like the standard base except that it is limited only to the percentage interests in the PTE owned, *directly or indirectly*, by owners of the PTE that are subject to the Connecticut personal income tax, whereas no such similar limitation applies when calculating the standard base. In general, the intention of this complex alternative base calculation, which is apparently unlike that of any other state that allows a PET, is to tax the PTE's Connecticut-source income that would be subject to taxation to nonresident owners and not tax Connecticut residents on income potentially subject to tax elsewhere, in consideration that such residents may be entitled to a resident income tax credit for income taxes paid to other states on that sourced income.

Once the two components of the alternative base are determined, the maximum Connecticut personal income tax rate (6.99 percent) is then applied to such amount to determine the PET.

The application of the alternative base is illustrated in Example 2.

Example 2 — The Alternative Base

Partnership ABC is a calendar-year filer. Partnership ABC has three equal partners: a resident individual (A), a nonresident individual (B), and a corporation (C). For the 2022 tax year, Partnership ABC elects to use the alternative base. Partnership ABC has $200,000 of net operating ordinary income, of which $100,000 is from Connecticut sources, $30,000 from Massachusetts sources, $30,000 from Rhode Island sources (using Connecticut's personal income tax apportionment method and sourcing rules), and $40,000 of which is considered unsourced income. Partnership ABC has nexus with Connecticut, Massachusetts, and Rhode Island. Accordingly, Partnership ABC has $100,000 of Connecticut-source income and $40,000 of unsourced income.

The first component of the alternative base is the resident portion of unsourced income. For Partnership ABC, this will equal one-third (which is the ownership percentage of Partnership ABC owned directly by Connecticut individual residents) multiplied by Partnership ABC's unsourced income of $40,000, or $13,333.

The second component of the alternative base is modified Connecticut-source income. This component looks to the ownership percentage of Partnership ABC's owners subject to the Connecticut personal income tax and multiplies the PTE's Connecticut-source income by such percentage. Two-thirds of Partnership ABC's income is distributable to owners subject to Connecticut's personal income tax (one-third is owned by A, the resident individual partner, and one-third is owned by B, the nonresident individual partner). Partnership ABC has $100,000 of Connecticut-source income. Therefore, Partnership ABC's modified Connecticut-source income is $100,000 multiplied by two-thirds, or $66,667.

Therefore, using the alternative base, Partnership ABC's taxable income base will be $13,333 plus $66,667, or $80,000. Applying the 6.99 percent PET rate to this base results in a PET liability of $5,592 for Partnership ABC. In determining its 2022 federal taxable income, Partnership ABC will deduct the PET from its ordinary income, resulting in net income of $194,408 ($200,000 reduced by the $5,592 PET), which amount will be allocated pro rata among the partners in accordance

[29] *See* Connecticut Office of the Commissioner Guidance, *supra* note 22.

with Partnership ABC's partnership agreement.[30]

Each of ABC's partners will also receive their allocated share of 87.5 percent of the PET as a credit, based on the percentage of the partner's distributive share of income that was included in ABC's income subject to the PET.

- Partner A (the Connecticut resident) has half the income that was in the modified Connecticut-source income base, or $33,333, plus all the $13,333 of income that was in the resident portion of unsourced income base of $13,333, for a total of $46,666 out of the $80,000 of income that was included in the alternative base, or 58.3 percent. Therefore, Partner A will be entitled to a PET credit of $2,853, which is determined by multiplying ABC's PET expense of $5,592 times 58.3 percent and multiplying the resulting amount of $3,260 times 87.5 percent. However, Partner A's distributive share of the PET expense is $1,845.
- Partner B (the Connecticut nonresident) also had half the income that was included in the modified Connecticut-source income, or $33,333, and no portion of the resident portion of unsourced income component of the base, resulting in Partner B having $33,333 divided by $80,000, or 41.66 percent, of such income. Therefore, Partner B will be entitled to a PET credit of $5,592 times 41.66 percent, $2,330, times 87.5 percent, or $2,038. These credits will be used by partners A and B against their Connecticut personal income tax liability. However, Partner B's distributive share of Partnership ABC's PET expense is $1,845.
- Since none of Partner C's income was included in the alternative base (because partner C is a corporation) Partner C is not entitled to any PET credit. However, Partner C receives a distributive share of Partnership ABC's PET expense of $1,845.

It is evident from the foregoing that the alternative base is a much more complicated base to apply than the standard base. However, there are certain benefits to be derived from the use of the alternative base. First, because the alternative base is limited only to the percentage ownership interests in the PTE of owners subject to the Connecticut personal income tax, income that is allocated to owners that are subject to the Connecticut corporate tax or tax-exempt owners is not taken into account. Therefore, a PTE with solely corporate owners would owe no PET under the alternative base (because both its modified Connecticut-source income and resident portion of unsourced income would be zero) but would owe tax under the standard base. Put differently, even though the PET is a mandatory tax, a PTE that has solely corporate owners can elect the alternative base and would have no resulting PET liability.

Another benefit to the use of the alternative base is that any PTE with both individual resident owners and unsourced income can increase the amount of the PET benefit to the owners by electing to use the alternative base, as doing so brings unsourced income of the PTE into the taxable base (that is, both other state unsourced income and investment income such as interest, dividends, and capital gains). Doing so increases the amount of the PET liability of the PTE, which will correspondingly increase the federal expense

[30] As will be discussed below, if the partnership/operating agreement contains no special allocation provisions dealing with the allocation of the PET expense, such expense would be allocated in accordance with each partner's interest in the partnership (that is, one-third each). Note that this allocation is different from the portion of each partner's share of the income that was included in the PTE's income to determine the alternative base. For example, since no portion of income allocated to Partner C (a corporation) factored into the determination of the alternative base, should Partner C receive any allocation of the PET expense allocation? The issue becomes in part an issue regarding the proper application of the substantial economic effect rules under Internal Revenue Code section 704 and the Treasury regulations issued thereunder and is beyond the scope of this article. Subject to the application of the substantial economic effect rules of IRC section 704 to the PTE's allocations, if the partnership agreement provided that the allocations of the PET expense matched up with the ownership of the income that was used to determine such expense, then Partner A (a resident individual) would be allocated the $932 portion of the PET expense ($13,333 times 6.99 percent) attributable to the "resident portion of unsourced income" (since only Partner A's income was used to determine resident portion of unsourced income) and Partner A (an individual) and Partner B (an individual) should be each allocated one-half of the $4,660 portion of the PET expense ($66,667 times 6.99 percent) attributable to the modified Connecticut-source income (since both of their shares of ABC's income was included in such base). Therefore, Partner A would be allocated $3,362 of the PET expense, Partner B would be allocated $2,330 of the PET expense, and none of the PET expense would be allocated to Corporation C.

deduction to be taken by the PTE,[31] which in turn increases the SALT limitation workaround benefit.

Some of the Major Concerns With the 2018 Connecticut PET Legislation

From its inception, the 2018 Connecticut PET legislation received generally positive reviews from practitioners and taxpayers as it seemed to accomplish its intended result of mitigating the harsh economic impact borne by the individual owners of PTEs because of the SALT limitation. The positive reaction to the legislation was solidified following the release of the November 2020 IRS notice that affirmed the ability of the PTE to take the PET expense deduction.

Notwithstanding its positive impact, there were several issues that arose from the fact that the PET was a mandatory tax.

One such issue raised related to the impact that the mandatory nature of the PET had on the PTE's cash flow management. Entities that were winding up or dissolving and failed to adequately reserve enough cash for their final PET return would get caught with a PET liability with no cash to pay the liability. For example, an LLC that sold its assets and distributed all the net proceeds from the sale to its members (and did not adequately reserve for the PET) would not have any cash available to fund the PET liability when the final Connecticut PET return was required to be filed. This, even though the owners of the PTE remained liable for their pro rata share of Connecticut personal income tax or corporate tax on their allocable share of the income of the PTE. The main alternative for PTEs that found themselves in this situation was to request that the members return capital to the PTE to fund the PTE's PET. Such a request may not always be respected by the members, especially if not provided for in the partnership/operating agreement, thereby leaving the PTE unable to pay its PET obligation. This outcome seemed nonsensical based on the purposes and goals of the PET and frustrated PTEs and their owners who could have satisfied their tax liabilities at the owner level.

Another issue raised by the mandatory nature of the PET is that the PET provisions provide no relief for cash-strapped PTEs that generate so-called phantom income (income with no corresponding cash). The phantom income recognized by the PTE could generate a significant PET obligation, with no cash at the entity level to satisfy such tax. A typical case would be a real estate foreclosure situation. In a foreclosure, it would not be unusual for a PTE to generate significant taxable income and no cash because a foreclosure is treated as a deemed sale of real estate under which the amount realized in the foreclosure is equal to the principal amount of the debt being foreclosed. In that situation, in the context of a partnership PTE, the only option available to the entity would be a capital call to the partners to fund the PET liability. Whether a capital call was available as an option would depend upon the provisions of the operative entity documents. Unfortunately, the PET did not contain a hardship exception that would have allowed the PTE not to pay the otherwise mandatory PET in this situation, again frustrating PTEs and their owners.

Summary of Significant Changes to the Connecticut PET, Effective 2024

Let us now turn to the significant changes made to Connecticut's PET by the Act.

Connecticut's 2023 budget bill, also known as Public Act 23-204, was signed by the governor on June 12. The Act contains several provisions affecting Connecticut taxes, but some of the more significant changes in the Act related to the overhaul to Connecticut's PET. While many practitioners were of the view that the changes would be limited to making the PET optional and possibly increasing the PET credit from 87.5 percent back up to its original 93.01 percent, to the surprise of many, the changes were much broader than had been anticipated.

A summary of the changes to the PET, all of which become effective for tax years beginning on or after January 1, 2024, follows.[32]

[31] It is beyond the scope of this article to discuss whether PET that is attributable to nonbusiness income, such as investment income, is deductible by the owners.

[32] The Act did not enact any PET changes effective for pre-2024 tax years.

The PET Will Become Elective Beginning in 2024

One of the most significant changes made to the PET is that effective for tax years beginning on or after January 1, 2024, the PET will no longer be a mandatory tax. It will instead become an elective tax. Accordingly, each PTE will be required to make an annual decision whether it wants to be subject to the PET provisions.[33] The conversion of the PET from a mandatory tax to one that is elective brings Connecticut into conformity with the PET provisions of the other states in the country. This is certainly welcome relief as this will provide each PTE and its owners with the flexibility of being able to determine each year whether it makes sense to elect into the PET regime to obtain the federal benefit.

By making the PET elective, PTEs will no longer have to determine how to fund a Connecticut PET liability if the PTE has insufficient cash; although as will be discussed below, because mandatory nonresident withholding has been reenacted, PTEs will still have an obligation to withhold and pay over to the DRS Connecticut personal income tax on its nonresident owners (as was the case for pre-2018 tax years).

Under the new provisions, each PTE that wishes to be subject to the PET in any year will be required to make an entity-level election to be subject to the PET. The Act provides that the election is done by submitting written notice to the DRS on an annual basis no later than the return filing deadline (including extensions).[34] Although not clear at this time, one would expect that the DRS will provide a box to be checked on the annual Form CT-1065/CT-1120SI submitted by the PTE that will allow PTEs to elect to be subject to the PET, similar to the box on the current return that applies to PTEs wishing to elect to use the alternative base. It seems unlikely that the DRS would require that a separate form be filed by the PTE or that the election be made online (separate and apart from the filing of the Form CT-1065/CT-1120SI), although this remains to be seen.

What is clear is that, unlike the case in some states (for example, New York), the Act does not contain a requirement that the PET election be made in advance of the due date of the PET return. That is certainly welcome news for PTEs as they will not need a crystal ball to predict their future when determining whether they should elect into the PET. For example, concerning the 2024 tax year, the election into the PET would not have to be made until the due date of the 2024 tax return, sometime in 2025.

One question that is not yet resolved is whether a PTE that does not make an election to be subject to the PET on its original return may thereafter file an amended return to be subject to the PET provisions. The language of the Act, which provides that the PET election is made "not later than the due date, or, if an extension of time to file has been requested and granted, the extended due date, of the return" of the PTE would seem to imply that if an election is not made on the original return, there may be no right to make an election through a future amended return.[35] However, if the election is not made on the original return filed, there may be an opportunity to make the election on a "superseding return" so long as it is filed before the due date. As this is not addressed in the statute, it is not certain what the DRS's position will be on this issue.

Similarly, it is unclear whether a PTE that elects into the PET can thereafter amend its return to rescind the election. The current instructions to the PET form indicate that any election to be subject to the alternative base is irrevocable, so although not entirely clear at this time, the DRS may take the same approach and not permit a PTE to rescind its PET election once it has been made. However, taking this approach may be without statutory authority as the Act does not specifically indicate that the PTE election is irrevocable.

It is hoped that the DRS will issue guidance soon on the mechanics of making the election, whether the election may be revoked after it is made, and whether there are any circumstances under which the election may be made through the filing of an amended or superseding return.

The Act does not require that a PTE call for a separate vote of the owners of the PTE to

[33] Conn. Gen. Stat. section 12-699(b) (effective July 1, 2023).

[34] *Id.*

[35] Conn. Gen. Stat. section 12-699(b) (effective July 1, 2023).

authorize the PTE to make the PET election. Some states specifically require that the PTE obtain the consent of its owners to elect into a state PTE tax and, in some cases, a special form evidencing such consent must be included with the filing of the return.[36] Unless the DRS issues administrative guidance to the contrary, it does not appear that Connecticut will require evidence to be submitted with the return that the owners of the PTE have specifically consented to the PET election.

That being said, the authorized person who makes the election on the PET return for the PTE to be subject to the PET will need to be comfortable that he or she has the proper authorization to do so. Such authorization could be directly granted in the PTE's applicable governing documents. For example, the operating or partnership agreements of many PTEs may delegate to the PTE's "partnership representative" broad authority to make all federal and state elections on behalf of the PTE, without receiving the prior consent of the owners. PTE's should confirm with their legal advisers that this type of broad authority is sufficient to authorize the partnership representative to make the PET election on behalf of the PTE.

However, some PTE governing documents contain narrow language regarding the making of any state tax elections; for example, a provision may exist that provides that no state elections that have a material tax impact on any member may be made without the owners' consent. Other governing documents may not address the issue at all. In those types of situations, the individual responsible for filing the Connecticut PET return should discuss with tax counsel whether, or to what extent, she must obtain the advance consent of the owners before making the election. In either case, it is advisable that before making the PET election, the governing documents for the PTE should be carefully reviewed to determine whether the person filing the Connecticut PET return on behalf of the PTE has the proper authority to make such election without first seeking the consent of some or all of the owners. Once an election is made, for Connecticut PET purposes, the election is binding on all owners, as the current statute does not provide an owner of the PTE to opt out of the PET regime.

Lastly, the Act does not limit the eligibility of a PTE to make the PET election based on the composition of its owners. Some states, for example, may disqualify a PTE from making a PET election if its owners are not composed of certain qualifying taxpayers. Although there is no prohibition on type of ownership to elect into the PET, as will be discussed below, the Act has revised the tax base to provide that the PET taxable income base is composed solely of taxable income associated with taxpayers that are subject to Connecticut's personal income tax (such as individuals, trusts, and estates); therefore, effective for tax years beginning on or after January 1, 2024, taxable income associated with corporations and tax-exempt entities will not be taken into account for purposes of determining the PET liability (see Example 2). Therefore, it is unlikely that PTEs whose owners consist of taxpayers that are not subject to the Connecticut personal income tax (such as corporations) will have an interest in the PTE electing into the PET. Nevertheless, they may not have a say depending on the composition of all the owners of the PTE.

The PET Tax Base Is Changing — The Standard Base Is Repealed

The next significant change to the PET regime is that the Act repeals the use of the standard base method in determining a PTE's PET liability, effective for tax years beginning on or after January 1, 2024. As described above, when the PET was originally adopted, the PET tax rate was imposed against a tax base that was determined using either the standard base or the alternative base.[37] While the standard base is far less complicated to calculate and apply (requiring just a determination of Connecticut-source income), there are potentially significant economic benefits to using the more complicated alternative base. As mentioned earlier, by electing into the

[36] For example, Wisconsin's PTE tax requires that persons holding more than 50 percent (shares or capital and profits) on the day of election must consent to pay tax at the entity level (*see* Wis. Stat. Ann. section 71.21). Alabama also requires the consent of holders of more than 50 percent of the voting control of the entity (Ala. Code section 40-18-24.4(d)). New Jersey requires consent of all members of the PTE at the time that the election is filed (N.J. Rev. Stat. section 54A:12-3(b)(1)).

[37] Conn. Gen. Stat. section 12-699(c).

alternative base, PTEs with Connecticut resident individual owners and unsourced income could increase the amount of the PET paid by the PTE, which in turn increases the economic benefits to the individual owners of the PTE.

In a significant change, effective for tax years beginning on or after January 1, 2024, the Act eliminates all references to the standard base. The Act also eliminates all references to the alternative base. Instead, the Act provides that any PTE electing into the PET will be required to use the "tax base" in determining its PET liability.[38] The Act provides that the tax base is equal to the resident portion of unsourced income plus modified Connecticut-source income, which are effectively the two components of the old alternative base, although as will be explained, the Act does make a significant change to one of the components of the former alternative base.[39] The tax rate applied to the taxable income determined under the tax base remains the same as under current law — the highest marginal tax rate in Connecticut, currently 6.99 percent.

Under the Act, in determining the tax base, the general method used under current law to compute the resident portion of unsourced income and the modified Connecticut-source income has not changed. However, the Act has made a subtle change to the definition of unsourced income. Under the definition in the 2018 Connecticut PET legislation, unsourced income did not include income derived from or connected with sources within another state that had jurisdiction to subject the PTE to tax, *regardless* of whether the other state actually subjected the PTE to tax. Contrast that with the definition of unsourced income in the Act, which provides that a PTE's income derived from another state will be excluded from unsourced income only if the state "*has jurisdiction to tax*" the PTE *and* "*actually imposes tax on the* [*PTE*] *or its members who are* [*Connecticut*] *residents.*"[40] Based on this language, PTEs will exclude from their unsourced income the income from states in which the PTE or its Connecticut residents file state tax returns (presumably with respect to the PTE's other state source income). This means that Connecticut's nexus rules should not be applied to determine whether income should be excluded as the other state's nexus rule would seemingly apply in order for the tax to be "actually imposed" by the state. The Act does not clarify what type of tax must be imposed on the PTE or its owners. For example, if a gross receipts tax, such as the Washington business and occupation tax or Texas margin tax, is imposed on the entity, is Washington- and Texas-source income excluded from unsourced income for PET purposes? Furthermore, it is unclear whether the DRS would still require a PTE to recalculate the other states' source income using Connecticut's sourcing and apportionment rules.

Example 3 — Illustration of the New Tax Base

Assume that a PTE has two equal owners, one a Connecticut resident individual and the other a nonresident individual, and that the PTE has $500,000 of Connecticut-source income and $500,000 of income that is sourced to Florida under general sourcing rules. Assume that the PTE has income tax nexus in Florida. Florida does not impose an income tax on PTEs or a personal income tax on the owners of a PTE, so neither the PTE nor its owners file a tax return in Florida.

Under current law, the $500,000 of Florida-source income would not be treated as unsourced income for purposes of computing the resident portion of unsourced income component of the current law's alternative base because Florida has jurisdiction to tax such income (even though it does not do so). Under the Act, however, it appears that the $500,000 of Florida-source income would be treated as unsourced income and, therefore, be included in the determination of the resident portion of unsourced income because Florida does not actually impose a tax on the PTE or the Connecticut residents (even though it has jurisdiction to do so because of the PTE's nexus).

[38] Conn. Gen. Stat. section 12-699(c) (effective July 1, 2023).

[39] *Id.*

[40] Conn. Gen. Stat. section 12-699(a)(8) (effective July 1, 2023) (emphasis added).

> If the $500,000 of Florida-source income is treated as unsourced income under the Act, the resident portion of unsourced income of the PTE would be $500,000 times 50 percent (that is, the resident owner's percentage), or $250,000. In this case, the modified Connecticut-source income component of the base would be $500,000 of Connecticut-source income, multiplied by 100 percent (since all owners are subject to the personal income tax).
>
> Accordingly, if the PTE elects into the PET in 2024, the PTE will owe a PET of $52,425 ($250,000 plus $500,000 times 6.99 percent). Under the current law, the PET would be only $34,950 ($500,000 times 6.99 percent).

The decision by the legislature to repeal the use of the simple standard method and not continue to make it an option in determining PET liability is curious. There is no legislative history that explains why the standard method has been eliminated. Any PTE that chooses to elect into the PET beginning with tax years commencing on or after January 1, 2024, will be forced to use a tax base that is similar to the more complex current alternative base method. While this may not be of any real concern to PTEs that are currently computing their PET liability on the alternative base, the new rules will raise a number of questions for PTEs that have historically used the standard base method and are now trying to determine whether they should elect into the PET and adopt the new tax base. The tax base under the Act varies significantly from the standard base that such users have become accustomed to using. As a result, PTEs that have historically been using the standard base should proceed with caution before electing into the PET regime.

For example, since the type of taxable income that is included in the tax base is only taxable income that is allocated to owners that are subject to the Connecticut personal income tax (a restriction that does not exist with the standard base), any income of the PTE that is allocated to owners that are not subject to the Connecticut personal income tax, such as corporate owners and tax-exempt owners, is ignored for PET-computation purposes. As a result, there would seemingly be no benefit for any PTE whose owners are *solely* composed of corporations or tax-exempt entities to elect into the PET. To the extent that these PTEs have been filing PET returns using the standard base, it seems unlikely that there would be any reason for these PTEs to elect into the PET. However, a PTE with at least one owner who is subject to the Connecticut personal income tax should still consider the benefits of electing into the PET. Interesting questions and complexities will arise regarding whether PTEs with no direct owner that is subject to the Connecticut personal income tax, but with one or more passthrough entities as owners (that is, tiered-entity structures), should elect into the PET.[41]

An issue that will need to be addressed by PTEs that have historically used the standard base in determining their PET liability arises concerning partnerships or LLCs (that have been treated as partnerships for tax purposes) whose ownership consists of both resident partners and nonresident partners, or whose ownership consists of both individual partners and corporate partners.

As previously explained, under the standard base method, any PTE with this type of owner composition was accustomed to the PET expense being determined based upon each owner's relative share of Connecticut-source income, irrespective of whether the owner was a Connecticut resident or subject to the Connecticut personal income tax. Moreover, all owners of the PTE shared in the allocation of the PET credit since all owners had a share of the PTE's Connecticut-source income. However, under the new tax base method, the tax base will be solely dependent on the amount of PTE income that is allocated to the resident and nonresident partners that are subject to personal income tax; no income is to be allocated to owners that are not subject to

[41] Under current DRS guidance, if a PTE (Parent PTE) is a partner in another PTE (Sub PTE) and the Sub PTE, which is subject to the PET does not have information on the makeup of the Parent PTE's partners (that is, individuals or non-individuals), the Sub PTE must assume that all of Parent PTE's partners are subject to the Connecticut personal income tax. Connecticut Office of the Commissioner Guidance, *supra* note 22. Since the PET is now elective and not mandatory, it will be interesting to see whether or to what extent the DRS determines to modify this presumption.

personal income taxation such as corporations and tax-exempt organizations.

Absent special allocation provisions in the governing documents, the PET expense that results from the tax base will generally be allocated to *all* the partners based on each partner's distributive share of income of the PTE. That is, the PET expense will not be allocated based on each partner's share of income that has been included in the tax base. That is to be contrasted with the allocation of the PET credit, which will be allocated based on each partner's share of the income that was used to determine the tax base. As result, there will be a mismatching of the allocation of the PET deduction and the PET credit to the partners. This will not be a new issue for PTEs that have been using the alternative base, but it will be a new issue for PTEs that have historically been using the standard base.

In such a case, there may be closer attention given to whether the operating/partnership agreement of the PTE should be amended to specially allocate the PET expense to those owners who have been allocated the income from the PTE that was used to determine the tax base. Any such allocation, to be respected by the IRS, would need to pass muster under the "substantial economic effect" rules of IRC section 704(b). If PTEs consider special allocations, they should also consider whether they should amend the governing documents of the PTE to provide that the cash flow attributable to the payment of such PET be economically borne by the individual partners whose incomes were used to determine the amount of taxable income that will be included in the tax base and the resultant PET. To ensure that the expense attributable to the PET is borne by the owners whose allocable income is being included in the tax base, the PTE could consider amending its governing documents to provide that the PET paid by the PTE be treated as an advance to the individual partners against future distributions, in an amount equal to their share of the PET, or that the individual partners should be required to make a contribution to the PTE to fund the PET liability in an amount equal to their allocable share of the PET.

In any event, for PTEs, operating as partnerships, other than those (1) that have only Connecticut resident partners or (2) have only Connecticut-source income and have no partners that are not subject to the personal income tax, it will be in their interest to do an analysis as to the economic effect of the PET election on each such partner, given each partner's separate status as either a resident or nonresident individual or as a corporate partner.

Example 4 — Who Bears the Economic Cost of the PET Liability?

Assume that a PTE, which is treated as a partnership for tax purposes, has two equal partners, one a Connecticut resident individual and the other a corporation. Assume that the PTE has $1 million of Connecticut-source ordinary income (determined under Connecticut's personal income tax rules).

Under existing law, the PTE has been determining its PET using the standard base method. If the PTE elects into the PET in 2024, the PTE will have a tax base of $1 million times 50 percent (that is, the ownership interests owned by its partners that are subject to the Connecticut personal income tax), or $500,000, and will owe a PET of $500,000 times 6.99 percent, or $34,950. If the operating agreement of the PTE does not contain any special allocations regarding the PET deduction, the $34,950 in PET will reduce each partner's share of ordinary income from the PTE by $17,475; however, the corporate partner will *not* be entitled to take a PET credit against its Connecticut income tax liability for this amount because the corporate owner is not entitled to a PET credit under the Act (as discussed later), but the individual partner will be entitled to all of the PET credit of $34,950. As can be seen, there is a mismatch of the PET deduction allocation versus the PET credit allocation and the resultant economics.

One option to be considered in this situation is whether the operating agreement of the PTE can be amended to provide that the PET expense, $34,950, is to be specially allocated entirely to the Connecticut resident owner, if such allocation satisfies the substantial economic effect rules of IRC section 704, and also to provide that the Connecticut resident partner agrees to bear the economic cost by funding such expense (either through a reimbursement to the partnership or a reduction of such owner's future distributions). It should be observed that the corporation does not forgo a deduction for Connecticut income taxes, rather the corporation will determine its Connecticut corporate apportioned taxable income generally, including its distributive share of income from the PTE, and deduct its Connecticut tax with respect to that taxable income.

In addition to partnership entities, S corporations that have been accustomed to using the standard base method also need to weigh the economic effect that the new tax base will have on the PTE and its shareholders before electing the PET. Unlike partnerships, however, S corporations do not have the flexibility to specially allocate the PET expense.

Regarding S corporations, a similar concern arises because S corporations are not permitted to have disproportionate allocations and distributions (the so-called single class of stock requirement). Because of the S corporation requirement that all items are allocated to the owners in accordance with their ownership percentages, if a PTE that is an S corporation has (1) both Connecticut-source income and unsourced income, and (2) both Connecticut resident shareholders and nonresident shareholders, it would appear that the economic cost of the PET will not be limited to the owners whose share of income is being used to determine the components of the tax base. Put differently, it could be possible, absent some form of compensatory distribution, that the nonresident shareholders of the PTE could be worse off with a PTE electing into the PET than they would be without the election.

Example 5 — S Corporations

An S corporation has two equal shareholders, one of whom is a Connecticut resident and one of whom is a nonresident of Connecticut. In 2024 the PTE has $200,000 of operating income: $100,000 from Connecticut sources and $100,000 of unsourced income.

The tax base for this PTE will be $150,000 ($100,000 plus $50,000), and the PET will be $150,000 times 6.99 percent or $10,485.

This tax base can be split into two parts. In determining the tax base, the $100,000 of Connecticut-source income will generate a PET of $6,990 (since 100 percent of the owners of the PTE are subject to the Connecticut personal income tax). The tax on the $100,000 of resident portion of unsourced income will be $3,495 ($100,000 times 50 percent (since 50 percent of the owners of the PTE are Connecticut resident owners) times 6.99 percent).

For federal income tax purposes, each of the two shareholders would have a reduction in their allocation share of operating income of 50 percent of $10,485, or $5,243 per shareholder.

To further the goals of the PET, it would make sense if the $6,990 in *expense* attributable to the modified Connecticut-source income could be allocated equally to both owners since income allocated to both was used to determine this taxable base component, while at the same time allocating the $3,495 PET expense attributable to the resident portion of unsourced income entirely to the Connecticut resident owner. That is, can the nonresident shareholder be allocated $3,495 of the PET expense and the resident shareholder be allocated $6,990 — similar to how their share of the PET credit would be allocated? Unlike a partnership that may specially allocate deductions in certain circumstances (as discussed in Example 4), this is not possible under the S corporation rules without violating the single class of stock requirement. Furthermore, as illustrated, there is a mismatch of the shareholders' PET deduction with their corresponding PET credit.

However, to correct this problem, can an S corporation make a special "true-up" distribution to a shareholder to compensate the shareholder for the lack of economics resulting from the example? It is questionable whether such a distribution would be able to survive the second class of stock challenge without further IRS guidance. Treasury reg. section 1.1361-1(l)(2)(ii) addresses the situation in which state laws require a corporation to pay or withhold state income taxes on behalf of some or all of a corporation's shareholders. This regulation treats the payment by a corporation of a shareholder's taxes as a constructive distribution, and a second class of stock is not created if, when the constructive distributions are taken into account, the outstanding shares confer identical rights to distribution and liquidation proceeds.[42] It is unclear whether this provision in the Treasury regulations would apply to the PET situation, since the PET is not designed as a tax that is being paid "for or on behalf of" the owners, but rather is designed as a tax on the entity. At a minimum, S corporations facing this situation would be advised to include a provision in the applicable shareholder agreement that provides that any true-up distribution made by the corporation is to be treated as an advance to the applicable shareholder that must be repaid or offset by reductions in future distributions to the applicable shareholders, although there is no guarantee that this type of provision will fully protect the PTE against an IRS challenge. S corporations that find themselves in this situation are urged to consult with their tax adviser and tax counsel before electing the PET for years beginning on or after January 1, 2024.

A separate issue arises concerning PTEs that are investment partnerships or have significant portfolio-type income. Such PTEs should exercise caution when deciding whether to elect into Connecticut's PET. Such concern arises regarding PTEs that have resident individual owners and significant unsourced investment-type income (such as interest, dividends, and capital gains). These PTEs need to be mindful that subjecting investment income to the Connecticut PET may not result in the desired federal tax deduction.[43] As a result, the risk of a potential challenge by the IRS to the PET deduction by the PTE may weigh against making the PET election. PTEs in this situation are urged to consult their federal tax adviser before making Connecticut's PET election.

In short, PTEs that have been using the alternative base method to compute their PET may have already addressed these issues and concerns. They now have the option to decide if the PET continues to make sense for them and their owners. PTEs that have historically been using the standard base method and wish to continue to take advantage of the PET should proceed with caution and analysis before making the PET election.

Net Operating Loss Carryforwards

Under the current law, PTEs that generate net operating losses under the mandatory PET regime are permitted to carry forward NOLs until fully used. However, no such provision was retained in the Act. It is uncertain whether the DRS will allow NOLs incurred before 2024 to be continued to be carried forward by the PTE into future years, rather than evaporate.

Amount of PET Credit

The 2023 legislative proposals released by Gov. Lamont in February 2023 included a provision that would have restored the PET credit from 87.5 percent to its original amount of 93.01 percent. The tax proposals released by the Republican caucus in May 2023 also included a provision that would have restored the PET credit to its original 93.01 percent. Curiously, the restoration of the PET credit to 93.01 percent did not make its way into the Act. Accordingly, the PET credit remains at 87.5 percent. With apparent strong support behind restoring the PET credit to 93.01 percent, it is possible that the PET credit percentage could be adjusted upward in future legislation.

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[42] Treas. reg. section 1.1361-1(l)(2)(v), Example 7. *See also* LTR 201608007.

[43] The issue, in brief, is whether the PTE is operating a "trade or business" for federal tax purposes.

Offsetting Tax Credit Eliminated for Corporations

Under the Act, effective for tax years beginning on or after January 1, 2024, the PET credit is eliminated for corporations. The repeal of the PET credit to corporations makes sense since the tax base to be used under the Act will be very similar to the alternative base.

Under the 2018 Connecticut PET legislation, an owner that was subject to the corporation business tax was permitted to take its allocable share of the PET as a credit against the corporate income tax. However, based on the operation of the law, owners subject to the corporation business tax only had an opportunity to use a PET credit if the PTE elected to use the standard base. Since no income that was allocated to owners subject to the corporation tax was included in the alternative base calculation, a corporation's share of the PET credit for a PTE that elected to use the alternative base was always zero.

As discussed above, the tax base that will be used beginning in 2024 to determine the PET will take into account only income allocated to resident and nonresident owners subject to the Connecticut personal income tax. Since a corporation is not subject to the Connecticut personal income tax, none of the PTE income allocated to a corporation will be taken into account in determining the tax base. Therefore, under the Act, a corporation that is an owner of a PTE will not receive any PET credit. All of the PET credit should now be allocated only to those owners who have their distributive share of income included in the tax base. The change made by the Act to repeal the ability of a corporation to take the PET credit is consistent with the revisions to the tax base made by the Act.

Note that a corporation may still obtain the benefit of the lower federal taxable income resulting from the PET expense, unless the provisions of the PTE's operating or partnership agreement properly provide for a special allocation of the PET expense deduction to the owners of the PTE who are subject to the personal income tax.

One question raised by the Act's repeal of the PET credit for corporations is whether any corporation that has a carryforward of a PET credit that was created concerning years beginning before January 1, 2024, will still be entitled to use the carryforward in future years until the credit has been fully taken against such company's corporate business tax liability. The Act, seemingly unfairly, repeals the provision of current law that authorizes the carryforward of the PET credit, and as a result it appears that the carryforward of the credit could be in jeopardy and create a windfall for the state. If this is in fact the case, corporations with an unexpired PET credit may want to explore options to maximize the benefit of the carryforward before it expires with the end of the 2023 year. This is a question that will require some guidance from the DRS or perhaps a legislative fix during the next legislative session. This is not a concern for owners who are subject to the personal income tax, as the PET credit was a refundable credit against the personal income tax, whereas the PET credit attributable to corporations was a nonrefundable carryforward credit.

Resident Tax Credits for PET Payments to Other States

The current PET statute contains a provision that permits residents and part-year residents of Connecticut who are owners of a PTE that is making PET-type payments to another state to take a credit against their Connecticut personal income tax for their direct and indirect share of the taxes paid.[44] However, the statute provides that the credit is available only if the DRS commissioner determined that the tax paid to the other state was a PTE tax that was substantially similar to the PET. Also, the statute provides that such credit was to be calculated in a manner "prescribed by the Commissioner" that was consistent with the existing limitations on the use and availability of tax credits that is set forth in Conn. Gen. Stat. section 12-704. The commissioner has never issued any guidance indicating which state PET-type taxes were substantially similar to the PET; consequently, there has been some uncertainty as to which state PET-type taxes qualify.

The Act eliminates the requirement that the commissioner make a determination that a state's

[44]Conn. Gen. Stat. section 12-699(g)(1)(B).

PTE tax is substantially similar to the PET.[45] The requirement that the state's PTE tax be substantially similar to the PET still remains; however, it now appears (at least for tax years beginning on or after January 1, 2024), pending issuance of guidance from the commissioner, that tax return preparers will be required to make the decision whether a state's PTE tax is similar to the PET. This is an area in which guidance from the DRS would be welcomed. Regardless of the change in the statute made by the Act, the DRS should follow the lead of other states, such as New York and New Jersey, that have published lists for their resident credit for PET paid to other states.

Combined Return Election Eliminated

The 2018 PET legislation permitted "commonly owned" PTEs (that is, more than 80 percent common voting control) to elect, on an annual irrevocable basis, to file a combined PET return. One of the benefits to filing a combined return was that in determining the PTE's taxable income (either under the standard base or alternative base), net losses from one commonly owned entity could offset net profits from another commonly owned entity, thereby lowering the tax base subject to the PET.

The Act eliminates this option.[46] Accordingly, effective for tax years beginning on or after January 1, 2024, each PTE that is a part of a group of commonly controlled PTEs will need to independently determine whether to elect into the PET, and if it does so, it will not be permitted to combine with other commonly controlled PTEs. Presumably, one reason that a profitable PTE may decide not to elect into the PET will be because losses from commonly controlled entities that flow up to the personal income tax returns of the owners of the PTE will substantially offset the profits from such PTE.

Example 6 — Commonly Owned Entities

Partnership AB owns more than 80 percent of subsidiary Partnership CD. Partnership AB and Partnership CD have historically elected to file a combined PET return under the alternative base. Partnership AB has $100,000 of alternative base operating income, and Partnership CD has $100,000 of alternative base operating losses. If Partnership AB and Partnership CD filed a combined return in 2023, the combined alternative base is $0, and there would be no PET liability. Beginning with tax year 2024 and thereafter, a combined return election will not be possible. If Partnership AB *elects* into the PET regime and has taxable base income, it will be subject to PET on its separate taxable base income.

PTE's Nonresident Owners Elective Tax Remittance Repealed

Before the 2018 Connecticut PET legislation, PTEs were required to pay Connecticut tax on behalf of all nonresident noncorporate owners whose share of the PTE's income from Connecticut sources was $1,000 or more. The 2018 Connecticut PET legislation repealed the composite tax requirement.

Under the 2018 Connecticut PET legislation, a nonresident individual was not required to file a Connecticut personal income tax return for any tax year if, for such tax year, the only Connecticut-source income of the nonresident individual (and the nonresident individual's spouse, if the nonresident individual filed a joint return with the spouse) was from one or more PTEs, and each of those entities paid the PET. In essence, the DRS considered that the PET that was paid by the PTE fully satisfied the nonresident's Connecticut personal income tax liability. Nevertheless, nonresidents often filed Connecticut personal income tax returns to start their statute of limitation period or to seek a refund because of the PET refundable credit exceeding their ultimate Connecticut personal income tax liability.

However, in 2019 (and under current law) following the reduction of the PET credit from 93.01 percent to 87.5 percent, the DRS published guidance stating that a nonresident individual whose only source of Connecticut income is from a PTE is not required to file a Connecticut income tax return only if (1) the individual receives a Schedule CT K-1 and the PET credit properly reported fully

[45] Conn. Gen. Stat. section 12-699(f)(2).

[46] 2023 Conn. P.A. No. 23-204, section 448 (effective July 1, 2023, repealed section 12-699(j)).

satisfies the Connecticut income tax liability (which would not generally be the case), or (2) the PTE *elects* to remit composite income tax (net of the PET credit) on behalf of the nonresident individual in accordance with the procedures set forth by the DRS. [47]

The Act eliminates the current law's *elective* tax remittance for the PTE's nonresident individual owners, effective for tax years beginning on or after January 1, 2024.[48] In its place, the Act reinstates the mandatory nonresident tax payment requirement from *pre-2018 law*.[49]

New Mandatory PTE Nonresident Composite Tax Return and Tax Withholding Requirement

Effective for tax years beginning on or after January 1, 2024, the Act reestablishes the pre-2018 mandate requiring that PTEs pay tax on behalf of any of its nonresident noncorporate owners (such as owners who are individuals, trusts, estates, and other PTEs) regarding the tax associated with their Connecticut-source income. There is no such withholding requirement for resident owners or corporate owners. The PTE's tax payment requirement is mandatory; no opt-out provision for nonresident owners was included in the Act.

Accordingly, effective for tax years beginning on or after January 1, 2024, the Act requires that each PTE file a Connecticut composite tax return and also make Connecticut income tax payments at the highest marginal tax rate (currently 6.99 percent) on behalf of its nonresident owners when the owner's share of passthrough income from Connecticut sources is at least $1,000.[50] In computing the amount of the nonresident tax that is due by the PTE, the required tax will be reduced by the direct and indirect PET credit properly reported by the PTE for the PET paid.[51] However, the PET credit may not reduce the nonresident tax payment due below zero. As a result, a nonresident individual's Connecticut tax filing obligation may be satisfied through the tax payment made by a PTE, so long as the nonresident does not have any other Connecticut-source income (other than from another PTE that paid the tax on behalf of such nonresident).[52]

Unlike the PET, which requires quarterly estimated tax payments, there is only one annual tax payment for the nonresident income tax required to be paid by the PTE. The tax is due on or before the date for filing the PTE's return, determined without regard to any extension of time for filing the return.[53] Therefore, no estimated tax payments are required to be made throughout the year to satisfy this tax payment obligation.

The interrelationship between the PET and the mandatory composite tax return is illustrated in Example 7.

Example 7 — New Mandatory Composite Tax Return Requirement

Partnership AB has a calendar tax year. In 2024 Partnership AB has two equal partners: a nonresident individual (A) and a resident individual (B). Assume that Partnership AB has $10,000 of Connecticut-source income and $10,000 of unsourced income. Under these facts, the resident portion of Partnership AB's unsourced income is $5,000 (that is, $10,000 times Partner B's 50 percent share), all of which is attributable to Partner B. Since all of Partnership AB's Connecticut-source income is distributable to owners subject to the Connecticut personal income tax, AB's modified Connecticut-source income is $10,000 (half of which is attributable to Partner A and half of which is attributable to Partner B).

Partnership AB will be subject to a PET of $1,049 ($10,000 of modified Connecticut-source income plus $5,000 of unsourced income (resulting in a $15,000 tax base) times 6.99 percent).

[47] This guidance was codified in Conn. P.A. No. 22-117, section 16 (effective May 27, 2022, added 12-699b).

[48] 2023 Conn. P.A. No. 23-204, section 448 (effective July 1, 2023, repealed section 12-699b).

[49] 2023 Conn. P.A. No. 23-204, section 362 (effective July 1, 2023, amended section 12-719(b)(1)(A)).

[50] *Id.*

[51] 2023 Conn. P.A. No. 23-204, section 362 (effective July 1, 2023, added section 12-719(b)(1)(C)).

[52] 2023 Conn. P.A. No. 23-204, section 362 (effective July 1, 2023, added section 12-719(e)).

[53] Conn. Gen. Stat. section 12-719(a).

Table. Partner Share Calculation

Partner	Modified CT-Source Income	Resident Portion of Unsourced Income	Share of Total Tax Base	PET Credit	Composite Income	Composite Tax Liability[a]	PTE Composite Tax Liability After PET Credit
A (nonresident individual)	$5,000	N/A	$5,000	$306	$5,000	$350	$44
B (resident individual)	$5,000	$5,000	$10,000	$612	N/A	N/A	No payment required
Total	**$10,000**	**$5,000**	**$15,000**	**$918**	**$5,000**	**$350**	**N/A**

[a]Conn. Gen. Stat. section 12-719(b)(2)(A), (c)(2)(A); Conn. Gen. Stat. section 12-700(a)(9). The Connecticut composite tax rate for nonresident owners that are individuals is the highest applicable marginal Connecticut individual income tax rate (6.99 percent).

Partnership AB's partners will, collectively, be allowed to claim a PET credit of $918 (the $1,049 PET times 87.5 percent). The $918 PET credit is allocated $5,000/$15,000 (one-third) to A (since $5,000 of A's income was included in the $15,000 of the tax base income), and $10,000/$15,000 (two-thirds) to B (since $10,000 of B's income was included in the $15,000 of the tax base income).

The table shows the calculation of each partner's share of Partnership AB's tax payment made on behalf of Partner A, after accounting for the PET credit.

In this example, Partnership AB has a PET liability of $1,049 ($15,000 tax base times 6.99 percent), which is calculated and reported on its PTE tax return.

Also, the PTE would be *required* to pay tax on behalf of nonresident Partner A, with respect to Partner A's Connecticut-source income, in the amount of $44 ($350 of Partner A's composite tax liability minus Partner A's $306 PET credit). If this is the only Connecticut-source income of Partner A, then Partner A would not have a filing requirement.[54] However, if Partner A has other Connecticut-source income and Partner A would be required to file a Connecticut personal income tax return, or chooses to file a Connecticut return, the $44 payment made by Partnership AB, on behalf of Partner A, can be used as a refundable credit against Partner A's ultimate Connecticut personal income tax liability (Partner A's Connecticut personal income tax return would include Partner A's share of the Connecticut-source income allocated to it from Partnership AB, as well as Partner A's other Connecticut-source income, if any). Partnership AB is not required to make a payment for Partner B because Partner B is a resident of Connecticut.

Unlike the PET, the tax that is being paid *on behalf* of nonresident owners (in this example, Partner A) is not a deductible amount for federal or state income tax purposes, as it is not an income tax that is imposed on the PTE itself. S corporations with Connecticut resident and nonresident shareholders need to be mindful of this to avoid a potential disqualification of S corporation status if pro rata cash distributions are not made to its resident shareholders.

PTE Estimated Tax Payment Requirement

Under the Act, any electing PTE will be required to file a PTE tax return (or extension) and remit payment of PET due by the 15th day of the third month following the close of the PTE's tax year (March 15 for calendar-year taxpayers).[55] This requirement is consistent with current law. Also, the PTE, as under current law, will continue to be required to remit estimated PET payments

[54]2023 Conn. P.A. No. 23-204, section 362 (effective July 1, 2023, added section 12-719(e)).

[55]Conn. Gen. Stat. section 12-699(b) (effective July 1, 2023).

throughout the year to avoid an underpayment of estimated tax penalty.

Because of 2024 estimated tax obligations, PTEs with a 2024 calendar tax year will need to decide much earlier than March 2025 whether they will be electing into the PET to avoid underpayment penalties. Quarterly estimated payments for the PET are required if tax due is expected to exceed $1,000 and are due on the 15th day of the fourth, sixth, and ninth months of the current tax year and the 15th day of the first month of the next succeeding tax year.[56] If the PTE does not pay the estimated tax when due, it will owe an underpayment penalty at the rate of 1 percent per month or fraction of a month on the amount of the underpayment for the period of the underpayment.[57]

To avoid the underpayment of estimated tax penalty/interest charges, estimated tax payments may be based on the *lesser* of 90 percent of the current year PET or 100 percent of the prior year tax if the prior year consisted of 12 months and a PTE tax return was filed.[58]

Accordingly, a PTE that decides to elect into the PET for the 2024 year will be subject to estimated tax requirements, with the first estimated tax payment date being April 15, 2024, for calendar-year taxpayers. To minimize or avoid estimated tax underpayment penalties/interest charges, a PTE should decide whether it wants to elect into the PET for 2024 not by March 15, *2025*, but at some point early in *2024*. Although the PET regime is first becoming elective starting in 2024, no legislation was enacted to waive the 2024 estimated tax payment requirements for 2024. It should also be noted that sufficient estimated tax payments are not a requirement to make the PET election.

If the PTE makes an estimated PET payment and, thereafter, determines not to elect into the PET, or if the estimated payments exceed the amount of the PET due, then the payments will be applied against the tax liability of the PTE under the nonresident income tax payment requirements, if any.[59] Presumably, any excess will be refunded to the PTE or applied to the PTE's next year PET liability, if so chosen.

Timing of the Deduction of Connecticut's Elective PET

Although it is beyond the general scope of this article, consideration should be given whether or to what extent the elective nature of the PET will affect the timing of the deduction of the PET expense. As previously mentioned, under IRS Notice 2020-75, PETs have *generally* been sanctioned as deductible state income taxes for federal income tax purposes. For a cash-basis PTE taxpayer (and ultimately its owners) to receive a federal income deduction for its 2024 PET liability in 2024, PET payments must be made during the 2024 year. For accrual-basis PTEs, because the Connecticut PET is now elective after the close of the PTE's tax year, consideration must be given whether an accrued tax liability exists as of the end of the PTE's tax year. An accrual-basis PTE may or may not be able to accrue the PET deduction, depending on its circumstances.[60] It is advisable that before electing into Connecticut's PET regime, PTEs, particularly accrual-basis PTEs, discuss the timing of the deductibility of the PET with their tax advisers to ensure that their owners can maximize the federal income tax benefit that the PET was intended to provide.

The Future

Although the Connecticut PET will remain a mandatory tax on PTEs in 2023, it is not too early for PTEs to begin planning and considering whether they should elect into the PET for 2024 and beyond.

For those PTEs that have been using the standard base method, there will be an educational process to assess the proper application of the PET because of the repeal of the standard base method and the required use of what was formerly known as the alternative

[56]Conn. Gen. Stat. section 12-699a.

[57]*Id.*

[58]*Id.*

[59]2023 Conn. P.A. No. 23-204, section 361 (effective July 1, 2023, amended section 12-699a). Conn. Gen. Stat. section 12-719 provides that "the commissioner may refund or credit any overpayment to either the partnership or the partner, in the commissioner's sole discretion."

[60]*See* Treas. reg. sections 1.461-1, 1.461-4(g), and 1.461-5.

base method. These two methods generally provided different results from a Connecticut and federal tax perspective. Also, PTEs that were historically filing combined returns will need to understand that a combined return election is no longer available and should consider the ramifications of making a PET election. And, at a high level, the overall complexity of PET compliance and ensuring that the economics of the tax are fairly distributed among the owners of the PTE may heavily factor into the decision whether to elect into the PET. Many issues, some of which are discussed herein and some which may surface in the future upon a review of a particular PTE's situation, will need to be considered in assessing whether it makes sense to elect into the PET. In short, it will be important for each PTE to analyze whether electing into Connecticut's PET makes sense for it.

Looming over all of this is the fact that under current law, the SALT limitation is scheduled to sunset in 2026. Significantly, there is no sunset provision in the Act for the Connecticut PET. Therefore, even if the SALT limitation does sunset in 2026, as of now, Connecticut's elective PET provisions will remain in place. If the SALT limitation does sunset, does that essentially convert the decision whether to make the Connecticut PET election into a two-year exercise (that is, for the two tax years beginning on or after January 1, 2024 and 2025)?[61] On the other hand, the PET regime may continue to have validity after 2025 if Congress decides to extend the SALT limitation or revise it. In any event, this is an area of state tax law that practitioners will need to pay particular attention to over the next couple of years as the tax law at both the federal and state level continues to evolve.

As discussed throughout, the revisions made by the Act to the PET raise many unanswered questions. Hopefully, the DRS will provide taxpayers and tax practitioners with clear guidance and examples on its interpretation of this new legislation. In addition, the Connecticut General Assembly may address some of these questions during its upcoming 2024 legislative session — similar to what has occurred in other states following adoption of their elective PET regimes. ■

[61] If the SALT limitation is removed, one issue that will need to be explored is whether the application of the federal alternative minimum tax could still create a basis of electing into the PET.