



OCG-6

OFFICE OF THE COMMISSIONER GUIDANCE Regarding the Calculation of the Pass-Through Entity Tax

This preliminary guidance is intended to assist taxpayers in calculating their Pass-Through Entity Tax (“PE Tax”) for purposes of making estimated payments. This guidance may be updated as needed to answer additional questions.

Separate guidance will be issued about how partners will be able to claim the PE credit. This credit may be used to offset a partner’s Connecticut income tax (under chapter 229) or corporation business tax liability (under chapter 208). If the PE credit exceeds a taxpayer’s Connecticut income tax liability, the excess credit can be refunded. Corporations will be allowed to carry an excess credit forward until fully used.

1. Who is subject to the PE Tax?

The PE Tax is imposed on the following entities that do business in Connecticut or have income derived from or connected with Connecticut sources:

- Partnerships, including limited liability companies that are treated as partnerships for federal income tax purposes, but excluding publicly-traded partnerships; and
- S corporations, including limited liability companies that are treated as S corporations for federal income tax purposes.

Sole proprietorships and single-member limited liability companies that are disregarded for federal income tax purposes are not subject to the PE Tax.

Entities subject to the PE Tax are collectively referred to as “PEs” in this publication.

2. How is the PE Tax calculated?

There are two methods that PEs may use to calculate their PE Tax. The “Standard Base” is the default method and must be utilized unless the PE elects to use the “Alternative Base” method. PEs will be able to decide each year whether to use the Alternative Base method and must elect to do so on or before the due date, or extended due date, of the PE Tax return. The PE Tax rate of 6.99% is applied to the applicable base to determine the amount of PE Tax due.

3. How is the Standard Base calculated?

The Standard Base is equal to the PE’s Connecticut source income,¹ determined under Connecticut income tax rules, less any distributive share of Connecticut source income that the PE received

¹ A PE’s Connecticut source income is equal to its separately and nonseparately computed items described in I.R.C. §§ 702(a) or 1366, to the extent derived from or connected with sources within this state, as determined under Connecticut income tax sourcing rules and as modified by the items described in Conn. Gen. Stat. § 12-701. The federal limitations on deductions for charitable contributions and capital losses do not apply.

from a subsidiary PE that filed a Connecticut PE Tax return. A PE that does not make an election to use the Alternative Base method is subject to tax on the entire amount of its Standard Base; no adjustments are made to account for the types of partners² (e.g., corporations or individuals) that own interests in the PE.

Standard Base	=	CT Source Income of PE	-	CT Source Income from Subsidiary PEs
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Example 1: PE has \$1,000 of ordinary income and has no other income. PE carries on business both within and without Connecticut and determines, based upon facts not stated in this example, that its apportionment fraction is 10%. In this situation, the PE has \$100 of Connecticut source income (\$1,000 * 10%) and has a PE Tax liability of \$6.99 (\$100 * 6.99%).

Example 2: PE has \$500 of Connecticut source income, including a distributive share of \$200 of Connecticut source income that it received from Sub PE. PE is a partner in Sub PE. Sub PE filed a PE Tax Return and paid the PE Tax due. PE is subject to tax on \$300 (\$500-\$200) of its Connecticut source income and has a PE Tax liability of \$20.97 (\$300 * 6.99%).

4. How is the Alternative Base calculated?

The Alternative Base is equal to *modified Connecticut source income* plus the *resident portion of un sourced income*. In general, the amount of tax due under the Alternative Base method depends upon the types of partners (e.g., individuals or corporations) that own interests in the PE.

Alternative Base	=	Modified CT Source Income	+	Resident Portion of Un sourced Income
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Modified Connecticut Source Income. Modified Connecticut Source Income equals the Standard Base multiplied by the percentage of “ownership interests” that are directly or indirectly³ held by partners subject to tax under chapter 229 (income tax).⁴ For purposes of this calculation, a partner’s “ownership percentage” is based upon the partner’s direct or indirect distributive share of the PE’s income.

Modified CT Source Income	=	Standard Base	x	Percentage of PE's Income Directly or Indirectly Allocated to Partners Subject to Tax Under Chapter 229 (Income Tax)
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² For purposes of this publication, the term “partner” is used to refer to partners in a partnership, members in a limited liability company treated as a partnership for federal income tax purposes, and shareholders in an S corporation.

³ A shareholder in a C corporation, which C corporation is a partner in a PE, is not an indirect partner.

⁴ If a PE (“Parent PE”) is a partner in another PE (“Sub PE”) and Sub PE does not have information on Parent PE’s partners, Sub PE must assume that all of Parent PE’s partners are subject to tax under chapter 229.

Example 3: PE has a Standard Base of \$10,000. The PE is owned by a resident individual, a nonresident individual, a corporation subject to the corporation business tax, and a tax-exempt entity. Each of these four partners receive distributive shares equal to 25% of PE’s income. Under these facts, 50% of the PE’s income is distributed to partners subject to tax under chapter 229 (the resident and nonresident individuals). Therefore, the PE’s modified Connecticut source income is \$5,000 (\$10,000 * 50%).

Example 4: PE is owned by two corporations subject to the corporation business tax. Each corporate partner receives a distributive share equal to 50% of PE’s income. Under these facts, 0% of the PE’s income is distributed to partners subject to tax under chapter 229. Therefore, the PE’s modified Connecticut source income is \$0.

Example 5: PE has a Standard Base of \$20,000. PE is owned by two other PEs (“Parent PE”). Each Parent PE is owned by either resident or nonresident individuals. Under these facts, 100% of the PE’s income is indirectly distributed to partners subject to tax under chapter 229. Therefore, the PE’s modified Connecticut source income is \$20,000 (\$20,000 * 100%).

Example 6: PE has a Standard Base of \$20,000. PE is owned by two other PEs (“Parent PE”). Each Parent PE is owned by either C corporations, insurance companies, or tax-exempt entities. Under these facts, none of the PE’s income is indirectly distributed to partners subject to tax under chapter 229. Therefore, the PE’s modified Connecticut source income is \$0.

Example 7: PE has a Standard Base of \$2,000,000. PE is owned by a resident individual and by a corporation subject to the corporation business tax. The resident individual receives an income allocation of \$30,000,000, \$3,000,000 of which is Connecticut source income. The corporation receives a loss allocation of (\$10,000,000), (\$1,000,000) of which is Connecticut source loss. Because the individual is allocated an amount of Connecticut source income that exceeds the amount of the Standard Base, 100% of the Standard Base is subject to tax. Therefore, the PE’s modified Connecticut source income is \$2,000,000.

Resident Portion of Unsourced Income. *Unsourced income* is a PE’s income that is not sourced to Connecticut or to another state with which the PE has nexus, regardless of whether the other state actually subjects the PE to tax. Unlike the Standard Base, unsourced income includes the distributive share of income a PE receives from a subsidiary PE. Whether income is sourced to Connecticut or to another state, or whether a PE has nexus in another state, is determined under Connecticut nexus and income tax sourcing and apportionment rules.

Unsourced Income	=	Total Income ⁵ of PE	-	CT Source Income	-	Income Sourced to Other States Where PE has Nexus
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⁵ A PE’s total income is equal to its separately and nonseparately computed items, as described in I.R.C. §§ 702(a) or 1366, regardless of where derived or connected, as modified by the items described in Conn. Gen. Stat. § 12-701. The federal limitations on deductions for charitable contributions and capital losses do not apply.

The resident portion of unsourced income equals unsourced income multiplied by the percentage of “ownership interests” that are **directly** held by Connecticut resident partners. For purposes of this calculation, a resident partner’s “ownership percentage” is based upon the partner’s **direct** distributive share of the PE’s income.

Resident Portion of Unsourced Income	=	Unsourced Income	x	Percentage of PE's Income Allocated Directly to CT Resident Individual Partners
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Example 3A (continuation of Example 3): PE has \$100,000 of total income. The PE is owned by a resident individual, a nonresident individual, a corporation subject to the corporation business tax, and a tax-exempt entity. Each of these four partners receive distributive shares equal to 25% of PE’s income. PE has nexus with Connecticut, Massachusetts and Rhode Island. Under Connecticut rules, PE has \$10,000 of Connecticut source income, \$20,000 of Massachusetts source income, and \$30,000 of Rhode Island Source Income. PE has \$40,000 of unsourced income (\$100,000 - \$60,000). A resident individual receives 25% of the PE’s distributive shares of income. Therefore, the resident portion of PE’s unsourced income is \$10,000 (\$40,000 * 25%).

Under the facts of Examples 3 and 3A, PE is subject to tax on \$15,000 (its \$5,000 of modified Connecticut source income plus \$10,000) and has a PE Tax liability of \$1,049 (\$15,000 * 6.99%).

Example 4A (continuation of Example 4): Because PE is owned by two corporations subject to the corporation business tax, none of the PE’s income is directly distributed to a resident individual. Therefore, the resident portion of PE’s unsourced income is \$0.

Under the facts of Examples 4 and 4A, PE is subject to tax on \$0 and, therefore, has no PE Tax liability.

Example 5A (continuation of Example 5): Because PE is owned by other PEs, none of the PE’s income is directly distributed to a resident individual. Therefore, the resident portion of PE’s unsourced income is \$0.

Under the facts of Examples 5 and 5A, PE is subject to tax on \$20,000 (its \$20,000 of modified Connecticut source income plus \$0) and has a PE Tax liability of \$1,398 (\$20,000 * 6.99%).

Example 6A (continuation of Example 6): Because PE is owned by other PEs, none of the PE’s income is directly distributed to a resident individual. Therefore, the resident portion of PE’s unsourced income is \$0.

Under the facts of Examples 6 and 6A, PE is subject to tax on \$0 and, therefore, has no PE Tax liability.

Example 7A (continuation of Example 7): PE is owned by a resident individual and a corporation subject to the corporation business tax. PE has nexus in Connecticut, New York and New Jersey. PE has \$20,000,000 of total income of which \$2,000,000 is Connecticut source income, \$4,000,000 is New York source income, and \$4,000,000 is New Jersey source income. Therefore, PE has \$10,000,000 of unsourced income.

The resident individual receives an income allocation of \$30,000,000 of the PE's total income. The corporation receives a loss allocation of (\$10,000,000) of the PE's total income. Because the resident individual is allocated an amount of the PE's income that exceeds the total amount of the PE's income, 100% of the unsourced income is subject to tax. Therefore, the resident portion of the unsourced income is \$10,000,000.

Under the facts of Examples 7 and 7A, PE is subject to tax on \$12,000,000 (its \$2,000,000 of modified Connecticut source income plus \$10,000,000) and has a PE Tax liability of \$838,800 ($\$12,000,000 * 6.99\%$).

5. Are guaranteed payments included in a PE's income subject to tax under the Standard Base or the Alternative Base method?

No, guaranteed payments are not included in a PE's income subject to tax under either the Standard Base or the Alternative Base method. Under federal law, guaranteed payments are deducted on Line 10 of Form 1065 when determining a PE's ordinary income. Therefore, for Connecticut PE Tax purposes, guaranteed payments are not included when determining the amount of a PE's income subject to PE Tax.

Nonresident individual partners who receive guaranteed payments are required to file Form CT-1040NR/PY to report all of their Connecticut source income, including the Connecticut source portion of their guaranteed payments.⁶ The Connecticut source portion of a guaranteed payment is determined at the PE level. The Connecticut portion is generally calculated by multiplying the amount of the partner's guaranteed payments by the PE's apportionment fraction.

6. Can a PE deduct the PE Tax when calculating income under the Standard Base or the Alternative Base?

No. When determining a PE's income subject to tax, no deduction should be taken for any PE Tax paid. In determining a partner's income subject to Connecticut income tax or corporation business tax, however, the partner is not required to add back any PE Tax paid by the PE.

7. Can PEs file combined returns to offset gain and loss between PEs?

PEs that are commonly-owned may elect to file a combined return. Commonly-owned means that more than 80% of the voting control of the PE is either directly or indirectly owned by a common owner or owners. The election must be made on an annual basis with the filing of the return by the

⁶ The provisions of Public Act 18-49, § 1(e), that excuse certain nonresident partners from filing Connecticut income tax returns do not apply to nonresident partners who receive guaranteed payments.

due date or extended due date. DRS will provide forms to make the election and to calculate the tax on a combined basis.

PEs electing to file a combined return must first separately calculate their tax base. All electing PEs must use the same method (either the Standard Base or Alternative Base). After calculating the separate base, each PE's tax base is then combined. This combined base is multiplied by the tax rate of 6.99% to determine the group's PE Tax.

8. Are PEs required to make estimated payments for 2018?

Yes. PEs are required to make estimated payments for 2018. Information on estimated payments is provided in **Special Notice 2018(4)**, *Guidance on 2018 Estimated Payments for the Newly Enacted Pass-Through Entity Tax*.

Due to the timing of the legislation, DRS recognizes that PEs may inadvertently underpay their 2018 estimated payments. If a PE receives a notice from DRS that the entity may have underpaid its estimated tax for 2018, the PE may contact DRS with a written explanation describing why it failed to comply along with all supporting documentation. These documents must be submitted to DRS by December 31, 2019,⁷ at the following address:

Department of Revenue Services
450 Columbus Boulevard, 11th Floor
Hartford, Connecticut 06103
Attn: Legal Division/PE Tax Estimate

Additionally, if the enactment of the PE Tax has created other issues relating to the calculation or payment of 2018 estimated payments of a PE or partner, the PE or partner should contact DRS at 860-297-5776 for assistance.

Additional Questions: Send an e-mail to the DRS Legal Division at legal.division@po.state.ct.us

TTY, TDD, and Text Telephone users only may transmit inquiries by calling 860-297-4911.

For Forms and Publications: Visit the DRS website at www.ct.gov/DRS

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Issue Date: 6/19/2018

⁷ DRS will also consider requests after this date if documents are sent within sixty days of receipt of a notice of underpayment of estimated payments.