



# STATE OF CONNECTICUT

## DEPARTMENT OF REVENUE SERVICES

OCG-7

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### OFFICE OF THE COMMISSIONER GUIDANCE Regarding the Pass-Through Entity Tax Credit

This guidance is intended to provide information to partners<sup>1</sup> about the credit available under the Pass-Through Entity Tax (“PE Tax”). This guidance may be updated as needed to answer additional questions.

#### 1. What is the Pass-Through Entity Tax Credit?

For taxable years that begin on or after January 1, 2018, pass-through entities (“PEs”) are subject to an entity-level tax on their own income.<sup>2</sup> Partners in PEs that are subject to the PE Tax are entitled to a credit (the “PE Tax Credit”) based upon a percentage of the partner’s direct and indirect share of a PE’s tax liability, provided the PE has paid such liability prior to the partner claiming the PE Tax Credit.

For taxable years that begin on or after January 1, 2018, but prior to January 1, 2019, the PE Tax Credit percentage is 93.01%. For taxable years that begin on or after January 1, 2019, the PE Tax Credit percentage is 87.5%

A partner may claim the PE Tax Credit against taxes imposed on the partner under chapter 208 (corporation business tax) or chapter 229 (income tax).<sup>3</sup>

*(Answer updated August 16, 2019)*

#### 2. How will a partner know the amount of PE Tax Credit to claim?

A PE must report the amount of PE Tax Credit allocated to each of its partners on Schedule CT K-1. *Member’s Share of Certain Connecticut Items.*

#### 3. In what year may a partner claim the PE Tax Credit?

A partner may claim the PE Tax Credit against the partner’s tax due for the year the distributive share of the PE’s income that creates the PE Tax liability is included in the partner’s income.

**Example 1:** PE is a calendar year filer. All of PE’s partners are individuals. PE’s tax liability for taxable year 2018 is \$100,000. PE makes estimated payments of \$90,000

<sup>1</sup> 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.

<sup>2</sup> Information on the calculation of the PE Tax is found in **OCG-6**, *Office of the Commissioner Guidance Regarding the Calculation of the Pass-Through Entity Tax.*

<sup>3</sup> The PE Tax 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. § 12-707.

during 2018 and pays the \$10,000 balance due on March 15, 2019. Partners in PE may claim the PE Tax Credit, calculated based upon PE's \$100,000 tax liability, on their 2018 Connecticut income tax returns.

#### **4. What happens if the PE Tax Credit exceeds a partner's tax liability?**

If the PE Tax Credit is claimed against the tax imposed under chapter 229 (income tax), any excess credit is treated as an overpayment and, provided the taxpayer does not have other tax liabilities or other debts or obligations to the state, will be refunded, without interest, to the taxpayer claiming the credit. If the PE Tax Credit is claimed against the tax imposed under chapter 208 (corporation business tax), any excess credit may be carried forward until used.

#### **5. How is the PE Tax Credit allocation calculated generally?<sup>4</sup>**

A partner is entitled to a PE Tax Credit based upon a percentage of the partner's share of the PE Tax liability (93.01% for taxable year 2018; 87.5% for taxable year 2019 and thereafter). A partner's share of the PE Tax liability is determined based upon the percentage of the partner's distributive share of income that is included in the PE's income subject to the PE Tax.

If a partner is allocated a net loss, such partner's share of the PE Tax is zero and, therefore, the partner is not entitled to any PE Tax Credit. The PE Tax should be prorated between the remaining partners based upon their relative distributive shares of income included in the PE's income subject to PE Tax.

#### **Standard Base Examples**

**Example 2A – Taxable Year 2018 Only:** PE has a PE Tax liability of \$1,000, which it has paid. Tom, an individual partner, receives 10% of the PE's distributive share of income. Tom's share of the PE's tax liability is \$100 ( $\$1,000 * 10\%$ ). Tom is entitled to a credit of \$93.01 ( $\$100 * 93.01\%$ ) against his Connecticut income tax liability.

**Example 2B – Taxable Year 2019 and Thereafter:** PE has a PE Tax liability of \$1,000, which it has paid. Tom, an individual partner, receives 10% of the PE's distributive share of income. Tom's share of the PE's tax liability is \$100 ( $\$1,000 * 10\%$ ). Tom is entitled to a credit of \$87.50 ( $\$100 * 87.5\%$ ) against his Connecticut income tax liability.

**Example 3A – Taxable Year 2018 Only:** PE has income of \$2,000,000 subject to tax under the standard base. This results in a PE Tax liability of \$139,800 ( $\$2,000,000 * 6.99\%$ ), which the PE has paid. PE has three individual partners: Abby, Betty, and Charlie. Collectively, these partners will be allowed to claim PE Tax Credits of \$130,028 ( $\$139,800 * 93.01\%$ ), which are allocated as follows:

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<sup>4</sup> The allocation of the PE Tax Credit may be different for partners of a PE that files a combined return. See question 8.

- Abby is allocated \$7,000,000 of income from PE. Abby's share of the PE Tax is \$97,860 (70% of the PE Tax) and, therefore, she is entitled to a PE Tax Credit of \$91,020.
- Betty is allocated \$3,000,000 of income from PE. Betty's share of the PE Tax is \$41,940 (30% of the PE Tax) and, therefore, she is entitled a PE Tax Credit of \$39,008.
- Charlie is allocated a loss of (\$8,000,000). Charlie's share of the PE Tax is zero and, therefore, he is not entitled to any PE Tax Credit.

**Example 3B – Taxable Year 2019 and Thereafter:** PE has income of \$2,000,000 subject to tax under the standard base. This results in a PE Tax liability of \$139,800 ( $\$2,000,000 * 6.99\%$ ), which the PE has paid. PE has three individual partners: Abby, Betty, and Charlie. Collectively, these partners will be allowed to claim PE Tax Credits of \$122,325 ( $\$139,800 * 87.5\%$ ), which are allocated as follows:

- Abby is allocated \$7,000,000 of income from PE. Abby's share of the PE Tax is \$97,860 (70% of the PE Tax) and, therefore, she is entitled to a PE Tax Credit of \$85,628.
- Betty is allocated \$3,000,000 of income from PE. Betty's share of the PE Tax is \$41,940 (30% of the PE Tax) and, therefore, she is entitled a PE Tax Credit of \$36,697.
- Charlie is allocated a loss of (\$8,000,000). Charlie's share of the PE Tax is zero and, therefore, he is not entitled to any PE Tax Credit.

### **Alternative Base Examples**

**Example 4A – Taxable Year 2018 Only:** PE has income of \$1,000,000 subject to tax under the alternative base, which is comprised of \$100,000 of modified source income and \$900,000 as the resident portion of unsourced income. This results in a PE Tax liability of \$69,900 ( $\$1,000,000 * 6.99\%$ ), which the PE has paid. PE has two individual partners: Adam and Bob. The PE Tax Credits of \$65,014 ( $\$69,900 * 93.01\%$ ) are allocated as follows:

- Adam, a resident individual, received 90% of the PE's distributive share of income. Adam's portion of the modified source income is \$90,000 ( $\$100,000 * 90\%$ ). Adam, as the only resident individual partner, is attributed all of the PE's resident portion of unsourced income. Of PE's \$1,000,000 of income subject to tax, \$990,000 (99%) is attributable to Adam's distributive share of income. Therefore, Adam's share of the PE Tax liability is \$69,201 (99% of the PE Tax liability), and he will be entitled to a PE Tax Credit of \$64,364 ( $\$69,201 * 93.01\%$ ).
- Bob, a nonresident individual, receives 10% of the PE's distributive share of income. Bob's portion of the modified source income is \$10,000 ( $\$100,000 * 10\%$ ). Because Bob is a nonresident, he is attributed none of the PE's resident portion of unsourced income. Of PE's \$1,000,000 of income subject to tax, \$10,000 (1%) is

attributable to Bob's distributive share of income. Therefore, Bob's share of the PE Tax liability is \$699 (1% of the PE Tax liability), and he will be entitled to a PE Tax Credit of \$650 ( $\$699 * 93.01\%$ ). If Bob's distributive share of PE's income is Bob's **only** source of Connecticut income, then, as a nonresident, Bob would not be required to file a Connecticut income tax return.

**Example 4B – Taxable Year 2019 and Thereafter:** PE has income of \$1,000,000 subject to tax under the alternative base, which is comprised of \$100,000 of modified source income and \$900,000 as the resident portion of unsourced income. This results in a PE Tax liability of \$69,900 ( $\$1,000,000 * 6.99\%$ ), which the PE has paid. PE has two individual partners: Adam and Bob. The PE Tax Credits of \$61,163 ( $\$69,900 * 87.5\%$ ) are allocated as follows:

- Adam, a resident individual, received 90% of the PE's distributive share of income. Adam's portion of the modified source income is \$90,000 ( $\$100,000 * 90\%$ ). Adam, as the only resident individual partner, is attributed all of the PE's resident portion of unsourced income. Of PE's \$1,000,000 of income subject to tax, \$990,000 (99%) is attributable to Adam's distributive share of income. Therefore, Adam's share of the PE Tax liability is \$69,201 (99% of the PE Tax liability), and he will be entitled to a PE Tax Credit of \$60,551 ( $\$69,201 * 87.5\%$ ).
- Bob, a nonresident individual, receives 10% of the PE's distributive share of income. Bob's portion of the modified source income is \$10,000 ( $\$100,000 * 10\%$ ). Because Bob is a nonresident, he is attributed none of the PE's resident portion of unsourced income. Of PE's \$1,000,000 of income subject to tax, \$10,000 (1%) is attributable to Bob's distributive share of income. Therefore, Bob's share of the PE Tax liability is \$699 (1% of the PE Tax liability), and he will be entitled to a PE Tax Credit of \$612 ( $\$699 * 87.5\%$ ).

**Example 5A – Taxable Year 2018 Only:** PE's income subject to tax under the standard base is \$2,000,000. PE has four partners:

1. Carl, a resident individual, received a 25% distributive share;
2. David, a resident individual, received a 12.5% distributive share;
3. Elliott, a nonresident individual, received a 12.5% distributive share; and
4. Corporation, a C corporation subject to the Connecticut Corporation Business Tax, received a 50% distributive share.

Because partners subject to the income tax under chapter 229 (Carl, David and Elliott) receive 50% of the PE's distributive shares of income, the PE's modified source income is 50% of the standard base, which is \$1,000,000 ( $\$2,000,000 * 50\%$ ).

PE's unsourced income is \$8,000,000. Because resident individuals (Carl and David) receive 37.5% of the PE's distributive shares of income, the PE's resident portion of unsourced income is \$3,000,000 ( $\$8,000,000 * 37.5\%$ ).

Accordingly, PE's income subject to tax under the alternative base is \$4,000,000 (\$1,000,000 + \$3,000,000), which results in a PE Tax liability of \$279,600 (\$4,000,000 \* 6.99%). PE's partners will, collectively, be allowed to claim PE Tax Credits of \$260,055 (\$279,600 \* 93.01%).

The chart below shows the calculation of each partner's share of the PE's tax and the associated PE Tax Credit:

| <b>Member</b> | <b>Modified Source Income</b> | <b>Resident Portion of Unsourced Income</b> | <b>Total Alternative Base</b> | <b>Partner's Share of the PE Tax</b> | <b>PE Tax Credit</b> |
|---------------|-------------------------------|---|-------------------------------|--------------------------------------|----------------------|
| Carl (RI)     | \$500,000                     | \$2,000,000                                 | \$2,500,000                   | 62.50%                               | \$162,535            |
| David (RI)    | \$250,000                     | \$1,000,000                                 | \$1,250,000                   | 31.25%                               | \$81,267             |
| Elliott (NR)  | \$250,000                     | N/A   | \$250,000                     | 6.25%                                | \$16,253             |
| Corporation   | N/A                           | N/A   | N/A                           | N/A                                  | N/A                  |
|               |                               |   |                               |                                      |                      |
| <b>Total</b>  | <b>\$1,000,000</b>            | <b>\$3,000,000</b>                          | <b>\$4,000,000</b>            | <b>100.00%</b>                       | <b>\$260,055</b>     |

**Example 5B – Taxable Year 2019 and Thereafter:** PE's income subject to tax under the standard base is \$2,000,000. PE has four partners:

1. Carl, a resident individual, received a 25% distributive share;
2. David, a resident individual, received a 12.5% distributive share;
3. Elliott, a nonresident individual, received a 12.5% distributive share; and
4. Corporation, a C corporation subject to the Connecticut Corporation Business Tax, received a 50% distributive share.

Because partners subject to the income tax under chapter 229 (Carl, David and Elliott) receive 50% of the PE's distributive shares of income, the PE's modified source income is 50% of the standard base, which is \$1,000,000 (\$2,000,000 \* 50%).

PE's unsourced income is \$8,000,000. Because resident individuals (Carl and David) receive 37.5% of the PE's distributive shares of income, the PE's resident portion of unsourced income is \$3,000,000 (\$8,000,000 \* 37.5%).

Accordingly, PE's income subject to tax under the alternative base is \$4,000,000 (\$1,000,000 + \$3,000,000), which results in a PE Tax liability of \$279,600 (\$4,000,000 \* 6.99%). PE's partners will, collectively, be allowed to claim PE Tax Credits of \$244,650 (\$279,600 \* 87.5%).

The chart below shows the calculation of each partner's share of the PE's tax and the associated PE Tax Credit:

| <b>Member</b> | <b>Modified Source Income</b> | <b>Resident Portion of Unsourced Income</b> | <b>Total Alternative Base</b> | <b>Partner's Share of the PE Tax</b> | <b>PE Tax Credit</b> |
|---------------|-------------------------------|---|-------------------------------|--------------------------------------|----------------------|
| Carl (RI)     | \$500,000                     | \$2,000,000                                 | \$2,500,000                   | 62.50%                               | \$152,906            |
| David (RI)    | \$250,000                     | \$1,000,000                                 | \$1,250,000                   | 31.25%                               | \$76,543             |
| Elliott (NR)  | \$250,000                     | N/A   | \$250,000                     | 6.25%                                | \$15,291             |
| Corporation   | N/A                           | N/A   | N/A                           | N/A                                  | N/A                  |
|               |                               |   |                               |                                      |                      |
| <b>Total</b>  | <b>\$1,000,000</b>            | <b>\$3,000,000</b>                          | <b>\$4,000,000</b>            | <b>100.00%</b>                       | <b>\$244,650</b>     |

(Answer and examples updated August 16, 2019)

#### **6. What happens if a PE (“parent PE”) is a partner in another PE (“subsidiary PE”)?**

A subsidiary PE will report to a parent PE the amount of PE Tax Credit that the parent PE is allocated. The parent PE cannot claim this credit against the PE Tax reported on its own return because the parent PE is not subject to tax under the Connecticut corporation business tax or individual income tax. Instead, the parent PE must flow-through the PE Tax Credit to its partners. PE Tax Credits that flow through a parent PE are called “indirect PE Tax Credits.”

#### **7. How are indirect PE Tax Credits allocated and reported?**

Indirect credits will be reported on the parent PE’s tax return and the parent PE will allocate the indirect credits to its partners. Each partner’s portion of the indirect credit will be reported on the partner’s Schedule CT K-1. Indirect credits should be allocated to each partner in a ratio that reflects the portion that the partner’s share of the distributive share of income contributes to the PE’s standard base (for standard base filers) or modified source income (for alternative base filers).

**Example 6 (Standard Base):** Parent PE is a partner in Sub PE. Sub PE filed PE Tax Return and paid the PE Tax due. Sub PE issued a Schedule CT K-1 to PE reporting that the PE Tax Credit available to Parent PE was \$1,200.

Parent PE calculates its PE Tax using the standard base. Therefore, Parent PE should allocate the \$1,200 of indirect PE Tax Credit consistent with the standard base methodology.<sup>5</sup>

Parent PE has four partners that each receive 25% of Parent PE’s distributive share of income: 1) a resident individual (RI), 2) a nonresident individual (NR), 3) a C corporation, and 4) a tax-exempt entity. Each partner will be allocated \$300 of indirect PE Tax Credit (25% of \$1,200).

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<sup>5</sup> Each partner should be allocated a portion of the credit in the same proportion that the partner’s distributive share of the PE’s income compares to the total distributive shares of the PE’s income.

**Example 7 (Alternative Base):** Same facts as Example 6, except that Parent PE elects to file using the alternative base. Parent PE should allocate the \$1,200 of indirect PE Tax Credit based upon the portion that each partner's distributive share of the PE's income was included in modified source income. Only the distributive shares of income attributable to RI and NR are included in the modified source income.

Because the distributive shares of income received by the C Corporation and tax-exempt entity are not included in modified source income, no indirect PE Tax Credit is allocated to those partners. RI and NR should each be allocated \$600 of indirect PE Tax Credit (50% of \$1,200) because each of their distributive shares of income compromises half of Parent PE's modified source income.

### **8. How is the PE Tax Credit allocation calculated for combined filers?**

A combined group may allocate the PE Tax Credit to the partners of the group's members in the manner it deems appropriate. This allocation is irrevocable and must be made when the original group return is filed.

Nonresident individuals who are partners of a PE included in a combined return, and who otherwise would be excused from filing a Connecticut income tax return, are required to file a Connecticut income tax return if the credit provided to such partner would not fully offset his or her Connecticut income tax liability. Administratively, DRS will presume that the PE Tax Credit is sufficient to cover the Connecticut income tax liability of a nonresident individual partner if the PE Tax Credit is equal to or exceeds the partner's portion of the combined group's Connecticut source income multiplied by 6.99%.

**Example 8A – Taxable Year 2018 Only:** PE1 and PE2 are commonly-owned and elect to file a combined return. PE1 and PE2 both use the standard base to calculate their income. PE1 has a standard base of \$2,000,000 and PE2 has a standard base of (\$1,500,000). After combining the \$2,000,000 of income with the loss of \$1,500,000, tax is due on the combined group's base of \$500,000. The group's PE Tax is \$34,950 ( $\$500,000 * 6.99\%$ ). The group has a total PE Tax Credit of \$32,507 ( $\$34,950 * 93.01\%$ ), which the group may allocate to the partners of PE1 and PE2 in a manner the group deems appropriate. This allocation must be reported on the combined PE Tax return and the partners' Schedule CT K-1s issued by the Designated Combined Reporting PE.

**Example 8B – Taxable Year 2019 and Thereafter:** PE1 and PE2 are commonly-owned and elect to file a combined return. PE1 and PE2 both use the standard base to calculate their income. PE1 has a standard base of \$2,000,000 and PE2 has a standard base of (\$1,500,000). After combining the \$2,000,000 of income with the loss of \$1,500,000, tax is due on the combined group's base of \$500,000. The group's PE Tax is \$34,950 ( $\$500,000 * 6.99\%$ ). The group has a total PE Tax Credit of \$30,581 ( $\$34,950 * 87.5\%$ ), which the group may allocate to the partners of PE1 and PE2 in a manner the group deems

appropriate. This allocation must be reported on the combined PE Tax return and the partners' Schedule CT K-1s issued by the Designated Combined Reporting PE.

*(Examples updated August 16, 2019)*

**9. Can a partner claim the PE Tax Credit before the partner receives a Schedule CT K-1 from the PE?**

No. The partner must wait until the PE issues the Schedule CT K-1 before claiming the PE Tax Credit. If the PE does not issue the Schedule CT K-1 until after the due date of the partner's return, the partner should request an extension of time to file. The partner should estimate the partner's tax due and PE Tax Credit and ensure that sufficient payments are made prior to the due date.

**10. Can a partner that is a trust claim the PE Tax Credit on Form CT-1041?**

A trust that is a partner of a PE and receives a Schedule CT K-1 reporting a PE Tax Credit may allocate all or a portion of such credit between the trust and its beneficiaries. Any PE Tax Credit allocated to the beneficiaries should be reported on Schedule CT-1041 K-1. Beneficiaries may claim their allocation of the PE Tax Credit against tax liabilities under the Connecticut corporation business tax or individual income tax.

**11. If a nonresident individual's only source of Connecticut income is a distributive share of income from one or more PEs that file PE Tax returns and pays the PE Tax, is the nonresident individual required to file a Connecticut income tax return?**

**Taxable Year 2018 Only:**

No, unless the nonresident individual:

- Receives Connecticut-source guaranteed payments from one or more PEs;
- Is a member of a PE that files a combined PE Tax return and the PE Tax Credit allocated by the combined group to the nonresident individual does not fully offset his or her Connecticut income tax liability; **or**
- Receives a Schedule CT K-1 reporting Connecticut source income and does not report a PE Tax Credit or otherwise does not have sufficient PE Tax Credit to satisfy his or her Connecticut income tax liability.

Nonresident individuals who receive Connecticut-source guaranteed payments or who have other sources of Connecticut income must file **Form CT-1040NR/PY** to report all of their Connecticut-source income. These nonresident individuals may claim the PE Tax Credit against their tax due.

A nonresident individual, who is excused from filing a Connecticut income tax return, may choose to file a **Form CT-1040NR/PY** to report his or her Connecticut-source income and claim the PE Tax Credit.

PEs with nonresident individuals who receive Connecticut-source guaranteed payments may visit the Pass-Through Entity Tax page on the DRS website for information on an option that is available to satisfy the nonresident individuals' requirement to file Form CT-1040NR/PY.

**Taxable Year 2019 and Thereafter:**

A nonresident individual whose only source of Connecticut income is from a PE is not required to file Form CT-1040NR/PY if:

- He or she receives a Schedule CT K-1 and the PE Tax Credit properly reported fully satisfies his or her Connecticut income tax liability; **or**
- His or her PE remits Composite Income Tax on behalf of the nonresident individual in accordance with the procedures set forth by DRS.

*Nonresident Composite Income Tax Remittance Option:* For taxable years beginning on or after January 1, 2019, DRS will allow a PE to make an annual election to remit composite income tax on behalf of its nonresident members. The elective composite income tax remittance is in addition to any PE Tax due. If a PE elects to remit composite income tax, its nonresident members will be excused from filing their own Connecticut personal income tax returns if they have no Connecticut source income other than from the electing PE.

If a nonresident member is not excused from filing, or otherwise chooses to file a Connecticut income tax return, the member should claim the composite income tax payment made by the PE on his or her behalf along with any PE Tax Credit available to him or her. The member must also include his or her distributive share of the PE's Connecticut source income on his or her return.

For nonresident members who are excused from filing and do not choose to file their own personal income tax returns, their returns will be deemed to be filed on the day their PE files its PE Tax return.

**Special Notice 2019(6)**, *2019 Legislative Changes Affecting the Pass-Through Entity Tax*, provides more information for PEs that are considering this elective option.

*(Answer updated August 16, 2019)*

**Additional Questions:** Send an e-mail to the DRS Legal Division at [legal.division@po.state.ct.us](mailto: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 [portal.ct.gov/DRS](http://portal.ct.gov/DRS)

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