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# How To Get a $450 Million Deduction From Your Capital Gain

## Sec. 1202 of the Internal Revenue Code has been in the tax law for over 20 years.

It was enacted to help stimulate entrepreneurship and investment by providing favorable tax treatment on the sale of certain stock (from Qualified Small Businesses). Combined with savvy planning, this tax provision can increase the potential benefit for starting or investing in young businesses.

### The Basics

If a non-corporate person invests in a Qualified Small Business (QSB) after September 2010 (investments before then also may qualify with reduced benefits), holds the stock for five or more years and otherwise does not encounter a disqualifying event, the investor can sell the shares and exclude gain up to the greater of $10 million or ten times the tax basis of the investment. For example, an angel investor who invests $50,000 in a QSB and then sells the stock for $10 million could pay no U.S. tax on the gain. Although what constitutes a QSB is beyond the scope of this article, such determination is critical as a starting point in any analysis.

## The Planning

As noted above, the maximum exclusion is the greater of $10 million of gain or ten times the seller's tax basis in the stock sold. Often, the first blush analysis is that a founder's tax basis is zero or close to zero in his or her stock and therefore the best available exclusion is $10 million of gain. However, Congress placed a special provision in the law that appears to have been designed to give founders credit not just for the cash they put in, but also for the value of their intellectual property (IP) and other assets that they contribute to the business. Under this rule, when a taxpayer contributes property to a corporation, the taxpayer's basis in the stock received from the company is based on the fair market value of the contributed property, rather than the contributed property's basis. While this provision only relates to the computation of the ten times the tax basis of the investment exclusion amount, its implications can be significant. Consider the following:

A founder starts a new business after working for years developing a unique idea. He forms a corporation and assigns the IP related to this idea to the corporation. Soon thereafter he raises his first round of external financing. This financing round implies a pre-money company value of $20 million, based largely on the contributed IP. If the founder otherwise meets all the Sec. 1202 requirements, depending on the basis of the contributed property, his maximum gain exclusion will not be $10 million but rather $200 million, ten times the implied value of his IP contribution.

Under the QSB rules, the most a company can be worth either before or after the time of contribution is $50 million. Therefore, if that $50 million of value is based entirely on the contribution, the ten-times-basis provision would allow for an exclusion of $500 million. However, under the rules any built-in appreciation in the property contributed cannot be excluded from income. As is often the case, contributed property does not have any tax basis and as a result, the contribution value of $50 million would need to be subtracted from the exclusion, leaving $450 million of tax-free gain upon sale in our example.

## Important Considerations

While relatively simple conceptually, there are many complexities involved with QSB stock and it is essential that taxpayers work with an advisor who has experience with these issues, including the various valuation concerns. There are several factors that could thwart this planning, including (but not limited to):

- Forming a new corporation by contributing the stock of an old company as the value of the contributed stock cannot be used in the ten-times-basis calculation.
- Using potentially understated Sec. 409A values for employee equity grants that imply a company value at odds with the value desired for the ten-times-basis calculation. To successfully achieve both results, a valuation specialist who understands these issues would likely be required. For example, a Sec. 409A valuation of $100,000 for all common stock may not be at odds with a founder's view of $20 million in IP value from contributed property, if the Sec. 409A value takes into account the $20 million IP value in its analysis. Too often, young companies won't spend the money for a quality Sec. 409A valuation which can be problematics in future years when the stock is sold.
- Contributing a founder's IP to a new company by contributing the stock of a corporation owned by the founder that houses the IP. While this structure is often preferred by prolific inventors, a contribution made in this manner will not count for purposes of the ten-times-basis rule.

## The Takeaway

The Qualified Small Business exclusion is a tremendous benefit for founders and early investors, but its real power is often realized by founders who contribute valuable ideas in the form of IP. It is critical that founders and advisors understand these rules, both when creating and selling their businesses.





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# Brewing a Lower Tax Bill

## As any brewery owner can attest, taxes are one of the most expensive ingredients in beer.

In fact, according to a study cited by the Beer Institute, taxes make up a whopping 40% of the average beer's retail price. Fortunately, there may be some relief. On December 22, 2017 the Tax Cuts and Jobs Act (TCJA) was signed into law, and among other things, lowered tax rates for both corporations and individual taxpayers, reduced tax rates for certain businesses organized as a passthrough, and modified or added deductions that are critical for capital intensive businesses. This article will explore how brewery owners can use today's tax code to grow their business, improve after-tax cash flow, and take some of the bitterness out of this expensive ingredient.

### More Incentives to Buy Equipment

In general, the costs of fixed asset acquisitions are capitalized and written-off for tax purposes over the asset's useful life, meaning any tax deduction to reduce the business' tax bill is often misaligned with the timing of any cash outlay for large capital expenditures. This mismatch can put a crimp on the cash flow of any small business, but can especially hamstring breweries, due to their large capital expenditure needs. The Internal Revenue Code (Code) includes some longstanding incentives designed to ameliorate this problem, including Sec. 179, which prior to the TCJA allowed small businesses to deduct the full cost of qualifying equipment in the year of purchase, up to $500,000 per year. The TCJA doubled this threshold to $1 million. This increase is a major consideration for brewers starting out, or existing breweries contemplating large capital expenditures as it could reduce federal taxes by up to $185,000. Timing is critical, however, to make sure capital expenditures are made in a year when the taxable income offset will yield a benefit at the highest tax rate.

## More Incentives to Expand

Once a business takes its Sec. 179 deduction, it can often also benefit from bonus depreciation, another Congressional incentive, for capital expenditures in excess of the Sec. 179 threshold. Prior to the TCJA, the bonus depreciation rules permitted businesses to deduct 50% of the cost of qualifying new property in the year in which the property was placed in service. For example, under prior law, if a business spent $2 million on qualified property, it could deduct $500,000 under Sec. 179 and claim bonus depreciation on an additional $750,000 (50% of the remaining $1.5 million cost basis), leaving $750,000 of cost basis to depreciate over the remaining useful life of the property.

Bonus depreciation was set to expire in 2020, but the TCJA extended the provision until 2026 (with phase-out beginning in 2023) and increased the deduction amount from 50% of cost to 100%. This increase is known as full expensing. Recalculating the example above using the new rules, a $2 million purchase of qualifying property in 2018 will be 100% deductible in 2018 ($1 million deduction under Sec. 179 and $1 million in bonus depreciation).

While there are limitations and nuances to bonus depreciation beyond the scope of this article, in general breweries can buy qualifying property and equipment and deduct 100% of the cost from taxable income in the year of purchase beginning in 2018. In addition to equipment, certain leasehold improvements may now qualify as well, which can help a brewer repurpose an old warehouse or garage for the needs of his or her brewery. Additionally, bonus depreciation previously applied only to purchases of new property but can now also apply to purchases of used property as long as the property is being used by the taxpayer for the first time. For an entrepreneur just starting out or an existing brewery looking to expand, these new rules offer tremendous opportunity to lower the cost of capital.

Bonus depreciation is elective, meaning that a business can opt to capitalize expenses and deduct over time rather than taking full expensing in the year property is placed in service. While counterintuitive, a business might want to take the deduction over time if its taxable income is relatively low today but will be higher in the future and potentially subject to higher marginal tax rates, meaning the deductions could be more valuable down the road. Further, the TCJA could be repealed or altered depending on the outcome of future elections, meaning today's relatively lower tax rates could be temporary. Accordingly, the next 18 months are an ideal time for growing breweries to consider their options and model the after-tax cost of their capital expenditures. The general principles are straightforward, but the devil is in the details, which is why it is important to contact an expert for help.

## Potential Rate Reductions for Partnerships and S Corporations

In addition to the benefits listed above, breweries organized as sole proprietorships, partnerships or S corporations may also qualify for a new 20% deduction enacted under the TCJA that reduces the tax rate imposed by the federal government. Provided certain thresholds are met based on the amount of wages paid and fixed assets placed in service, the effective tax rate imposed on taxable income could drop from 37% down to 29.6%.

In concept, this rate reduction is usually available to businesses engaged in producing a tangible product, but often not to those providing a service. It is important to know what parts of the business qualify for this provision, as each brewery may have certain activities that qualify and others that do not. For instance, if the brewery has an associated tap room or restaurant, that part of the business likely would not qualify for the deduction. In such circumstance, it may be possible to split these activities to take advantage of this new rule. The government has included substantial anti-abuse provisions to penalize aggressive taxpayers, but an expert can help navigate these new rules.

## Fewer Excise Taxes

The most targeted change for breweries came via the Craft Beverage Modernization and Tax Reform Act of 2017 (CBMTRA), which cut the federal excise tax on beer. The lobbyists behind the CBMTRA sought to lower the tax burden on small to midsize breweries, especially those that brewed just over 60,000 barrels annually but were paying tax at the same rate as the beer conglomerates producing hundreds of millions of barrels a year.

The CBMTRA did not close the gap entirely, but it did halve the excise tax from $7.00/barrel to $3.50/barrel, which applies to the first 60,000 barrels produced by domestic breweries that produce less than 2 million barrels per year. For all other breweries and beer importers that exceed these barrelage amounts, the first 6 million barrels are taxed at $16.00/barrel, and any barrelage exceeding 6 million remains subject to the old $18.00/barrel rate.

To provide some context, there are approximately 150 breweries in Massachusetts and only one (Samuel Adams, the flagship brewery of the Boston Beer Company) produces more than two million barrels per year, so most of these breweries will qualify for the $3.50/barrel tax rate. However, the CBMTRA is set to expire in 2020, so this rate reduction might not last forever.

## More Collaborations

The CBMTRA also eliminated tax on the transfer of beer between bonded facilities. This permits breweries to begin production in one facility and finish in another. Prior to the CBMTRA, a brewery could only receive and store beer produced by another brewery if the taxes were already paid and the beer was already packaged. Beer collaborations have become increasingly popular in the past decade, seen as a way to reach new audiences and also learn from fellow brewers. Now, breweries no longer need to host the production at a single site but can instead ship unfinished beer back and forth. However, this benefit all comes with one caveat – state laws. The CBMTRA is a federal law and there are still state and local regulations on intrastate beer transportation of which breweries need to beware.

## Other Items to Consider

It is easy to overlook old tax incentives when there is new tax legislation enacted. With that in mind, here are a few additional tax issues to keep on the radar that may not be new, but may be material:

- Tip Credits – Many breweries open a tap room as a way to get people drinking their beer. Tap rooms collecting and reporting tips on poured beers may be entitled to tax credits on social security payments paid to the government. These tip credits can add up to tens of thousands of dollars per year.

- Sales Taxes for Multi-State Operations – As a brewery grows, so does its regional footprint. State taxes may be a burden, but compliance is crucial to ensure the brewery does not end up paying state sales or use taxes, which should be paid by customers.
- Research & Development (R&D) Credits – Breweries today are innovating with new styles of beer and doing business in ways the industry has not seen before. Breweries creating new canning processes or developing new techniques to improve efficiency may be entitled to tax credits for research and development (R&D) expenditures on these innovative endeavors. The R&D credit rules are complex, but the credits can yield real dollar-for-dollar tax savings at both the federal and, potentially, state levels.

## The Takeaway

Both the new and preexisting tax law contain many provisions that can impact breweries. Since many breweries are organized as flow-through entities, that impact is felt directly by the individual owners. It is important to seek advisors that can work with the businesses and the individual owners simultaneously to proactively implement tax saving strategies and structural planning.





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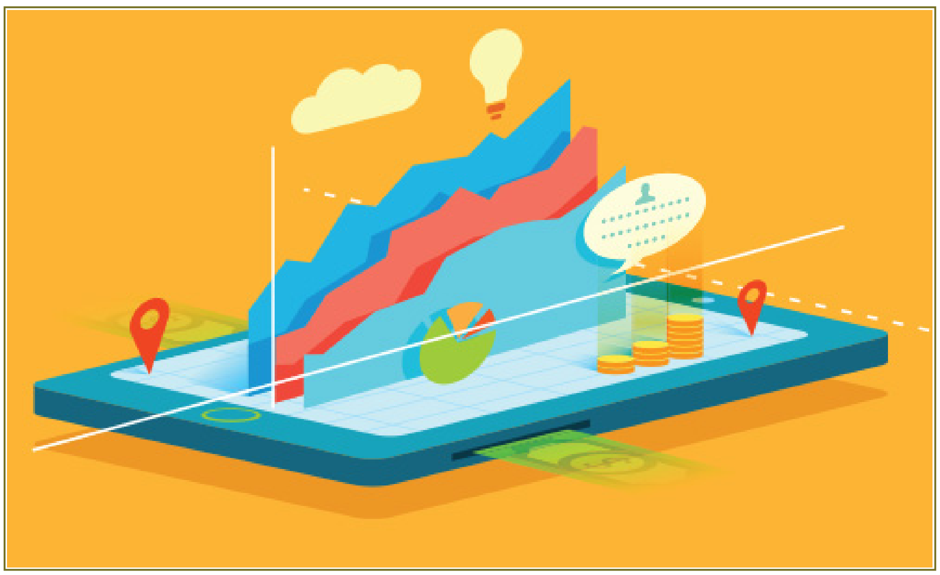
# Taxing the Digital Economy: Spotlight on OECD and EU Initiatives



## The rise of the digital economy has attracted tax administrations seeking to ring the register and cash in on the billions made in online revenues.

While the Organization for Economic Cooperation and Development (OECD) issued a report on the tax rules that should be applied to the digital economy, the European Union (EU) proposed to temporarily tax large companies that sell online advertising, provide online sales platforms, or sell user data to third parties. A second EU proposal outlines a longer term fix that includes changes to international tax rules and introduces the concepts of digital permanent establishment and user-generated value.

The growth of the digital economy has also prompted other tax administrations and their regulators (such as in Argentina, Chile, India) to discuss, and in some cases introduce, new taxes to try to collect on the thriving digital economy. Generally these new laws are based on a theory of significant economic presence, a concept that is gaining ground both internationally and in the state tax arena.

This article focuses on the recent initiatives of the OECD and the EU as they seek to address the uncertainty of taxing billion-dollar digital businesses that do not have a significant physical presence in markets abroad. The evolving international debate on how to tax the online economy is rooted in the proposals discussed below.

## OECD Report

On March 16, 2018, ahead of the Group 20 (G20) Summit meeting in Buenos Aires, Argentina, the OECD released its interim report titled Tax Challenges Arising from Digitalisation (OECD Report). Following up on the work delivered in 2015 under Action 1 of the Base Erosion and Profit Shifting (BEPS) program, the OECD Report is the result of a consensus reached between more than 110 member countries regarding tax issues in the context of the digital economy.

The OECD Report describes characteristics that are typical of digitalized business models, such as a wide digital footprint with no or limited physical presence, heavy reliance on intangible assets and the importance of data and user participation. Members agreed that two key factors of the existing tax framework needed to be reviewed in light of digital businesses: nexus and profit allocation rules. However, the OECD Report also acknowledges that views differ on how the issues should be addressed and stops short of recommending or introducing specific measures. Instead, the OECD Report offers general guidance for jurisdictions that may be considering immediate action with a goal of issuing an update by 2019, and reaching consensus on a long-term solution by 2020.

## European Commission (EC) Proposals

Discussions on the taxation of the digital economy have intensified in the EU since September 2017 when the European Commission (EC) issued a communication presenting the critical challenges in taxing businesses that provide services digitally and proposed both long-term and short-term solutions. The EC published conclusions in December 2017, which simply continued this dialogue and aimed at finding a common EU approach to the issue. On March 21, 2018, the EC presented a series of measures directed at ensuring fair and efficient taxation of digital businesses operating within EU Member States. Interim measures are included as well as a long-term solution. These measures are discussed briefly below:

Digital Services Tax (DST) – An interim solution until a final tax model is adopted, the DST would apply as of January 1, 2020 and would be levied at the single rate of 3% on gross revenues.

- The DST would apply to certain digital services, including: (i) the supply of advertising space; (ii) the making available of marketplaces to facilitate transactions directly between users; and (iii) the transmission of collected user data.
- Only businesses that meet certain thresholds would be subject to the DST (e.g., entities with total worldwide revenue above €750 million and total annual revenue stemming from digital services in the EU above €50 million). The threshold for an entity that is part of a consolidated group should be assessed at the group level.
- It is important to note that the DST should be due in the EU Member States where the users are located. If users are in different Member States, certain allocation keys would be applied to determine the tax base.
- To mitigate double taxation, taxpayers should have the possibility to deduct DST as a cost from their corporate income tax base.

Digital Permanent Establishment (DPE) – Broader in scope than the DST, the DPE measure is designed to introduce taxable nexus for digital businesses operating within the EU, with no or limited physical presence.

- The DPE aims at taxing, under the normal corporate income tax system of a Member State, the profits generated by businesses providing certain digital services and having a significant digital presence.
- Significant digital presence builds on the existing permanent establishment concept and covers any digital platform (e.g., a website or a mobile app) that meets one of the following criteria:

    1. Annual revenue from providing digital services in a given Member State exceeds €7 million, or
    2. Annual number of users of such services is above 100,000 in a given Member State, or
    3. Annual number of online contracts for digital services with business users in a given Member State exceeds 3,000.

- The DPE measure would be applicable to EU taxpayers but also enterprises established in a non-EU jurisdiction with which there is no double-tax treaty with the Member State where the taxpayer is identified as having a significant digital presence.
- The proposed rules on profit allocation are based on the current OECD framework applicable to permanent establishments and suggest the profit split as the preferred method of allocation. The measure also lists economically significant activities that should be taken into account to reflect the notion that value is created where users are based and data is collected.

Significantly, the EC proposals include recommendations to Member States to amend their double tax treaties with third countries so that the rules would also apply to non-EU companies. It is expected that once a Member State complies with the concept of digital permanent establishment, that Member State will discontinue application of the DST. The EC proposals will be submitted to the European Parliament for consultation and then to the EU Council for adoption, which must be unanimous. If an agreement among the 28 EU Member States cannot be reached, it is possible for EU states to proceed with a tax on revenue under EU enhanced cooperation, which would require only nine states to join. EU states may also impose a temporary tax unilaterally. The UK expressed its intention to act unilaterally absent an international agreement in a recently released position paper.

## The Takeaway

Some EU Member states have expressed their concerns with the DST proposal, primarily the fact that the DST is a revenue tax, which means that the tax must be paid even when the company has a loss. The DST would also not be creditable against corporate income tax in the home country of the company, as generally only profit taxes can be taken into account as a foreign tax credit. As a result, the possibility to deduct the DST as an expense would only partially mitigate the risk of double taxation. Another major issue is the U.S. response to the EC proposals, because the U.S. typically rejects any approach which targets or taxes digital businesses separate from the rest of the economy. Therefore, the U.S. could introduce counter measures if the EU were to adopt these proposals.

The digital economy has become a concern for tax authorities at an international level. As a result, countries worldwide are discussing plans and taking steps to expand their taxation rights over the profits of digital companies. Business and tax leaders of multinational companies should be planning for both the immediate and long-term future with these potential changes in mind.

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# Tax Reform Considerations for Aircraft Owners

## Passage of the Tax Cuts and Jobs Act (TCJA) in late 2017 reshaped the landscape for current and prospective aircraft owners.

Many rules have changed, creating a new patchwork of considerations for those operating an aircraft business or those considering the purchase of an aircraft. This article provides a brief discussion of these changes and other general tax reform measures that may affect a taxpayer's decision to purchase and/or operate a business aircraft.

### Full Expensing for New and Pre-Owned Aircraft

Following passage of the TCJA, taxpayers can immediately write off the cost of new and pre-owned aircrafts acquired and placed in service after September 27, 2017. This write-off provision gradually phases down beginning in 2023 and then expires in 2026. Unlike previous bonus depreciation provisions, the aircraft does not need to be new to be eligible for bonus depreciation. However, a pre-owned aircraft is not eligible for bonus depreciation if it was previously used by either the acquiring taxpayer or a related party. As under prior law, business use requirements must be met for the aircraft to be eligible for depreciation and the normal depreciable period for corporate jets remains five years.

## Elimination of Like-Kind Exchange for Aircraft

Aircraft are no longer eligible for tax-deferred like-kind exchange treatment. A transition rule preserves like-kind exchanges of personal property (including aircraft) if the taxpayer has either disposed of the property or acquired replacement property on or before December 31, 2017. Since 100% bonus depreciation is available for new and used aircraft, investing in replacement aircraft often will create new depreciation deductions to offset gain recognized on the sale of an aircraft.

## Business Entertainment

Beginning in 2018, all entertainment expenditures are 100% disallowed, regardless of whether they are directly related to a business purpose. Taxpayers can continue to utilize aircraft for business entertainment, but if the primary purpose of the trip is business entertainment, these expenditures will no longer be tax deductible. IRS guidance may be forthcoming regarding how to apply this new rule for trips with multiple activities, some of which include entertainment.

## Employee Commuting Expenses

Also beginning in 2018, employers are prohibited from deducting the cost of providing transportation to employees to commute between the employee's residence and place of employment unless it is necessary for ensuring the safety of the employee. Further guidance is needed to understand what is needed to meet the ensuring the safety of the employee statutory exemption, but prior regulatory guidance suggests that utilizing an aircraft pursuant to an independent security program or other security program provided to an employee on a 24-hour basis would likely qualify for the exemption.

## Ticket Tax

The Federal Transportation Excise Tax, or ticket tax, was also amended in the course of tax reform. The amendments clarify that owner flights on managed aircraft are not subject to the ticket tax, but rather are subject to the non-commercial fuel tax. The ticket tax is a substantial excise tax of 7.5% and generally applies to situations where a customer purchases a ticket on a commercial aircraft. However, IRS had taken the position that the tax applies whenever there is a payment or reimbursement for a flight on an aircraft with crew. The TCJA amended the ticket tax so that payments made to a management company by an aircraft owner or qualified lessee for support services on owner flights are generally excluded from the tax.

## Interest Expense Limitations

The TCJA also instituted a new limitation on the deductibility of business interest expense. The deduction for business interest expense in excess of business interest income is limited to 30% of the taxpayer's adjusted taxable income, which is generally taxable income from the business before interest expense, and in years prior to 2022, depreciation and amortization expense. Interest expense deductions that are limited are carried forward to future years where there is excess adjusted taxable income to absorb the interest expense. Although an exception applies to businesses with annual gross receipts under $25 million, a related party aggregation rule applies in determining the amount of gross receipts which may limit the applicability of the exception for many aircraft businesses. Given the fact that aircraft buyers typically incur substantial debt to finance aircraft purchases, the new limits on interest expense deductions will likely have a significant impact on U.S. aircraft buyers, particularly starting in 2022 when adjusted taxable income is not increased for depreciation expense. Leasing rather than purchasing an aircraft may be a better option for some aircraft users since rental expense remains fully deductible.

## Special Deduction for Pass-through Business Income

Aircraft business income reported by an individual directly or through pass-through entities may be eligible for a special 20% deduction, which effectively brings the top marginal federal tax rate from 37% to 29.6%. The deduction is generally capped annually based on W-2 wages paid to employees of the business and unadjusted tax basis of qualified property used in the business. For non-corporate owners of aircraft, the business is often managed by independent contractors (e.g., third party servicers) rather than employees. In such case, as there are no W-2 wages, the annual cap would effectively be 2.5% of the original purchase price of depreciable aircraft and other eligible property.

## Deferral of Business Losses

The TCJA further created a new excess business loss limitation regime for non-corporate taxpayers, which is in addition to existing rules for passive losses. Specifically, taxpayers other than corporations may not be able to fully offset aggregate net business losses otherwise allowed during the year (active and passive) against other types of income (investment, compensation) as was possible in the past. Excess business losses (e.g., $500,000 or more on a joint tax return) must instead be carried forward and treated as net operating losses (NOLs). The NOL can be used to offset any type of income, effectively creating a one-year loss deferral for taxpayers with sufficient other income to absorb the NOL in the succeeding year. NOLs may be carried forward (not back) and may only be used to offset up to 80% of taxable income in any particular year. Many aircraft businesses have historically been subject to the passive activity loss limitation rules. The new regime now places a hurdle on active losses and may further defer passive losses once they are allowed.

## The Takeaway

Current and prospective aircraft owners should review the tax reform changes discussed above to determine the impact on their tax position. Depending on the circumstances, the tax reform changes may have a positive effect on an aircraft owner's tax position, or may prove costly. Planning and careful structuring with the assistance of a tax advisor who is well versed in the tax reform changes and the nuances of the tax rules as they relate to aircrafts can help to minimize the impact of potentially unfavorable measures.

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# Connecticut Pass-Through Entity Tax


*As of January 1, 2018, Connecticut (CT) imposes a new entity level tax at the rate of 6.99% on affected pass-through entities (PE), including partnerships.*

There are two methods for calculating this new tax, the Standard Base and the Alternative Base.

## The Standard Base

Under this method, the tax is imposed on the PE's Standard Base which is equal to its CT-sourced income, less any CT source income from subsidiaries that already paid the tax. Although the default method, the Standard Base does not take into account the classification of the PE's underlying partners/members. As a result, the tax is imposed on the entire Standard Base, with no adjustments for tax exempt partners or non-US partners.

In situations where there are multi-tiered PE structures, if an upper tier PE pays its entity tax due, a lower-tier PE that is a partner in the upper-tier need not pay tax on its share of that CT income (i.e., the lower-tier PE will only owe tax on its other CT income that has gone untaxed). As an example, assume Partnership A has $500 of CT-sourced income, $200 of which was received from Partnership B in which it is a partner. Partnership B filed and paid its entity tax due. Therefore, Partnership A is only subject to entity tax on the remaining $300, leaving a tax liability of $20.97 ($300 x 6.99%).

## The Alternative Base

In contrast to the first method, the Alternative Base method allows for adjustments based on the underlying partner composition. Under this method, the tax is imposed on the sum of the PE's modified CT source income plus the resident portion of its unsourced income. Modified CT source income is the Standard Base multiplied by the percent of the PE's income directly/indirectly allocated to partners subject to Chapter 229 income tax. Therefore, any partner not subject to CT income tax (typically based on whether an individual or entity is exempt from federal income tax) would not be included in this percentage, which effectively lowers the amount of CT-sourced income.

Further, the resident portion of unsourced income is calculated as unsourced income multiplied by the percent of PE's income directly allocable to CT resident individual partners. Therefore, any non-individual (e.g. not a natural person), even a CT resident, would be excluded from this percentage causing the resident portion of unsourced income to be lower.

The CT Department of Revenue Services (DRS) has provided the following example: Partnership P is composed of a resident individual, a non-resident individual, a corporation subject to corporate business tax, a tax-exempt entity and a non-US individual. The partners receive distributive shares of 20% each. For 2018, Partnership P has $100,000 of total income, with $60,000 sourced to CT, $20,000 sourced to Massachusetts, and $20,000 unsourced. The following are the tax results:

- Resident Portion of Unsourced = $20,000 x 20% = $4,000
- Modified CT Source Income = $60,000 x 60% = $36,000
- Alternative Base = $36,000 + $4,000 = $40,000
- Tax Due = $40,000 x 6.99% = $2,796

Using the tiered-structure treatment under the Alternative Base, it is possible to look through the structure to determine the percentage of income directly/indirectly sourced to partners subject to Chapter 229 income tax. Doing so may allow for a decrease in the PE's modified CT source income that will be subject to tax.

As further provided by the CT DRS: Partnership A has a Standard Base of $20,000. Partnership A is owned by Partnerships B and C which are both owned by a mix of C corporations, insurance companies, and tax-exempt entities. Because the C corporations, insurance companies, and tax-exempt entities are not subject to income tax under Chapter 229, Partnership A's modified CT source income is $0 and therefore no entity tax will be due. Utilizing the Alternative Base method may allow the passthrough to significantly decrease or altogether avoid paying entity tax on its entire CT-sourced amount. Since income allocated to exempt partners would not be included in the Alternative Base, no tax would be due on their income nor should any tax be allocated to these partners. To ensure the Alternative Base method is used, an election must be made on or before the due date (or extended date) of the return.

Beginning in tax year 2018, estimated payments against the tax due are required to be made quarterly by the PE itself. For calendar year filers, estimated payments, which can be made via a coupon and check to the CT DRS (and electronically starting in September), are due according to the following schedule:

| Due Date | Payment Due |
|---|---|
| April 15, 2018 | 22.5% of PE's tax liability |
| June 15, 2018 | 22.5% of PE's tax liability |
| September 15, 2018 | 22.5% of PE's tax liability |
| January 15, 2019 | 22.5% of PE's tax liability |

Acknowledging late enactment of this new law, the CT DRS allows for catch-up payments to be made to bring PEs into compliance with the payments due. These payments can be made in several ways, including making one lump-sum payment that brings the PE up to date, or annualizing estimated payments for the year. The PE may also re-characterize any estimated payments made by its partners (with partner consent) so that such payments can apply towards its tax liability for the year.

## The Takeaway

Going forward, many CT residents will no longer have to make estimated payments on their CT pass-through income, while non-residents, with no other CT income, will generally have no CT income tax filing requirement or estimated payment obligation so long as the PE pays its entity tax due. By contrast, if the PE makes the Alternative Base election, corporate partners should continue to make their estimated payments as done previously. To avoid double taxation, partners may claim a credit on their CT tax returns for their share of the tax paid. It is important that CT residents and non-CT residents with CT source income keep these new rules in mind.