The Asset Management Industry
SERVING INDIVIDUAL INVESTORS
INVESTMENT COMPANY INSTITUTE

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CONNECTICUT REPLACES COMBINED REPORTING WITH INTEREST EXPENSE DISALLOWANCE AND INCREASE IN "PREFERENCE TAX" ON COMBINED FILERS

[16451] August 20, 2003 TO: TAX MEMBERS No. 46-03 ADVISER DISTRIBUTOR TAX ISSUES TASK FORCE No. 17-03 RE: CONNECTICUT REPLACES COMBINED REPORTING WITH INTEREST EXPENSE DISALLOWANCE AND INCREASE IN “PREFERENCE TAX” ON COMBINED FILERS On August 16, 2002, the Connecticut legislature passed H.B. 6806, which repeals the mandatory combined reporting previously passed by the legislature and enacts an interest expense disallowance for related companies and an increase in Connecticut’s preference tax applicable to certain combined returns. The Governor is expected to sign H.B 6806 in the near future. Attached is a copy of the new statutory provisions regarding interest expense disallowance and the increase in the preference tax. The budget legislation previously passed by the legislature, H.B. 6802, required mandatory combined reporting in Connecticut for affiliated companies based on certain factors, even where the affiliated companies had no independent nexus with Connecticut. The Institute wrote the Governor and legislative leaders to identify the problems such an approach raised, particularly for the mutual fund industry.1 The Governor delayed signing H.B. 6802, which included mandatory combined reporting, until the Legislature enacted H.B. 6806, which repeals that requirement. In place of mandatory combined reporting, H.B. 6806 enacts other changes intended to raise revenue and address perceived abusive tax schemes. Section 78 of H.B. 6806 disallows otherwise deductible interest expenses and costs directly or indirectly paid to related members. A related member is defined broadly, and includes “component members” under Section 1563 of the Internal Revenue Code, as well as entities that own directly or indirectly at least 50% of the taxpayer’s stock. However, a taxpayer is entitled to a deduction for interest paid to a related member if it can show it meets one of three tests (by clear and convincing evidence): 1. a principal purpose of the transaction was not the avoidance of tax, and the interest is paid pursuant to a contract reflecting arm’s length rate and terms, and either (1) the related member was subject to tax on the interest in a state or foreign country 1 See Institute Memorandum to Adviser Distributor Tax Issues Task Force, No. 15-03, and to Tax Members, No. 43-03, (16408), dated August 6, 2003. 2 and the applicable tax rate was within three percentage points of the Connecticut statutory tax rate, or (2) the taxpayer is subject to Connecticut’s tax on insurance premiums, or a comparable tax in another state; 2. the related member is located in a foreign country which has a comprehensive income tax treaty with the United

States; or 3. the adjustments are unreasonable. In addition, where there are substantial inter-company business transactions, a taxpayer may deduct interest paid to related members if it elects to file on a unitary basis for at least five years, or if the taxpayer and the Commissioner agree to an alternate method of calculating tax. This provision is effective for tax years beginning on or after January 1, 2003. However, Section 79 of the bill provides that, for tax years beginning in 2003 and 2004, taxpayers will not owe an interest penalty to the extent an underpayment of estimated tax was caused by the application of the interest expense disallowance. Section 80 of H.B. 6806 increases the maximum preference tax for taxpayers filing combined returns from $25,000 to $250,000. The Connecticut preference tax is calculated by determining the tax that companies filing on a combined basis would owe if they filed separately, and subtracting from that amount the tax owed filing on a combined basis. The net amount, not exceeding $250,000, is then added to the tax owed on the combined return. David Orlin Assistant Counsel Attachment (in .pdf format)
