OFFICE OF LEGISLATIVE RESEARCH
Objective Research for Connecticut's Legislature

Issue Brief

Connecticut's Response to Federal Tax Reform

Federal Tax Cuts and Jobs Act of 2017

The federal Tax Cuts and Jobs Act of 2017 (P.L. 115-97), signed into law on December 22, 2017, made sweeping changes to the federal tax code, with far-reaching implications for individual and business taxpayers. Among its many changes, it lowers individual and corporate tax rates, increases the standard deduction, limits or eliminates certain itemized deductions, expands business expensing, establishes a new deduction for pass-through income, and overhauls international tax provisions. Most of its provisions took effect on January 1, 2018. Its corporate tax provisions are generally permanent, while its individual tax changes generally sunset at the end of 2025.

These numerous changes have implications for most states, including Connecticut, that link their tax code to the federal tax code by incorporating federal provisions. During the 2018 session, the General Assembly analyzed the impact of these changes to the state budget and individual taxpayers and made a number of conforming or compensating changes to the state's tax code in response. Most of the legislature's actions were encompassed in PA 18-49. This issue brief summarizes its most significant provisions.

SALT Deduction Cap

The new federal tax law caps the deduction for state and local taxes (SALT) at $10,000 ($5,000 for married taxpayers filing separately) starting in 2018. The Department of Revenue Services (DRS) estimates that this cap will cause Connecticut taxpayers to lose an estimated $10.3 billion in SALT deductions in 2019, and will increase Connecticut taxpayers' federal income tax liability by approximately $2.8 billion in 2018.

In response, the legislature created a new entity-level income tax on most pass-through businesses. The tax, known as the pass-through entity tax, is (1) levied at the top personal income tax rate or 6.99% and (2) offset by a state personal or corporation income tax credit for the entity's members. Because entity-level taxes remain deductible at the federal level, pass-through businesses will be able to claim this new tax as a deductible expense against their federal taxes and pass along the benefit of the deduction to their members (PA 18-49, §§ 1-8).

The legislature also enacted a second workaround to the SALT deduction cap targeted at residential property taxpayers. Under the new law, municipalities may provide a property tax credit to eligible taxpayers who make voluntary payments to a municipally-approved nonprofit that is organized exclusively to support municipal spending on programs and services (i.e., community supporting organizations). It was designed to allow taxpayers that make these payments to claim a federal charitable contribution deduction for the donation to the nonprofit. However, the Internal Revenue Service has issued proposed regulations meant to block states from circumventing the SALT cap through charitable donations, raising significant doubts about the implementation of this program (PA 18-49, § 10).

In July 2018, Connecticut joined New York, Maryland, and New Jersey in a multi-state lawsuit challenging the constitutionality of the SALT deduction cap. The lawsuit argues that the cap (1) was enacted to target Connecticut and similarly situated states, (2) interferes with states' rights to make their own fiscal decisions, and (3) will disproportionately harm taxpayers in these states (*New York v. Mnuchin*, Dkt. No. 1:18-cv-06427 (S.D.N.Y. filed July 17, 2018)).

Gift and Estate Tax Exclusion

The federal tax law doubled the basic exclusion amount for the federal estate tax to approximately $11 million in 2018, after adjusting for inflation. Under the 2017 budget act, Connecticut was scheduled to increase its state gift and estate tax threshold to the federal exclusion from 2018 to 2020. In 2018 however, the legislature extended this phase-in to the federal threshold by three years to 2023 (PA 18-81, §§ 66-68).

Repatriated Foreign Income

The federal tax law reformed the international tax system by changing the way in which foreign profits of U.S. based multinational corporations are taxed. One such change established an exemption for foreign profits (dividends) paid back to the United States. It is intended to encourage U.S. companies to repatriate their accumulated foreign earnings and invest them domestically.

Connecticut includes dividend s in the calculation of its corporation business tax, but provides a 100% dividends received deduction for dividends from foreign corporations. Thus, taxpayers that report foreign-source dividends will claim a deduction that will fully offset their foreign income. They must, however, add back any expenses related to these dividends when calculating their net income.

To make it easier for these companies to calculate these related expenses and for DRS to verify them, the legislature enacted a new law specifying that expenses related to dividends equal 5% of all dividends received by a company during an income year (PA 18-49, § 13).

Depreciation and Expensing Assets

As a way to encourage companies to invest in new assets and, in turn, stimulate the economy, the federal tax law allows companies to deduct the cost of eligible capital investments up front, rather than claiming the deductions over time. Because Connecticut generally conformed to these federal rules, they would have resulted in a deferral of state revenue.

To smooth out the revenue impact of these changes, the legislature enacted a law requiring business taxpayers to spread out the bonus depreciation and expensing deductions over four and five years, respectively (PA 18-49, §§ 11 & 12).

Limit on Business Interest Deductions

Under the federal tax law, the amount of business interest a company may deduct from gross income is generally limited to 30% of its income. Because Connecticut generally conforms to these federal rules, this change would have resulted in increased revenue for the state. The legislature, however, decoupled the state corporation business tax from this new federal limitation (PA 18-49, § 13).

Qualified Opportunity Zones

The new federal Opportunity Zone program, created as part of the federal tax law, is designed to spur economic development and job creation in low-income communities by providing special tax benefits for private investments in the zones. The program's tax benefits are available to investors that reinvest gains earned on prior investments in a qualified opportunity zone fund.

Connecticut has 72 opportunity zones in 27 municipalities that were nominated by Governor Malloy and approved by the U.S. Treasury Department earlier this year. A 2018 law requires the Department of Economic and Community Development commissioner to identify best practices for marketing the zones' benefits to increase investment in them and, by January 1, 2019, report her findings to the Commerce Committee (PA 18-49, § 21).

Learn More

"Connecticut's Tax Treatment of Federal Bonus Depreciation," OLR Report 2018-R-0168

"Federal Changes to 529 Plans," OLR Report 2018-R-0036

Opportunity Zones, OLR Report 2018-R-0196

Federal Tax Reform and the States, National Conference of State Legislatures

"President Signs Sweeping Tax Overhaul Into Law", CCH Tax Briefing, December 22, 2017

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