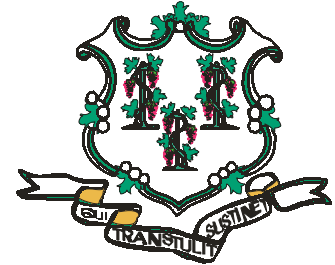


Connecticut Tax Update

(We wrote this update before Governor John G. Rowland signed into law the recent tax increases to help fund the 2003 Budget deficit.)



Connecticut over the past several months, made several legislative changes that apply to the taxation of businesses, not-for-profit organizations and individuals. Unfortunately, none of them will improve the climate for doing business in the state. Below are selected highlights of major changes.

Business Entity Tax

The **creation of a new** annual minimum tax of \$250 for Limited Liability Corporations (LLCs) that are taxed as a partnership or disregarded entity, Limited Liability Partnerships (LLPs), S-Corporations, and Limited Partnerships (LPs), and extending to tax-exempt entities with a Single Member Limited Liability Corporation (SMLLC). Excluded from the minimum tax are General Partnerships or Sole Proprietors. Failure to pay the minimum tax by the due date will subject the entity to a \$50 penalty and interest at the rate of 1% per month from the due date until the tax is paid.

Use of Tax Credits Limited

For tax years beginning after January 1, 2002, use of tax credits to offset Connecticut corporate tax is limited to 70% of tax liability. And, the \$250 minimum tax cannot be offset by credits. **Previously, companies could offset their entire tax liability** to the extent of the credits generated.

Bonus Depreciation Disallowed

The legislation disallows the bonus depreciation created by the Federal Job Creation and Worker Assistance Act of 2002.

This change applies to the special 30% bonus depreciation on business property acquired after September 10, 2001 and before September 11, 2004. C Corporations and pass-thru entities are treated differently.

C Corporations

Modifications must be made to depreciation expense as follows:

1. **Eliminate** the 30% bonus depreciation claimed on the corporation's federal tax return
2. Compute the depreciation allowed for state tax purposes in each year in which the property is depreciated.

For example, ABC Inc., on January 2, 2002, purchased 5-year property with a cost of \$100,000.

The initial year depreciation deduction for this asset for both federal and Connecticut purposes follows:

	<u>Federal</u>	<u>CT</u>
Cost	\$100,000	\$100,000
Less bonus depreciation	(30,000)	<u> </u>
Depreciable base	70,000	100,000
Less first year depreciation (20% rate)	(14,000)	(20,000)
Remaining basis at December 31, 2002	<u>\$ 56,000</u>	<u>\$ 80,000</u>

For Connecticut tax purposes, in year one (1), the Company will increase taxable income by \$30,000 (bonus depreciation), and reduce taxable income by \$6,000 (\$14,000 - \$20,000). This results in **Connecticut taxable income being \$24,000 higher than federal**. Going forward, the company will deduct excess Connecticut depreciation over the federal depreciation until fully depreciating the asset.

Tax cost also increases if the Company sells the asset for a gain before it is fully depreciated, as the gain for Connecticut purposes will be calculated based on the federal computation. That is, the corporation will not be able to reduce the gain by any remaining undepreciated Connecticut basis. Therefore, for Connecticut tax purposes the gain will include the effect of the 30% bonus depreciation although the tax taxpayer did not receive the complete benefit of the increased deduction. Effectively this results in a tax payment on a loss.

Pass-through Entities

It gets worse for pass-through entities (e.g., S Corporations, LLC, LLP, etc.). Individuals claiming bonus depreciation on their federal tax returns as result of activity from pass-thru entities will be required to addback the bonus depreciation when computing adjusted gross income for state tax purposes. Unlike the C-Corporation, no deduction is allowed for the excess Connecticut depreciation. This will result in **a permanent disallowance** of the bonus depreciation for state tax purposes.

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Sales & Use Tax

The 1% sales and use tax on computer and data processing services to be repealed on July 2002 has been **extended** through June 30, 2004.

A New Tax

Now taxed at the rate of 6% is the use of self-storage units. Self-storage units are defined as secure areas, such as rooms, units, compartments, or containers, whether accessible from outside or from within a building.

These areas must be for the use of a customer, where the customer can store and retrieve property and has either unlimited free access or free access within reasonable business hours or upon reasonable notice. It does not include the rental of an entire building, such as a warehouse.

Personal Income Tax Increases

Owners of pass-thru entities will be required to addback all of the 30% bonus depreciation taken for federal tax purposes. As discussed previously, for Connecticut purposes this **deduction is permanently lost** and requires the bonus depreciation to be added back to the income of the individual owner's Connecticut personal income tax return.

Planned increases in the personal exemption and personal credit will be delayed until tax years beginning January 1, 2004. Also delayed to 2004 is the increase in the threshold used for claiming the property tax credit.

In our next update, we will report on legislative changes arising from the 2003 Connecticut Budget Deficit Reduction Act. Meanwhile, if you have any questions, please call us.

We are at (203) 929-3535