

## Effect of Federal Tax Law Changes on the Taxation of Limited Liability Companies and S Corporations and Their Shareholders

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**PURPOSE:** This Special Notice replaces SN 98(3), Part II, Paragraph C, dealing with S corporations and qualified S corporation subsidiaries (QSSS) to reflect the recent legislative changes to the definition of an S corporation as set forth in Conn. Gen. Stat. §12-213(a)(22). The Department issued SN 98(3) on January 22, 1998, to explain the effect of the federal check-the-box regulations and changes to the federal income tax laws affecting the treatment of certain limited liability companies and S corporations for purposes of the Connecticut personal income tax, corporation business tax, additional tax on capital and minimum tax, sales and use taxes, real estate conveyance tax and controlling interest transfer tax.

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**EFFECTIVE DATE:** Effective for taxable years beginning on or after January 1, 1997, except for Part II, paragraph C, which is effective January 1, 1998.

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**STATUTORY AUTHORITY:** Conn. Gen. Stat. §§34-101(9); 34-113; 12-213(a)(22) as amended by 1998 Conn. Pub. Acts 244 §5; 12-407(1), §12-701(a)(33) and (34), 12-494, *et seq.* and 12-638a, *et seq.*

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**INTRODUCTION:** Changes in federal income tax law introduced qualified subchapter S subsidiaries (QSSSs) and single-member limited liability companies (SMLLCs), two new business entities referred to as **see-through** entities. This Special Notice explains the Department of Revenue Services' treatment of these see-through entities for purposes of the personal income tax, corporation business tax, additional tax on capital and minimum tax, sales and use taxes, real estate conveyance tax and controlling interest transfer tax. Part I addresses the federal check-the-box regulations and their impact on Connecticut's tax treatment of

limited liability companies (LLCs). Part II addresses S corporation law reform.

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**BACKGROUND:** Before Treasury Regulation §301.7701 was revised, the federal entity classification rules listed six corporate attributes that were used to determine whether an unincorporated business entity should be classified as a partnership or as a corporation. An organization was classified as an association unless such organization had more corporate characteristics than non-corporate characteristics. Entities that possess a preponderance of the six attributes were classified as corporations. Thus, under the prior regulations all unincorporated business entities, other than sole proprietorships, were treated for federal income tax purposes either as partnerships or as corporations.

In December 1996, the IRS issued the check-the-box entity classification regulations in an attempt to simplify the entity classification process. The check-the-box regulations, which entail an elective classification scheme, allow every unincorporated business entity that is not properly classified as a trust or expressly taxed as a corporation under the Internal Revenue Code to elect how it is to be classified and taxed for federal income tax purposes.

Connecticut treats unincorporated business entities based on their classification for federal income tax purposes.

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### **PART I:**

**CONNECTICUT'S TAX TREATMENT OF LIMITED LIABILITY COMPANIES:** The check-the-box rules, which took effect January 1, 1997, recognized single member limited liability companies (SMLLCs) for the first time.

The check-the-box rules in Treasury Regulation §301.7701-2(a) provide, in part, that:

*[a] business entity with only one owner is classified as a corporation or is disregarded; if the entity is disregarded, its activities are treated in the same manner as a sole proprietorship, branch, or division of the owner.*

Thus, under the check-the-box rules, single-member unincorporated business entities may elect either to be taxed as corporations or to be disregarded as entities separate from their owners, in which case they will be treated as a sole proprietorship, branch, or division of the owner. Unincorporated business entities with two members or more may elect to be taxed as partnerships or as corporations.

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**CURRENT CONNECTICUT LAW:** Many states, including Connecticut, now allow the formation of SMLLCs. Conn. Gen. Stat. §34-101(9), as amended by 1997 Conn. Pub. Acts 70, §2, changes the definition of a limited liability company from an organization having two or more members to an organization having one or more members.

Additionally, Conn. Gen. Stat. §34-113 (as amended by 1997 Conn. Pub. Acts 70) provides that:

*[a] limited liability company formed under sections 34-100 to 34-242, inclusive, as amended by this act, or a foreign limited liability company transacting business in this state pursuant to the provisions of said sections shall be treated, for purposes of taxes imposed by the laws of the state or any political subdivision thereof, in accordance with the classification for federal tax purposes.*

**A. Income Tax Treatment Generally.** In determining the Connecticut income tax treatment of both an SMLLC and an LLC with two members or more, the Department of Revenue Services will adopt the entity's federal income tax classification, as determined under the check-the-box rules. Thus, for taxable years beginning on or after January 1, 1997, an SMLLC will be disregarded as an entity separate from its owner for Connecticut income tax purposes if it is so disregarded for federal income tax purposes. Otherwise, an SMLLC will be treated as a corporation for Connecticut income tax purposes if it is classified as such for federal income tax purposes.

Similarly, effective for taxable years beginning on or after January 1, 1997, an LLC with two members or more will be treated as a partnership for Connecticut income tax purposes if it is

classified as such for federal income tax purposes. Otherwise, an LLC with two members or more will be treated as a corporation for Connecticut income tax purposes if it is classified as such for federal income tax purposes.

**B. Filing of Connecticut Partnership Returns.**

SMLLCs that elect to be treated as sole proprietorships are not required to file **Form CT-1065**, *Connecticut Partnership Income Tax Return*.

LLCs that are treated as partnerships for federal income tax purposes and that have income, gain, loss or deductions derived from or connected with Connecticut sources during the year continue to be required to file a **Form CT-1065**. See Conn. Gen. Stat. §§12-701(a)(33) and (34), as amended by 1997 Conn. Pub. Acts 286, §3, which incorporate LLCs treated as partnerships for federal income tax purposes, and their members, in the definitions of *partnership* and *partner*, respectively.

**C. Corporation Business Tax Treatment of Corporation-Owned SMLLCs.**

Where an SMLLC that elects to be disregarded as a separate entity is owned by a corporation, the SMLLC will be treated as a branch or division of the owner. Accordingly, the corporation owner must take into account the activities of its SMLLC in determining whether the owner is doing business in Connecticut. For purposes of this determination, all of the SMLLC's activities will be attributed to the owner. Additionally, the corporation owner must take the SMLLC's items of income, loss and deduction into account in determining the owner's net income and must include the SMLLC's property, payroll and sales in determining the owner's apportionment factors.

**D. Sales and Use Tax Treatment.**

For purposes of the sales and use tax, the separate existence of an SMLLC will be recognized. See Conn. Gen. Stat. §12-407(1) (definition of *person*) and *SFA Folio Collections, Inc. v. Timothy F. Bannon, Commissioner of Revenue Services*, 217 Conn. 220, 585 A.2d 666 (1991). In general, therefore, the sales and use tax laws apply to SMLLCs as they would to any other *person* as that term is defined in Conn. Gen. Stat. §12-407(1).

Sales and use taxes apply to transfers of tangible personal property and enumerated services, for consideration, between an individual and an SMLLC, unless expressly exempted. Where the member/owner of an SMLLC renders a service to the SMLLC, the transaction is subject to tax if the member/owner of the SMLLC is compensated for

the rendition of such services other than through a distribution of SMLLC profits.

**Sales and Use Tax Nexus Consequences of Agency Relationships.** Although SMLLCs generally are not accorded see-through status for sales and use tax purposes, if the entities are acting as agents or representatives of one another, the non-Connecticut entity could be found to have nexus with Connecticut.

**Sales and Use Tax Exemption for Services Rendered.** SMLLCs and their owners do not qualify for the exemption allowed under Conn. Gen. Stat. §12-412(62) for services rendered between parent companies and wholly-owned subsidiaries, because both entities must be stock corporations.

**Registration Requirements.** SMLLCs that are doing business in Connecticut must register for sales and use tax purposes.

**E. Real Estate Conveyance Tax Treatment.**

For purposes of the real estate conveyance tax, the separate existence of an SMLLC will be recognized. *See Bjurback v. Commissioner of Revenue Services*, 44 Conn. Sup. 354, 690 A.2d 902 (1996).

Where an individual who owns Connecticut real estate in his or her individual capacity forms a limited liability company of which the individual is the single member and transfers the property to the limited liability company in exchange for his or her limited liability company membership interest, and where the value of the real property is at least \$2,000, the deed contributing the property to the limited liability company is subject to the real estate conveyance tax. This situation is distinguishable from the situation in **PS 93(5.1)**, *Real Estate Conveyance Tax Implications for Conversions of Partnerships to Limited Liability Companies*, where the new deed merely records the proper ownership of real property in the case of a continuing partnership within the meaning of 26 U.S.C. §708.

**F. Controlling Interest Transfer Tax Treatment.**

The separate existence of an SMLLC will be recognized for purposes of the controlling interest transfer tax because it is the complement to the real estate conveyance tax. *See Bjurback v. Commissioner of Revenue Services*, 44 Conn. Sup. 354, 690 A.2d 902 (1996).

**BACKGROUND:** Changes to S corporation law in the Small Business Job Protection Act of 1996 (*the Act*) eliminated or eased several restrictions on federal S corporation eligibility. Starting with 1997 taxable years, the Act makes it easier for corporations to qualify as federal S corporations and to remain eligible for federal S corporation treatment. Specifically, S corporations may now have 75 shareholders, whereas only 35 shareholders were permitted under prior law. *See* 26 U.S.C. §1361(b)(1)(A), as amended by P.L. 104-88 §1301. In addition, certain entities that were previously ineligible to be S corporation shareholders may now own S corporation shares. *See* 26 U.S.C. §1361(c)(2), as amended by P.L. 104-88, §§1302 and 1303 (expanding the eligibility of trusts to own corporate shares); 26 U.S.C. §1361(c)(7), as amended by P.L. 104-88 §1316(a)(2) (permitting certain tax exempt organizations to own S corporation shares).

Also among the changes to S corporation law is one that permits S corporations to own subsidiary corporations that, for federal income tax purposes, will not be considered to be separate corporations. 26 U.S.C. §1361(b)(3)(A) now provides that

- (i)[a] *corporation which is a qualified subchapter S subsidiary shall not be treated as a separate corporation, and*
- (ii) *all assets, liabilities, and items of income, deduction and credit of a qualified subchapter S subsidiary shall be treated as assets, liabilities, and such items (as the case may be) of the S corporation.*

The Act allows S corporations to own qualified S corporation subsidiaries (QSSS) starting with 1997 taxable years. *See* 26 U.S.C. §1361(b)(3). A corporation is a QSSS if it is 100 percent owned by an S corporation and that S corporation elects to treat the subsidiary as a QSSS. 26 U.S.C. §§1361(b)(3)(B)(i) and (ii). For federal tax purposes, the QSSS is not treated as a separate corporation. Rather, all of the subsidiary's assets, liabilities, and items of income, deduction and credit are treated as those of the S corporation parent. 26 U.S.C. §1361(b)(3)(A). These items then flow through to the shareholders as provided in 26 U.S.C. §1366.

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**CURRENT CONNECTICUT LAW:** Connecticut relies on the current Internal Revenue Code for purposes of defining S corporations under both the personal income tax and the corporation business tax. Conn. Gen. Stat. §12-213(a), *Corporation Business Tax Definitions*, and Conn. Gen. Stat. §12-701(a)(17), *Definitions*, both define *S corporation* as any

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**PART II:  
S CORPORATION REFORM AND QSSSs**

corporation that is an S corporation for federal income tax purposes.

**A. Income Tax Treatment Generally.** Because the personal income tax and the corporation business tax both incorporate the federal income tax definition of S corporations, a corporation that meets the expanded definition of an S corporation for federal tax purposes will be treated as an S corporation in Connecticut. In addition, where an S corporation has a QSSS, the subsidiary's items of income, loss and deduction pass through to the parent's shareholders.

**B. Personal Income Tax Treatment.** An S corporation must pass its items of income, loss and deductions through to its shareholders. No provision of Connecticut law changes these results where the S corporation owns a QSSS. Where an S corporation elects see-through treatment for a QSSS, only one **Form CT-1120SI**, *S Corporation Information and Composite Income Tax Return*, is required to be filed. Where an S corporation does not elect see-through treatment for a QSSS, two **Forms CT-1120SI** are required to be filed: one for the S corporation parent and one for the S corporation subsidiary. (See Section C, below, for information regarding S corporation requirements for filing Connecticut corporation business tax returns.)

**C. Corporation Business Tax Treatment.** In the case of an S corporation, the corporation business tax is determined under Conn. Gen. Stat. §12-214, *et seq.* An S corporation parent must take into account the activities of its QSSS in determining whether the parent is doing business in Connecticut. Likewise, a QSSS must take into account the activities of its parent in determining whether the QSSS is doing business in Connecticut. For purposes of this determination, all of the QSSS's activities will be attributed to the parent. The S corporation parent must take into account the QSSS's assets and liabilities and items of income, deduction and credit in determining its Connecticut corporation business tax. In addition, the S corporation parent must also include the QSSS's property, payroll and sales factors for purposes of computing the parent's apportionment percentage in Connecticut.

A QSSS is not treated as a separate corporation for purposes of the Connecticut corporation business tax, regardless of whether the measure of such tax is net income, capital or the minimum tax (see below). Accordingly, **an S corporation parent and its QSSS must file a single Connecticut corporation**

**business tax return** in which the assets, liabilities, income, deductions and credits of each corporation are combined and intercompany transactions are eliminated. This tax treatment should be distinguished from the tax treatment of an S corporation parent and its S corporation subsidiary that is not a QSSS. An S corporation and its S corporation subsidiary that is not a QSSS must file separate Connecticut corporation business tax returns.

**Combined Returns.** An S corporation parent and its S corporation subsidiary that is not a QSSS may not file a combined return as provided by Conn. Gen. Stat. §12-223a(1), because they may not be included in a consolidated return for federal income tax purposes. However, such S corporations may petition the Commissioner of Revenue Services to file a combined return under Conn. Gen. Stat. §12-223a(2). These petitions will be considered on a case-by-case basis.

**Additional Tax On Capital and Minimum Tax.** As a result of a QSSS election, an S corporation parent and a QSSS are treated as a single entity subject to only one additional tax on capital or minimum tax imposed by Conn. Gen. Stat. §12-219.

**Registration Requirements.** As a result of the election to treat an S corporation subsidiary as a QSSS, only the S corporation parent (whether resident or nonresident) is required to register and file an S corporation business tax return as a Connecticut taxpayer for corporation business tax purposes. However, it may be necessary for a QSSS to register separately as a Connecticut taxpayer for sales and use tax purposes. (See Section D)

**D. Sales and Use Tax Treatment.** For purposes of the sales and use tax, the separate existence of a QSSS and its S corporation parent will be recognized. *See* Conn. Gen. Stat. §12-407(1) (definition of *person*) and *SFA Folio Collections, Inc. v. Timothy F. Bannon, Commissioner of Revenue Services*, 217 Conn. 220, 585 A.2d 666 (1991).

**Sales and Use Tax Nexus Consequences of Agency Relationships.** Even though QSSSs generally are not accorded see-through status for sales and use tax purposes, if the QSSS or its parent are found to be acting as agents or representatives of one another, the non-Connecticut entity could be found to have nexus with Connecticut.

**Sales and Use Tax Exemption for Services Rendered.** S corporations and their QSSSs or other corporate subsidiaries may qualify for the

exemption allowed under Conn. Gen. Stat. §12-412(62) for services rendered between parent companies and wholly-owned subsidiaries.

**Registration Requirements.** QSSSs and their S corporation parents that do business in Connecticut must register separately for sales and use tax purposes.

**E. Real Estate Conveyance Tax Treatment.**

For purposes of the real estate conveyance tax, the separate existence of a QSSS will be recognized. See *Bjurback v. Commissioner of Revenue Services*, 44 Conn. Sup. 354, 690 A.2d 902 (1996).

Where an existing S corporation forms a QSSS, any deed transferring real property from the S corporation to its QSSS (in a tax-free exchange under 26 U.S.C. §351) would be subject to real estate conveyance tax if the value of the real property were at least \$2,000.

**F. Controlling Interest Transfer Tax Treatment.**

The separate existence of a QSSS will be recognized for purposes of the controlling interest transfer tax, since it is the complement to the real estate conveyance tax. See *Bjurback v. Commissioner of Revenue Services*, 44 Conn. Sup. 354, 690 A.2d 902 (1996).

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**EFFECT ON OTHER DOCUMENTS:** This document modifies and supersedes **PS 93(5.1)**, *Real Estate Conveyance Tax Implications for Conversions of Partnerships to Limited Liability Companies* and **SN 98(3)**, *Effect of Recent Federal Tax Law Changes on the Taxation of Limited Liability Companies and S Corporations and their Shareholders*.

**EFFECT OF THIS DOCUMENT:** A Special Notice is a document that announces a new policy or practice in response to changes in State or federal laws or regulations or to judicial decisions. A Special Notice indicates the Department's informal interpretation of Connecticut tax law and may be referred to for general guidance by taxpayers or tax practitioners.

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**FOR FURTHER INFORMATION:** Please call the Department of Revenue Services during business hours, 8:00 a.m. to 5:00 p.m., Monday through Friday:

- **1-800-382-9463** (toll-free from within Connecticut), or
- **860-297-5962** (anywhere).

**TTY, TDD and Text Telephone users only** may transmit inquiries 24 hours a day by calling 860-297-4911.

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**FORMS AND PUBLICATIONS:** Forms and publications are available all day, seven days a week:

- **Internet:** preview and download forms and publications from the DRS web site: <http://www.state.ct.us/drs>;
- **DRS TAX-FAX:** call **860-297-5698** from the handset attached to your fax machine and select from the menu; or
- **Telephone:** Call 1-800-382-9463 (toll-free from within Connecticut), or 860-297-5962 (anywhere) and select **Option 2** from a touch-tone phone.