

Sec. 12-225-2. Adjustments to net income resulting from subtraction of exempt income shall be net of expenses

(a) **Definitions.** As used in this section, the following terms have the meaning ascribed to them in this subsection. The meaning which such terms have ascribed to them elsewhere is not pertinent to their use in this section.

(1) “Interest expense” means the aggregate amount allowable for purposes of chapter 208 of the general statutes to the taxpayer as a deduction for interest paid or incurred for the income year, determined without regard to section 12-225 of the general statutes or this section, and includes amounts, whether or not designated as interest, paid or incurred in respect of deposits, investment certificates, or withdrawable or repurchasable shares. “Interest expense” also includes, with respect to interest paid or incurred on indebtedness incurred or continued to purchase or carry tax-exempt obligations, any amount paid or incurred by any person making a short sale, as defined for federal income tax purposes, in connection with personal property used in such short sale, or any amount paid or incurred by any other person for the use of any collateral with respect to such short sale, but shall not include any amount paid or incurred by any person making a short sale if the taxpayer provides cash as collateral for any short sale, and the taxpayer receives or accrues no material earnings on such cash during the period of the sale.

(2) “Exempt income” means income, the taxation of which by the State of Connecticut is prohibited by the laws or constitution of the United States, as applied, or by the laws or constitution of the State of Connecticut, as applied, and includes exempt interest income.

(3) “Exempt interest income” means interest income, the taxation of which by the State of Connecticut is prohibited by the laws or constitution of the United States, as applied, or by the laws or constitution of the State of Connecticut, as applied.

(4) “Tax-exempt obligation” means any obligation the interest on which is exempt interest income.

(5) “Financial institution” means any person who accepts deposits from the public in the ordinary course of such person’s trade or business, and is subject to Federal or State supervision as a financial institution.

(b) **Expenses relating to exempt income.** Any refund or adjustment to net income based on the erroneous inclusion of exempt income, and that is based on a claim made in accordance with subsection (b) of section 12-225 of the general statutes, shall be calculated net of expenses related thereto. Where the corrected return adjusts net income by subtracting an amount of exempt income reported on the originally filed return, no amount shall be allowed as a deduction, as permitted by subsection (a) of section 12-217 of the general statutes or, in the case of a life insurance company, as permitted by section 12-213 of the general statutes, for any expense or amount which is otherwise allowable as a deduction and which is allocable to a class or classes of exempt income, determined without regard to the exclusion or deduction referred to in section 12-213-2 of the regulations of Connecticut state agencies, related to such subtracted income. Accordingly, any deductions taken for expenses related to the income subtracted on the corrected return shall be disallowed in calculating the corrected net income.

(c) **Allocation of expense to a class or classes of exempt income.** Expenses and amounts otherwise allowable which are directly allocable to any class or classes of exempt

income shall be allocated thereto; and expenses and amounts allocable to any class or classes of nonexempt income shall be allocated thereto. If any expense or amount otherwise allowable is indirectly allocable to both a class of nonexempt income and a class of exempt income, a reasonable proportion thereof determined in light of all the facts and circumstances in each case shall be allocated to each.

(d) **Interest expense relating to tax-exempt income.** No amount shall be allowed as a deduction for interest expense paid or incurred on any indebtedness incurred or continued to purchase or carry any tax-exempt obligation.

(e) **Pro rata allocation of interest expense of financial institutions to tax-exempt interest.**

(1) In general. Any provision of this section to the contrary notwithstanding, in the case of a financial institution, no deduction shall be allowed for that portion of the taxpayer's interest expense which is allocable, as provided in this subsection, to exempt interest income. Accordingly, any financial institution filing a corrected return under section 12-225 of the general statutes, which corrected return adjusts net income by subtracting exempt interest income, shall adjust its interest expense deduction in accordance with the allocation required by this subsection.

(2) Allocation. For purposes of this subsection, the portion of a financial institution's interest expense which is allocable to exempt interest income is an amount which bears the same ratio to such interest expense as the taxpayer's average adjusted basis, for federal income tax purposes, of tax-exempt obligations bears to such average adjusted basis for all assets of the taxpayer.

(f) **Interpretation.** Section 12-225 of the general statutes and this section shall be interpreted to apply to any expense related to exempt income that is earned on tax exempt obligations that are issued by or on behalf of the State of Connecticut, its agencies, authorities, commissions or other instrumentalities, or by or on behalf of any Connecticut political subdivision, its agencies or instrumentalities, to the same extent as section 12-225 of the general statutes and this section apply to any expense related to exempt interest that is earned on tax exempt obligations that are issued by or on behalf of the United States, its agencies, authorities, commissions or instrumentalities. This subsection shall apply only to income years prior to income years with respect to which Public Act 95-2 is effective.

(g) This section shall be applicable to amended returns, as defined in subsection (b) of section 12-225 of the general statutes, irrespective of when such returns were filed, in connection with which a claim for refund is granted or denied or an adjustment to net income is allowed, in whole or in part, on or after March 8, 1995 (the effective date of Public Act 95-2).

(Effective March 8, 1995)