

Sec. 12-701(a)(20)-3. Modifications reducing federal adjusted gross income

(a) The following items are to be subtracted from federal adjusted gross income in computing the Connecticut adjusted gross income of a resident individual:

(1)

(A) Any income with respect to which taxation by any state is prohibited by federal law, to the extent properly includible in gross income for federal income tax purposes. Such income is from obligations issued by or on behalf of the United States, as defined in subparagraph (B) of this subdivision, or from other obligations, as discussed in subparagraph (B) of this subdivision, the taxation of which by states has been expressly prohibited by Congress, and is to be subtracted from federal adjusted gross income in computing Connecticut adjusted gross income. On the other hand, such income does not include income discussed in subparagraph (D) of this subdivision which is not includible in gross income for federal income tax purposes and which is not to be subtracted from federal adjusted gross income in computing Connecticut adjusted gross income.

(B) The type of credit instrumentalities that the United States Supreme Court has recognized as being constitutionally exempt from state and local taxation have been characterized by (1) written documents, (2) the bearing of interest, (3) a binding promise by the United States to pay specified sums at specified dates and (4) specific Congressional authorization, which also pledged the faith and credit of the United States in support of the promise to pay. *Smith v. Davis*, 323 U.S. 111, 114–15 (1944). For example, United States savings bonds meet the four criteria to be considered obligations of the United States. Interest on those bonds is includible in gross income for federal income tax purposes. The amount of such interest is, therefore, subtracted from federal adjusted gross income in computing Connecticut adjusted gross income. Other obligations do not meet the criteria established in *Smith v. Davis*, but, nonetheless, Congress has expressly prohibited states from taxing income derived from such obligations. For example, obligations of the Home Owners' Loan Corporation do not meet the four criteria to be considered obligations of the United States, but Congress has expressly prohibited States from taxing income from such obligations. Interest on these obligations is includible in gross income for federal income tax purposes. The amount of such interest is, therefore, subtracted from federal adjusted gross income in computing Connecticut adjusted gross income.

(C) Examples of obligations described in subparagraph (B) of this subdivision, the interest income from which is includible in gross income for federal income tax purposes and, therefore, is subtracted from federal adjusted gross income in computing Connecticut adjusted gross income include, but are not limited to, obligations issued by or on behalf of Banks for Cooperatives, Federal Intermediate Credit Banks, Federal Land Banks, Production Credit Associations, the Student Loan Marketing Association, the Tennessee Valley Authority, the United States Postal Service, the Federal Deposit Insurance Corporation and the Resolution Trust Corporation, and United States Treasury bonds, bills, notes and certificates.

(D) Examples of obligations described in subparagraph (B) of this subdivision, the interest income from which is not includible in gross income for federal income tax purposes and, therefore, is not subtracted from federal adjusted gross income in computing Connecticut adjusted gross income include, but are not limited to, obligations issued by or

on behalf of the Commodity Credit Corporation, Federal Home Loan Banks, Federal Savings and Loan Insurance Corporation, The Resolution Funding Corporation, Guam, Puerto Rico and the Virgin Islands.

(E) Examples of income that is includible in gross income for federal income tax purposes but that is not subtracted from federal adjusted gross income in computing Connecticut adjusted gross income include, but are not limited to:

(i) interest paid on federal income tax refunds or on open accounts and other unsettled claims or demands,

(ii) interest paid by federal credit unions to depositors or by the Federal Home Loan Bank on demand deposits,

(iii) interest paid by a seller-borrower to a purchaser-lender under a repurchase agreement, and

(iv) interest paid on an obligation where the United States is merely an insurer or guarantor and has only a secondary or contingent liability, and is not the primary obligor.

(F) *Example:* Income described in this subparagraph includes, but is not limited to, obligations guaranteed and insured by the Federal National Mortgage Association and the Government National Mortgage Association, and obligations issued by or on behalf of the International Bank for Reconstruction and Development, the National Consumer Cooperative Bank and New Community Development Corporations.

(2)

(A) Exempt dividends paid by a qualified regulated investment company. As provided in Section 12-718 of the general statutes, a regulated investment company is a qualified regulated investment Company if, at the close of each quarter of its taxable year, at least 50% of the value of its total assets (as defined in section 851(c)(4) of the Internal Revenue Code) is invested in obligations which states are prohibited from taxing by federal law.

(B) The portion of the dividends received by a shareholder of a qualified regulated investment company that may be subtracted from federal adjusted gross income is based upon the portion of income received by the company that is derived from obligations which states are prohibited from taxing by federal law. Where all of the income of the company is derived from interest on obligations that states are prohibited from taxing by federal law, the full amount of the dividends received by the shareholders may be subtracted. Where less than the full amount is derived from such interest, the amount to be subtracted is determined as follows:

$$\frac{\begin{array}{l} \text{Interest income on obligations} \\ \text{which states are prohibited} \\ \text{from taxing by federal law} \\ \text{less expenses attributable} \\ \text{to such income} \end{array}}{\begin{array}{l} \text{Regulated investment} \\ \text{company's taxable income} \end{array}} = \frac{\begin{array}{l} \text{Percent of dividends} \\ \text{received by shareholders} \\ \text{that qualifies as exempt} \\ \text{dividends} \end{array}}$$

(C) In the case of a series fund, the portion of the dividends paid that is exempt from Connecticut income tax shall be determined on a fund-by-fund basis.

(D) Dividends attributable to obligations which states are prohibited from taxing by federal law that are distributed by nonqualified regulated investment companies are fully taxable for Connecticut purposes and may not be subtracted under this section.

(E) *Example:*

(i) Computation for regulated investment company. Z, a qualified regulated investment company, receives income from the following sources:

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|---|-----------|
| Capital gains from the sale of stock | \$ 20,000 |
| Interest income from federal obligations | 70,000 |
| Dividends from a corporation | + 10,000 |
| Total: | \$100,000 |
| Expenses (\$10,000 of which are directly related to interest income on federal obligations) | – 20,000 |
| Taxable income: | \$ 80,000 |

Z distributed the entire \$80,000 to its shareholders. The percentage of this distribution that may be subtracted from federal adjusted gross income under this section is computed as follows:

$$\frac{\$70,000 - \$10,000}{\$80,000} = 75\% \quad \begin{array}{l} \text{(percentage of dividends that} \\ \text{qualifies as exempt dividends)} \end{array}$$

(ii) Computation for shareholder. An individual shareholder receives dividend distributions of \$2,000 in 1992 from Z. The amount of these dividends qualifying as exempt dividends is 75% of \$2,000, or \$1,500.

(3) Any refund or credit for overpayment of income taxes imposed by Connecticut or any other state of the United States or political subdivision thereof, or by the District of Columbia or any province of Canada, to the extent properly includible in gross income for federal income tax purposes. This modification applies to a refund of income taxes which

was actually included in federal adjusted gross income, whether the refund represented Connecticut income tax or the income tax of another taxing jurisdiction. However, the modification does not include any portion of the total refund which represents interest received. Such interest, whether received in connection with a state, federal or other tax refund, is not subtracted in computing Connecticut adjusted gross income since it is paid on a claim against the particular government, rather than paid on an obligation thereof arising from the exercise of its borrowing powers.

(4) To the extent properly includible in gross income for federal income tax purposes, annuities, as defined in 45 U.S.C. § 231(p), including Tier I and Tier II railroad retirement benefits, and supplemental annuities, as described in 45 U.S.C. § 231a(b), the taxation of which by states is prohibited under 45 U.S.C. § 231m.

(5) Interest income on Connecticut obligations, to the extent properly included in gross income for federal tax purposes.

(6)

(A) To the extent properly includible in determining the net gain or loss from sales or other dispositions of capital assets for federal income tax purposes, any gain (or amount that is properly treated as a capital gain dividend, as defined in section 852(b)(3) of the Internal Revenue Code) from the sale or exchange of Connecticut obligations, in the taxable year such gain was recognized, whether or not, for federal income tax purposes, gains from sales or other dispositions of capital assets exceed losses therefrom.

(B) *Example:* A resident individual has, for federal income tax purposes, a long-term capital gain of \$3,000 arising from the sale of Connecticut obligations and a long-term capital loss of \$2,000 arising from the sale of bonds issued by the Commonwealth of Massachusetts. The individual's federal adjusted gross income shall be reduced by \$3,000, the amount of the gain derived from the sale of the Connecticut obligations.

(7)

(A) Interest expenses on indebtedness incurred or continued by an individual to purchase or carry obligations or securities, the interest income from which is subject to Connecticut income tax but exempt from federal income tax, to the extent such expenses (i) would be deductible in determining federal adjusted gross income if the interest income were subject to federal income tax and (ii) are attributable to a trade or business carried on by such individual. However, to the extent such expenses would be deductible from federal adjusted gross income in determining federal taxable income if the interest income were subject to federal income tax or if such expenses are not attributable to a trade or business carried on by such individual, such expenses are not to be subtracted from federal adjusted gross income.

(B) *Example:* A resident individual is a partner in a partnership that borrows money in order to purchase New Jersey governmental bonds, the income from which is exempt from federal income tax. The partner's share of the interest expense paid during the taxable year on this indebtedness is \$200. The partner shall subtract this amount from his federal adjusted gross income.

(8)

(A) Expenses paid or incurred by an individual during the taxable year for (i) the production or collection of income which is subject to Connecticut income tax but exempt

from federal income tax or (ii) the management, conservation or maintenance of property held for the production of income which is subject to Connecticut income tax but exempt from federal income tax or (iii) the amortizable bond premium for the taxable year on any bond, the interest income from which is subject to Connecticut income tax but exempt from federal income tax, to the extent that such expenses and premiums (a) would be deductible in determining federal adjusted gross income if such income were subject to federal income tax and (b) are attributable to a trade or business carried on by such individual. However, to the extent such expenses and premiums would be deductible from federal adjusted gross income in determining federal taxable income if such income were subject to federal income tax or if such expenses and premiums are not attributable to a trade or business carried on by such individual, the amount of these expenses and premiums may not be subtracted from federal adjusted gross income.

(B) *Example:* A nonresident individual is a partner in a Connecticut partnership that purchases shares in a mutual fund that invests solely in New York City government obligations. The income therefrom is exempt from federal income tax. The partner's share of expenses paid during the taxable year to produce this income is \$100. The partner shall subtract this amount from her federal adjusted gross income.

(9) With respect to an individual who is a shareholder of an S corporation that carries on business in Connecticut (as the term is used in Section 12-214 of the general statutes, and as defined in § 12-214-1), the amount of such individual's pro rata share of the corporation's nonseparately computed income (as defined in § 12-701(b)-1 of Part XIV), multiplied by the corporation's apportionment fraction, if any, as determined under Section 12-218 of the general statutes (irrespective of whether the S corporation shall pay the additional tax under Section 12-219 of the general statutes).

(10) The amount, if any, by which the amount of social security benefits properly includable in gross income for federal income tax purposes under section 86 of the Internal Revenue Code, as amended by section 13215 of the Omnibus Budget Reconciliation Act of 1993, Pub. L. No. 103-66, 107 Stat. 312, 475-477, exceeds the amount of social security benefits properly includable in gross income for federal income tax purposes under section 86 of the Internal Revenue Code, as in effect immediately prior to such amendment.

(b) While this section pertains to Section 12-701(a)(20) of the general statutes, for purposes of supplementary interpretation, as the phrase is used in Section 12-2 of the general statutes, the adoption of this section is authorized by Section 12-740(a) of the general statutes.

(Effective November 18, 1994)