State of Connecticut

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Hartford

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Commissioner Catherine Smith
Department of Economic and Community Development
505 Hudson Street
Hartford, CT 06106-7106

Commissioner Kevin B. Sullivan
Department of Revenue Services
25 Sigourney Street Ste 2
Hartford, CT 06106-5032

Dear Commissioner Smith and Commissioner Sullivan:

Thank you for your leadership and hard work, and that of your respective staff members, on the Governor's Business Tax Policy Task Force.

As requested, below are my policy recommendations for consideration by the task force. Focused on improving the transparency, efficiency and effectiveness of the state's business tax system, my recommendations are designed to ensure stronger oversight of government expenditures while at the same time promoting a business tax structure that encourages economic growth and aligns with the state's public policy goals.

Recommendations to improve transparency, oversight and evaluation processes and practices:

1) *Create an on-line searchable database for business tax credits.* Tax credits reduce revenue in order to achieve a specific public policy purpose. In that way they are very similar to appropriations. The public has direct access to information regarding all state appropriations, including grants made to specific entities. The same should be true for tax credits. This database would help to eliminate the disparity between credits and appropriations and thereby improve the transparency of our tax credit programs.

2) *Require combined reporting for all corporations.* Combined reporting would ensure that all related corporations file one Connecticut corporate income tax return. It eliminates the ability of corporations to lower their tax liability by shifting income amongst related entities. It also allows the losses from one entity to be deducted from the profits of another, which in some cases is a net benefit to the corporate group.

By implementing combined reporting, the CBT will be simpler, more transparent and fair. It will close all inter-group transfer loop-holes while placing single entity corporations on an equal playing field with conglomerates. Currently, 23 states and the District of Columbia require combined reporting including most of Connecticut's neighbors.

I would further recommend that any increased revenue in Connecticut that is the direct result of combined reporting should be used to lower the Corporation Business Tax (CBT) rate in order to keep the proposal revenue neutral.

3) *Encourage municipalities to regularly produce publicly available reports on existing property tax abatements.* Like the state, local governments use tax incentives to encourage business development and influence business location decisions. As the state continues to improve the oversight and evaluation of its tax incentive programs, municipalities should be encouraged to do the same.

4) *Produce an annual tax incidence analysis report.* Tax incidence analysis reports estimate who actually pays the taxes levied. In many cases the entity required to collect the tax is not who actually pays the tax. A tax incidence analysis seeks to determine the actual distribution of the tax burden in the state. The analysis helps policy makers understand the impact of past and present policy decisions. Knowing who pays which taxes and how much they pay is essential to making informed business tax policy decisions.

   Currently, several other states produce regular tax incidence analysis reports.[1] A comprehensive tax incidence report should include all major taxes and analysis of their impact on various business categories (broken down by industry and business size - based on gross receipts) and categories of individuals (broken down into income deciles with additional categories for the top 5% and 1%; the top decile requires additional categories since it includes such a wide expanse of income earners). The report should also include all major tax expenditures and estimate the distribution of benefits born by the above identified groups.

5) *Produce an annual effective tax rate report for businesses.* An effective tax rate report would differ from a tax incidence report in that it would not seek to determine the final payer of a levied tax, but rather would determine the actual rate of tax liability incurred by businesses. This report is essential to understanding Connecticut's tax system which, with its many credits, exemptions and varied formulas for calculating tax liability, can be difficult to unravel for businesses, the general public, and policy makers alike. Reporting the effective tax rates for various industry categories would assist the public, policy makers and prospective new businesses in understanding the difference between the

[1] Texas and Minnesota have particularly good tax incident analysis reports. The Texas report can be found at: http://www.texastransparency.org/budget/reports.php; The Minnesota report can be found at: http://www.revenue.state.mn.us/newsroom/Pages/2011_Tax_Incidence_Study.aspx

state's statutory and effective tax rates on businesses. The report should place businesses in categories by industry, size (based on gross receipts) and form of organization (corporations and pass-through entities). In each category it should include the following information:

- Number of tax payers
- Total tax liability
- Number and value of credits and exemptions claimed (individually categorized)
- Total taxes paid
- The effective tax rate for the group

Finally the report should include an appendix that provides additional detail regarding the taxes paid by corporations. The additional detail would allow further analysis of our tax system and should include by name of corporation the following information[2]:

- Industry
- Gross receipts
- Total tax liability – before credits and deductions
- The number and value of credits and deductions claimed (individually categorized)
- Total taxes paid
- Effective tax rate

The database should list credit recipients by name and address, including the amount and type of credit received. It should also be searchable by company, industry, year and type of credit[3].

6) *Publish an annual report reviewing the current status of each firm in the DECD business assistance portfolio.* DECD currently provides information regarding assistance recipients. DECD's annual report identifies the firms receiving assistance, the type and amount of assistance received, the jobs created or retained and the additional state domestic product produced as a result of the funded project. DECD's reporting is comprehensive but could be further enhanced with additional information regarding the funded projects including:
    - An explanation of the justification of the project (Why was this project selected?)– Criteria met, relationship to economic development goals, etc.

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[2] This information would require amendment or repeal of Sec. 12-15 of the General Statutes. Sec. 12-15 prohibits the release of any information reported on Connecticut tax returns. Many of the state's business tax credits are only reported on tax returns. As a result little is known about who is utilizing these credits or the benefits created by the state's investment in the credits.

[3] Implementing this recommendation would require either amending Sec. 12-15 of the General Statutes or alternate tax credit reporting to DECD. Oklahoma currently has such a database, Rhode Island publicly lists the recipients of 6 business tax credits and Connecticut publishes the names and addresses of the recipients of the Urban and Industrial Tax Credit as well as other assistance provided to companies through DECD.
Oklahoma's searchable database can be accessed at - https://www.ok.gov/okaa/tax/app/search.php , Rhode Island's Tax Credit Transparency report can be found at - http://www.tax.ri.gov/reports/FYE2011%20Credit%20&%20Incentive%20Report.pdf, Connecticut lists recipients of the UI tax credit and other DECD assistance in its DECD annual report.

- A statement of the basic terms of the agreement including measurable outcomes
- An assessment of the firm's progress toward meeting the terms of the agreement
- A list of actions taken including claw-backs triggered or adjustments made to the agreement as a result of non-compliance with the terms and conditions of assistance

The additional information would subject state funded economic development projects to greater scrutiny, and further ensure responsible and effective investments of public money by our state.

7) *Enhance the Office of Fiscal Analysis' biennial tax expenditure report.* The Office of Fiscal Analysis produces one of the most comprehensive tax expenditure reports in the country. The document estimates the lost revenue from each of the tax expenditures included in the Connecticut General Statutes. With additional information, the document could be further enhanced to include:
    - Implicit tax expenditures like industry specific apportionment formulas, optional combined reporting and services not covered under the sales and use tax
    - Specific statements on the purpose of the tax expenditure
    - The distribution of the benefits of each expenditure by income level and or business size – as defined by gross receipts

8) *Create a permanent commission of tax and policy experts to review all tax expenditures on an ongoing basis.* To follow-up on the good work of the Governor's Business Tax Policy Task Force, a permanent commission of tax and policy experts should be created to review all tax expenditures on an ongoing basis[4] A standing commission would ensure tax expenditures are reviewed consistently. The evaluation prepared by the commission would assist the Governor, the General Assembly, and other policy makers in keeping our tax expenditures aligned with the state's evolving policy goals. In order to do this effectively the commission should have access to expert staff at DECD, DRS, and other agencies and funds to hire consultants to perform additional analysis outside the expertise available in these state agencies. In its analysis the commission should:
    - Define a measurable goal for each tax credit if one has not been otherwise explicitly expressed by state law
    - Identify the number, size and geographic location of institutions benefiting from the expenditure and the dollar amount of tax benefit received from the tax expenditure for these institutions
    - Identify the changes in behavior that result from the expenditure
    - Evaluate the impact of the expenditure on its measurable goal

[4] Washington State currently has a similar tax commission and Minnesota proposed creating such a commission in 2011.

- Evaluate the impact of the expenditure on employment, gross state product and state and local government revenues
- Consider potential alternatives to the current tax expenditure and whether such alternatives could achieve the presumed goal of the credit more effectively, efficiently or at less cost
- Recommend whether to retain or repeal the credit, and/or a better use for the foregone tax dollars that could more effectively and efficiently achieve the stated goal of the tax expenditure

Thought should be given to the procedure for legislative review and action on the commission's reports. In Minnesota, while considering a similar commission, the proposal included an automatic trigger to sunset expenditures following their review in the absence of legislative action. The trigger was designed to spur legislative action. In Connecticut the legislature should consider policies that will encourage legislative review and action on the commission's recommendations.

9) *Require all future tax credits to include an annual limit on the total dollar amount that can be claimed under the credit.* In recent years it has been the general practice of the legislature to place annual caps on the claims of new tax credit programs. Capping credits improves revenue stability and predictability while placing a real value on the activity being supported.

Recommendations to promote economic development and competitiveness

10) *Move to market sourcing for all service industries subject to the CBT.* Many corporations operate in multiple states, and as a result must determine the amount of their income that is applicable to taxes in each state of operation. This practice of allocating income is called apportionment. In Connecticut one of the factors used to calculate the amount of income applicable to the state's CBT is the company's sales. For companies operating in the service industry the state determines the apportionment of sales based upon the location where the income producing activity was performed (the state in which the service, for instance accounting, was performed). Market sourcing instead apportions sales based upon the state in which the customer resides or the sale occurs: the market. In general, market sourcing of sales places a larger tax burden on companies exporting sales to Connecticut than those exporting sales from Connecticut. As a result market sourcing rewards and encourages companies to have property and employment in the state. Currently, only the financial services industry enjoys the benefit of market sourcing. Across the country 13 states have market sourcing for all industries.

11) *Move to market sourcing for businesses subject to the Personal Income Tax (pass-through entities).* Neighboring states, including Massachusetts and New York already practice a form of market sourcing under their Personal Income Tax. The result is that companies operating in Connecticut and selling services to New York or Massachusetts are sometimes double taxed, while those selling into

Connecticut from either of those states are sometimes not taxed at all. This disparity creates an incentive for companies to move their operations to neighboring states. Changing our apportionment formula under the Personal Income Tax would eliminate the competitive disadvantage currently faced by Connecticut based pass-through companies.

12) *Analyze the potential for moving all industries to single factor sales apportionment.* As was previously mentioned, corporations operating in multiple states must apportion their taxable income amongst the states in which they operate. States require corporations to apportion their income based upon specific formulas. In Connecticut the state requires different apportionment formulas for different industries. The manufacturing, finance and broadcasting industries apportion their income based upon their sales only, while all others use a weighted formula that includes sales, property and employment. The sales only formula provides significant tax benefits to export industries in the state. These firms have a lower percentage of sales in the state than property or employment. The result is a reduction in CBT liability. The industries currently apportioning their income based on a single factor sales formula are all major export industries in the state. Standardizing the state's apportionment formula across all industries based upon single factor sales would benefit in-state exporters in other industries and potentially bring in additional corporate tax income.

    By placing only export industries on a single sales apportionment formula, the state forgoes the additional income that could be generated from applying a single factor sales apportionment formula to import industries, like retail and wholesale. In fact, manufacturing accounted for 87% of the state's total exports in 2010.[5] Given the high percentage of total exports by the manufacturing industry, the vast majority of lost revenue from moving to single factor sales has already been incurred while the corresponding increase in revenue from import industries has not been realized.

    Additional CBT revenue that may occur from the implementation of this policy should be used to lower the statutory rate of the tax in order to keep this recommendation revenue neutral.

    Lastly, this recommendation comes with two important caveats. 1) Before moving to a single factor sales apportionment formula for all industries, a thorough analysis of the potential impact on state revenues should be performed to ensure the change would be a revenue booster or at least revenue neutral. 2) It should include a trigger provision that moves all industries to a standard three factor formula in the event Congress requires businesses to have a minimum physical presence in the state in order to be subject to the CBT. In the absence of such a trigger a higher nexus threshold would result in significantly reduced CBT income.

[5] US Bureau of Economic Analysis

13) *Create a committee with the sole purpose of developing and evaluating property tax reform alternatives.* The property tax is the largest tax paid by businesses in the state. While the property tax is clearly relevant to the discussion of business taxes and incentives, its integration with school funding, local control and land use planning mean that any changes to the property tax paid by businesses should occur within the framework of a broader discussion on property tax reform.

In addition to the recommendations above I applaud the efforts of the chair's to improve customer service in their respective agencies and I support continued progress in this area. As we met with various groups around the state, issues regarding ambiguity and uncertainty in tax administration and frustrations with permitting agencies were common. The Department of Revenue Services under the leadership of Commissioner Sullivan is becoming more customer oriented and the Department of Economic and Community Development under the leadership of Commissioner Smith is providing valuable assistance to businesses as they work their way through required permitting processes in other agencies. This customer friendly atmosphere is a welcome change.

These recommendations reflect many of the concerns we heard from Connecticut businesses and tax professionals across the state, while also recognizing that consistent reporting and evaluation of Connecticut tax expenditures and business tax policy is essential in making informed policy decisions in the future.

In the short-term I am proposing adjustments to our current business tax policy that reduce ambiguity in our tax system, create uniform treatment of companies regardless of industry and sources sales income in a way that encourages rather than discourages companies to invest in property and labor in Connecticut.

For the long-term I am proposing more extensive reporting requirements and evaluation of our business taxes and expenditures. These recommendations will help to provide the consistent, unbiased information that is essential to developing and implementing a tax policy that efficiently and effectively meets the state's policy goals.

Again thank you for your work and leadership on the task force, and I look forward to discussing these and other proposals at our next meeting.

Sincerely,

Kevin Lembo

Kevin Lembo, Comptroller

cc: Governor's Business Tax Policy Task Force members
President Pro Temp Donald E. Williams, Jr.
House Speaker Christopher G. Donovan
Senate Minority Leader John McKinney
House Minority Leader Lawrence F. Cafero
Senate Majority Leader Martin M. Looney
House Majority Leader Brendan Sharkey
Co – Chairs of the Finance and Appropriations Committees