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Connecticut's Corporation Business Tax: It's Time for Repair

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I. Introduction

This report – the first of a series that focuses on Connecticut's various sources of revenues -- focuses on Connecticut's corporation business tax. We begin with this tax because it has declined markedly as a source of state revenue since 1990 in nominal and real dollars, and as a share of overall state tax revenues. It also is a tax that is less well understood by Connecticut's citizens than the taxes they pay as individuals (e.g., the personal income tax, sales tax, property tax).

The report addresses the central question of what role, if any, the corporation business tax should play generally in creating a fair and balanced tax system, and specifically in helping to address Connecticut's current and projected General Fund deficits. It first presents the rationale for the corporation business tax, and then presents data about changes in Connecticut's corporate business tax revenues over time, and relative to other states. The report next examines what factors have contributed to the decline in our corporation business tax revenues. It concludes by summarizing some of the ways Connecticut could repair this tax and reverse this trend, including measures that other states – including neighbors such as New Jersey, New York, and Massachusetts -- have adopted.

While Connecticut needs to repair its corporation business tax to restore needed state revenues, repair also would restore some equity among Connecticut's corporate taxpayers, as well as between Connecticut's corporate and individual taxpayers, in their shared obligation to support the public sector services central to maintaining Connecticut's economic competitiveness and high quality of life.

II. What <u>Is</u> the Corporation Business Tax -- In Brief?

The subjects of every state ought to contribute towards the support of government,
as nearly as possible in proportion to their respective abilities; that is,
in proportion to the revenue which they respectively enjoy under the protection of the law.
Adam Smith, *The Wealth of Nations* (1776)[1]

The corporation business tax "is a tax on the privilege of carrying on a business in a corporate capacity in Connecticut."[2] Doing business as a corporation is deemed a "privilege" because corporations exist only because the law allows them to exist. They are "created as ways to amass more capital, attract more investment and make higher profits than might be feasible for an individual to accomplish, and with less risk."[3] This reduced risk results from a unique benefit of corporate status -- reduced individual liability for corporate acts.[4]

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1 A. Smith, *The Wealth of Nations.* Vols. 1 and 2. Original 1776 work edited by E. Cannan (New York, Putnam Books, 1904).

2 State of Connecticut, Department of Revenue Services, *Informational Publication, 2001*, p. 14.

3 M. Forsberg , *A Question of Balance: Taxing Businesses in the 21st Century* (New Jersey Policy Perspective, 2003).

4 Connecticut grants corporations certain special privileges not enjoyed by individuals, simple partnerships, or sole proprietorships. They include the right to conduct business as a separate legal entity, limited liability, and an unlimited life. "Limited liability" is the privilege of corporate owners/shareholders to collect all the profits from a prospering corporation, but not be liable for all of a corporation's debts if it breaks its contractual promises or causes injury. The liability of shareholders is generally limited to their stake in the corporation. For example, if Jane Gates owns $1 million of stock in Acme Corp., representing 50% of Acme's $2 million in total stock, Jane has a 50% controlling interest in the

State taxation of the corporate form of business dates back to the early 19th century when corporate charters were initially granted through individual acts of state legislatures; fees were collected for the privilege of incorporating and doing business in the state.[5] In the middle of the 19th century, many states broadened these registration fees to levies on the measured capital stock (usually net worth) of the corporation. Over time, as incorporation came to be administered by state secretaries of state, these fees became general corporation taxes. As is true also of the personal income tax, state adoption of the corporation income tax preceded federal adoption of the tax. Hawaii passed the first corporate net income tax in 1901, eight years before Congress enacted the federal corporate income tax.[6]

Today, 47 states (all but Nevada, Washington, and Wyoming) levy what could be called a corporation business tax. States levy taxes on one (or a combination) of three bases: net income, gross receipts, and capital stock or net worth.

Corporations subject to Connecticut's corporation business tax[7] must calculate tax due under two alternative methods, and remit the higher amount. The first of these methods is the Net Income Base method.[8] It is based on Connecticut Net Income, with an apportionment formula applied to determine what portion of a multi-state corporation's income is taxable in Connecticut. The second method is the Capital Base Method. The capital base is calculated as the total value of the corporation's average capital stock, surplus and undivided profits, and surplus reserves, less the corporation's average values of deficits and stockholdings in private corporations. Connecticut Net Income is taxed at the rate of 7.5%; the Capital Base is taxed at a rate of 3.1 mils ($0.0031) per dollar, up to a maximum tax of $1 million. If a corporation owes less than $250 under *both* methods,[9] it must pay the "alternative minimum tax" (AMT), which is a total of $250 for the tax year.[10]

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company. If Acme distributes $10 million in profits as dividends to its shareholders, Jane will receive half – or $5 million. But, if Acme sells faulty parts or spills chemicals into Long Island Sound, causing $10 million in damages, Jane is not 50% liable for these actions (i.e. $5 million). Her "liability" is limited to her share of the corporation - her $1 million in stock. Her other, individual assets are protected; those whom Acme harmed cannot turn to her for compensation for their injuries. This contrasts sharply, of course, with instances in which individuals or non-corporate entities cause injury. They lack such insulation from personal liability. Importantly, Limited Liability Companies (LLCs), Limited Liability Partnerships (LLPs) and Subchapter S Corporations, which now are all exempt from Connecticut's corporation business tax, also enjoy the privileges of corporate status, including limited liability.

5 Corporations generally succeeded earlier colonial business forms (such as trading and joint stock companies) because the corporate form offered limited liability as well as ease of investment to shareholders, and perpetuity to the business itself. R. Strauss & A. Franco, "Corporate Income Tax: State and Local," in J. Cordes, R. Ebel, & J. Gravelle (eds.), *The Encyclopedia of Taxation and Tax Policy* (Urban Institute, 2000).

6 R. Strauss & A. Franco, "Corporate Income Tax: State and Local," in J. Cordes, R. Ebel, & J. Gravelle (eds.), *The Encyclopedia of Taxation and Tax Policy* (Urban Institute, 2000).

7 Conn. Gen. Stat. §§12-213 *et seq.* Note: Many corporations are exempt from Connecticut's corporation business tax, as discussed below.

8 See generally, CT Office of Legislative Research, *Corporation Business Tax* (2003-R-0397, April 28, 2003).

9 As discussed later, a variety of credits against the corporate business tax can markedly reduce a corporation's final tax liability.

10 PA 03-2 imposed a temporary 20% surtax on the corporation business tax for the 2003 income year; the surcharge is based on tax liability *before credits*. The AMT, with this surtax, is $300.

III. What is the Rationale for Requiring Corporations To Pay a Corporation Tax?

The basic premise underlying all forms of taxation is that members of society – be they individuals or corporate entities – should help pay for the various services and infrastructure that government provides that allows them to function and indeed thrive - in society. As former US Supreme Court Justice Oliver Wendell Holmes said, "I like to pay taxes. With them I buy civilization."[11] More recently, Franklin Roosevelt said, "Taxes, after all, are dues we pay for the privileges of membership in an organized society" and "Taxes shall be levied according to ability to pay. That is the only American principle."[12]

The "most compelling rationale" for imposing tax on corporations is that "such levies reimburse states for the significant services provided to the business community:"

> Corporations use public services provided by the state as much as individuals and unincorporated businesses. They benefit from a state's transportation infrastructure – the roads, railways, airports, and harbors used to receive materials and move products to market. Corporations also benefit from public safety operations, including police, fire, and medical emergency services. In addition, the state judicial system protects their contractual, intellectual property and other legal rights. Corporations also depend on the state's school system to produce an educated workforce….High-quality school systems also help attract qualified employees.[13]

Of course, corporations, like individuals, pay other state taxes (as discussed below) and there may be significant advantages to having corporations locate in a state. Corporation employees pay taxes to the state and economic activity generated by the corporation's presence (e.g., through vendors to the corporation) generates additional revenues.[14]

Some argue that these benefits *to* the state outweigh the benefits corporations receive *from* the state; corporations, they claim, should have no further fiscal obligations. Others admit these benefits, but assert that the "ultimate beneficiaries of public services provided to corporations are the shareholders:"

> The owners of the corporation receive the profits and enhanced stock value from successful business operations. In today's economy, those shareholders are likely to reside out of state or may themselves be corporations (especially in the case of publicly traded corporations). Only corporate income taxes can be directly linked to the operations of the corporation and are thus paid by the party that ultimately benefits from the public services.
>
> A state's personal income, consumption, and excise taxes are, after all, not necessarily paid by the shareholders of corporations doing business in the state….The property tax does not

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11 In R. E. Paul, *Taxation for Prosperity* (Indianapolis, Indiana: Bobbs-Merrill, 1947), p. 279.
12 Campaign speech, October 2, 1936, Worchester, MA.
13 D. Brunori, *State Tax Policy: A Political Perspective* (Urban Institute Press, 2001), p. 107.
14 There also may be some significant disadvantages, such as increased levels of air and water pollution, increased traffic and urban sprawl, and, if the jobs that are created pay low-wages increased demand for state-funded, means-tested programs (e.g., HUSKY, child care subsidies).

generally reflect the benefits received by companies relying more heavily on intellectual capital than on plant and equipment.

The only way the true beneficiaries of public services provided to corporations can reimburse the state is through the corporate income tax. No other levy accurately places the burden of paying for government on those who actually receive the benefits.[15]

Three other rationales for the corporation business tax are frequently given:

- *Diversifying the tax base.* Most public finance experts believe that the most stable state revenue systems are those that impose a variety of taxes at low rates, rather than relying too much on a few taxes imposed at higher rates. Just as in stock portfolios, diversification and balance are important.

- *Promoting greater equity among corporations.* The corporation business tax compensates for deficiencies in the property tax, which does not take into account that businesses require varying degrees of property inputs to produce the same level of profits. Capital-intensive operations (such as manufacturing) are taxed more heavily through a property tax than are labor-intensive companies (such as knowledge-based, high tech firms). This inequity is compounded by the difficulty in assessing property taxes on intangible property. To restore some equity to the tax treatment of corporations, a tax on corporate income is included in the mix of revenue sources rather than relying solely on taxing business inputs.[16]

- *Promoting greater overall tax equity.* The corporation business tax also reduces, to some extent, the overall regressivity of state and local tax systems. While a greater proportion of the population owns corporate stock than ever before, most corporate wealth remains in the hands of wealthy individuals. Along with a progressive personal income tax, the corporation business tax offsets some of the regressive effects of sales/use and excise taxes imposed by states. The revenues generated through a corporate business tax can reduce somewhat states' reliance on taxes that fall more heavily on lower and middle-income families.[17]

While corporations have a normative responsibility to pay a "fair share," they also have a responsibility to their shareholders to maximize returns on investment. In increasingly competitive business environments, this responsibility has caused corporations – particularly larger corporations - to arm themselves with accountants, lobbyists, and lawyers whose responsibility it is to minimize taxes paid by the corporate entity. The result has been a steady erosion of revenues from this source.

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15 D. Brunori, *State Tax Policy: A Political Perspective* (Urban Institute Press, 2001), p. 108.

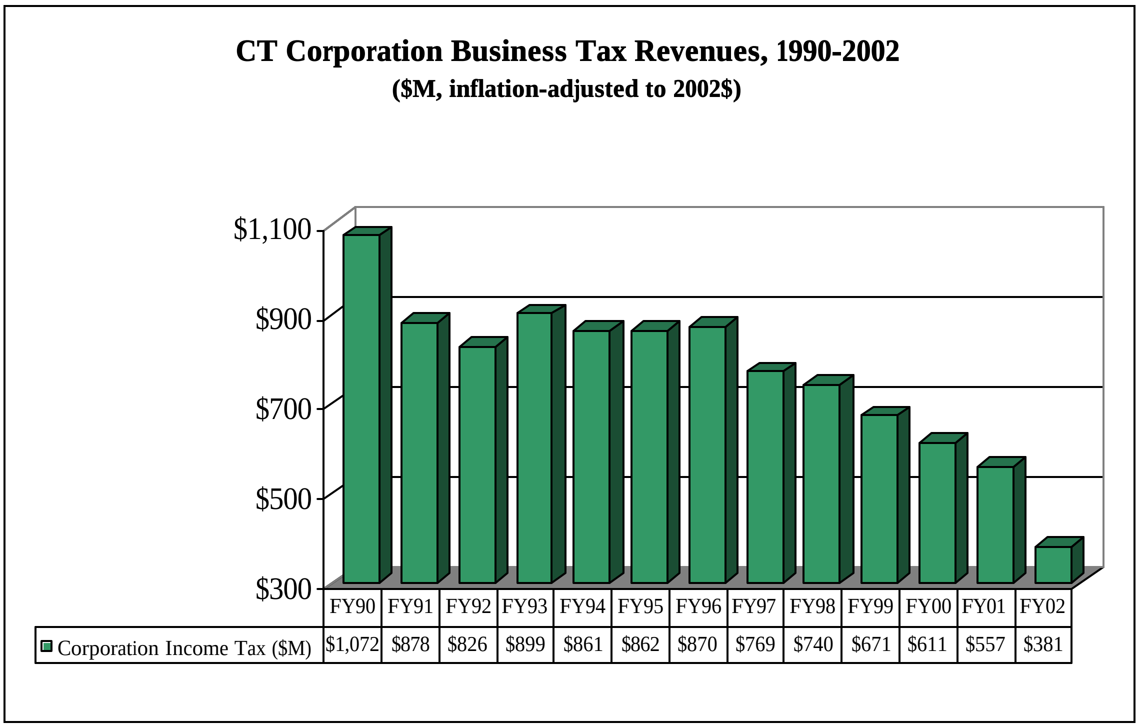
16 D. Brunori, *State Tax Policy: A Political Perspective* (Urban Institute Press, 2001), p. 106.

17 See *Who Pays? A Distributional Analysis of Connecticut's Income, Property and Sales Taxes* (CT Voices for Children, 2002). The report, based on data from the Institute for Taxation and Economic Policy, found that the share of income paid in state and local taxes by the wealthiest 1% of Connecticut's income earners (4.4% of personal income, after federal deduction) is **less than half** the share of income paid in such taxes by 80% of Connecticut's income earners (between 10.2% of personal income for the poorest 20% and 9.2% for the second-wealthiest 20%, after federal deduction). This analysis also found that while poorer families pay a greater share of their income in sales and excise taxes, middle income families pay a greater share in property taxes and the wealthiest families a greater share in income taxes.

IV. Where Does Connecticut Stand on Corporation Business Tax Revenues?

Most agree that Connecticut's corporation business tax was too high in the late 1980s and early 1990s (before Connecticut adopted its personal income tax). The following data show, however, that *reductions* in Connecticut's corporation business taxes over the prosperous 1990s may well also have been excessive. The following measures show a consistent trend of steady decline in corporate contribution to the public investments essential to corporate success, notwithstanding corporate profitability. Indeed, taxes have declined as a share of corporate profits. Nationally, in 1980, state corporation business and related taxes equaled 9.6% of corporate profits. By 2000, this had declined to 5.2%.[18]

A. Declining Real Corporation Business Tax Revenues. In real (inflation-adjusted) dollars the revenues from Connecticut's corporation business tax have declined markedly over the 1990s:[19]



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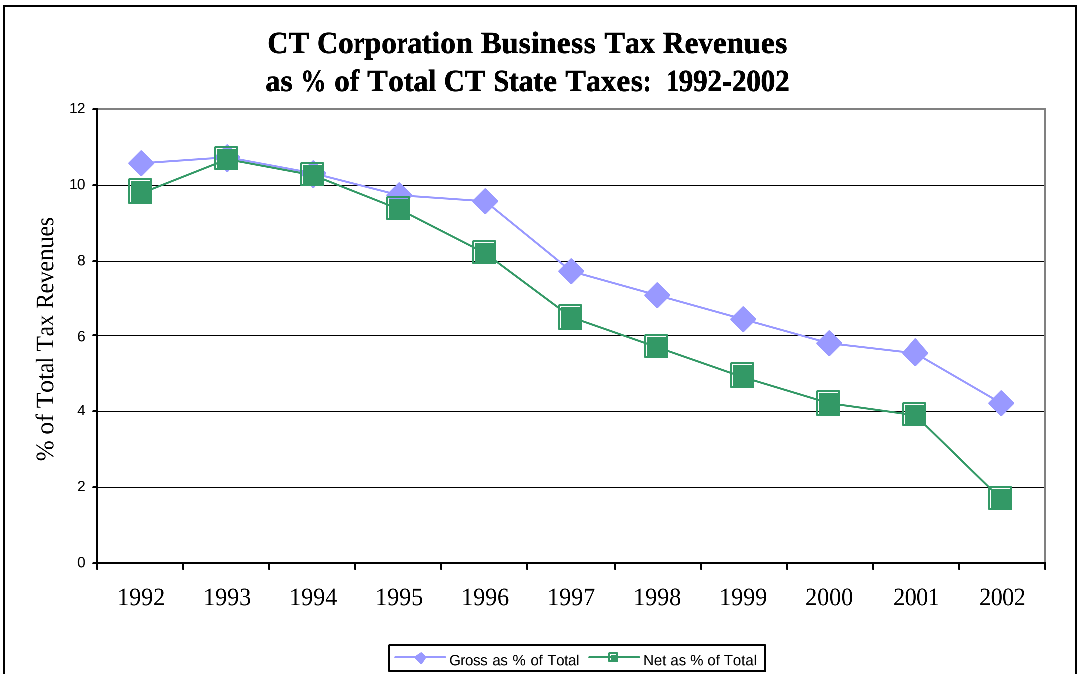
[18] This lower effective tax rate meant that companies paid $32 billion in such taxes instead of about $60 billion, yet tax changes enacted by state legislatures explain only about $5.6 billion (or 20%) of this drop in corporate taxes. This suggests increasingly aggressive use of tax shelters to shift profits from states that tax to those that do not (or to tax shelters outside the United States). Indeed, between 1996 and 1998, *untaxed* corporate profits increased from 14% of the profits reported to shareholders to 24% of profits reported to shareholders – an increase of two-thirds. G. Plesko, "Reconciling Corporation Book and Tax Net Income, Tax Years 1996-1998," *Statistics of Income Report* (Internal Revenue Service, Spring 2002). By comparison, a comprehensive study by Harvard Business School Professor Mihir Desai, discussed later, found evidence of corporate tax avoidance much larger than shown in this IRS study; untaxed corporate profits totaled $247 billion in 1998, but deductions for stock options and other legitimate deductions explained only about $88 billion of this amount. A third report, just released by the Multistate Tax Commission, *Corporate Tax Sheltering and the Impact on State Corporate Tax Revenue Collections* (July 15, 2003) found that corporation taxes as a percentage of corporate profits fell from about 9% between 1980-89 to 5.9% in 2001; 1/3 of the decline was due to tax sheltering.

[19] Non-inflation-adjusted changes in revenues are taken from CT Office of Fiscal Analysis, *Revenue and Budget Data* (March 2002).

Importantly, the chart above shows real corporation business tax revenues *prior* to refunds. Corporation business taxes *after* refunds can be, and increasingly have been, appreciably lower. For example, the United States Census Bureau reported that Connecticut's *net* corporation business tax revenues in 2002 were just $149.5 million. That is, our *net* corporation tax revenues were only 40% of the gross revenues collected; 60% of the corporation business tax revenues Connecticut collected were refunded.[20]

B. ***Declining <u>Share</u> Of State Tax Revenues.*** Corporation business tax revenues also have declined markedly as a *share* of *total* state tax revenues. The following chart shows Connecticut's gross corporation business tax revenues and net corporation business tax revenues as a proportion of Connecticut's total tax revenues over the period 1992-2002 (not adjusted for inflation).

As shown below, Connecticut's 2002 gross corporation business tax revenues were 4.2% of total state tax revenues; net corporation business tax revenues were just 1.7%. This is a marked decline from 1992, when gross corporation business tax revenues were 10.6% of total state tax revenues and net corporation business tax revenues were 9.8% of the total. Said another way, in 1992, nearly 1 in every 10 dollars in taxes raised by the state of Connecticut came from the corporation business tax. By 2002, less than 1 in every 50 dollars of taxes collected came from this source.[21]



Sources: CT Office of Fiscal Analysis, *Revenue and Budget Data* (March 2002); United States Census Bureau, *State Government Tax Collections.*

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20 For FY 01, the Census Bureau reported net Connecticut corporation business taxes of $387.8 million, i.e.$550 million in Connecticut corporation business tax revenues offset by $163 million in refunds. U.S. Census Bureau, Governments Division, *State Government Tax Collections: 2001 & 2002 (revised April 2003);* OFA, *Revenue & Budget Data* (March 2002)

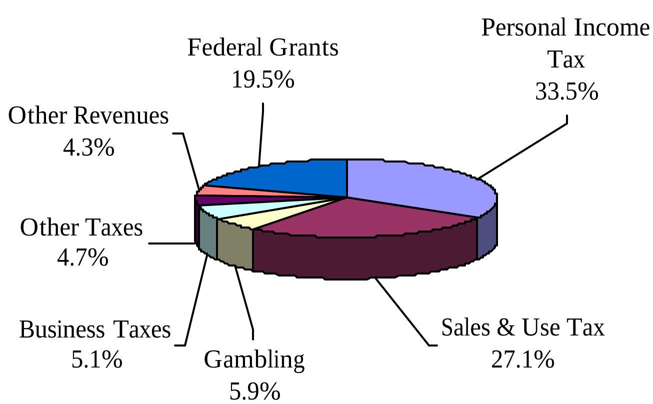
21 Data comparing gross corporation business tax revenues as a share of General Fund tax revenues demonstrate that the corporation business tax contributed *at least* 1 in every 10 dollars to total General Fund revenues throughout the period 1976-1996 and, in 1989, contributed 1 in every 5 dollars. Indeed, between 1976 and 1988, the percentage of General Fund revenues coming from gross corporation business taxes ranged from a low of 14% in 1976 and 1981 and a high of 19% in 1986.

C. ***How The Erosion Occurred.*** The General Assembly's non-partisan Office of Fiscal Analysis (OFA) reported in January 2001 that $845 million in corporation business tax revenues were no longer being collected *each year* due to changes made since 1991 to the corporation business tax. These reductions resulted from a reduction in the tax rate, erosion of the tax base, and newly-enacted exemptions, deductions and credits.[22] Without these changes, OFA estimated that FY 02 net corporation business tax revenues would have been *more than five times greater* than the revenues Connecticut actually netted. There is *additional* erosion from tax sheltering activities, not included in these numbers (but discussed later in this report).

Since 1991, Connecticut corporations also benefited from $368 million in reductions to the sales and use tax, as well as more modest reductions to the public services gross earnings tax ($27 million), the petroleum gross earnings tax ($8.4 million), and the insurance premiums tax ($41 million). *Total* revenue foregone through these reductions to various taxes on businesses since 1991 was estimated by OFA to be $1.288 *billion per year.* In addition, as a result of changes to Connecticut's workers' compensation system effective July 1, 1993, workers' compensation premiums fell by a cumulative average of 47.2% from July 1, 1993 to January 1, 2001.[23]

As the following chart illustrates, the share of General Fund revenues coming from Connecticut's corporation business tax and its other business taxes (public service companies gross earnings tax, insurance premiums tax, petroleum companies gross earnings tax) has now fallen *behind gambling* as a source of General Fund revenues: [24]

FY 02 General Fund Revenues, Actual Collections



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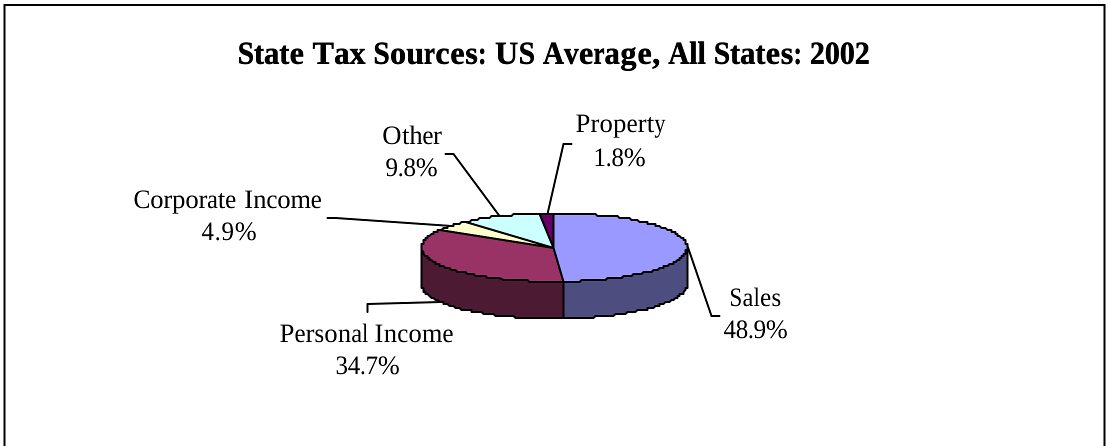
[22] OFA, *Synopsis of Tax Reductions for Businesses and Worker's Compensation Reductions* (January 2001). Some have criticized OFA's report for making comparisons between current tax revenues and tax revenues in the early 1990s when Connecticut had a very high corporation business tax rate and a temporary surtax on this tax. While a comparison to net taxes in the mid-1990s would have shown *less* of a reduction, the trend throughout the 1990s was consistent – a steady erosion of corporation business tax revenues.

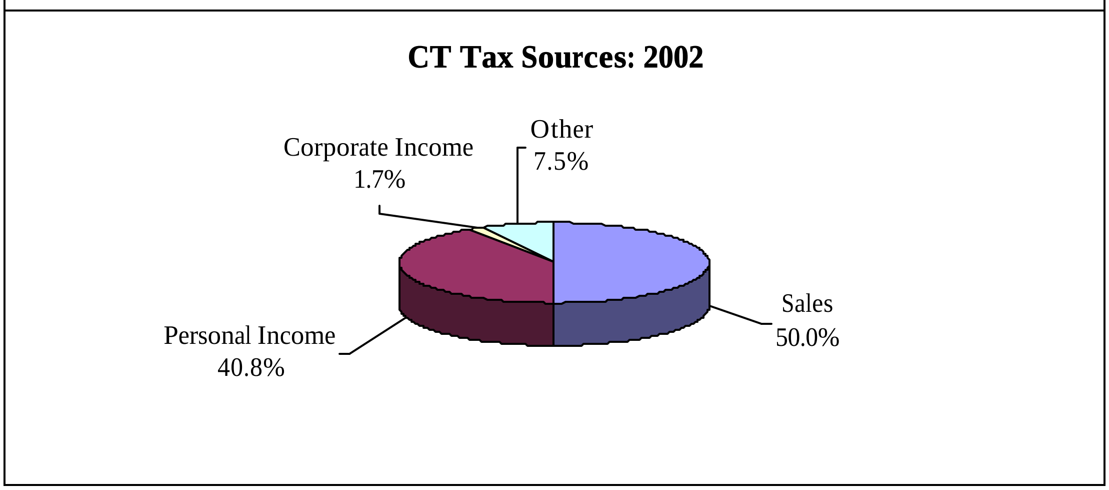
[23] OFA, *Synopsis of Tax Reductions for Businesses and Worker's Compensation Reductions* (January 2001).

[24] Of the 5.1% of revenues from business taxes, 1.4% is from the corporation business tax, 1.5% from the public service companies gross earnings tax, 1.9% from the insurance premiums tax, and 0.2% from the petroleum companies gross earnings tax. "Gambling" revenues represent 3.4% from Indian gaming and 2.5% from the CT Lottery and Off-Track Betting. "Other taxes" include the inheritance tax (1.3%), cigarette tax (1.4%), real estate conveyance tax (1.1%) and alcohol beverage taxes (0.4%). "Other revenues" include licenses, permits and fees (1.3%) and funds from the Tobacco Settlement (1.1%). OFA, *Where Does the Money Come From? An Overview of the State's Revenue* (December 10, 2002).

D. ***Where Connecticut Stands Nationally.*** As of 2002, 1.7% of Connecticut's *total tax* revenues[25] came from its various corporate business taxes,[26] well below the national average (4.9%). By comparison, and not surprisingly, Connecticut's reliance on its personal income tax significantly *exceeds* the national average (40.8% in Connecticut compared to 34.7% in the United States). This reflects the shift in tax burden in Connecticut from corporations to individuals that resulted from the adoption in the early 1990s of a broad-based personal income tax (replacing our dividends, interest and capital gains tax) and the steady erosion of the corporation business tax ever since.[27]

The following charts show Connecticut's standing relative to the national average in the proportion of *total tax* revenues coming from its various taxes:





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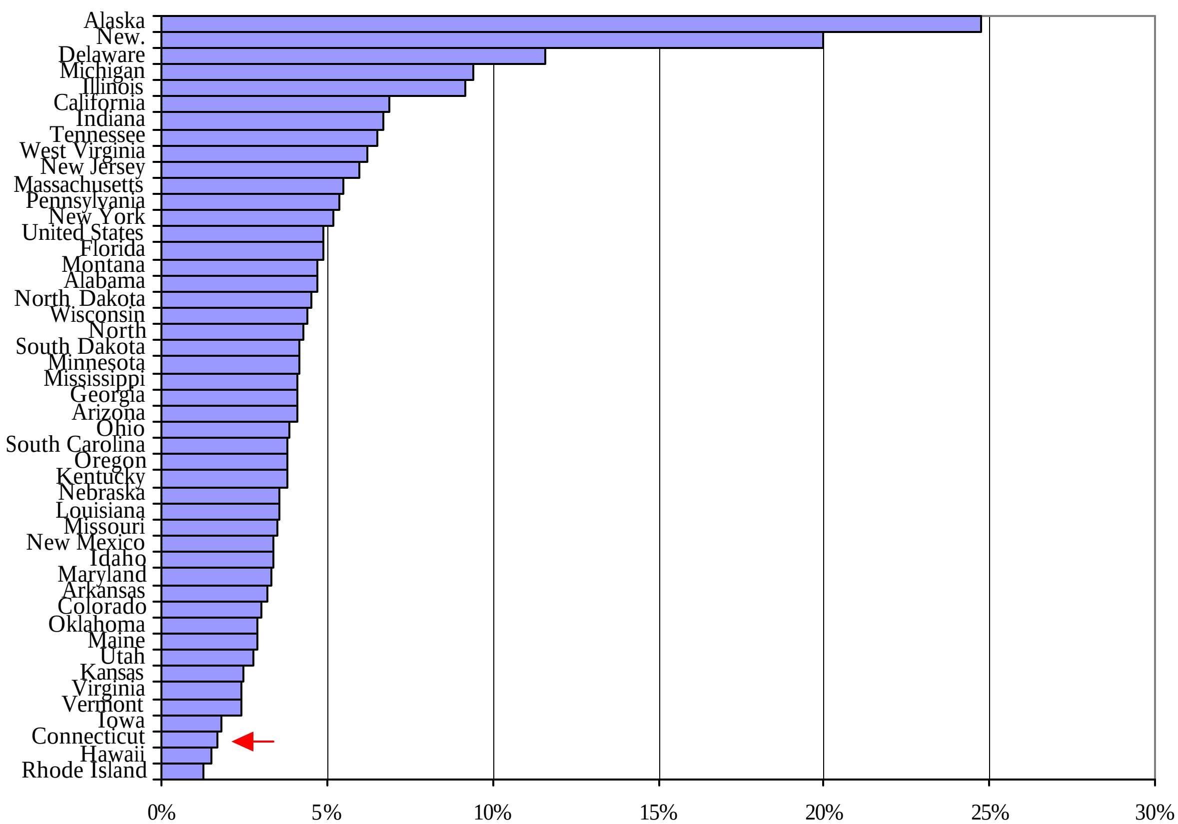
25 This differs from data on the previous page that shows corporation business tax revenues as a percentage of total *General Fund* tax revenues. The comparisons reported in this section compare *total net* corporate income tax revenues to the *total state taxes* of *all* state budget funds, including the General Fund and the Special Transportation Fund.

26 U.S. Bureau of the Census, *2002 State Tax Collections by Source (Percentage of Total)*, available at www.taxadmin.org/fta/rate/02taxdis.html. The Census Bureau defines "corporation net income" tax to include taxes on all types of corporations and unincorporated businesses (when taxed separately from individual income) imposed on net income. (http://www.census.gov/govs/www/qtaxtechdoc.html).

27 As discussed later, tax changes enacted since 2002 will exacerbate this trend. PA 03-2 increased Connecticut's 4.5% personal income tax rate to 5.0%, resulting in an additional $400 million/year in personal income tax revenues. It also imposed a one-year 20% temporary surcharge on the corporation business tax, resulting in a total of about $65 million in new, *but one-time*, revenues from this source.

E. Where Connecticut Stands Compared to Other States. With 1.7% of its total state tax revenues coming in 2002 from all its various corporation business taxes, Connecticut ranks *3rd lowest* among states with a corporate income tax in the share of total state tax revenues coming from this source.[28] In 2001, by comparison, Connecticut ranked 13th lowest.[29] As seen in the chart below, in our region only Rhode Island has a *smaller* share of its tax revenues coming from corporation income taxes (1.3%); all other states in our region have a *greater* share of their tax revenues from this source (Maine, 2.9%, Massachusetts, 5.5%; New York, 5.2%; New Jersey, 6.0%, New Hampshire, 20.0%, and Vermont, 2.4%). Importantly, all other states in our region (except New York) *also* have a *state* property tax that imposes additional tax burden on corporations. Indeed, 31.6% of Vermont's state tax revenues come from its statewide property tax, as does 26.6% of New Hampshire's tax revenue. These revenues are in addition to those from any local property tax.

Corporation Income Taxes as % Total Tax Revenue, 2002



US Census Bureau, Government Statistics Division, *2002 State Tax Collections by Source.* Note: Nevada, Washington and Wyoming do not tax corporate income.

[28] U.S. Bureau of the Census, *2002 State Tax Collections by Source (Percentage of Total)*, available at www.taxadmin.org/fta/rate/02taxdis.html.

[29] U.S. Bureau of the Census, *2001 State Tax Collections by Source (Percentage of Total)*, available at www.taxadmin.org/fta/rate/01taxdis.html.

F. Who is Paying Connecticut's Corporation Business Tax? With such substantial erosion in Connecticut's corporation business tax, it is logical to ask *which* corporations are paying this tax now, and *how much are they paying*. *Unfortunately, we cannot know the answer to this question*. There currently[30] is no public disclosure of how much corporations individually pay to the State of Connecticut in corporation business taxes. What we *do* have is some aggregate data that allows us to know the following:

1. *Many Connecticut Corporations Have Been Paying Little, Or No, Corporation Business Tax*. In 1999, nearly 84,000 corporations filed Connecticut corporation business tax returns: 50,099 single filers, 32,428 Subchapter S filers (which, in 1999, were not yet exempted from the tax) and 1,234 combined filers.[31] Two points are striking:

- While a total of $506.35 million of tax was reported due (before credits), *nearly two-thirds* of these corporations (52,687) paid only the Alternative Minimum Tax – just $250 each. Thus, one-third of the corporations paid 97.6% of the total tax (i.e., all but $12 million).

- As of the 2001 income year, Subchapter S corporations are totally exempt from the corporation business tax. That is, 32,428 of the 84,000 corporations that filed corporation tax returns in 1999 (39%) are now entirely exempt from the tax. [32]

The following table presents the 1999 income year data:

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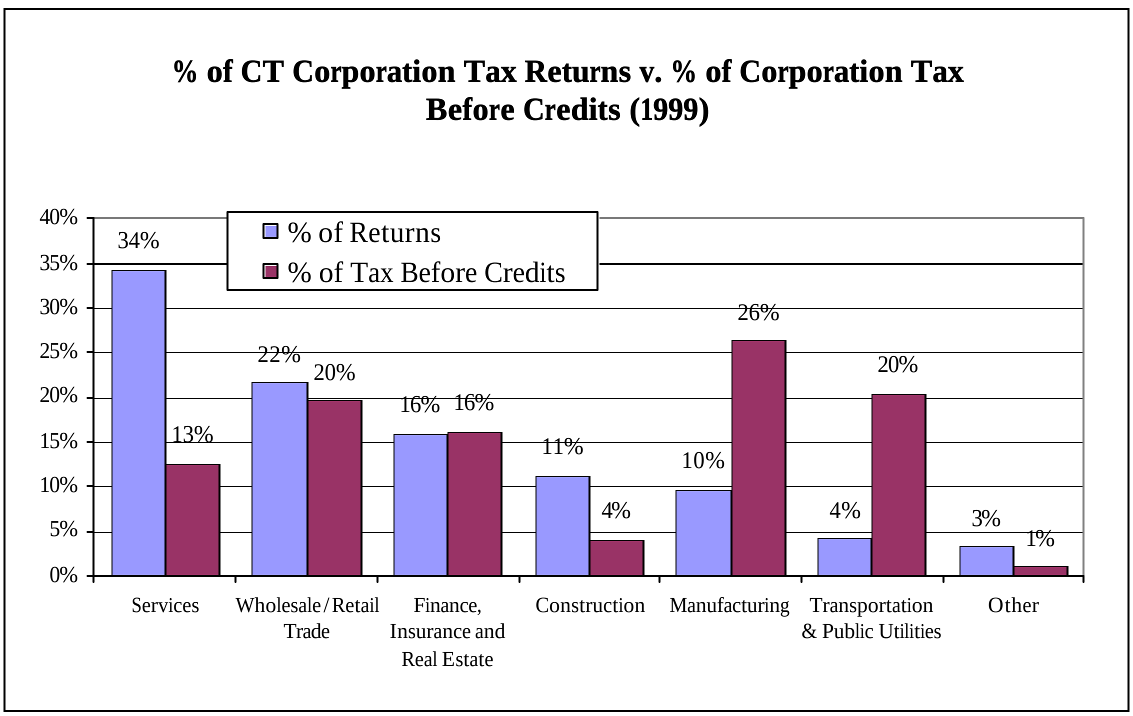
30 As discussed more fully later, state corporation business tax returns have not always been shielded from public disclosure. Prior to the enactment of the Securities Act of 1933 and the Securities Exchange Act of 1934, corporate tax returns (or key items of tax information) were frequently matters of public record. Currently, the SEC mandates the disclosure by publicly-traded corporations of extensive financial data, including numerous components of tax expense including information on the investment tax credit, federal corporate taxes paid, and state and local taxes paid *in the aggregate*. A number of states (Massachusetts, Wisconsin, Arkansas, West Virginia) require *some* state-level disclosure of tax-related information by specific corporate name. R. Pomp. *Corporate Tax Policy and the Right to Know: Improving State Tax Policy by Enhancing Legislative and Public Access* (Fiscal Policy Institute, 1993).

31 If a corporation is permitted to file a federal consolidated return, it may elect to file a combined return in Connecticut. Filing a combined return allows a group of corporations engaged in business in Connecticut to file jointly. Their combined Connecticut tax liability is determined after each corporation individually apportions its income to Connecticut. A preference tax is imposed on corporations filing a combined return; the corporations are not entitled to the first $25,000 of tax savings over what they would have had to pay if they had filed separately. In 1999, the total tax due by combined filers was $220.1 million, including $8.9 million in preference tax. If they had filed separately, the total tax due to Connecticut would have been nearly double this -- $400.8 million. CT Department of Revenue Services, *2000-01 Annual Report*, p. 32. Connecticut's combined return differs markedly from a mandatory unitary (combined) reporting system as exists in California. The Connecticut combined return aggregates the separately-apportioned income of each participating entity in the group. In contrast, under a unitary system, all affiliated companies in a unitary relationship are generally joined together in a single combined return, and their income is apportioned on the basis of aggregate group-wide apportionment factors. R. W. Tomeo, *Connecticut and New Jersey Legislatures Address Intercompany Tranactions* (unpublished manuscript, 2002).

32 Only recently, in PA 02-1 (May Special Session), was a modest $250/year business entity tax again placed on the Subchapter S and other pass-through corporations (LLCs, LLPs).

1999 CT Corporation Business Tax Returns		
	Number of Taxpayers	**Tax Due Before Credits**
Single Filers		
-Net Income	12,166	$186,710,317
-Capital Base	4,806	$21,414,162
-Minimum Tax ($250)	33,127	$7,439,212
Subchapter S Filers		
-Net Income	9,776	$58,520,846
-Capital Base	3,092	$7,268,295
-Minimum Tax ($250)	19,560	$4,879,849
Combined Filers	1,234	$220,120,340
TOTAL	**83,761**	**$506,353,021**
Source: Connecticut Department of Revenue Service, *2000-01 Annual Report* (2002), p.34		

2. *Some Industries Contribute A Greater Share Of The Revenues.* The Connecticut corporation business tax liability (before credits) is not distributed evenly across various industries. For example, in 1999, while manufacturing accounted for fewer than one in ten returns filed, the tax reported by manufacturing corporations was more than one-quarter of Connecticut's total corporation business tax before credits. In contrast, the service industry accounted for more than one in three returns filed, but reported just 12.5% of the tax before credits. Because of the dearth of publicly available, company-specific data, it cannot be determined to what extent these differences reflect differences across industries in the size of companies, in their profitability, and/or in preferential tax treatment or other factors. The following chart illustrates these differences:



3. Many Of Connecticut's Largest Corporations Had Been Paying No Corporate Business Tax. The various exemptions, deductions, and exclusions to, and credits against, the Connecticut corporation business tax have allowed some of Connecticut's *largest* corporations to pay little or no corporation tax.

A summary of the total tax due and the tax due after credits, in 1999, for Connecticut's *95 largest* corporations[33] found the following:

- The 95 corporations had a combined total tax due after credits of $51 million.[34] One corporation paid $21.4 million of this sum and another $16.03 million -- between them a total of nearly ¾ of the total tax paid. Four other corporations paid between $1.3 million and $3.06 million each. All together, these six corporations paid *nearly 90%* of the total tax paid by the 95 largest corporations.

- 38 of these largest 95 corporations (40%) had *no* tax due at all after credits. Nearly half of these corporations claimed more than $100,000 *each* in tax credits. Five claimed more than $1 million in tax credits (including one corporation that claimed $9.29 million in credits, another that claimed $6.49 million, and a third that claimed $3.9 million in credits).

- An additional 7 of these corporations paid only Connecticut's $250 Alternative Minimum Tax.

G. In Sum. Connecticut's corporation business tax has steadily eroded, without any overall strategy to assure continued equity among corporate taxpayers and equity between corporate and individual taxpayers. Corporate business taxes are now a relatively small share of Connecticut's total tax revenues, and a smaller share of tax revenues than in the majority of other states. In addition, many types of corporations are now totally exempt from the corporation business tax, or have been provided with sufficient tax credits to offset much of their tax liability.

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33 A list of the 95 largest corporations in Connecticut, as identified by the Hartford Courant, was provided to the Connecticut Department of Revenue Services by the non-partisan legislative Office of Fiscal Analysis. DRS reported, *without identifying corporate names*, the total tax due, the tax credits claimed, and the tax after credits in 1999 for each of the 95 corporations. Connecticut is not unique in having so many of its largest corporations paying little in corporation business tax. The Boston Globe reported that 15 of the 50 largest employers in Massachusetts paid only its corporate minimum tax ($456) in 2000. S. Bailey, "Is Business Doing Its Part?" (Boston Globe, Business Section, March 19, 2003). Also, when New Jersey Governor McGreevey announced his corporate business tax reform initiative in 2002, he released a report showing that of the 50 companies with the largest payrolls in New Jersey, 30 paid only New Jersey's $200 minimum corporate tax and the 50 largest businesses (measured by numbers of employees) paid a total of $345 million in corporate income taxes *combined* in 1999; 10 of the 50 paid 91% of the taxes collected. He also reported that only 23% of New Jersey's 262,341 corporations paid *more than* New Jersey's minimum corporate tax of $200. The remaining 77% (201,258 corporations) paid only $200 in corporate tax and of these, 70% (141,811 corporations) were viable businesses, engaged in real economic activity (not shell corporations). See M. Forsberg, *Corporate Tax Reform: The New Jersey Experience* (New Jersey Policy Perspectives, April 16, 2003).

34 Four companies based in Connecticut are among the 100 largest corporations in the nation: General Electric (#1, with 2002 revenues of $131 billion and profits of $15 billion), United Technologies (#44, with 2002 revenues of $28 billion and profits of $2.2 billion), Hartford Financial Services (#60, with 2002 revenues of $16 billion and profits of $1 billion) and International Paper (#97, with 2002 revenues of $25 billion and profits of $295 million). Aetna is #116, with 2002 revenues of $20 billion and profits of $443 million. Other large corporations based in, or with a significant presence in, Connecticut include, Xerox, MeadWestvaco, Premcor, Praxair, Pitney Bowes, Pfizer (with 2002 profits of $9 billion), and SBC Communications. See http://www.forbes.com/lists/

While many of these changes were enacted to promote economic development and keep Connecticut economically competitive, it is noteworthy that there is *no* routine review of the changes to assess if the state is realizing its goals. Unlike the economic development assistance provided through the CT Department of Economic and Community Development, this assistance through Connecticut's tax code has no formal monitoring and assessment. Indeed, legislators do not even know *all* of the companies that are benefiting from changes in tax law, what economic benefits they are reaping, and what gains Connecticut may, or may not, be receiving in return. Yet, without such information, it is difficult for legislators, the Governor, and the public (taxpayers) to determine if Connecticut is getting its money's worth, or if these funds could be more prudently used to bolster Connecticut's educational system, transportation infrastructure, and other services that make Connecticut a desirable place for business.

Importantly, the *cost* of these tax expenditures also is not being monitored and reviewed after they have been enacted. Thus, a tax credit that was projected to cost the state $5 million/year can grow to cost many times this amount without any re-evaluation. For example, in a January 2001 report to the Finance, Revenue and Bonding Committee[35] OFA reported a $0.2 million cost in FY 02 for the recently-enacted refundable Research and Development Credit (PA 99-173). OFA's 2002 *Connecticut Tax Expenditure Report*, published just a year later, reported an annual revenue loss of $30 million from this "refundable" credit – a 150-fold increase in the cost of this refundable credit in just one year.[36]

V. How Does The Corporation Business Tax Work, and How Is It Being Avoided?

Why do we have less uniformity in state tax laws than we did in the early 1980s? Because businesses don't support it. They undermine uniformity whenever they see it because they have learned [that] the lack of uniformity creates opportunities for tax shelters.

Dan Bucks, Executive Director, Multistate Tax Commission[37]

To understand how Connecticut's corporation business tax works, and how it increasingly is being avoided, an understanding of certain key concepts is essential: nexus, tax base, apportionment, tax rate, and tax credits.

In brief, for any business, the tax base defines how big the corporation business tax "pie" is in a given state, apportionment defines how much of this pie can be taxed by that state, the tax rate establishes how much of that pie slice will go to taxes, and tax credits reduce the tax that would otherwise be due. Nexus determines if the pie can be taxed at all.

Further explanation of each of these key concepts follows.

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35 OFA, *Synopsis of Tax Reductions to Businesses and Worker's Compensation Reductions* (January 4, 2001).

36 PA 02-1 (May Special Session) placed a limit on this refundable credit program, limiting the exchange of credits to $1 million per filer for income years 2000 and 2001 (if the refund had not been paid as of 7/1/02) and $1.5 million per filer for income years 2002 and thereafter. There is *no* limit placed on the total revenue loss to the state that is allowed by this credit, however.

37 "State FTA Roundtable Debates Viability of Corporate Income Tax," *State Tax Notes* (June 10, 2002), p. 1008.

A. Nexus. A fundamental legal principle is that a state may not tax a corporation unless the corporation has nexus, or sufficient connection, with the state. Determining nexus essentially asks the question, "Can this corporate entity be taxed in Connecticut? Is it 'here' in some meaningful way?" The American Institute of Certified Public Accountants (AICPA) explains nexus:

> Nexus describes the amount and degree of business activity that must be present before a state can tax an entity's income. If a taxpayer has nexus in a particular state, the taxpayer must pay and collect/remit taxes in that state. In general, nexus is created for income tax purposes if an entity derives income from sources within the state, owns or leases property in the state, employs personnel in the state in activities that exceed "mere solicitation," or has capital or property in the state. The amount of activity or connection that is necessary to create nexus is defined by state statute or case law and/or regulation and, consequently, tends to vary from state to state. However, all states are limited by Constitutional principles, judicial doctrine and federal law.[38]

Broadly speaking, there are two competing theories of what constitutes "substantial nexus" between a state and a business that the state is seeking to tax through its corporation business tax: 1) actual physical presence in the state (as has been the required nexus standard for collection responsibility for a state's use tax but has *not* been explicitly extended by the United States Supreme Court to business activity taxes); *or* 2) economic presence in the state (as has been affirmed by two United States Supreme Court decisions upholding application of an economic presence standard to business activity taxes[39]). Public Law 86-272 prohibits a state from imposing a tax on, or measured by, net income when an entity's *only* connection with the state is the solicitation of orders or sales of *tangible personal property*, and such orders are accepted and shipped or delivered from *outside* the state. Solicitation for the sale of real property, intangible property, or services is *not* provided immunity under Public Law 86-272.[40]

The challenge of establishing nexus has become increasingly complex as more corporations do business in multiple states and nations and through means not envisioned when corporation business taxes were first enacted (e.g. Internet transactions). Moreover, states increasingly encounter corporate entities that manipulate their corporate structures to avoid nexus status in many states, preferring to establish nexus only in those states with the most favorable corporate taxes for them.[41]

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38 *State Corporate Tax Issues Practice Guide* (http://209.204.235.158/acache/praguide.htm#nexusiss). Note: While the imposition of a duty to collect the use tax on an out-of-state seller requires "physical presence" in the state to establish nexus, it is not at all settled that this same standard applies for corporation income tax nexus. Rather, it is generally held that a tax on corporate net income tax can be imposed either if the company has a physical presence in the state *or* is involved in events or transactions in the state that are within the protection of the state (including the presence of intangible property in the state) i.e., has an *economic* presence in the state.

39 These decisions are International Harvester v. Wisconsin Department of Taxation, 322 U.S. 435 (1944) (upholding the constitutionality of a Wisconsin tax on the privilege of declaring and receiving dividends; the tax was collected from an in-state corporation on dividends paid to non-resident shareholders) and Wisconsin v. J.C. Penney Co., 311 U.S. 435 (1940)(upholding the same Wisconsin tax, and stating that the requisite nexus is supplied if the corporation avails itself of the "substantial privilege of carrying on business within the State.")

40 For a more practice guide on corporate tax issues such as nexus, multi-state issues and state net operating loss issues, see *State Corporate Tax Issues Practice Guide* (AICPA State and Local Taxation Committee), available at http://209.204.235.158/cache/praguide.htm.

41 This is a reason why interstate cooperation and the enactment of unified reporting is so essential if corporation business taxes are to remain a part of the state's revenue stream.

When nexus status cannot be avoided, corporations then seek *apportionment* of their income/assets in such a way as to minimize the taxes owed in the states in which they have nexus.

B. Tax Base. The tax base is essentially "what" is taxed. It defines both what types of corporations are subject to the tax (since not all corporations are) and what of a corporation's income and assets may be subject to tax.

1. WHICH Business Entities Are Subject To The Corporation Business Tax? There are four primary types of corporate entities in Connecticut: C-corporations;[42] Subchapter S-corporations;[43] Limited Liability Corporations (LLCs); and Limited Liability Partnerships (LLPs).[44] All four corporate structures are creatures of state law, established to insulate their owners from some of the liabilities inherent in operating a business.[45]

Currently, only the first of these – C-corporations – is subject to the Connecticut corporation business tax. The other three types of corporations are known as "pass through" corporations. Essentially, rather than taxing the net income of these corporations as corporate income at 7.5% and then also taxing any distributions to shareholders as their personal income, the net income of these entities is "passed through" the corporate entity and taxed *only* as shareholder/partner income subject to Connecticut's lower personal income tax rate.[46]

It is a relatively recent development that Connecticut has exempted "pass through" corporations from its corporation business tax. The emergence of this exemption has encouraged more firms to incorporate initially as "pass through" corporations. In addition, both in Connecticut and

42 C Corporations are the standard corporate form, offering continuous life, limited liability, ease of transfer, self-employment tax savings, and multiple avenues to raise capital. Unlike S corporations, they have no limit on the number and type of stockholders. Net income is taxed at the corporate level under the corporation business tax. When profits are distributed to shareholders, they are subject to tax as well under the personal income tax. C Corporations have greater tax planning flexibility than the "pass-through" corporations; they do not have to immediately distribute profits to shareholders as dividends.

43 Subchapter S of the Internal Revenue Code, for and by which S Corporations are named and governed, was enacted in 1958 and substantially revised in 1982 and 1996. An S corporation must be a domestic corporation with no more than 75 shareholders (with married couples counting as a single shareholder), allow only individuals to be shareholders (with the exception of some estates and trusts), not have any nonresident aliens as shareholders, have only one class of stock, and not be a bank, an insurance company, or a member of an affiliated group, or any of certain other types of corporations. Limits are placed on how much of its profits can come from passive investments. Profits and losses passed through an S Corporation must be allocated according to each shareholder's proportionate share in ownership. G. Plesko, "Subchapter S Corporation," in J. Cordes, R. Ebel, & J. Gravelle (eds.), *The Encyclopedia of Taxation and Tax Policy* (Urban Institute, 2000), p. 402.

44 Limited Liability Corporations (LLCs) and Limited Liability Partnerships (LLPs) have become popular alternatives to S corporations. Recognized in nearly all 50 states, these entities offer the same benefits of limited liability and pass-through tax treatment as S corporations, but have fewer operational restrictions. For example, LLCs have no limits on the number of shareholders or classes of stock. Also, like a partnership (but unlike an S corporation) an LLC can make disproportionate distributions among its owners. G. Plesko, "Subchapter S Corporation," in J. Cordes, R. Ebel, & J. Gravelle (eds.), *The Encyclopedia of Taxation and Tax Policy* (Urban Institute, 2000), p. 403. Members who are active participants in the business of an LLC also are permitted to deduct the LLC's operating losses against their regular income, to the extent permitted by law. While this is also the case for shareholders of S Corporations, it is not true for shareholders of C Corporations. On the other hand, the salaries *and* profits of an LLC are subject to self-employment taxes, while with a C Corporation, only salaries (not profits) are subject to such taxes. PA 93-267 authorized LLCs in Connecticut, described as a "new form of business that combines the limited liability characteristics of corporations with the tax status of partnerships." PA 97-70 authorized single-member LLCs (which are treated like sole proprietorships, but without comparable liability exposure).

45 For tax purposes, other forms of business organizations are traditional partnerships and proprietorships.

46 There is, however, a modest $250 "entity" tax recently imposed on pass-through corporations in Connecticut.

throughout the United States, there has been a conversion of many corporate entities from C-corporations to S-Corporations, LLCs, and LLPs to take advantage of this more favorable tax treatment.

Connecticut first allowed the creation of LLCs in 1993.[47] Prior to this change, OFA estimated a revenue loss of $15 million/year in corporation business taxes as a result (assuming more than 20,000 LLCs would be established).[48] Connecticut authorized single-member LLCs in 1997.[49] In addition, beginning in 1997, Connecticut began to phase-out the corporation business tax on Subchapter S corporations.[50] Prior to this date, S corporations were subject to the corporation business tax on profits, and shareholders paid the personal income tax on any distributions of profits to them. Subchapter S corporations were *totally exempted* from Connecticut's corporation business tax as of January 1, 2001. The total corporation business tax revenues that are forgone because of this change are estimated by OFA to be about $26 million/year.

OFA's estimates of revenues lost each year by exempting all pass-through corporations from Connecticut's corporation business tax may well be underestimates, however. The LLC increasingly is being used as the corporate form of organization for business start-ups. In 2002 alone, Connecticut authorized the creation of about 2,100 regular domestic C-corporations, but more than 19,000 domestic LLCs and LLPs.[51] In addition, the Multistate Tax Commission reports considerable growth in the proportion of corporate entities classified as Subchapter S corporations, from less than a quarter (22%) in 1985 to half (50%) in 1996.[52]

The impacts of these exclusions from the corporation business tax are three-fold:

- No *corporation business tax* revenues are collected although these corporations (like those corporations that continue to pay the corporation business tax) enjoy the rights and privileges of corporate status under Connecticut law and the benefits of Connecticut's investments in education, health care, transportation, infrastructure, and public safety.

- The *rate* at which profits *are* taxed is less – at the 3% and 5% rates of Connecticut's personal income tax rather than the 7.5% Connecticut corporation business tax rate.

- Some profits may escape tax even through Connecticut's personal income tax. Enforcement of the tax is more difficult with regard to out-of state shareholders/partners of these pass-through corporations. While the out-of-state owners (which may be individuals and/or corporations) are obligated to pay Connecticut income tax on the profits passed-through the Connecticut corporations, unless there is a statutory requirement that such corporations

47 P.A. 93-267.
48 OFA, *Synopsis of Tax Reductions to Businesses and Worker's Compensation Reductions* (January 4, 2001).
49 Single-member LLCs are not taxable as entities separate from their owners, yet offer their owners limited liability. Like corporate shareholders, the members of an LLC (or the single member of a single-member LLC) risk their investment but are usually not personally liable for the entity's debts and other liabilities.
50 PA 96-175 phased out the corporation business tax on the net income of Subchapter S corporations by reducing the percentage that is taxable until it was totally exempt in the 2001 income year.
51 CT Secretary of the State, *Connecticut Business Starts Index, 2002.*
52 Cited in M. Forsberg , *A Question of Balance: Taxing Businesses in the 21st Century* (New Jersey Policy Perspective, 2003), p. 17.

withhold taxes due from these out-of-state shareholders/owners Connecticut risks not collecting taxes due; the state does not even know who these out-of-state owners might be.

In addition to the exemption for these pass-through corporations, Connecticut law explicitly exempts various other corporations from its corporation business tax. Together, all these exemptions result in an *annual* revenue loss from the corporation business tax of nearly $100 million. The following table shows the types of corporations exempt from the corporation business tax (Conn. Gen. Stat. §12-214), OFA's estimates of revenues lost in FY 02 because of the exemptions, and the estimated number of corporate taxpayers that benefit from the exemptions:

Corporations Exempted From CT's Corporation Business Tax (2002)		
Exempted (year of exemption)	*FY 02 Revenue Loss*	*Taxpayers Benefiting*
Foreign Insurance Companies	$10.0M	900
Railroad Companies (subject to gross earnings tax)	$0.8M	7
Cooperative Housing Corporations (PA 94-4)	$0.1M	< 50
Political associations exempt from federal income under §527 of the Internal Revenue Code (1975)	$2.5M	25
Electric Cooperatives	$2.8M	6
Alternate Energy Systems Companies (1980)	$0.25M	50
Aero-Driver Gas Turbine System Companies (1992)	$0.1M	10
Regulated Investment Companies (mutual funds) and Real Estate Investment Trusts (PA 93-74)	$1.1M	10
Domestic Insurance Companies (PA 98-110)	$20.0M	125
Passive Investment Companies (formed by financial services companies to hold and manage loans secured by real property) (PA 98-110)	$20.0M	10
Pass-through Corporations		
Subchapter S Corporations (PA 96-175; PA 98-244)	$26M	30,000
Limited Liability Corporations (PA 93-267, PA 97-70)	$15M	20,000
TOTAL	$98.65M	~51,190

In addition, as of FY 01, the following also were exempted from the corporation business tax:

- Banks, insurers, and investment companies whose corporate headquarters are located in the insurance and financial services export zone in the City of Hartford and are conducting all of their business outside the United States (PA 96-253);
- Out-of-state corporations if their only contact with Connecticut is participation as a limited partner in an investment partnership in Connecticut (PA 96-197);
- Non-United States corporations whose sole activity conducted in Connecticut is the trading of stocks, commodities and securities "for its own account" (Conn. Gen. Stat. 12-214).[53]

[53] CT Department of Revenue Services, *2000-01 Annual Report*, p.33. UBS Warburg in Stamford, operating one of the nation's largest stock trading floors, would seem to fall within the last-listed exemption, for example.

Importantly, Connecticut's corporation business tax is based on the net income reported by a corporation to the state. Over time, corporations have devised a variety of mechanisms to reduce the amount of income they must report to a state in which they are taxable by creating subsidiary corporations *out-of-state* to reduce, or evade, corporation business taxes. These mechanisms are coming under increasing legislative and judicial scrutiny.[54] Courts have upheld the imposition of corporation business tax on companies that do no business in the state and own no personal property in the state, but are subsidiaries of companies doing business in the state against constitutional challenges under the Commerce and Due Process Clauses.[55]

2. WHAT Is Subject To The Corporation Business Tax? For those corporations that are subject to the corporation business tax, states typically levy taxes on one (or a combination) of three bases: net income (45 states); gross receipts (1 state); and capital stock or net worth (25 states). Of the 25 states levying taxes on the capital stock or net worth, only two – Texas and Wyoming – rely solely on this base. The other 23, including Connecticut, use both net income and net worth.[56] In most of those 23 states, corporations are required to calculate the taxes they owe using both bases, and must report using the method that yields the most tax. In Connecticut, as in many other states, an Alternative Minimum Tax is imposed if the tax due under either of these two methods is less than the AMT, which is, in Connecticut, $250. [57]

The following table provides detail on this state-by-state variation:

54 Illustrative of these mechanisms is the "trademark income-shifting loophole." In this, the corporation transfers its trademarks and patents to a subsidiary corporation (often referred to as "passive investment companies" or PICs) located in a state that does not tax royalties, interest, or similar types of "intangible income" (most often Delaware or Nevada). The profits of the operational part of a business that would otherwise be taxable in a state in which the company is located are siphoned out of the state by having the tax-haven subsidiary charge a royalty to the rest of the business for the use of the trademark or patent. The royalty is a deductible expense for the corporation paying it, and so reduces the amount of profit such corporation has in states in which it is taxable. Often, the "profits" of the PIC are then loaned back to the rest of the corporation, and a secondary siphoning of income occurs through the payment of deductible interest on the loan. *See generally*, M. McIntyre, P. Miner, & R. Pomp, "Designing a Combined Reporting Regime for a State Corporate Income Tax: A Case Study of Louisiana, 61 *Louisiana Law Review* 699 (2001). Connecticut restricts deductions for royalties, intangible expenses, and interest expense payments between affiliated companies (Conn. Gen. Stat. §12-218c).

Connecticut law also authorizes the DRS Commissioner to disallow a deduction or expense if he determines it has no valid business purpose (Conn. Gen. Stat. §12-226a), but the effect of this law was limited by the Connecticut Supreme Court's decision in the *Carpenter Technology* case. Carpenter Technology, using another option to avoid tax, set up a Delaware subsidiary, capitalized it with $300,005,000 and, a few days later, borrowed all but $5,000 back. The company then deducted the interest on the loan, saving $196,102 in corporation business tax in Connecticut in 1990 and 1991. The Court overruled the DRS Commissioner's determination that this transaction was a sham, devised to avoid state tax. While PA 02-1 (MSS) sought to nullify this decision and expressly bar companies from using methods like Carpenter's to reduce or avoid Connecticut's corporation business tax, it did not go so far as to presumptively disallow interest or similar payments among corporate affiliates.

55 *See, e.g.,* Comptroller of the Treasury v. SYL, Inc. (Maryland Court of Appeals, June 9, 2003)

56 In 1982, a fourth alternative base was established in Connecticut and imposed only on corporations whose gross *receipts* exceeded $50,000. These corporations also were required to calculate their tax liability on the base of a 5% tax on 50% of their net income and compensation paid to officers and owners of more than 1% of the common stock. It was repealed for income years beginning 1/1/83. OFA, *Revenue and Budget Data* (March 2002), pp. 77-78.

57 In Connecticut, as in most states, federal net income is the starting point for calculation of taxable income, when using the *net income base*. The *capital base* method looks at "the average value of issues and outstanding capital stock, surplus and undivided profits, and surplus reserves reduced by: the average value of any deficit carried on the balance sheet and holdings of stock of private (nongovernmental) corporations including treasury stock." Connecticut Department of Revenue Services, *Informational Publication 2001*, p. 14.

State[58]	Gross Receipts	Net Income	Capital Stock or Net Worth	State	Gross Receipts	Net Income	Capital Stock or Net Worth
Alabama (a)		X	X	Montana		X	
Alaska		X		Nebraska		X	X
Arizona		X		New Hampshire (g)		X	
Arkansas		X	X	New Jersey		X	
California		X		New Mexico		X	
Colorado		X		New York (h)		X	X
Connecticut (b)		X	X	North Carolina		X	X
Delaware (c)		X	X	North Dakota		X	
Florida		X		Ohio		X	X
Georgia		X	X	Oklahoma		X	X
Hawaii		X		Oregon		X	
Idaho		X		Pennsylvania		X	X
Illinois		X	X	Rhode Island		X	X
Indiana		X		South Carolina		X	X
Iowa (d)		X	X	South Dakota (i)			
Kansas		X	X	Tennessee (j)		X	X
Kentucky		X	X	Texas			X
Louisiana		X	X	Utah		X	
Maine		X		Vermont		X	
Maryland		X		Virginia		X	
Massachusetts (e)		X	X	Washington	X		
Michigan (f)				West Virginia		X	X
Minnesota		X		Wisconsin		X	
Mississippi		X	X	Wyoming			X
Missouri		X	X	District of Columbia		X	
				Totals	1	45	25

a. *Net income base method.* In calculating the corporation business tax due in Connecticut using the net income base method, certain deductions and exclusions from the federal base are authorized by state law. For example, when a domestic corporation elects the foreign tax credit for federal

[58] Notes: "Gross receipts" include only general business taxes based on business gross receipts and do not include various special business taxes that also may be based on gross receipts, such as insurance gross premiums or utility taxes. Some corporate income tax bases have a capital stock component. Net worth is the assets of a business minus its liabilities.
(a) Two separate co rporation franchise taxes.
(b) Tax is on the highest of the two bases or the minimum tax. The income and capital bases are not combined.
(c) Two separate corporation taxes: income and franchise, which is based on capital stock outstanding. The corporate franchise tax is levied for the privilege of being incorporated in the state.
(d) Annual filing fee with secretary of state no longer based on value of capital stock; $30 fee for all corporations.
(e) Also has non-income measure of the tax based on tangible personal property or net worth allocable to the state.
(f) Single business tax, which is a modified value-added tax.
(g) Modified value-added tax.
(h) Net income base pertains primarily to taxation of general business corporations. Transportation and transmission companies (i.e. utilities) pay tax on gross receipts base.
(i) Limited income tax on certain banks and financial institutions.
(j) Two distinct corporate taxes: excise (income) tax and franchise tax imposed on higher of either apportioned capital stock or value of property owned and leased in the state.

income tax purposes, the amount that is treated as dividends received by the domestic United States corporation from a foreign corporation is excluded from gross income for state tax purposes. The revenue loss from this is about $25 million/year; the provision benefits fewer than 500 corporate taxpayers. Also, Net Operating Losses (NOL) can be deducted not just in the current tax year, but in future tax years. PA 99-173 extended Connecticut's NOL carry-forward period from 5 years to 20 years, resulting in additional foregone revenue; the estimated revenue loss in FY 02 was $50 million. Net Capital Losses also can be deducted and, like NOL, can be carried forward now for 20 years. The estimated revenue loss in FY 02 was $65 million. Capital gains income from the sale of open space or land to the state, a town, or a non-profit land conservation organization or water company also is exempted from tax. Revenue loss was $1 million in FY 02, with 10 taxpayers benefiting.

Additionally, corporate "tax sheltering"[59] is also *significantly* reducing the income some Connecticut corporations are reporting to the state.

As discussed in a recent report by the Multistate Tax Commission, *Corporate Tax Sheltering and the Impact on State Corporate Income Tax Revenue Collections* (July 15, 2003), corporate tax sheltering reduced state corporate income tax revenues nationally by more than a third (35%) in 2001. However, the report found Connecticut's 2001 loss in corporate income revenues *due to tax sheltering* to be even greater. It estimated that Connecticut lost $172 million in 2001 revenues --- *a 42% reduction in its corporation business taxes.* That is, without corporate tax sheltering, Connecticut corporation business tax revenues in 2001 would have been $585 million, rather than $413 million. These revenue losses *are in addition* to those that result from legislatively-enacted exemptions, deductions, exclusions, credits and rate reductions to the corporation business tax discussed throughout this report.

b. Capital base method. Tax due under Connecticut's capital base method is calculated as the total value of the corporation's average capital stock, surplus and undivided profits, and surplus reserves, less the corporation's average values of deficits and stockholdings in private corporations. The Capital Base is taxed at a rate of 3.1 mils ($0.0031) per dollar, up to a maximum tax of $1 million. Importantly, the maximum tax has not been adjusted for inflation. After an increase from $0.1 million to $0.5 million in 1987, it was last increased more than a decade ago (in 1992) to the current $1 million (PA 91-3, JSS). In addition, PA 98-110 excluded financial service companies from the capital base (while concurrently changing to a single sales factor apportionment formula for these companies).

c. Alternative Minimum Tax. If the total tax due under both the net income and capital base methods is less than Connecticut's Alternative Minimum Tax, corporations are required to pay the AMT, which currently is just $250 (with a 20% temporary surtax for income year 2003, bringing the

59 The report defines tax sheltering as "taxpayer reporting behavior that reduces tax payments to states below what would occur if each corporation calculates its net income through methods reviewed and approved by federal or state tax authorities, and each corporation reports income to each state in reasonable proportion to the business activity being conducted in that state." The report indicates that the majority of revenue losses identified in the analysis are linked to such "exotic" tax sheltering techniques as: a) "creating separate corporations to house 'intangibles' (e.g. trademarks) then siphoning profits away from taxation in the states in which companies actually do business;" b) "using complex interpretations of tax laws to create so-called 'no-where' income that is earned by a corporation but then not reported to states that impose corporate income taxes;" c) "reincorporating strictly for tax income purposes in Bermuda, or other 'tax havens';" or d) "shifting taxable income away from the U.S. to other nations through the pricing of goods and services involved in transactions between jointly-owned companies." Multistate Tax Commission, *Corporate Tax Sheltering and the Impact on State Corporate Income Tax Revenue Collections* (July 15, 2003), available at http://www.mtc.gov/statebudgetcrisis.html.

AMT to $300)[PA 03-2]. Until recently, however, even AMT liability could be extinguished through the use of tax credits [PA 02-1, MSS].

C. Apportionment. The general purpose of apportionment[60] is to avoid, reduce, or eliminate the risk of multiple taxation of multi-state business activity. The extent to which any state can tax an interstate business is regulated by the Commerce, Due Process and Equal Protection clauses of the United States Constitution and a specific federal statute (PL 86-272) that defines when a state's corporation business tax may be imposed on a multi-state business. Conn. Gen. Stat. §§12-218 to 12-218b specify how the net income of taxpayers that are taxable both within and outside Connecticut is to be apportioned. Connecticut law deems a taxpayer to be "taxable in another state" if the taxpayer is conducting business in the state and is subject to a net income tax, a franchise tax, or a corporate stock tax on that business *or* if the state "has jurisdiction to subject" the taxpayer to such a tax "regardless of whether such state does, in fact, impose such a tax."[61]

The policy issues surrounding *apportionment* are perhaps best understood through an illustration.[62] Imagine a profitable oil company with oil fields in 2 states, pipelines running through 15 states to refineries in 4 states, that in turn sell gasoline and deliver it by truck to gas stations in all 21 of these states. How does each of these 21 states decide which portion of that corporation's profits it is fair and appropriate to tax? The answer to this question varies by state, depending on the *apportionment formula* used.[63]

In the first half of the 20th century, states used a variety of apportionment formulae before converging toward a common standard, later incorporated in the 1957 Uniform Division for Income Tax Purposes Act (UDITPA). The three-factor formula that emerged placed equal weight on traditional "input" factors – capital (property) and labor (payroll) -- and on sales within the state. The UDITPA sought to establish uniformity in apportionment across states so that *all* income was taxed in *some* state, but no income taxed more than once, and so that states could be compensated in some measure for the services provided to corporations in the state. Under the UDITPA, income taxable in State A is determined by averaging the share of payroll, property, and sales in State A as compared to total payroll, property and sales in the states in which that corporation is taxable, then multiplying this percentage by the corporation-wide taxable income:

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60 "Apportionment" is to be distinguished from "allocation" which involves the attribution of certain types of business receipts of a multi-state business (usually investment income) to *one* taxing jurisdiction. The Uniform Division of Income for Tax Purposes Act (UDITP), developed by the Multi-State Tax Commission, distinguishes between income to be apportioned among taxing states and income, primarily from investments, to be entirely allocated to the state of a corporation's commercial domicile.

61 This definition, obviously, creates the possibility of there being some "no where" income – income that is taxed in no state at all. For example, if a Connecticut manufacturer does business in Connecticut and Washington, the fact that Washington does not impose a corporation business tax does not prevent the Connecticut corporation from apportioning its income. Because Connecticut has single sales factor apportionment for manufacturing, this corporation would be taxed *only* on sales made within Connecticut. Income from sales anywhere else would totally evade tax -- in Washington because there *is* no corporate business tax there, and in any other state because sales into a state alone do not create sufficient "nexus" to make a company subject to a corporate business tax.

62 This illustration is drawn from a presentation by Michael Mazarov, *The 'Single Sales Factor' Formula for State Corporate Taxes: A Boon to Economic Development or a Costly Giveaway?* (Center on Budget and Policy Priorities, December 2000).

63 All apportionment formulae presume that a corporation's business income is known. However, as discussed earlier, in the case of multi-tiered, multi-state/multi-national corporations, the nature of the filing unit, as defined by state tax law, interacts with the apportionment formula in affecting state-by-state business tax liability. States vary considerably as to whether they permit or require a corporation to file on a consolidated, combined, unitary, or separate basis.

$$\text{Taxable Income in CT} = \left[\frac{\dfrac{\text{CT Payroll}}{\text{Total Payroll}} \quad \dfrac{\text{CT Property}}{\text{Total Property}} \quad \dfrac{\text{CT Sales}}{\text{Total Sales}}}{3}\right] \times \text{Total Taxable Income}$$

Most states have used this 3-factor formula for determining their taxable share of corporate profits, weighing equally the in-state shares of property, payroll, and sales. Under this formula, a company with 10% of its property, 50% of its payroll, and 60% of its sales in Connecticut would have 40% of its corporate profit taxable in Connecticut ((10+50+60)/3=40).

The United States Supreme Court has held that variants of this apportionment formula do not constitute an undue burden on interstate commerce, and so are constitutional.[64] To promote in-state investments, increasing numbers of states began to adopt an apportionment formula that places extra weight on the sales factor, most commonly double-weighting sales. This favors corporations with significant out-of-state sales. In 1982, Connecticut changed to a double-weighted sales apportionment formula. As shown in the following table, half the states now use a double-weighted sales formula:

State Apportionment of Corporate Income (as of January 1, 2003)

State	Formula	State	Formula	State	Formula
Alabama	3 Factor	Kentucky	Double Wtd. Sales	North Dakota	3 Factor
Alaska	3 Factor	Louisiana	Double Wtd. Sales	Ohio	60% sales, 20% property, 20% payroll
Arizona	Double Wtd. Sales	Maine	Double Wtd. Sales	Oklahoma	3 Factor
Arkansas	Double Wtd. Sales	Maryland	Double Wtd. Sales	Oregon [65]	Double Wtd. Sales
California	Double Wtd. Sales	Massachusetts	Double Wtd. Sales/Sales	Pennsylvania	Triple Wtd. Sales
Colorado	3 Factor/Sales & Property	Michigan	90% sales, 5% payroll, 5% property	Rhode Island	3 Factor
Connecticut	Double Wtd. Sales/Sales	Minnesota	75% sales, 12.5% property, 12.5% payroll	South Carolina	Double Wtd. Sales/Sales
Delaware	3 Factor	Mississippi	Accounting/3 Factor	Tennessee	Double Wtd. Sales
Florida	Double Wtd. Sales	Missouri	3 Factor/Sales	Texas	Sales
Georgia	Double Wtd. Sales	Montana	3 Factor	Utah	3 Factor
Hawaii	3 Factor	Nebraska	Sales	Vermont	3 Factor
Idaho	Double Wtd. Sales	New Hampshire	Double Wtd. Sales	Virginia	Double Wtd. Sales
Illinois	Sales	New Jersey[66]	Double Wtd. Sales	West Virginia	Double Wtd. Sales
Indiana	Double Wtd. Sales	New Mexico	Double Wtd. Sales	Wisconsin	Double Wtd. Sales
Iowa	Sales	New York	Double Wtd. Sales	District of Columbia	3 Factor
Kansas	3 Factor	North Carolina	Double Wtd. Sales		

Source: Federation of Tax Administrators, *State Apportionment of Corporate Income* (February 2003). Note: South Dakota, Washington, and Wyoming have no state corporate business tax. The formulae listed here are for general manufacturing businesses. Some industries have formulae that differ from those reported in this table.

[64] For example, the United States Supreme Court sustained the constitutionality of Iowa's single factor apportionment formula based on sales (at destination) of tangible personal property in Moorman Mfg. v. Bair, 437 US 267 (1978).

[65] Effective May 1, 2003, formula weights will be 80% sales, 10% property and 10% sales.

[66] New Jersey uses a 3-factor formula for corporations not subject to the corporation business franchise tax.

More recently, some states, including Connecticut, have sought to promote in-state economic development by placing even greater emphasis on sales, adopting a *single* sales factor formula for certain corporations. That is, the share of a corporation's payroll and property in Connecticut is not even considered in apportioning taxable income.

Connecticut is now one of just eight states that have adopted a single sales factor formula (SSFF) for at least manufacturers.[67] Connecticut's adoption of single sales factor apportionment formulas[68] has been incremental, and now extends to multiple industries:

- 1996 - Applied to management, distribution or administrative services to or on behalf of certain regulated investment companies and to security brokerage services (PA 96-111)
- 1998 – Applied to credit card income from certain banks that issue credit cards (PA 97-4, June Special Session)
- 1999 – Applied to financial service companies (and excluded such companies from the capital base alternative) (PA 98-110)
- 2001 – Applied to manufacturers (eff. 1/1/01) and to broadcasters (eff. 10/1/01) (PA 00-170)

OFA has estimated a loss of $60 million in corporate tax revenues in FY 02 resulting from the change from a double-weighted sales factor formula to a single sales factor formula for credit card, manufacturing, and broadcasting industries; it estimates that less than 50 taxpayers benefit from these changes.[69]

The single sales factor apportionment formula has been promoted as an economic development tool that encourages businesses to locate or expand physical plant and payroll in a state, by making the share of these factors (as compared to the corporation's *total* plant and payroll) immaterial in the apportionment of taxable income. Thus, for corporations existing in a state, moving to a single sales factor formula removes any tax-based disincentive to increasing jobs or expanding physical plant.[70]

It is clear, however, that there are corporate "winners" and "losers" when the change is made from a three-factor formula to one that double-weights sales, or relies on sales only. The shift primarily benefits manufacturing plants and industries that are particularly "export-oriented" (making most of their sales out-of-state). By comparison, state-based corporations that have more of their sales in Connecticut can be harmed. The following table illustrates this point, showing the portion of income that would be taxed in Connecticut for two Connecticut-based manufacturers operating at either extreme –*only* in-state sales and *only* exports – under the 3 common apportionment formula:

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[67] The states with single sales factor apportionment for at least manufacturers include Connecticut, Iowa, Massachusetts, Nebraska, Illinois, Maryland, Missouri, and Texas. See Michael Mazarov, *The "Single Sales Factor" Formula for State Corporate Taxes: A Boon to Economic Development or a Costly Giveaway?* (Center on Budget and Policy Priorities, 2001).

[68] Depending on the industry, "sales" are defined in different ways.

[69] OFA, *Synopsis of Tax Reductions to Businesses and Worker's Compensation Reductions* (January 4, 2001).

[70] Under a three-factor formula, the corporation business tax due Connecticut from a *multi-state* corporation located in Connecticut would increase when the corporation adds jobs or adds to its plant or equipment. Under single sales factor, there is no change. Hence, basing apportionment solely on in-state sales is said to reduce disincentives to invest growing a business in Connecticut.

Fraction of Income That is Taxable In Connecticut (assuming all output is either sold within CT or is exported for sale outside CT)		
	CT Manufacturer That Sells In-State Only	CT Manufacturer That Exports Only
Equally-weighted 3 factor formula (property, payroll, sales in state)	100%	66.7% (2/3)
Double-weighted sales formula	100%	50%
Sales-only apportionment	100%	0

In short, the net effect of placing greater weight on sales in an apportionment formula is to reduce the tax paid on income associated with exports, while leaving the tax on income associated with in-state sales unaffected. That is, with sales-only apportionment, a Connecticut corporation pays *no* tax in Connecticut if it exports *all* of its output out of state, but pays tax on *all* its income if it sells its product just in Connecticut.[71] To the extent that corporate business taxes are passed on to consumers, this results in Connecticut consumers paying more for products produced by Connecticut corporations, and out-of-state consumers paying less.

The single sales factor apportionment formula also benefits only Connecticut corporations in the specified industries that have a *multi-state* presence, markedly reducing taxes owed by such corporations. This places a greater burden for financing state government on our smaller, exclusively Connecticut-based businesses and individuals.[72] The exception to this is for financial services companies that, since 1998, have been allowed to "apportion" their income even if they are taxable *only in Connecticut.* Conn. Gen. Stat. §12-218b.[73]

Ironically, the Connecticut Department of Revenue Services' *Factor Relief for Manufacturers Ad Hoc Committee Final Report* (January 2000), produced at the request of Speaker Moira Lyons to consider various apportionment "relief" alternatives including "the possible enactment of a single factor formula," noted:

> [O]ver 90% of the manufacturers in Connecticut have 100 or fewer employees, and it is likely that a large number of such small manufacturers do not now qualify for apportionment of their income. Accordingly, 100% of their income is taxable by the State of Connecticut.

71 The advantage given to corporations increases as the proportion of their total sales that are exported increases. The example used presents the two extremes only, for the sake of graphic illustration of the point.

72 M. Mazerov, *The "Single Sales Factor" Formula for State Corporate Taxes: A Boon to Economic Development or a Costly Giveaway?* (Center on Budget and Policy Priorities, 2003).

73 Connecticut's financial services companies, therefore, have been given a benefit not accorded to other types of corporations subject to Connecticut's corporation business tax. *Whether or not* they are taxable only in Connecticut or are taxable in other states, they "apportion" their net income by multiplying the income by "the receipts factor" which is the proportion of Connecticut receipts as compared to total receipts. Financial services companies taxable only in Connecticut thus are taxed only on the share of their sales that are in-state, and avoid tax totally on sales made out-of-state. While this may create "parity" with financial services companies that are taxable by more than just Connecticut, it creates inequality as compared to other Connecticut industries.

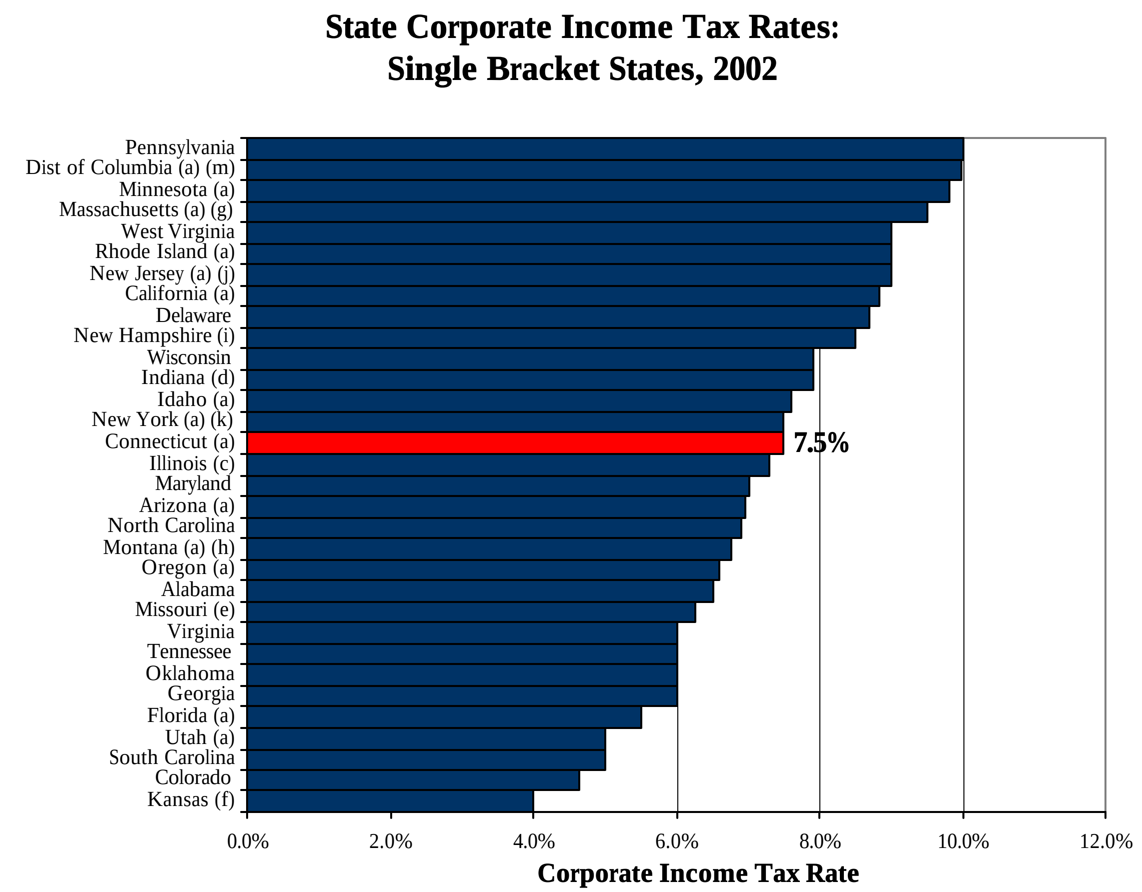
That is, none of these small Connecticut manufacturers would benefit from single sales factor apportionment; the benefit is limited to corporations that are taxable in more than one state and thus are permitted to apportion their income under Conn. Gen. Stat. §12-218.

Importantly, *all* corporations with physical plant and payroll in Connecticut rely on Connecticut services and infrastructure to do business. Single-factor apportionment unfairly exempts from the responsibility for helping to pay for these services the corporations in specified industries that have more of their sales out of state and *all* financial services companies. It also places corporations with primarily in-state sales at a competitive disadvantage. Indeed, two prominent tax experts have argued that "sales-only" apportionment rules violate international trade rules that prohibit subsidies for export sales.[74] Moreover, it places more of the burden for financing state-funded services on companies in industries other than these now accorded this preferential treatment.

D. Tax Rates. The tax rate is applied to the taxable income of a business subject to tax in a state to determine tax due (*before* off-setting tax credits). The rates applied when taxing corporate income vary significantly among states, from 4% in Kansas, to 10% in Pennsylvania and the District of Columbia. Connecticut's 7.5% rate places it solidly mid-range among states with a single tax bracket (see chart below). Among the thirteen states with multiple brackets,[75] Connecticut's 7.5% rate is lower than the highest bracket in ten states. The highest maximum rate is Iowa's 12.0%.
The following chart illustrates these comparisons:

74 C. McLure & W. Hellerstein, Does Sales-Only Apportionment Violate International Trade Rules? *State Tax Notes* (September 8, 2002). Mr. McClure is a senior fellow with the Hoover Institution at Stanford University. Mr. Hellerstein is a tax professor at the University of Georgia. The authors also suggest that in some instances the formula also could constitute a tax on imports that is also prohibited by international trade rules.

75 The states with *multiple* corporate income tax brackets as of January 1, 2003 are: Alaska (10 brackets from 1.0% to 9.4%, with lowest bracket at $10,000 and highest at $90,000); Arkansas (6 brackets from 1.0% to 6.5%, with lowest bracket at $3,000 and highest at $100,000); Hawaii (3 brackets from 4.4% to 6.4%, with lowest bracket at $25,000 and highest at $100,000; capital gains are taxed at 4% and there is an alternative tax of 0.5% of gross annual sales); Iowa (4 brackets from 6.0% to 12.0%, with lowest bracket at $25,000 and highest at $250,000); Kentucky (5 brackets from 4.0% to 8.25%, with lowest bracket at $25,000 and highest at $250,000); Louisiana (5 brackets from 4.0% to 8.0%, with lowest bracket at $25,000 and highest at $250,000); Maine (4 brackets from 3.5% to 8.93%, with lowest bracket at $25,000 and highest at $250,000; there is alternatively a 27% tax on Federal Alternative Minimum Taxable Income); Mississippi (3 brackets from 3.0% to 5.0%, with lowest bracket at $5,000 and highest at $10,000); Nebraska (2 brackets – 5.58% and 7.81% -with upper bracket at $50,000); New Mexico (3 brackets from 4.8% to 7.6%, with lowest bracket at $500,000 and highest at $1,000,000); North Dakota (6 brackets from 3.0% to 10.5%, with lowest bracket at $3,000 and highest at $50,000); Ohio (2 brackets – 5.1% and 8.5%, with highest at $50,000. Alternatively, 4.0 mills times the value of the taxpayer's issued and outstanding shares of stock, with a maximum payment of $150,000. An additional litter tax is imposed equal to 0.11% on the first $50,000 of taxable income, 0.22% on income over $50,000, or 0.14 mills on net worth); and Vermont (4 brackets from 7.0% to 9.75%, with lowest bracket at $10,000 and highest at $250,000). Federation of Tax Administrators, *Range of State Corporate Income Tax Rates* (February 2003).



Source: Federation of Tax Administrators, cited in Forsberg, 2003.

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[76] The structure of the Michigan and Texas corporate tax systems do not lend themselves to comparison with other states. Three other states – Nevada, Washington, and Wyoming –do not levy corporate income taxes. Notes for the chart are as follows:

(a) An alternative minimum tax applies in Alaska, Arizona, California, Connecticut, Florida, Idaho, Iowa, Maine, Massachusetts, Minnesota, Montana, New Jersey, New York, Ohio, Oregon, Rhode Island, Utah, Vermont and the District of Columbia.

(b) In Hawaii, capital gains are taxed at 4%. There is also an alternative tax of 0.5% of gross annual sales.

(c) In Illinois this includes a 2.5% personal property replacement tax.

(d) In Indiana this consists of 3.4% on income from sources within the state plus a 4.5% supplemental income tax.

(e) In Iowa and Missouri 50% of the federal income tax is deductible.

(f) In Kansas this includes an additional surtax of 3.35% on taxable income over $50,000.

(g) In Massachusetts the rate includes a 14% surtax.

(h) In Montana this includes a 7% tax on taxpayers using water's edge combination.

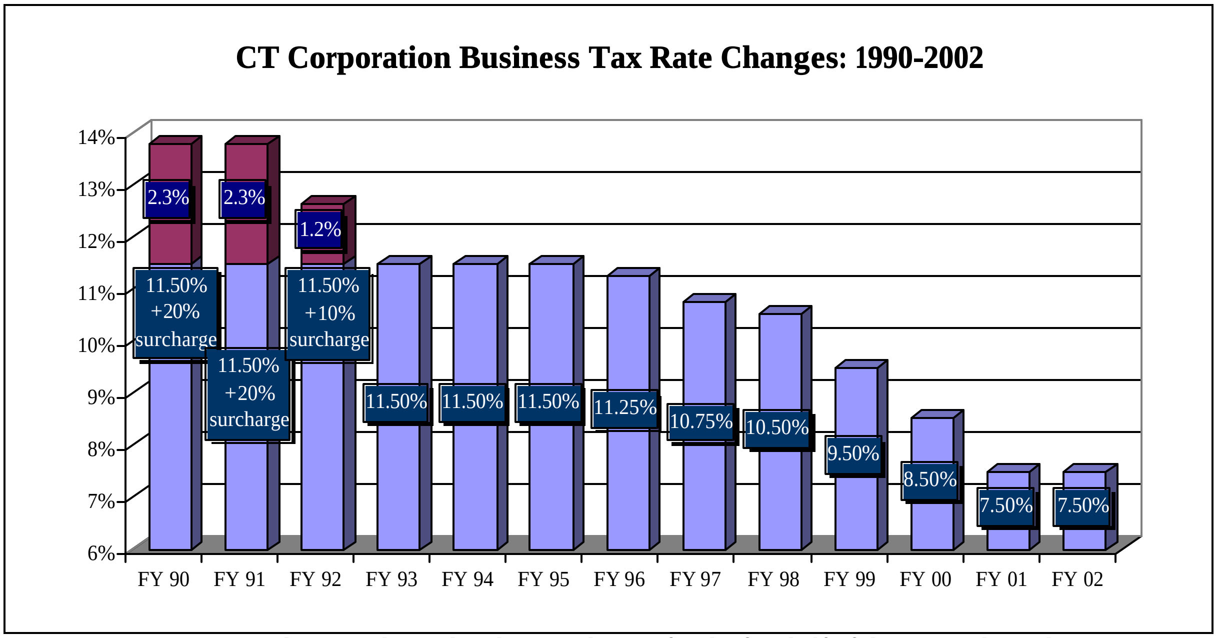
(i) In New Hampshire this includes an additional 0.5% tax on the enterprise base (total compensation, interest and dividends paid). Business profits tax is imposed on both corporations and unincorporated associations.

(j) In New Jersey the corporation business tax is a franchise tax measured by net income. Effective 1/1/02 there are three rates: 6.5% for corporations with net income below $50,000, 7.5% for those between $50,000 and $100,000 and 9% for corporations with net income over $100,000.

(k) In New York, the alternative is 1.78 mills per dollar of capital up to $350,000 or 3.0% of the minimum taxable income, or a minimum of $100 to $1,500 depending on payroll size if any of these is greater than the tax computed on net income. Small corporations with income under $200,000 pay a 7.5% tax on all income.

Note that in comparing states it is not sufficient to compare only *statutory* tax rates. The *effective* tax rates (ETR) are even more significant, and vary depending on available exemptions and deductions. In four states, for instance, federal corporate income taxes are deductible from income in calculating state taxes. These differences can be more significant in determining final tax liability than a one or two percentage point difference in the statutory tax rate.

During the prosperous 1990s, eight states, including Connecticut, reduced their corporate business tax rates, while two – New Hampshire and Vermont – raised their rates. Changes in Connecticut's corporate business tax rate can be seen in the figure that follows:



Note: For FY 1995-2000, the rates changed mid-year. The rate for the first half of the year is shown here.

As noted on the chart above, in FY 90 and FY 91 there was a 20% surtax on the corporation business tax; in FY 92, a 10% surtax.

What is noteworthy is that Connecticut's current corporation business tax rate is -- at 7.5% -- the lowest it has been in at least the last 30 years.[77] Yet, after taking available exemptions, deductions

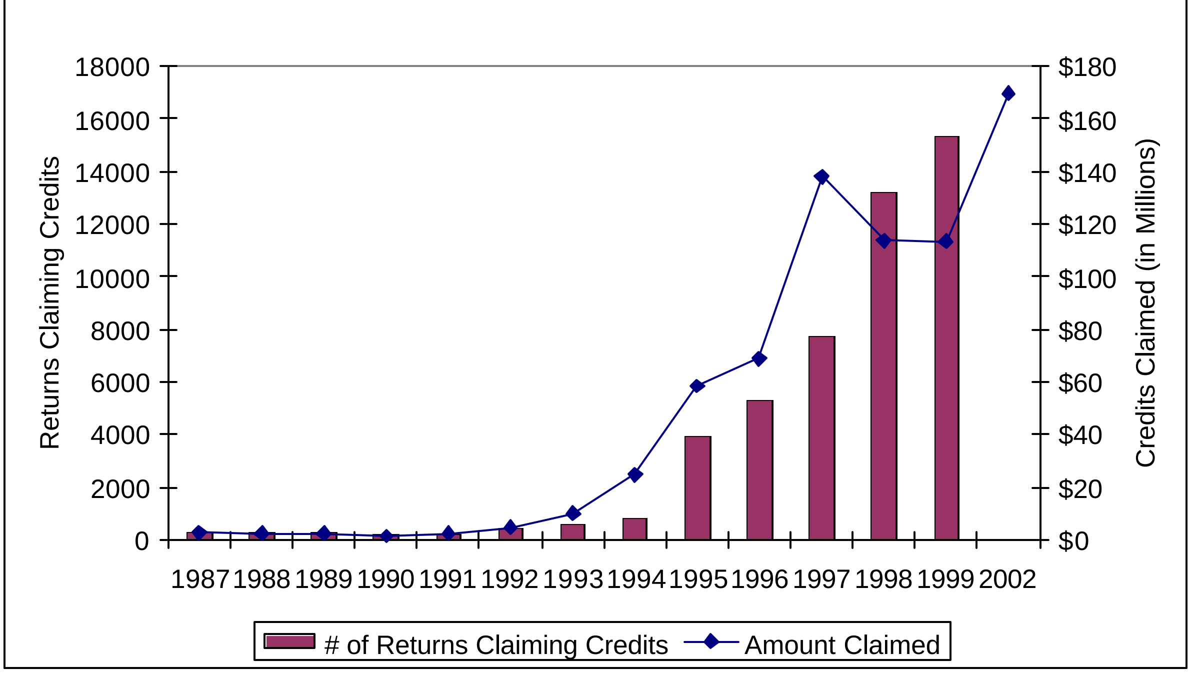
(l) In Ohio, the alternative is 4.0 mills times the value of the taxpayer's issued and outstanding share of stock with a maximum payment of $150,000. An additional litter tax is imposed equal to 0.11% on the first $50,000 of taxable income, 0.22% on income over $50,000; or 0.14 mills on net worth.

(m) In District of Columbia, effective Jan. 1, 2003, the tax rate decreased to 9.45%.

[77] Between 1972-1975, the corporation business tax rate was 8%. From 1976-1983 it was 10% and from 1984-1995 11.5% (with a 20% surtax in 1990-91 and a 10% surtax in 1992). Beyond the rate reduction in the corporation business tax over the 1990s, Connecticut corporations also benefited from the change in our personal income tax insofar as it reduced the tax on dividend income, making such income more attractive to investors. The top tax rate on dividend income in Connecticut was 9% from 1978-1983, increased to 13% from 1984 to 1986, declined to 12% from 1987 to 1989, and then increased again to 14% from 1990 to 1991. When the personal income tax was passed in 1991, however, the dividends tax was repealed; all dividend income is now subject to the much lower personal income tax rate. If one looks at the *combined* corporation business tax rate and dividends tax rate, one sees the full impact of these changes. In 1990-1991, the corporation business tax rate was 13.8% (11.5% and a 20% surtax) and the top dividends tax rate was 14% -- a total of 27.8%. In 2002, the corporation business tax rate was 7.5% and the top personal income tax bracket

and credits, many of Connecticut's largest corporations will end up paying far less than 7.5% of their profits in corporation business taxes.

E. Tax Credits. Connecticut offers an increasing number of corporation business tax credits that reduce corporation business tax liability. Over the period 1987 to 2002, the *number* of credits has increased, as have the number of returns claiming these credits and the total amount claimed in credits. The following chart illustrates this point:



CT Corporate Tax Credit Growth: 1987-99

In 1987, there were just nine tax credits to offset the Corporation Business Tax[78] and 289 returns claimed one or more of these credits, reducing tax liability by a total of $2.71 millions. By 1999, there were 22 tax credits, with 15,313 returns claiming credits, reducing tax liability by a total of $113.29 million. That is, over 12 years, the number of available tax credits increased from 9 to 22, the number of returns claiming tax credits increased from 289 to 15,313, and the amount claimed as credits – offsetting dollar-for-dollar Connecticut's corporation business tax revenues – increased from $2.71 million to $113.29 million. The credits for which the largest total sums were claimed in 1999 were: a) the fixed capital credit (6,055 returns, $37.4 million claimed); b) the electronic data processing credit (6,329 returns, $29.3 million); c) the research & development credit (279 returns, $15.2 million); and d) the research & experimentation credit (192 returns, $13.6 million).[79]

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was 4.5% -- a total of just 12%, and for "pass-through" corporations the maximum tax rate was just 4.5%. OFA, *Revenue and Budget Data* (March 2002), pp. 77-88.

[78] The credits were: Neighborhood Assistance; New Facilities (in distressed municipalities); Industrial Waste; Apprenticeship; Enterprise Zones, Air Pollution Abatement; Work Education; Child Day Care; and Rental Housing.

[79] CT Department of Revenue Services, *2000-01 Annual Report*, p. 44.

Since 1999, the revenues lost through credits against the corporation business tax have continued to climb. OFA's 2002 *Connecticut Tax Expenditure Report* estimated a $169.5 million revenue loss in FY 02.[80] Credits claimed in FY 02 include:[81]

Tax Credits	Initial Enactment[82]	Est. FY 02 Revenue Loss ($M)
Enterprise Zones	1978	$0.6
New Manufacturing Facilities Located in Enterprise Zones	1978	$2.0
Apprenticeship Training	1979	$0.5
Low and Moderate Income Housing/Rental Housing Program	1979	$2.5
Neighborhood Assistance Act	1982	$2.5
Vehicles Powered by Clean Alternative Fuels or Electricity	1991	$0.5
Research and Experimentation Expenses	1992	$20.0
Research and Development Expenses	1993	$20.0
Technology-Related Research Grants to Higher Education	1992	$0.3
Employer Assisted Housing Credits	1993	$0.5
Small to Medium Sized Companies Capital Goods Expenditures	1993	$8.0
For Property Tax Paid on Data Processing Equipment	1994	$35.0
Fixed Capital Investment	1997	$40.0
Human Capital Investment	1997	$3.0
Donation of Land for Open Space or Watersheds	1999	$0.1
Guarantee Fees Paid When Obtaining SBA Financing	1999	$0.1
For Rehabilitation of Historic Homes	1999	$1.0
Refund of "Unused" R&D and R&E Credits at 65% of Value	1999	$30.0
Donation of New or Used Computers to Local Schools	2000	$0.5

Importantly, Connecticut's R & D and R & E credits now not only can be used to *reduce* corporation business tax liability, but also can actually be "cashed in." For income years beginning January 1,

80 Credits available in FY 02 that were not available in FY 99 include a credit for the donation of new or used computers to schools (revenue loss in FY 02 of $0.5 million) and the sale-back to the state at 65% of value of "unused" R&D and R&E credits (revenue loss in FY 02 of $30 million).

81 This is the list of credits in OFA's *Connecticut Revenue and Budget Data* (March 2002), p. 93. It does not include all possible credits against the corporation business tax. There are, for example, also tax credits for employing persons who are receiving benefits from Connecticut's Temporary Assistance program, tax credits for expenditures related to traffic reduction programs, and tax credits "for financial institutions constructing new facilities and creating new jobs" (Conn. Gen. Stat. §12-217u) targeted for UBS Warburg (then called Swiss Bank). The latter, enacted in 1994 and 1995, made a company eligible for up to $120 million in tax credits against up to 50% of its corporation tax for 10 years if it: a) constructed a new facility in Connecticut for direct or indirect corporate purposes with at least 900,000 square feet; b) received a temporary certificate of occupancy for the building; and c) employed an average of 2,000 "qualified" employees during the year it claims a credit (to be able to claim a 50% credit. A smaller credit can be claimed if the number of employees is less). The company was also eligible for up to $145 million in additional credits through a 25% credit against its corporation tax for the following five consecutive years if it employed at least 3,000 "qualified" employees in year 10 through year 15. A person was to be counted as a "qualified" employee if the person was employed by the corporation (or a related person) or an independent contractor of that firm or a related firm and worked an average of at least 35 hours/week for "at least 8 consecutive weeks." See OFA, *State Assistance for Warburg Dillon Read* (2000-R-0425).

82 Many of these tax credit provisions were amended after initial enactment. For a comprehensive history, see OLR, *Tax Changes 1991-2002* (2002-R-0884, November 1, 2002), pp. 19-26.

2000, qualified small businesses (i.e., gross sales less than $70 million) that have no or inadequate tax liability to fully use their R & D or R & E credits may "exchange" the unused amounts of the credits for a cash payment from the state equal to 65% of the value of the credit. Alternatively, they may carry the credits forward at full value until fully used. These "refundable" credits – which are in practical effect no different from cash grants to these corporations – were projected to "cost" the state $0.2 million when adopted (PA 99-173).[83] In FY 02, OFA estimated the revenue loss from these refundable credits to be $30 million.

Credits that grew most markedly between FY 99 and FY 02 are as follows:

Credit	**Amount Claimed in FY 99 ($M)**	**Estimated Claim in FY 02 ($M)**
For Research and Experimentation	$13.6	$20.0
For Personal Property Tax Paid on Data Processing Equipment	$29.3	$35.0
For Research and Development	$15.2	$20.0
For Fixed Capital Investment	$37.4	$40.0
For Sale of "Unused" R&D and R&E Credits	$0	$30.0
Source: CT Department of Revenue Services, *2000-01 Annual Report*, p. 44; Office of Fiscal Analysis, *Connecticut Tax Expenditure Report* (2002), p. 10.		

Some believe the state spending cap and state debt limit[84] have contributed to the acceleration in the number of credits enacted in the late 1990s to promote economic development. Were these $169 million in credits in FY 02 given instead to businesses through direct cash grants, this sum would have counted against the state spending cap. Further, if such economic development aid were provided, instead, through bond funds, it would have counted against the state debt limit. Using tax credits for economic development avoided both constraints.

There are at least three problems with relying on tax credits for economic development assistance, however.

First, the use of credits (rather than grants and loans) reduces markedly the transparency and accountability of Connecticut's these economic development assistance efforts. Neither the public, nor legislators, know *which* corporations claimed *what* credits and *how much* in credits they claimed. Currently, state corporation business tax returns, even for publicly-traded corporations, are not public documents. Also, unlike with grants and loans provided through DECD (for example) there is rarely any agreement between a corporation claiming tax credits and the state regarding what the corporation is expected to do to receive the financial benefit (e.g., create a certain number of new jobs). Indeed, there typically is *no* process to monitor if Connecticut got *anything* at all in return for its investment.

83 OFA Fiscal Note for SB 1 - An Act Concerning Various Tax Reductions, Exemptions and Credits for Individuals and Businesses (PA-99-173).
84 For a description of the state spending cap and debt limit, see S. Geballe, *A Citizen's Guide to the Connecticut State Budget* (2002), pp. 20-22, available at www.ctkidslink.org.

Second, with a few exceptions, the tax credits are not capped. As a result, the potential for revenue loss is virtually unlimited in any given year.

Finally, the credits themselves are not periodically reviewed, as direct expenditures would be, to assess if they are still consistent with state budgetary needs.

In short, such credits are rapidly-growing *entitlements.* They provide eligible corporations a virtual "blank check" in perpetuity, with *no* oversight.

F. Alternative Minimum Tax (AMT). Eighteen states and the District of Columbia impose an "alternative minimum tax" (AMT) that is owed if the tax due yields less than the AMT amount. In Connecticut, the AMT has been $250 since 1982 when the AMT was increased from $50 (the AMT was temporarily reduced to $100 between 1986 and 1989). In 1999, more than two-thirds of Connecticut's corporations paid only this $250 AMT.[85] If Connecticut's AMT merely had been adjusted for inflation, it would now be $477.20 and revenues from this *de minimus* tax would nearly double.

Over the 1990s, a number of corporations were exempted from paying even this modest $250 tax,[86] and, until recently, corporations could use tax credits to offset even this modest minimum tax. PA 02-1 (May Special Session)(sec. 55) changed this. It bars corporations from using tax credits to reduce their minimum corporate tax to less than $250. It also requires each corporation included in a combined return to pay the minimum tax and repealed the exemption from the minimum tax for financial services companies.

VI. What Other Taxes Are Paid by CT Corporations?

While this report focuses on the corporation business tax, it is important to recognize that Connecticut corporations pay various taxes to state and local governments *in addition to* the corporation business tax.

Like individual taxpayers, corporations pay sales/use, property,[87] and real estate conveyance taxes. They also may pay some taxes that are unique to businesses (e.g., the unemployment benefit tax), while they would not pay other taxes specific to individuals (e.g., the inheritance tax).

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85 New Jersey found that 77% of its 262,341 corporations paid only the AMT of $200 in 1999, and 70% of these corporation were viable businesses, engaged in real economic activity, and not shell corporations. 30 of New Jersey's 50 *largest* corporations paid only the AMT. M. Forsberg, *A Question of Balance* (New Jersey Policy Perspective), p. 19.

86 The exempted corporations include foreign corporations whose sole activity in Connecticut is trading stocks and securities for its own account (e.g., UBS Warburg)(PA 98-244).

87 Businesses pay property tax on their real property (land and improvements permanently attached to it) and, in most states, also pay property taxes on some personal property (i.e., all property, tangible or intangible, that is *not* real property). There are, however, numerous exemptions from the property tax for various types of personal property: business inventories are exempt in 38 states, *all* commercial/industrial personal property is exempt in 10 states, intangible personal property (e.g., equities, bonds, copyrights, patents) are exempt to some extent in 33 states (though the income flow is then commonly taxed under a broad-based income tax). M. Beaumont, "Property Tax" in J. Cordes, R. Ebel, & J. Gravelle (eds.), *The Encyclopedia of Taxation and Tax Policy* (Urban Institute, 2000). Importantly, nearly three-quarters of all states (36 states) impose some *statewide* property tax; Connecticut's property tax is imposed only locally.

Connecticut's Department of Revenue Services administers most of Connecticut's state-wide taxes,[88] although other business-related taxes and fees may be imposed by other state agencies as well. For example, the Department of Labor assesses the Unemployment Benefit Tax[89] and the Department of Consumer Protection requires licensing fees for some 115 occupations.[90] In addition, municipalities impose property taxes on businesses, as well as individuals.

A. How Much Of Connecticut's Other Taxes Do Corporations Pay? While it is not difficult to identify the various *types* of taxes to which corporations may be subject, it is far more difficult to determine what is businesses' share of all these taxes.

For some taxes, the amount and share paid by corporations can easily be discerned.[91] For example, estimated revenues in FY 03 (before refunds) from taxes on the various public service corporations are estimated to be $197.3 million, from the insurance companies taxes $238.3 million, and from petroleum companies taxes $116.0 million.[92]

Property Tax. There *are* useful data on the amount and share of local property tax paid by businesses. In FY 02, for example, a total of $6.086 billion was paid to Connecticut's 169 cities and towns in local property taxes. Of this, *about one-quarter* ($1.542 billion) was paid by businesses and the rest by families.[93] As the following map illustrates, the proportion of each town's property taxes that come

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88 State of Connecticut, Department of Revenue Services, *Annual Report 2000-01* (*available at:* http://www.drs.state.ct.us/01annualsection1.htm) lists the various taxes that generated revenues in Connecticut in FY 01: admissions/dues/cabaret tax, alcoholic beverages tax, automobile rental surcharge, cigarette tax, community antenna TV systems companies tax, controlled substances tax, controlling interest transfer tax, corporation business tax, dry cleaning storage surcharge, electric and power companies tax, estate tax & fiduciary estate tax, gas companies tax, gas and electric companies tax, gift tax, hazardous waste tax, health care centers tax, hospital gross earning tax, income tax, inheritance tax, domestic insurance companies tax, foreign insurance companies tax, motor carrier fuels tax, motor vehicle fuels tax, motor vehicle rental surcharge, occupational tax, petroleum companies gross earnings tax, real estate conveyance tax, sales & use tax, solid waste tax, tobacco products tax, tourism account surcharge, unauthorized insurers tax, and unrelated business income tax. Of the $9.986 billion in taxes collected in FY 01, 79% were attributable to the personal income tax and the sales & use tax. The hazardous waste assessment and hospital gross earnings tax were repealed in 2000.

89 See http://www.ctdol.state.ct.us/uitax/txmenu.htm.

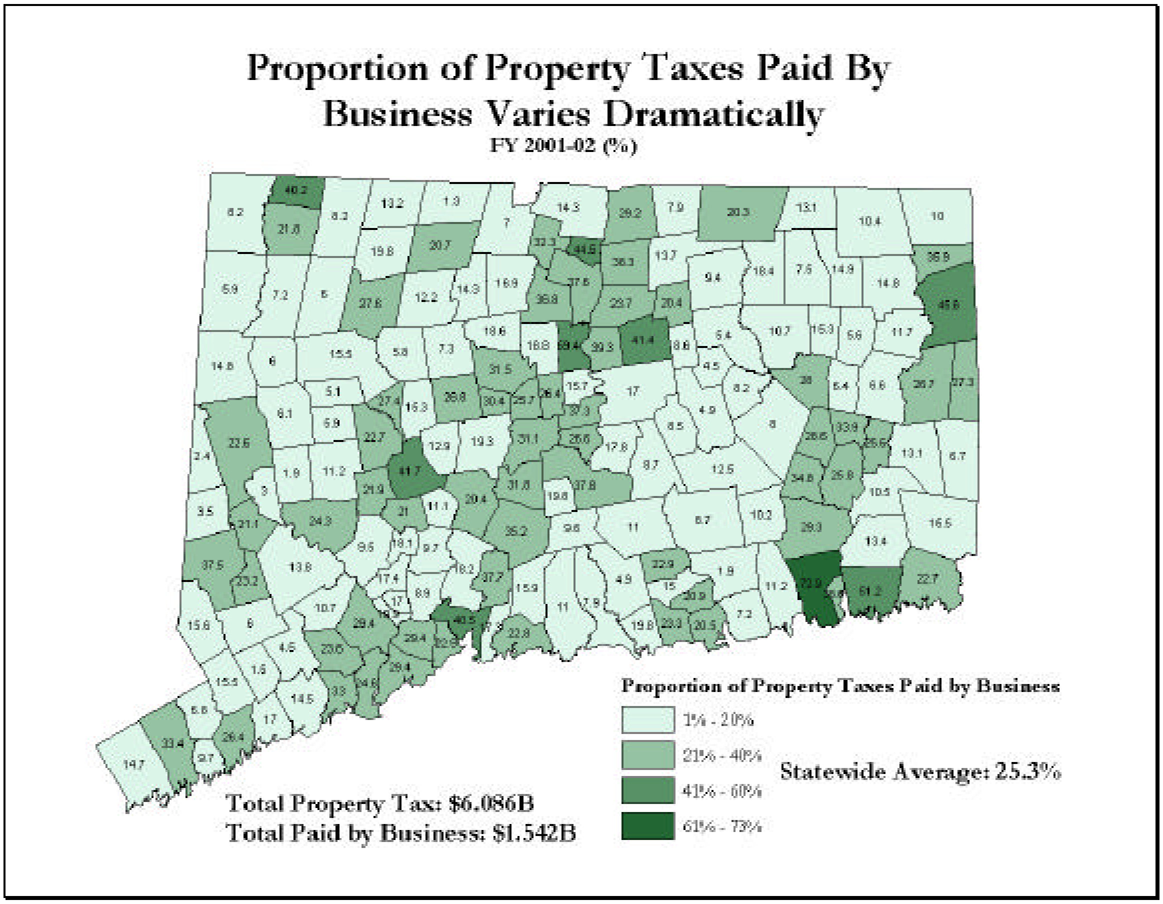
90 Since many of these licenses must be renewed at least annually, they could be characterized as a tax. See http://www.dcp.state.ct.us/licensing/all.htm

91 Economists are quick to note, however, that taxes "paid" by corporations are ultimately borne by individuals – whether they be by employees through lower wages, customers through higher prices, owners through lower profits, and/or investors through lower rates of return. The Minnesota Department of Revenue, for example, which regularly analyzes the incidence of Minnesota's state and local taxes, found in 2000 that 32% of business real property taxes were ultimately borne by consumers, 2% by labor, 24% by "capital," and 42% by nonresident shareholders, while sales taxes were borne 55% by consumers, 9% by labor, 8% by capital and 28% by nonresidents, and the corporation franchise tax was borne 42% by consumers, 8% by labor, 3% by capital, and 47% by non-residents. Minnesota Department of Revenue Services, Tax Research Division, *2003 Minnesota Tax Incidence Study* (March 2003), available at http://www.taxes.state.mn.us/legal_policy/other_supporting_content/whole_doc_feb2003.pdf.

92 Office of the State Comptroller, *July 1, 2003 Monthly Report*, Exhibit C.

93 Grand List data for FY 01-02 (Grand List Year 2000) from Office of Policy and Management, *Total Grand Lists by Town, 2000*, http://www.opm.state.ct.us/igp/DATARESC/glsum95.htm. Corresponding mill rates and business property tax data were provided by the Connecticut Conference of Municipalities in correspondence (April 14 & 23, 2003). Note: The share of local property taxes paid by Connecticut businesses is markedly less than the share of Massachusetts' local property taxes paid by its businesses. A study by Ernst & Young (released by the Associated Industries of Massachusetts on June 24, 2003) reported that businesses paid 51% of Massachusetts' local property taxes and 38% of its sales taxes.

from businesses varies widely across Connecticut's 169 cities and towns – from about 73% in Waterford to just 1% in Hartland.[94]



Sales/Use Tax. For other taxes like the sales and use tax, the task of determining the share and amount of taxes paid by businesses is more difficult. For example, if the owner of a small business buys a copy machine at Office Max, Office Max does not record and report to DRS whether that machine is to be used by the owner in his home for his personal use, or in the owner's business. Office Max simply reports the tax paid on the sale of the copier. Consequently, DRS cannot report what percentage of Connecticut's total annual sales and use taxes are attributable to businesses, rather than individuals.

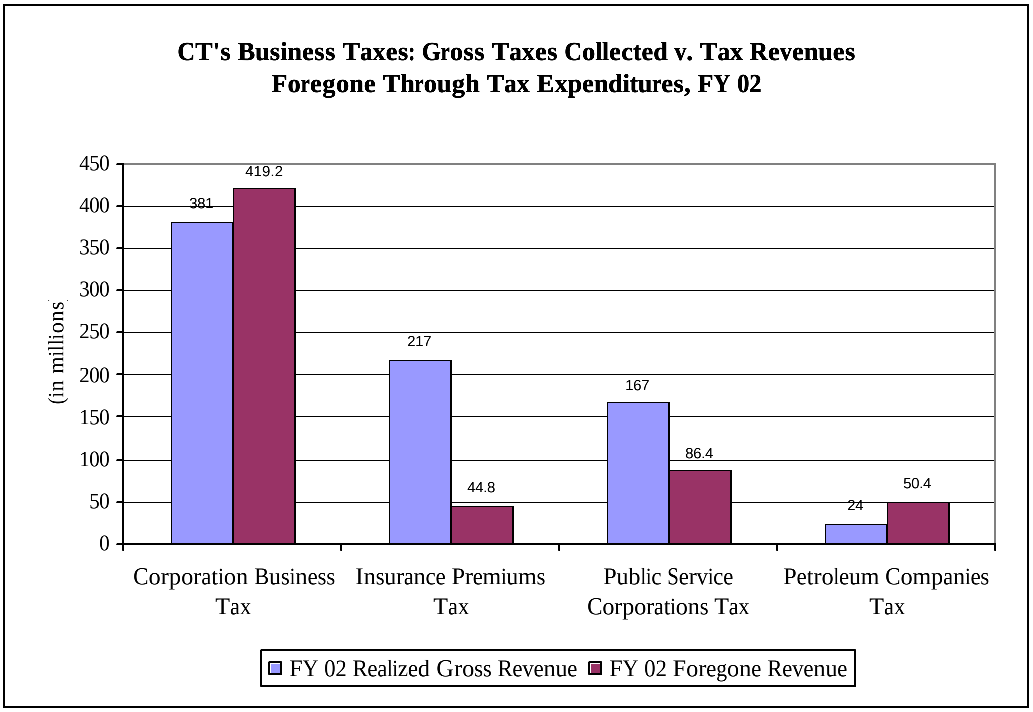
Historically, input-output models have been used to estimate sales tax incidence. Using such an approach, analysts have estimated that Connecticut's corporations pay roughly 40% of the total

[94] Grand List data for FY 01-02 (Grand List Year 2000) from Office of Policy and Management, *Total Grand Lists by Town, 2000*, http://www.opm.state.ct.us/igp/DATARESC/glsum95.htm. Corresponding mill rates and business property tax data were provided by Connecticut Conference of Municipalities in correspondence (April 14 and April 23, 2003).

amount of sales and use tax collected.[95] About half of that share, however, is likely to be passed on to Connecticut's consumers and the balance to consumers out of state.[96]

B. Do Corporations Pay These Other Taxes In Full? As is true with the corporation business tax, the fact that a corporation may be subject to a particular tax does not necessarily mean that the corporation will pay all, or even some, of that tax. Multiple credits, exemptions, exclusions, and deductions exist to these other taxes, as they do to the corporation business tax. Data on the amount of *state* tax revenues *foregone* through these various tax expenditures is reported in the Office of Fiscal Analysis' *Connecticut Tax Expenditure Report* (January 2002).

1. Other Business Taxes. A comparison of the tax revenues realized in FY 02 and the tax revenues forgone in FY 02 because of preferential exemptions, deductions, exclusions and credits shows how tax expenditures have significantly eroded the base of some of Connecticut's other business taxes:



2. Sales Tax. OFA's *Connecticut Tax Expenditure Report* (January 2002) identifies $226 million of revenues not collected on account of various "business and agricultural" exemptions to the state sales tax. Largest among these is the $125 million foregone through the sales tax exemption for machinery used in manufacturing, and related exemptions for component parts for assembly of manufacturing machinery ($10 million) and production materials ($10 million). Also exempt are sales of commercial trucks, trailers, and commercial vehicles used in interstate commerce ($10

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95 In phone conversation with a CT Department of Revenue Services' analyst, it was explained that this figure probably originated with a KPMG tax incidence report prepared in the early 1990s as part of that era's tax reform debate; no current DRS data on this point seem to exist.

96 These figures were generated by a model used by the Institute on Taxation and Economic Policy. ITEP reports that, nationally, corporations typically bear 20-40% of states' sales tax incidence.

million), commercial printing ($12 million), and data transmission equipment sold to telecommunications or CATV companies ($8 million).[97]

In addition to these $226 million of exemptions characterized by OFA as "business and agricultural" exemptions, a number of other exemptions to the sales tax would appear to benefit businesses alone or primarily. These include the exemptions for the sale of services between parent companies and subsidiaries ($12 million), computer and data processing services ($58 million), and advertising services ($20 million).

3. Local Property Taxes. In addition to the many preferential tax exemptions, deductions, and credits to these various *state* taxes that might be imposed on Connecticut businesses, there are multiple exemptions from *local property taxes* that also benefit many businesses.

For example, state law exempts from local property tax: a) manufacturers' inventories; b) structures and equipment for air pollution control; c) wholesale and retail business inventory; d) active solar energy systems; e) solar energy electricity generating and cogeneration systems; f) certain manufacturing or service facilities in a distressed municipality or a targeted investment community; g) certain machinery and equipment in a manufacturing facility in a distressed municipality or targeted investment community; h) vessels used primarily for commercial fishing; i) passive solar energy systems; j) vanpool vehicles; k) new machinery and equipment in manufacturing facilities (including machinery and equipment used in biotechnology); and l) certain vehicles used to transport freight for hire. (Conn. Gen. Stat. §12-81).

These exemptions reduce the property tax owed by many corporations doing business in Connecticut, but also deplete resources available to cities and towns. Only the Payment in Lieu of Taxes (PILOT) program for new manufacturing machinery and equipment begins to make towns whole for these lost property tax revenues. Specifically, Connecticut reimburses cities and towns for *some* but not all of the local property tax revenues lost on account of this exemption. First adopted in 1990, this exemption was intended to encourage manufacturers to invest in new equipment and machinery by exempting these items from property taxes for a set numbers of years. The state was to reimburse towns 100% for lost taxes. Since 1990, the exemption itself has been extended in multiple ways (by making more types of property exempt from tax),[98] yet the percentage of state

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97 All together, OFA estimated that $1.58 *billion* of sales and use tax revenues were foregone in 2002 because of tax expenditures. $226 million of these foregone revenues were attributed to "business and agricultural exemptions." Another $242 million were attributable to exemptions for certain services, many of which benefit businesses as well as individuals. Another $942 million were attributed to exemptions for various consumer goods, some of which might also be purchased by businesses (e.g., food products).

98 PA 90-279 (the Manufacturing Assistance Act of 1990) first required towns to provide a four-year 100% property tax exemption for new manufacturing equipment, and required Connecticut to fully reimburse towns for any property taxes lost due to the exemption. Over the 1990s, this exemption's benefit was extended: a) to cover "newly acquired" as well as "new" equipment (i.e., extended the exemption to used or rebuilt equipment new to the manufacturer acquiring it)(PA 92-193); b) to extend the exemption from four to five years (PA 95-283), c) to establish a new depreciation schedule (PA 96-171), d) to broaden the definition of eligible machinery to include equipment or machinery used in biotechnology (PA 96-252); and e) to broaden eligibility to include certain commercial trucks and vehicles used in combination with them (PA 96-265). The exemption also was extended to new or newly acquired equipment used in the production of motion pictures and video and sound recordings. PA 01-06 (JSS) reduced state reimbursement from 100% to 80% of the taxes exempted, but did not change the requirement that towns give a 100% property tax exemption. See, OLR, *PILOT for Manufacturing Machinery and Equipment* (2003-R-0345)(April 1, 2003) and OLR, *History and Rationale for the State Reimbursement of Manufacturing Machinery Property Tax Exemption* (2002-R-0376)(April 8, 2002).

reimbursement to towns has fallen. In FY 02, the state reimbursed towns for 80% of lost property taxes ($75.5 million) on account of this exemption. In FY 03 (after mid-year cuts), this had been reduced to just 63% ($56 million).

C. That Corporations Pay Other Taxes Ought Not Divert Attention from the Serious Erosion in the Corporation Business Tax. Some in the business community critique the suggestion that Connecticut's corporation business tax should be repaired by saying that a focus on this tax fails "to give a complete picture of what businesses contribute to the state revenue stream."[99] Often cited is a study commissioned by the Council on State Taxation (COST), *A Closer Examination of the Total State and Local Business Tax Burden,* that was written by Dr. Robert Cline of Ernst & Young and Dr. William Fox of the University of Tennessee.[100] The study highlights other taxes corporations pay in addition to the corporation business tax and urges a broad approach to business tax reform. While the study provides national estimates of the proportion of various taxes that are paid by corporations, it provides *no state-specific* data on the amount and share of taxes actually paid by businesses.[101]

Further, as Robert Tannenwald (an economist with the Federal Reserve Bank of Boston) points out, the COST study should not be viewed as measuring *tax burden*; it reports only estimates of the share of each tax paid by businesses. To measure tax burden, one should know the relationship between the taxes being paid by businesses and businesses' income and profits.[102] For example, New Jersey, in an analysis seminal to its Business Tax Reform initiative in 2002, found that the increase in revenues from its corporation business tax (from $1.13 billion in 1990 to $1.45 billion in 2000) failed to keep pace with growth in corporate profits (from $15.6 billion in 1990 to $31.2 billion in 2000).

Finally, and importantly, *none* of these other taxes are *new* taxes. They all existed in 1990, just as they exist now, and *their* bases also have been eroded over the 1990s to the benefit of businesses, just as Connecticut's corporation business tax eroded. That is, until some of the changes adopted last year (discussed in the next section) Connecticut imposed *no new* tax obligations on its corporations through newly-enacted or newly-increased state taxes that would have offset the substantial tax reductions they enjoyed in the corporation business tax. The possible exception to this are property tax increases in some towns – triggered in part by the erosion of state funding for public education -- that would have fallen on corporations and individuals alike.[103]

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99 CT Business & Industry Association, *Connecticut Businesses Paying Billions in Numerous Taxes* (April 21, 2003), available at www.cbia.com/gov/gar/0403/043101.htm.

100 COST is a non-profit trade organization consisting of about 550 multi-state corporations engaged in multi-state, interstate and international businesses. The objective of COST is to "preserve and promote equitable and nondiscriminatory state and local taxation of multi-jurisdictional business entities." See http://www.statetax.org/COSTHome.cfm.

101 Specifically, the study released in January 2003 by COST, distributed by CBIA to demonstrate that Connecticut businesses are paying a "fair share" of taxes, provides only *estimates* of taxes paid by *all* businesses in the United States and also by Fortune 1000 businesses, and only *national-level* data. There are no state-specific data on the total amount of taxes being paid by Connecticut businesses now, or as compared to the early 1990s. R. Cline, W. Fox, T. Neubig, and A. Phillips, *A Closer Examination of the Total State and Local Business Tax Burden* (COST, January 3, 2003).

102 R. Gavin, "Study Points to Business Tax Load," *Boston Globe* (June 24, 2003). The COST study reports, for example, that the Fortune 1000 employ 20% of private-sector workers, but pay 47% of state and local business taxes, and concludes that large, multi-state businesses pay a disproportionately high share of state and local property and sales taxes. A more useful metric for comparison would have been the share of business taxes paid by the Fortune 1000 as a percentage of their total income, as compared to smaller companies and individual families.

103 Since 1991, the average effective property tax rate in Connecticut has increased by 41%, from 12.8 to 18.1, and only four municipalities have a lower Effective Tax Rate (ETR) than in 1991. The ETR is based on the total actual market

VII. What Are the Recent and Proposed Changes to Taxes Paid by CT Businesses?

After years of General Fund surpluses, Connecticut began to experience deficits beginning in SFY 02. Including the initial deficit mitigation measures enacted in November 2001, Connecticut already has addressed nearly $3 billion in cumulative deficits, and now is struggling to address about $1 billion more.

To date, increases in taxes imposed on businesses have been a very modest part of the solution. *Total* revenues from permanent and temporary changes to corporate business taxes are about $122 million in FY 03 --$90 million in permanent revenue increases and $32 million from the temporary 20% surtax.[104] This represents about 1/6 of all new FY 03 revenues resulting from deficit-mitigating tax and fee increases.[105] By comparison, spending cuts to date to address FY 02 and FY 03 deficits total more than $900 million, and a variety of one-time revenues and fund transfers total nearly $1.2 billion.

The most significant changes[106] to taxes that impact on corporations are described below.

<u>2002</u>

Enacted in the May Special Session, PA 02-1 and PA 02-4 made a number of changes to the corporation business tax:

- *Business Entity Tax***.** Beginning January 1, 2002, Connecticut's pass-through corporations[107] must pay an annual $250 tax. Estimated new revenue: $28 million in both FY 03 and FY 04.[108]
- *Limit on Research and Development and Research and Experimentation Tax Credit "Refunds."* Connecticut limited how much a business taxpayer can claim in these tax credit "refunds." Specifically, if the tax credit "refund" is sought for income years 2000 or 2001 and was not

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value of real property in a municipality, not on the total assessed value, providing an "apples-to-apples" comparison of tax rates among communities. Of property taxes collected by Connecticut towns, on average 63% comes from taxes on residential real property, 7% from taxes on motor vehicles owned by individuals, 18% from taxes on real property owned by businesses, 2% from personal property taxes on motor vehicles owned by businesses and 8% from taxes on other business personal property (as of FY 01). Connecticut's local public education system is more reliant on the local property tax than all other states, with 53% of local property tax revenues being used for this purpose, compared to a national average of 30% (in FY 00). D. Klepper-Smith, *Connecticut's Current State-Local Tax System, A Comparative Analysis* (Connecticut Conference of Municipalities, September 22, 2002).

104 FY 04 revenues anticipated from changes to the corporation business tax enacted to date are $119.5 million -- $86.5 million from the permanent tax changes and $33 million from the temporary surtax.

105 Structural changes to corporation business taxes are expected to generate about $72 million annually. In addition, PA 03-2 imposed a temporary 20% surtax on the corporation business tax for income year 2003 that is expected to generate $32.4 million in FY 03 and $33 million in FY 04. A one-time tax amnesty program generated modest one-time revenues, as well.

106 For greater detail on revenue changes in 2002, see S. Geballe, *SFY 03 Budget Revised: Part 2: Addressing the SFY 02 Deficit & Adjusting SFY 03 Revenues* (Connecticut Voices for Children, 2003).

107 These include Subchapter S corporations, Limited Liability Companies (LLCs) (including single member LLCs), Limited Liability Partnerships (LLPs); and Limited Partnerships (LPs). As discussed earlier in the text, these corporations are *exempt* from the Connecticut corporation business tax.

108 http://www.drs.state.ct.us/pubs/SN's/2002/sn02-11.htm

paid by July 1, 2002, the filer may receive no more than $1 million in credit refunds in the state fiscal year in which the initial refund is paid, "with any remaining unpaid balance to be paid in two equal installments" in the following two state fiscal years. For credit refunds in income year 2002 and thereafter, there is a cap place on the amount of tax credit refunds that can be claimed by any one taxpayer; filers may receive no more than $1.5 million in refunds in any one such income year. Estimated "saved" revenue: $13.0 million in FY 03 and $8.5 million in FY 04.

- *Alternative Minimum Tax*. Each corporation included in a combined return is required to pay at least the alternative minimum tax of $250. In addition, the exemption from the AMT for financial services companies is repealed and all companies are barred from using tax credits to reduce tax owed to less than the $250 AMT (effective in the 2002 income year and thereafter). Estimated new revenue: $ 0.5 million in both FY 03 and FY 04.

- *Limit on Use of Tax Credits to Extinguish All Tax Liability.* For income years beginning January 1, 2002, tax credits may be used to offset no more than 70% of the corporation business tax due before credits. Estimated "new" revenue: $30 million in FY 03 and FY 04.

- *Tax Amnesty.* A tax amnesty was authorized for the period September 1, 2002 to November 30, 2002. A taxpayer could avoid civil penalties and criminal prosecution by payment of all taxes and interest due and approval of an amnesty application by the Department of Revenue Services Commissioner. Estimated one-time revenue: $6 million.

In addition to these changes, PA 02-1 (MSS) delayed the phase-out of the 1% sales tax on computer and data processing services by two years (precluding a tax reduction for some corporations and saving the General Fund $10 million in revenues in FY 03). It also de-coupled state law from new federal bonus depreciation changes, averting a $20 million state revenue loss.

Concurrently however, and *despite* the state's dire fiscal condition, the General Assembly also made a number of changes that *reduced* the tax certain corporations would pay:

- *PA 02-1 (MSS)* enacted a new sales tax exemption, retroactive to January 1, 1994. Exempted were "any business analysis, management, management consulting, and public relations services when such services are rendered in connection with an aircraft leased or owned by a certificated air carrier or in connection with an aircraft that has a maximum certificated take-off weight of six thousand pounds or more." Revenue loss: $0.8 million in FY03 and $0.2 million each year thereafter.

- *PA 02-4 (MSS)* extended and expanded various preferential tax exemptions for clean fuels. Revenue loss: $1.3 million in FY03 and FY 04.

- *PA 02-4 (MSS)* created a new exemption for non-cable communications services bought by a cable television network. Estimated revenue loss: "Less than $100,000" per year.

2003

PA 03-2 made the following changes in taxes impacting on businesses:[109]

- *Business Tax Surtax*. As was done in the early 1990s, a *temporary* 20% surcharge was imposed on the corporation business tax, as well as on the $250/year entity tax on "pass-through" corporations (increasing this tax to $300 for income year 2003 only).[110] Corporations are required to calculate their surcharges based on their tax liability, excluding credits. Estimated *temporary* revenue gain: $32.4 million in FY 03 and $33 million in FY 04.

- *Sales Tax*. Repealed a sales tax exemption for advertising and public relations services related to the development of direct mail and media advertising, but imposed a 3% rate on these services, rather than the standard 6% sales tax rate. Estimated revenue gain: $24.1 million in FY 03, $75.5 million in FY 04 and $74.5 million in FY 05.

- *Real Estate Conveyance Tax*. Increased temporarily (from March 15, 2003 to June 30, 2004), the *municipal* portion of the real estate conveyance tax, increasing the rate from 0.11% to 0.25% of the total sale price (with the amount paid by the seller). PA 03-2 also gave 17 "targeted investment communities" and any town that has a manufacturing plant that qualifies for enterprise zone benefits the option of increasing their conveyance tax by an additional quarter point, to 0.5%.[111] Estimated temporary revenue gain to towns: $15-20 million in FY 04 and $15-20 million in FY 05 based on the temporary rate increase, with an additional $1.7 million in FY 03 and $10 million in FY 04 in municipal revenues if all towns with discretionary authority to increase rates even more exercise this option.[112]

In short, *total* revenues from permanent and temporary changes to various corporation business taxes are about $122 million in FY 03 ($90 million in permanent revenue increases and $32 million from the temporary 20% surtax) and $119 million in FY 04 ($86.5 million in permanent revenue increases and $33 million from the surtax). The other changes listed above to the sales and real estate conveyance taxes also will result in some additional tax being paid by corporations. By comparison, the personal income tax rate increase (from 4.5% to 5.0%) *alone* was projected to cost Connecticut families $207 million in FY 03 and $404 million in FY 04. Also, other of the many tax increases enacted since November 2001 also will fall on families (e.g., cigarette tax increase, tax on self-storage units, reduction in sales tax exemption for clothing, repeal of sales tax exemption for health clubs and newspapers and magazines), as will the impact of the millions of dollars of cuts in state spending.

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109 PA 03-2 also increased Connecticut's top bracket personal income tax rate from 4.5% to 5%. While this has some impact on income from pass-through corporations that is taxed under the personal income tax, the increase is not characterized here as an increased tax on business since the pass-through corporations themselves are not being taxed.

110 http://www.drs.state.ct.us/pubs/SN's/2003/SN03-2.pdf.

111 Towns affected by this supplemental authority are: Bloomfield, Bridgeport, Bristol, East Hartford, Groton, Hamden, Hartford, Meriden, Middletown, New Britain, New Haven, New London, Norwalk, Norwich, Southington, Stamford, Waterbury, and Windham.

112 PA 03-2 (section 53) also allows municipalities (in FY 04) to tax the *difference* between the state reimbursement received in FY 03 for the property tax exemption for new manufacturing machinery and equipment and trucks and full 80% reimbursement.

Other Recent Proposals

Governor's FY 03-05 Proposals. The Governor's proposed FY 03-05 budget would have increased corporate tax revenues by $27.8 million in FY 04, and by $21.3 million in FY 05 through the following five measures:[113]

- Eliminate the neighborhood assistance tax credit ($2.0M in FY 04, $4.0M in FY 05);
- Eliminate the low and moderate income housing tax credit. ($2.0 million in each year);
- Eliminate the employer assisted housing tax credit. ($0.5 million in each year);
- Eliminate the historic housing tax credit. ($0.5 million in each year);
- Impose a 10% temporary surcharge in income year 2004, only. ($22.8 million in FY 04, $12.3M in FY 05).

Notably, only $5 million of the new revenue in each fiscal year represented structural change to the corporation tax; the surcharge was to have been for one income year only. Moreover, the credits that would have been eliminated play an important role in addressing our critical shortage of workforce housing (especially since state bond funds appropriated for this purpose have declined markedly over the 1990s).

First Vetoed FY 03-05 Budget in 2003 Session. PA 03-279,[114] vetoed by the Governor on May 16, 2003, was the General Assembly's first attempt to pass a budget for FY 03-05. It would have generated significantly more revenue than the Governor's proposed budget, which was $300 million in deficit when introduced.[115]

This budget would have imposed a 20% surtax on the corporation business tax for income years 2004 and 2005 (rather than the Governor's proposed 10% surtax in income year 2004 only), but rejected the Governor's proposal to eliminate $5 million in housing tax credits. This bill would have generated about $43 million in new corporation business tax revenues (*more* than the Governor's budget) but the revenues were one-time in nature; no structural repair of the corporation business tax was proposed. In addition, this bill would have allowed businesses that pay corporation business tax based on their capital base to sell back to the state their "unused" research and development/research and experimentation tax credits (as other corporations can). This would have resulted in a permanent *loss* of $15 million in corporation business tax revenues. The net gain in FY 03 would have been about $28 billion, but long-term there would have been a $15 million annual revenue loss.

Other changes in this bill that would have resulted in an *increase* in taxes paid by businesses included: a) certain changes to the sales tax (rate increase, new requirement that state agency vendors collect use tax on remote sales); b) extending the cap on the use of tax credits to offset tax liability to insurance companies; and c) imposing a 5% tax on the gross earnings of satellite TV businesses.

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113 S. Geballe, *Revenue Changes in Governor Rowland's Proposed FY 03-05 Budget: Who are the Tax 'Winners' and 'Losers'?* (Connecticut Voices for Children, 2003).

114 For a summary of this proposed budget, see S. Geballe, *PA 03-279 (HB 6720), AAC the State Budget for the Biennium Ending June 30, 2003 and Making Appropriations Therefor, and Various Taxes and Other Provisions Related to the Revenues of the State* (Connecticut Voices for Children, May 2003).

115 While the Governor's FY 03-05 budget would have raised $233 million in new revenues in FY 04 (of which $163 million was from one-time fund transfers), this proposed budget (PA 03-279) would have raised $667 million in new revenues in FY 04 (with $123 million in one-time fund transfers).

One change would result in a *reduction* in taxes that impact on businesses -- elimination of sales tax on patient care services.

Second Vetoed FY 03-05 Budget in 2003 Session. PA 03-185, which was vetoed by the Governor on June 13, 2003, was the General Assembly's *second* attempt to pass a budget for FY 03-05.[116] This budget would have generated substantially *less* in new tax revenues from all sources – including from businesses -- than the first vetoed budget.

It would have imposed a 20% surtax on the corporation business tax in 2004 and a 15% surtax in 2005, while also extending the tax credit refund program to capital-base reporting corporations. Again, the surtax revenues would have been one-time, while the $15 million revenue loss would have been permanent. This bill also proposed a smaller sales tax rate increase than the first vetoed budget and, in addition, would have *restored* the sales tax exemption for advertising services (a $20 million revenue loss that would have primarily benefited business). Like the first vetoed bill, this bill would have required state vendors to collect use tax on remote sales, capped the use of tax credits by insurance companies to offset all tax liability, and imposed a 5% gross receipts tax on satellite TV. In addition, it would have increased *temporarily* the state real estate conveyance tax on all commercial and higher value residential property from 1% to 1.5%, effective July 1, 2004.

VIII. What Are Some *Smart* Options to Repair Connecticut's Corporation Business Tax?

Like a dike, the corporate tax requires constant vigilance, maintenance, and repair.
Prof. Richard Pomp, University of Connecticut Law School (1998)[117]

Multi-state and multi-national corporations have become adept at manipulating both nexus rules and state apportionment formulas to minimize total taxes owed. A proliferation of companies incorporating in states with lower tax rates or which do not tax intangible income (such as Delaware) has resulted. Such tax avoidance strategies are more readily exploited by larger corporate entities with parent companies and subsidiaries to the detriment of smaller businesses and private citizens who are left with greater responsibility for funding the state services on which these corporations rely.

As shown in this report, Connecticut's corporation business tax revenues have eroded significantly over the course of the past decade, both absolutely and as a proportion of state tax revenues. This has occurred through the *appropriate* reduction of the corporation business tax rate to the national median, and also by the enactment of generous tax exemptions, exclusions, deductions and credits *(that may, or may not have been appropriate)* and the growing sophistication of tax attorneys and accountants at minimizing state taxes through tax shelters.

The erosion of corporate tax revenues, and the lack of transparency and accountability to assure that the state gets *some* meaningful benefit from this loss of revenue, points to the need for corporate

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116 For a summary of this proposed budget, see S. Geballe, *A Last Ditch Proposal? PA –3-185 (HB 6721), AAC Expenditures and Revenues for the Biennium Ending June 30, 2005* (Connecticut Voices for Children, June, 2003).

117 R. Pomp, "The Future of the State Corporate Income Tax: Reflections (and Confessions) of a Tax Lawyer," in D. Brunori (ed.), *The Future of State Taxation* (Urban Institute Press, 1998).

business tax reform. A variety of strategies exist to repair Connecticut's corporation business tax. They include the following:

A. Collect the Taxes to Which Connecticut is Entitled

1. Enhance Collection Of State Income Tax From Out-Of-State Shareholders And Owners Of Connecticut Pass-Through Corporations. As discussed earlier, Subchapter S corporations, LLCs, and LLPs receive the benefits of corporate status, but are exempt from Connecticut's 7.5% corporation business tax. Instead, income from these corporate entities is "passed-through" to their partners/shareholders where it is subject to Connecticut's personal income tax. The exemption of these pass-through corporations from Connecticut's corporation business tax not only eliminated revenues from *this* tax, but also increased the potential for non-payment of the personal income tax by out-of-state shareholders/partners. While out-of-state individuals and corporations with ownership interests in Connecticut pass-through corporations have an obligation to pay Connecticut personal income tax on income distributed to them through these corporations, the income will escape Connecticut taxation if they fail to file a Connecticut personal income tax return.

New Jersey estimated it was losing about $50 million/year because owners (partners/shareholders) of pass-through New Jersey entities who live out of state were not reporting all of the income they earned in New Jersey through pass-through corporations.[118] To improve compliance, New Jersey took two steps last year:

- Instituted a $150 per owner processing fee on owners of pass-through entities having more than one owner (with an estimated revenue gain of $80 million).

- Required pass-through corporations to begin withholding state income tax due at a top rate of 6.37% for individual partners (New Jersey's top personal income tax rate) and 9% for non-individual business entity partners (New Jersey's corporate income tax rate). Payments were to be credited against the partners' respective tax liabilities.

Other states that have recently enacted a withholding requirement include Alabama, California, New York, Ohio, and West Virginia. All together, ten states now require pass-through corporations to withhold on behalf of non-resident partners/shareholders. Pennsylvania Governor Ed Rendell included a withholding requirement as part of his 2003 budget proposal, as well. He explained:

> Many companies pay income taxes through the Corporate Net Income Tax. Other companies – known as "pass-through businesses" – are allowed to pass through their profits to the shareholders or owners. Those people are then supposed to pay tax on the income. The system works fine when everyone involved lives in Pennsylvania, but it gets more complicated when they don't.
>
> Right now there is a need to improve enforcement for some Pennsylvania companies who have owners or shareholders that live in other states. One set of companies has to withhold taxes for non-resident owners, but another set does not. Closing this loophole means requiring pass-through businesses to withhold income taxes, too. The plan is an

118 M. Forsberg , *A Question of Balance: Taxing Businesses in the 21st Century* (New Jersey Policy Perspective, 2003), p. 25.

improvement because it treats all these non-resident owners and shareholders of Pennsylvania businesses the same, and it makes sure that they all pay the Pennsylvania taxes that they owe.[119]

Gov. Rendell estimated that this withholding requirement would result in $11 million of additional income taxes annually.[120]

If Connecticut were to adopt this change, it should *repeal* the nominal $250 tax on these pass-through corporations. This would eliminate any potential constitutional challenge by an out-of-state corporate partner/shareholder that it has no "nexus" to Connecticut sufficient to justify Connecticut tax.[121] "Nexus" to Connecticut would be determined to "pass through" the non-taxed corporation to all out-of-state corporate partners/shareholders (in the aggregate) along with the income, since all shareholders/partners, whether in or out-of-state, would be sharing in profits of the pass-through entity.

2. *Require Corporations With Which Connecticut Does Business To Collect Use Tax Due The State.* Both vetoed budgets (PA 03-185 and PA 03-279) would have required each vendor of tangible personal property that is doing business with the State of Connecticut to collect and remit the use tax on behalf of its customers. This initiative would be strengthened by applying the requirement to all affiliated companies of the vendor as well, so that the requirement cannot be avoided by creating a subsidiary corporation.[122]

3. *Assign/Add Sufficient DRS And Attorney General Staff To Collect Taxes Due From Connecticut's Top 100 Delinquent Taxpayers.* DRS maintains a list of the top 100 delinquent taxpayers, defined as persons or entities that owe Connecticut tax for more than 90 days after all appeal rights have expired. See www.drs.state.ct.us/delinq/top100.html. The top 10 delinquent taxpayers together owe Connecticut $3.68 million.

4. *More Aggressively Collect Sales/Use Tax From Businesses With Nexus To Connecticut That Are Making Sales Into Connecticut Through The Internet And Catalogs.* Business entities making sales to Connecticut residents over the Internet or through catalogs may have nexus with Connecticut through some physical presence in the state,[123] whether through bricks & mortar facilities (to which products can be returned for refunds or exchanges, e.g., Barnes and Noble, Wal-Mart), service contracts (to service products sold, e.g. Dell Computers), or in some other fashion. Though Connecticut residents are legally required to pay *use* tax on these purchases, many do not know of

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119 Gov. E. Rendell, *Plan for a New Pennsylvania: Funding Pennsylvania's Growth Plan*, available at: http://www.state.pa.us/budget

120 In its 2002 legislative session, Pennsylvania changed the filing requirements for out-of-state corporations that have a presence in the state through a pass-through entity. The changes were intended to resolve corporate tax nexus issues.

121 See generally J. Haas, " 'A Business Perspective': Passthrough Nexus? Nexus Issues for Nonresident Corporate Partners, Members and Shareholders," *State Tax Notes* (2003 STT 91-6, April 29, 2003).

122 Virginia adopted a new law April 2, 2003 (Chapter 1006, SB 938) that prohibits state agencies from doing business with vendors that are required to collect sales/use tax on goods delivered into the state, but fail or refuse to do so.

123 The United States Supreme Court in Quill Corp. v. North Dakota, 504 U.S. 298 (1992), interpreted the Commerce Clause of the United States Constitution to require that remote vendors have a physical presence in the state for a state to compel the vendor to collect a use tax. While the Court noted that Congress was free to overrule the holding and set a different standard for the "substantial nexus" requirement of the Commerce Clause (such as an "economic presence" test), absent such action this decision creates barriers to taxing electronic commerce. *See generally* M. Graham, "Evaluating Internet Sales Tax Proposals," *State Tax Notes* (September 2, 2002), pp. 721-729.

this obligation, and many that *do* know may choose not to do so. Requiring corporations with some business presence in the state to collect and remit this sales/use tax on sales into the state through remote sales could boost sales tax receipts that are rapidly being eroded in this way. It would also create a more level "playing field" among in-state businesses (that currently must charge sales tax) and remote sellers.

B. Restore the Base

1. Institute Unified Reporting. University of Connecticut Law professor Richard Pomp, a national expert in state tax law, asserts that worldwide unified (combined) reporting is "a powerful tool to restore the integrity of the corporate tax system,"[124] and "a state that does not require related corporations conducting a unitary business to file a combined report is at the mercy of its corporate taxpayers."[125] Michael Mazerov of the Washington D.C.-based Center for Budget and Policy Priorities concurs, stating that unified combined reporting is "the single most important change that could revitalize the Connecticut corporate tax."[126] Charles McLure, Senior Fellow at the Hoover Institute and a leading Treasury Department official in the Reagan administration has called the failure to use unified reporting "an open invitation to tax avoidance."[127] Indeed, prior to tax law changes made in the Reagan administration, worldwide combined reporting was the norm.

Unified reporting[128] requires *more accurate* reporting of corporate income. It would require corporations to list on their tax returns *all* profits they have earned, including the profits earned by *any subsidiary or related corporation* with which they are engaged in a unitary business.[129] In addition, it would require a parent corporation and all its subsidiaries and related corporations engaged in a unitary business to combine their apportionment factors -- i.e., *total* payroll, property and sales in a given state as a share of *total* payroll, property and sales -- to determine their tax liability in Connecticut. This modification would assure that accountants' decisions about allocating income to various subsidiaries could no longer be used as a tax avoidance tool. As Professor Pomp notes, "So many of the corporate tax planning games center on cutting the egg that is the corporation into pieces." Without combined reporting, "states can't put Humpty Dumpty together again."[130]

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124 R. Pomp, at the CT Voices for Children Forum, *A Look at Corporate Taxation*, Hartford, CT, April 16, 2003.

125 R. Pomp, "The Future of the State Corporate Income Tax: Reflections (and Confessions) of a Tax Lawyer," in D. Brunori (ed.), *The Future of State Taxation* (Washington, Urban Institute Press, 1998), p. 62.

126 M. Mazerov, at CT Voices for Children Forum, *A Look at Corporate Taxation*, Hartford, CT, April 16, 2003.

127 C. McLure, "The Nuttiness of State and Local Taxes – and the Nuttiness of Responses Thereto," *State Tax Notes* (September 16, 2002), p. 851.

128 Unified reporting is commonly called "combined" reporting. Connecticut, however, uses the term "combined reporting" quite differently. In Connecticut, a company that files a "combined" return has its final tax due determined by the sum of the *separate* net income or loss of each corporation included in the return, or the minimum tax base of the included corporations, but only to the extent that the income, loss, or minimum tax of any included corporation is separately apportioned to Connecticut (Conn. Gen. Stat. §12-233a).

129 State tax experts Michael McIntyre, Paul Mines and Richard Pomp urge that a "unitary" business be defined as a "common enterprise undertaken by one or more commonly-controlled entities in pursuit of business profits" with, among other characteristics, "the participants in the enterprise [contributing] in a nontrivial way to each other's profitability" or "its activities managed by some central authority of the enterprise." See M. McIntyre, P. Mines, & R. Pomp, "Designing a Combined Reporting Regime for a State Corporate Income Tax: A Case Study of Louisiana," 61 *Louisiana Law Review 99* (2001).

130 K. Setze, *Expert at FTA: Adopt Combined Reporting, Save Corporate Tax*. (TaxAnalysts, Doc. 2003-14642).

The United States Supreme Court has twice affirmed the legality of combined, unified reporting,[131] and currently sixteen states[132] require it, including New Hampshire and Maine. Any multi-state corporation doing business in any of these sixteen states already is filing a unified return; the administrative burden on these corporations if Connecticut were to adopt unified reporting would not be great. In addition, to assure that Connecticut could not lose any revenues in the short-term, mandatory combined reporting could be adopted as an alternative minimum tax. By broadening the base of Connecticut's corporation business tax, moreover, it should be possible to lower the tax rate and still generate some additional revenues. That is, unified reporting would generate *more* corporate business tax revenues from Connecticut's largest multi-national corporations and thereby enable Connecticut to *reduce* some of the burden on our smaller, start-up businesses.

Revenue estimates by other states indicate that corporate business tax revenues would be increased from 13% to 20% if unified reporting were required.[133] Based on the Connecticut State Comptroller's estimate[134] of about $560 million in Connecticut corporation business tax revenues in FY 03 (before refunds), unified reporting could result in $73-$111 million of additional revenues annually.

Importantly, states that require unified reporting have maintained strong growth in manufacturing employment. Between 1979 and 2000, 11 of the top 15 states in employment growth in manufacturing mandated unified reporting. [135] Indeed, of the 16 states with unified reporting, four were among the top five states in terms of growth in manufacturing employment over the 1995-2000 period, and eight placed in the top ten on this measure of economic vigor.

2. *Substitute A More Broad-Based Corporation Business Tax For The Current Tax, So That The Tax Rate Might Be Reduced.* Connecticut could re-impose the corporation business tax on *all* types of corporations that are currently exempted from it (including pass-through corporations), or on some greater proportion of them (such as the larger pass-through corporations).[136] If *no* corporation were

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131 The United States Supreme Court held worldwide combined reporting to be constitutionally-permissible as applied to a United States-based corporation in Container Corporation of America v. Franchise Tax Board, 463 U.S. 159 (1983) and as applied to a non-United States-based corporation in Barclays Bank PLC v. Franchise Tax Board, 512 U.S. 289 (1994).

132 These states are Alaska, Arizona, California, Colorado, Hawaii, Idaho, Illinois, Kansas, Maine, Minnesota, Montana, Nebraska, New Hampshire, North Dakota, Oregon, and Utah.

133 Wisconsin Legislative Fiscal Bureau, *Corporate Income and Franchise Tax - Combined Reporting* (Paper #112, June 1999)(13.0%); Iowa Department of Revenue and Finance, *Issue Brief – Combined Reporting* (January 2003)(16.6%); Maryland Department of Legislative Services, *SB 398 – Fiscal and Policy Note* (March 2003)(19.6%).

134 State Comptroller's Letter to the Governor (June 2, 2003). This estimate *includes* additional revenues resulting from the 20% temporary surtax on the corporation business tax imposed by PA 03-2 (as well as earlier changes to the tax in PA 02-1 (May Special Session)). Note: The State Comptroller's FY 03 revenue estimate for the corporation business tax as of July 1, 2003 had declined to $516.4 million.

135 M. Mazerov, at the CT Voices for Children Forum, *A Look at Corporate Taxation*, Hartford, CT., April 16, 2003. During a more recent time frame, 1989-2000, eight of the top nine states required combined reporting.

136 In its 2002 legislative session, North Carolina imposed the state franchise tax on a corporation if its related members together indirectly own at least 70% of an LLC's assets. In 2002, New Jersey also froze temporarily its phase-out of the corporation business tax on S-corporations. NOTE: As of late 2002, 29 states imposed an entity-level tax on LLCs (10 imposed minimum level taxes or fees, Alabama imposed its business privilege tax, the District of Columbia imposed a 14.5% tax on source income earned in the District, Florida taxed LLCs as corporations, Illinois imposed a 1.5% income tax, Michigan imposed its single business tax, New Hampshire imposed its business profits tax and Wisconsin imposed its business and occupation tax). See Ely & Grissom, "The LLC/LLP Scorecard – 2002 Update," *State Tax Notes* (November 18, 2002), p. 463)[2002 STT 222-2]. In addition, 24 states impose a tax on S corporations: 11 impose a state franchise tax (California [at 1.5%], Georgia, Kansas, Mississippi, New Mexico, South Dakota, Tennessee, Texas, West

exempt from this tax, an additional $100 million in revenues would be collected. By so broadening the base of the tax, Connecticut could also reduce the corporation business tax rate somewhat. Alternatively, Connecticut could join at least 11 other states in adopting a *graduated* corporate business tax rate structure that would impose a higher rate on larger, more profitable corporations and a lesser rate on smaller and start-up businesses (see discussion below). In this way, corporate tax liability would *not* depend on corporate structure or preferential tax treatment.

3. *Eliminate the Exemption from the Capital Base For Financial Service Companies.* PA 98-110 excluded financial service companies from the capital base, while concurrently changing to a single sales factor apportionment formula. This combination markedly reduces any potential tax liability for these corporations. Connecticut could repeal this exemption.

4. *Revise Connecticut's Nexus Test.* Connecticut could explicitly define nexus for purposes of corporation business tax liability to require simply some in-state economic activity (as New Jersey did last year), making it clear that physical presence is not required.[137]

5. *Roll Back The Time Limits For Carry-Forwards Of Net Operating Losses And Net Capital Losses.* Prior to PA 99-173, Connecticut corporations could carry-forward their net operating and net capital losses for 5 years. PA 99-173 extended the allowable carry-forward period to *20 years.* That is, losses that corporations "book" now continue to reduce taxes paid for up to the next 20 years. This is *more* generous than in 21 other states.[138] Connecticut could wholly, or partially, roll-back this carry-forward period. Illinois, for example, just reduced its net operating loss carry-forward period from 20 years to 12 years while Maine, last year, repealed its two-year net operating loss carry-back.[139]

6. *Temporarily Suspend Net Operating Loss Carry-Forwards and Net Capital Loss Carry-Forwards.* A number of states have temporarily *suspended* carry-forwards to reduce refunds against current corporate business tax revenues.[140] In such instances, corporations do not *lose* the value of the carry-forward, they are just delayed in taking it. In FY 02, according to the U. S. Census Bureau,

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Virginia, Wisconsin, and Wyoming), Michigan imposes its single business tax, Illinois imposes a tax at 1.5% of taxable income, the District of Columbia imposes its corporate income tax but does not tax the shareholders, New Hampshire imposes its business profits tax but does not tax the shareholders, Washington imposes its business and occupations tax but does not tax the shareholders, Louisiana and Ohio impose tax *only* on the distributive shares of nonresident share holders who do not live in the state, Maryland imposes a 5% tax on nonresidents' distributive shares, and Idaho, Montana and Nevada impose minimal fees. Two states tax limited partnerships (limited partnerships in California must pay a minimum franchise tax of $800 and limited partnerships in New Jersey are subject to a business income tax). Seven states (Illinois, Massachusetts, Michigan, New Hampshire, Oklahoma, Tennessee and West Virginia) tax general partnerships. See, J. Haas, " 'A Business Perspective': Passthrough Nexus? Nexus Issues for Nonresident Corporate Partners, Members and Shareholders," 2003 STT 91-6 (April 29, 2003).

137 In its 2002 legislative session, Pennsylvania changed the filing requirements for out-of-state corporations that have a presence in the state through a pass-through entity as a way to better address corporation tax nexus issues.

138 M. Gardner et al, *Balancing Act: Tax Reform Options for Illinois* (Institute on Taxation and Economic Policy, 2002), p. 58.

139 Connecticut does *not* allow NOL carry-backs. See generally M. Mazerov, *Many States Could Avoid an Unnecessary Revenue Loss During the Current Fiscal Crisis by Disallowing Business Operating Loss Carrybacks* (Center on Budget and Policy Priorities, May 2003).

140 In the 2002 legislative session, California and New Jersey suspended their corporate net operating loss deductions for two years. Business leaders in California had agreed to suspend their regular 60% NOL deduction for two years (2002-03) to help close the mounting budget shortfall in return for a full 100% deduction in 2004. W. Rojas, "Aides Suggest State Will Turn to Corporate Tax Hikes to Plug Budget Gaps," 26 *State Tax Notes* 460, 2002 TNT 219-7 (November 18, 2002).

Connecticut's *net* corporation business tax revenues were just $149.5 million -- $373.8 million in gross revenues were reduced by refunds of $224.3 million. In FY 02, Connecticut's corporation business tax revenues were reduced by $50 million on account of the Net Operating Loss Carry-Forward and by $65 million on account of the Net Capital Loss Carry-Forward.

Temporarily reducing refunds against current corporation business tax revenues could help tide Connecticut through these difficult budget times. Last year, for example, California suspended its corporate net operating loss deduction for two years (resulting in a $1.2 billion revenue increase in FY 03 and an $800 million increase in FY 04), and New Jersey also suspended these deductions as a part of its corporate tax reform (discussed below).

7. Broaden the Definition of Taxable "Business Income" to Include Corporate Profits from Irregular Transactions. A series of United States Supreme Court decisions has made clear that the entire profit of a corporation is not necessarily subject to formula apportionment among all states in which the corporation is doing business. Rather, "business income" (defined as income arising from transactions and activity in the regular course of a taxpayer's trade or business) is to be apportioned among all states in which the corporation is taxable, while "non-business income" (defined as all income other than "business income") is to be assigned to a particular state for taxation. Non-apportionable income items generally are to be assigned for tax purposes to the state in which the corporation manages the asset(s) generating the income – most often the corporate headquarters state.

While a 1992 United States Supreme Court decision affirmed the Court's position that not all corporate income is subject to formula apportionment, it also made clear that states *may* include as apportionable profits many of the irregular income items that corporations had been claiming were non-business income (e.g. profits on the sale of a corporate subsidiary actively managed by the parent corporation at the time of sale). Amending a state definition of "business income" to include "all income which is apportionable under the Constitution of the United States" would bring state law into conformity with the decision.

Currently, Connecticut defines *all* corporate income as apportionable.[141] While this ensures that Connecticut can tax profits realized on most irregular transactions by *out-of-state* corporations, it may unnecessarily relinquish Connecticut's right to tax 100% of certain "non-business" income items of large *in-state multi-state* corporations.[142] Connecticut could *maximize* its ability to tax its fair share of profits arising from the irregular corporate transactions of major multi-state corporations based in Connecticut by: a) making a distinction in our state law between apportionable business income and allocable non-business income; b) defining apportionable "business income" to mean all income

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141 Connecticut is one of 13 states that define all corporate income as apportionable. The other states are Delaware, Georgia, Maine, Maryland, Massachusetts, Nebraska, New Hampshire, Rhode Island, South Carolina, Vermont and Virginia.

142 If, for example, a large multi-state corporation that is based in Connecticut with facilities in other states has a 35% Connecticut apportionment factor, 35% of its nationwide business income is taxed in Connecticut. However, if this corporation earns a large capital gain from the sale of an asset that is truly *non*-apportionable income under the standards set by the United States Supreme Court, Connecticut would still seek to tax only 35% of the gain because it treats all income as apportionable. If no other state could tax the gain (because it is non-apportionable) the other 65% of the gain would be "nowhere income" – profit untaxed by any state. However, Connecticut has the constitutional right to tax 100% of the gain on this transaction. Amendment of Connecticut law, as suggested in the text, would capture these gains.

apportionable under the US Constitution; and c) defining allocable income as all other income of a taxable corporation.[143]

8. *Inflation-Adjust the Alternative Minimum Tax and the Maximum Tax Under the Capital Base.* Connecticut's AMT was set at $250 in 1982. Adjusted for inflation, this would now be $475. Similarly, the maximum tax under Connecticut's capital base was set at $1 million in 1992. Adjusted for inflation, this would be $1.3 million now. OFA estimated last year that an increase in the AMT from $250 to $450/year would generate about $5.7 million in new revenues annually. New Jersey, last year, increased its AMT from $250 to $500. OFA has not done an estimate of revenue gains by adjusting the capital base for inflation.

C. Repair Apportionment

1. *Repeal Single-Factor Apportionment.* As discussed earlier, single-factor apportionment creates corporate winners and losers, and among the "losers" are Connecticut corporations without significant sales outside Connecticut and those that operate solely within Connecticut. Connecticut is in the minority in using single factor apportionment so extensively. Moreover, it has made *other* changes to its tax law to encourage the growth of capital and jobs within the state that do not have a comparable downside (e.g., exempting from local property tax new manufacturing equipment and machinery). Repeal of single factor apportionment could save $60 million/year, based on OFA's estimates.

2. *Eliminate "nowhere" income.* Public Law 86-272 often blocks a state in which a corporation merely makes sales from imposing a corporation income tax on the state's respective share of the corporation's profit (as calculated by the state's apportionment formula). As a result, some of a corporation's profits will evade tax – so-called "nowhere" income. There are two alternatives to address this conflict between nexus law and state apportionment formulas. Either would help assure that Connecticut gets its fair share of corporation business tax revenues:

> a. *Eliminate "nowhere" income by implementing a throw-back rule. More than half of all states* with a corporate business tax already have a "throwback" rule[144] that helps assure that *all* income is taxed *somewhere.* The throwback rule allows a state in which a corporation produces a product to tax profits on the sales the corporation makes in states where the corporation lacks sufficient physical presence ("nexus") to be subject to tax. (The sales are said to be "thrown-back" for tax purposes from the state in which the purchaser is located to the state in which the seller is located). If a state does not have a "throw-back" rule, it is estimated that more than half of the profits of its resident corporations will not be subject to tax

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143 Florida, Iowa, Minnesota, Pennsylvania, and Texas all have had statutes that maximize their ability to tax profits from irregular transactions. See M. Mazerov, *Closing Three Common Corporate Tax Loopholes Could Raise Additional Revenue for Many States* (Center on Budget and Policy Priorities, 2003). In addition, in the 2002 legislative session, North Carolina amended its definition of business income to include all income that is apportionable under the United States Constitution, while Alabama revised its definitions of "business" and "non-business" income.

144 The 20 states without a throw-back rule include Arizona, Connecticut, Delaware, Florida, Georgia, Iowa, Kentucky, Louisiana, Maryland, Massachusetts, Minnesota, Nebraska, New York, North Carolina, Ohio, Pennsylvania, Rhode Island, South Carolina, Tennessee and Virginia. The other 25 states with a corporate income tax already have a throw-back rule in effect. M. Mazerov, *Closing Three Common Corporate Tax Loopholes Could Raise Additional Revenue for Many States* (Center on Budget and Policy Priorities, April, 2003).

anywhere – so-called "nowhere" income. OFA has estimated that a "throw-back" rule in Connecticut would generate $6-$10 million annually in new revenues.

Adding a single sentence to our corporation business tax is all that would be necessary: "Sales of tangible personal property are deemed to be in Connecticut for apportionment purposes if the property is shipped from an office, store, warehouse, factory, or other place of storage or manufacture in this state and the taxpayer is not taxable in the state of the purchaser."

b. Implement a throw-out rule. This rule is an alternative to the "throw-back" rule. It "throws out" the portion of sales made by a corporation in states that do not tax sales (i.e. so-called "nowhere sales") when calculating the Connecticut corporation business tax.[145] Since the corporation tax is computed based on the share of sales within a state as compared to total sales, including in the denominator all sales a Connecticut corporation made in states in which no tax is imposed results in a smaller proportion of sales arising in Connecticut, and therefore less tax due to Connecticut. OFA has estimated that adoption of the "throw-out" rule would result in $25-$33 million of additional revenues each year.

D. Institute a Graduated Rate Structure

Just as many states have a graduated rate structure in the personal income tax, a number of states have adopted a graduated corporate tax rate structure that reduces tax on smaller, start-up businesses while imposing a greater responsibility on larger, more profitable enterprises. New Jersey's Business Tax Reform Act of 2002, for example, changed its rate structure from a two-tiered tax (a 7.5% tax on a corporation's net New Jersey income of $100,000 or less and 9% on income over $100,000) to create a third tax rate of 6.5% for corporations with net income of less than $50,000. Interestingly, the New Jersey State Treasurer recently testified to New Jersey's Assembly Budget Committee that "New Jersey is coming off a record year for the number of companies registering to do business here" noting that the 2002 New Jersey corporation business tax reform initiative "incorporated changes to protect small and medium-sized businesses."[146]

E. Cap the Revenue Loss From Tax Credits

1. Temporarily (Or Permanently) Cap Tax Credits At Some Fixed Amount Of Foregone Revenues. Currently, only a few of Connecticut's many business tax credits are capped at a fixed amount. This results in an open-ended loss of revenues, with no review process to assess the state's return on its investment. Additional tax credits (including the "refundable" R&D and R&E credits that currently result in $30 million of cash refunds to corporations) could be capped at least temporarily (say, at a total of $10 million/year), as several of the individual credits already are.[147]

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145 For example, if $100 million of a Connecticut corporation's sales were in Connecticut, $100 million in states that tax the sales, and $100 million in states that do not ('nowhere sales'), with a throw-out rule the Connecticut sales factor would be one half ($100,000/$200,000), rather than one-third ($100,000/$300,000), since the "no-where" sales would be taken out of the denominator.

146 John McCormac, New Jersey State Treasurer, *Testimony Before the Assembly Budget Committee* (May 27, 2003), available at www.state.nj.us/treasury/news/2003/p30527a.html.

147 For example, Connecticut's Employer-Assisted Housing Credit is capped at a total of $1 million/year (Conn. Gen. Stat. §12-217p) and the credit for donating computers to schools is also capped at a total of $1 million/year (Conn. Gen.

2. *Reduce (Temporarily Or Permanently) Some Of The Tax Credits.* Last year, the Finance Committee considered a bill that would have reduced from 5% to 3% the tax credit for fixed capital investments. It would have saved $8.0 million in revenues. The Finance Committee also considered a bill that would have reduced by half the tax credit for property taxes paid on computers/data processing, saving $10 million/year.[148]

F. Increase Transparency and Accountability of the Corporation Business Tax

> *The secrecy surrounding corporate tax-reduction strategies should be eliminated. Corporate tax returns should be public, giving investors the information they need to determine whether earnings are inflated by questionable techniques.*
>
> N. Byrnes & L. Lavelle, *Special Report: Corporate Tax Game: How Blue Chip Companies Are Paying Less and Less of the Nation's Tax Bill*
> Business Week, March 31, 2003

Measures to increase the transparency and accountability of the multiple exemptions, exclusions, deductions and credits to the taxes that corporations pay to Connecticut would markedly enhance the democratic process. Unlike direct appropriations, these tax expenditures are not subject to annual review, though they confer significant financial benefit on corporations. They are not routinely included in the weighing of budget choices but become virtual entitlements, even if there are significant changes in state budget circumstances. In addition, it is not publicly known *which* individual corporations are receiving these financial benefits. By comparison, DECD's grants and loans to corporations (like other appropriated funds) are pursuant to written agreements that not only specify the financial support being provided, but also what is expected in return.

As the British journal *The Economist* recently noted in its critique of American law on corporate non-disclosure of tax payments,[149]

> At certain points in the past, disclosure of tax-return information was much fuller. President Taft, under whom the first corporate tax was levied in 1909, saw publication of tax returns as a way to discourage undesirable business conduct.

The Economist reports that the so-called "tax-book" gap (the "divergence between the profits that American firms report to the taxman and the accounting ('book') profits disclosed to the investing public") has "widened alarmingly across corporate America, especially since the late 1990s." In the past, according to a study by Harvard Business School economist Mihir Desai, such factors as the differential treatment of depreciation, the reporting of foreign source income and the changing nature of employee compensation (e.g., proceeds from the exercise of stock options) explained nearly all the gap. However, by 1998, more than half the difference between book and tax income

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Stat. §10-228b). In the 2002 legislative session, Virginia lowered its cap on corporate income tax credits for qualified investments.

148 In the 2002 legislative session, Indiana rolled back the corporate income tax credit for property tax paid on the first $37,500 assessed value of business personal property.

149 "Corporate Tax & Accounting: Many Happy Returns?" (The Economist, May 10, 2003).

(about $154.4 billion) could not be accounted for by these factors. The gap grew, he found, because of increased use – in the late 1990s -- of corporate tax shelters.[150]

Importantly, investors are among those who are put at risk by the increased use of tax shelters and non-disclosure of tax return information. A study of the tax-book gap of over 3,000 publicly traded firms over the period 1973-2001 found that the 20% of firms with the *smallest* gap between tax and book profits showed strong average profit growth over the subsequent five years; the 20% of firms with the largest gaps tended to see their profits deteriorate markedly.[151] *The Economist* concludes that measures to increase transparency and accountability would also help investors who "would surely benefit from much fuller disclosure of a firm's tax return."

Ideas about how to increase disclosure and accountability abound. *The Economist* suggests three alternatives: a) a single set of accounts for both the taxman and investors; b) a requirement to publish corporate tax returns in full; and c) a requirement that firms publish an expanded version of Schedule M-1 (a table that currently rather superficially reconciles taxable and accounting profits). A recent report by the Office of Legislative Research[152] includes other proposals to enhance transparency and accountability regarding tax credits specifically. They include: a) establishing reporting requirements on tax credit programs similar to those imposed on firms that receive direct financial assistance; b) re-activating the Corporation Business Tax Review Committee (which was established in 1997 but has never met) and mandating that it evaluate all tax credits, including those unrelated to economic development; and c) capping the total amount of tax credits that are available annually and dividing this amount among the various tax credit programs on an annual basis after legislative review of current priorities. What follows are some specific suggestions from CT Voices for Children:

1. *Increase Transparency and Accountability in the Use of Tax Credits and Other Tax Expenditures.* Connecticut could require firm-specific reporting of the companies that are claiming tax credits, how much each is claiming each year, and data about jobs created/lost (as is done in Minnesota and some other states). There *should* be monitoring of economic development assistance provided through tax credits that is at least as rigorous as DECD's monitoring of its grants and loans. This could include written contracts that specify what a company receiving financial assistance through the tax code is committed to do in return (e.g., targets for job creation) and monitoring of compliance. Minimally, there should be public disclosure of *which* companies are receiving *which* tax credits, and in what amounts. Ideally, there should be full disclosure of the amount of state corporation business tax each publicly-traded corporation in Connecticut pays Connecticut, as well as incentive-specific disclosure. Other states (e.g. Maine, Minnesota) require much fuller disclosure than Connecticut does of the financial benefits provided to corporations through their tax codes.

2. *Sunset All Current Tax Expenditures.* In light of the state's current fiscal situation, Connecticut could require the sunset of all current tax expenditures (tax exemptions, exclusions, deductions, and

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150 M. Desai, *The Divergence Between Book and Tax Income* (forthcoming in J. Poterba (ed.) *Tax Policy and the Economy)*; M. Desai, *The Corporate Profit Base, Tax Sheltering Activity, and the Changing Nature of Employee Compensation* (National Bureau for Economic Research Working Paper 8866, March 2002), available at www.people.hbs.edu/mdesai/pubs.html.

151 Baruch Lev (New York University's Stern School) and Doron Nissim (Columbia Business School) did this analysis, reported in *The Economist* (May 10, 2003), p. 57.

152 J. Rappa, *Proposed Reporting and Tax Expenditure Requirements* (Office of Legislative Research, 2003-R-0209)(February 11, 2003).

credits) unless and until re-approved. This would allow the merit of the tax expenditure to be weighed against expenditures that would be possible if each were not reinstated.

3. *Sunset New Tax Expenditures.* The state could require that every *new* tax expenditure sunset within 5 years of the date of its enactment, unless the General Assembly provides some other period of time (ranging from 2 to 8 years) that the General Assembly expressly deems appropriate in light of identified circumstances, such as the rapidity of changing economic conditions, the purpose of the tax expenditure, and the like.

4. *Require Publicly-Traded Company Disclosure.* For publicly-traded companies, the state could require public access to company-specific information concerning Connecticut state taxes owed and paid, tax credits claimed, and/or other specific tax benefits enjoyed by specific companies.

5. *Expand OFA's Tax Expenditure Report.* Connecticut could expand current tax incidence reporting regarding *which* taxpayers benefit from each tax expenditure by showing not only the approximate number of taxpayers who benefit from each tax expenditure (as is currently done), but also by providing more description of *who* these taxpayers are (individual or corporate; approximate size of taxpaying entity; geographic location; nature of business or company; average income level of individuals/businesses). Additionally, the state could organize the report not only by tax type, as is currently done, but also by program category (education/job training, economic development, etc.) so that the reader can more easily understand the magnitude of different categories of investments supported financially through the tax code. For business tax expenditures benefiting ten or fewer companies, OFA could specifically identify the names of the corporations and the tax benefit derived by each. The report could also expand commentary regarding trends in state tax expenditure growth, projected impact on state revenues in the out-years (in real dollars), and impact on tax code equity.

6. *Include Tax Incidence Impact Statement in Fiscal Notes on Tax Expenditure Bills*: For fiscal notes on bills proposing new taxes, tax expenditures, or tax cuts, the state could require the inclusion of not only potential revenue gain (loss) but also a "tax incidence impact statement" that explains which taxpayers (by type of taxpayer, by income level, and – for businesses – by size of business) will bear the cost (or derive the benefit) of the tax change.

7. *Develop a Unified Development Budget Report*: Connecticut could require that OFA publish a biannual Unified Development Budget Report that includes all state on-budget and off-budget economic development spending through grants and loans by public and quasi-public agencies, as well as through preferential tax breaks. The Report could: a) include tax expenditures and major tax code changes designed to enhance economic development; b) categorize (by type of benefit, purpose of benefit, and type of beneficiary) total state spending on economic development; c) include all state spending to foster job creation, technology development, a healthy business sector, and help for employers in securing a skilled workforce, whether the spending is through grants, loans, tax expenditures or other preferential tax code changes; and d) include all on-budget and off-budget economic development spending through state agencies and through quasi-public agencies for the benefit of for-profit and not-for-profit entities. In addition, to assure that the data in the Report are complete, the state could require annual incentive-specific reporting for each economic development investment.

8. Establish A Blue Ribbon Commission on State Tax Policy. It has now been more than a decade since the personal income tax was adopted. Since that time, rate reductions and new tax expenditures have reduced by more than $2 billion Connecticut's on-going tax revenues, the share of state funding for public education has declined (placing a greater burden on the property tax), the state tax system has become increasingly out-of-step with the current economy (as is true in other states), and the demand for state-funded services has grown. There is also evidence that the increase in the use of tax expenditures for economic development (particularly refundable tax credits) and the increase in state debt is due, in part, to state spending cap avoidance, another important topic ripe for review. As Moody's explained in its downgrade of Connecticut's General Obligation Rating to Aa3 (from Aa2) on July 2, 2003, "Connecticut's debt per capita was almost three times the 2.3% median in 2002. The constraints of the spending cap have made it difficult to embed a baseline level of pay-as-you-go capital financing in the budget, as is the practice in most highly-rated states."

Other states, understanding the need to modernize their state tax systems, have created Blue Ribbon Commissions or Committees to study and make recommendations. States as diverse as Nevada,[153] North Carolina,[154] and California[155] have done so recently.

IX. What is the Impact of Strategic Repair Of Connecticut's Corporation Business Tax on State Economic Development Efforts?

> *I never made an investment decision based on the tax code….If you are giving money away I will take it. If you want to give me inducements for something I am going to do anyway, I will take it. But good business people do not do things because of inducements….*
>
> Paul O'Neill, former US Treasury Secretary & Chairman of Alcoa[156]

Much research has assessed the impact of taxes on economic growth using a variety of measures and controlling for factors important to businesses other than taxes.[157] These well-designed studies find

153 Governor's Task Force on Tax Policy in Nevada, *Analysis of Fiscal Policy in Nevada* (November 2002).

154 North Carolina Commission to Modernize State Finances, *Draft Recommendations* (November 2002)(established by Governor Easley and charged with developing a plan to reduce the volatility of state tax revenues, simplify the tax code, and update the tax system to reflect today's economy). Recommendations regarding the corporate tax were: a) to eliminate or reduce the use of credits; b) to avoid the problem of "no where" income by moving to combined reporting and establishing a "throw-out" provision; c) to conform more closely to the federal definition of "income" (by examining the merits of various adjustments to federal taxable income such as the interest expense deduction for financial institutions earning tax-exempt income); and d) to move back to the equal weighting of payroll, property, and sales in apportionment (since the change to a double-weighted sales factor in 1989 results in a loss of $60 million in revenues annually). See 2002 STT 229-19 (November 25, 2002).

155 Select Committee on Fiscal Restructuring (established by the California State Senate, and charged with completing its work by mid-August 2003). See 2003 STT 128-3 (July 2, 2003).

156 Testimony before the United States Senate Finance Committee, January 18, 2001.

157 These studies look at the impact of state and local business taxes on business formation, assuming that all other differences among states that potentially affect economic development – such as access to a well-trained workforce, the quality of public services, the cost of energy, etc. – are held constant. In fact, however, the differences among states in these factors are often significantly greater than differences in tax burden, and have a much greater impact on the relative attractiveness of different states in corporate investment, location, and re-location decisions. M. Mazerov, *The "Single Sales Factor" Formula for State Corporate Taxes: A Boon to Economic Development or a Costly Giveaway?* (Center on Budget and Policy Priorities, 2003).

that the impact of taxes (including the design of specific taxes and the aggregate tax burden) is very small. As one expert noted, “Site selection data do not suggest any correlation between low taxes and positive economic growth, or between high taxes and slow growth. The location requirements are too many, the process too complicated, and other factors too important to justify a strong relationship.”[158]

This results, in large part, from the fact that state and local taxes are a relatively small share of a corporation’s total costs of doing business – 4% of total operating costs for manufacturing operations and 5% for “back-office” operations, according to one study.[159] The impact of taxes on economic development decisions also exists only if one holds everything else – including the level of government services – equal. As one expert noted, “The only case where taxes alone could sway a location decision is a company relocation within a relatively autonomous geographic area, such as a city or metropolitan area, where labor, transportation, and utility costs are consistent.”[160]

One of the most recent of these studies was published by Robert Tannenwald, an economist with the Federal Reserve Bank of Boston. He looked at the impact of total state business tax burdens on manufacturing investment in five industries, after controlling for other non-tax factors likely to affect business location decisions. The study measured interstate variation in business tax burdens in a particularly rigorous manner. For the states in the study (that included the 22 most important manufacturing states including Connecticut), Tannenwald found that business tax climate exerted only a small and highly uncertain effect on the decision by manufacturers regarding where to invest in plant and equipment. He concluded, “states may be more likely to stimulate their economy by enhancing public services valued by business.”[161]

More recent research has complemented the work on tax effects by looking at the effects of state and local public services on economic development. As explained by an economist who summarized this literature recently, “Accurate estimates of the possible negative effects of taxes require similar estimates of the possible benefits from the public services financed by the taxes.”[162]

Careful studies of the relationship among taxes, spending, and job growth show that undermining a state’s educational system, its infrastructure, and other services vital to businesses will, over the long run, do *more* damage to a state’s economy than maintaining or modestly increasing taxes.[163] Indeed, business executives, in multiple surveys, place taxes low on the list of important location factors

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158 R. Ady, “Discussion on Papers by Ronald Fisher and Michael Wasylenko, *New England Economic Review* (March-April 1997), p. 80. Ady is an Executive Consultant with Deloitte & Touche/Fantus Consulting who focuses on helping corporations with relocations decisions.

159 R. Ady, “Discussion on Papers by Ronald Fisher and Michael Wasylenko, *New England Economic Review* (March-April 1997), p. 80.

160 R. Ady, “Discussion on Papers by Ronald Fisher and Michael Wasylenko, *New England Economic Review* (March-April 1997), pp. 77-82.

161 R. Tannenwald, “State Business Tax Climate: How Should It Be Measured and How Important Is It?” *New England Economic Review* (January/February 1996), pp. 23-38.

162 R. Fisher, “The Effects of State and Local Public Services on Economic Development,” *New England Economic Review* (March-April 1997), pp. 53-67.

163 See, for example, M. Wasylenko, “Taxation and Economic Development: The State of the Economic Literature,” *New England Economic Review* (March-April 1997), pp. 37-52; R. Fisher, “The Effects of State and Local Public Services on Economic Development,” *New England Economic Review* (March-April 1997), pp. 53-82; R. Lynch, *Do State and Local Tax Incentives Work?* (Economic Policy Institute, 1996); T. Bartik, *Who Benefits from State and Local Economic Development Policies?* (W.E. Upjohn Institute for Employment Research, 1991).

such as labor availability, costs, and training, access to market, access to raw materials; transportation costs, public services, and quality of life. Among these factors, according to a corporation relocation specialist, education "has been found to be the single most important service, greatly exceeding the value of all other services combined. A distant second is highway adequacy, followed by public safety and then infrastructure."[164]

Since *total* business tax obligations do not seem to have a significant impact on business location decisions according to Tannenwald's study and others', then repairing the corporation business tax (which is estimated to account for just 10% of total state and local taxes paid by corporations) is also unlikely to have any significant adverse impact on state economic development. It would, however, provide the additional revenues necessary to preserve and enhance essential public investments in public education, transportation, and other factors so important to businesses.

In addition, there is good evidence that state budget-cutting can have a harmful impact on the state's ability to recover from the current economic downturn, and that the harm from state spending cuts can exceed that from state tax increases. As Nobel Prize-winning economist Joseph Stiglitz and Peter Orszag (of the Brookings Institution) explained:

> …If taxes increase by $1, consumption may fall by 90 cents and saving may fall by 10 cents. Since a tax increase does not reduce consumption on a dollar-for-dollar basis, its negative impact on the economy is attenuated in the short run. Some types of spending reductions, however, would reduce demand in the economy on a dollar-for-dollar basis and therefore would be *more* harmful to the economy than a tax increase

In particular, "Reductions in direct government spending could have a larger adverse impact on a state's economy than tax increases, which have a stronger adverse impact on out-of-state goods and services" because "spending by individuals and businesses that would be affected by tax increases often is less concentrated among local producers….part of the decline in purchases that would occur if taxes were raised would be a decline in the purchase of goods produced *out of state*."[165]

X. How Have Other States Begun to Repair Their Corporation Business Taxes to Preserve Public Investments that Assure a Competitive State Economy?

With nearly every state facing a state budget crisis, it is not surprising that states are considering and adopting measures to repair their corporate business taxes. The New Jersey Business Tax Reform Act P.L. 2002, Chapter 40, is the most comprehensive of recent efforts, and is estimated to have more than doubled New Jersey's corporate tax revenues for FY 03 --from $800 million to $1.8

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164 R. Ady, "Discussion on Papers by Ronald Fisher and Michael Wasylenko, *New England Economic Review* (March-April 1997), p. 79.

165 P. Orszag & J. Stiglitz, *Budget Cuts vs. Tax Increases at the State Level: Is One More Counter-Productive Than the Other During a Recession?* (Center on Budget and Policy Priorities, November 1, 2001), available at: http://www.cbpp.org/10-30-01sfp.pdf.

billion. Seeing the success of New Jersey's comprehensive reform initiative,[166] New York and Massachusetts followed suit, as described below.[167]

A. New Jersey's Business Tax Repair Efforts. Newly-elected Gov. James McGreevey, facing a fiscal crisis comparable to Connecticut's and armed with public opinion polls showing that two-thirds of New Jersey residents supported increasing corporate taxes as a way to balance the budget, framed the reform as one of "fairness" and of leveling the playing field between large multi-national corporations and small businesses. In his Budget Address to the Joint Session of the Legislature, he explained:

> We're also making changes to the Corporate Business Tax which is neither fair nor equitable. It's broken. And we're going to fix it. The changes I am proposing today are designed to ensure corporations pay their fair share, just as every New Jersey family must do. The Corporate Business Tax once accounted for 15 percent of all state revenues collected. But today, it's less than 5 percent – which means that the rest of us are paying the bill.
>
> Why are corporate tax revenues so low today? Because some companies are using loopholes and accounting gimmicks to make their profits look smaller. They're shifting money from their New Jersey books into out-of-state companies or they're changing the structure of their companies on paper from one legal designation to another – all to avoid paying our taxes.
>
> Consider this: Of the 50 companies with the largest payrolls in New Jersey, 30 of them paid only the minimum corporate tax: $200 per year…. And that's not acceptable. You don't need an accountant to know those loopholes are not fair and must be changed. We're going to make sure that all companies are paying their fair share. We're going to restore the integrity of the corporate income tax by eliminating the loopholes and gimmicks that have allowed companies to shirk their responsibilities…. We're going to do this fairly, so that companies that have already been paying their fair share are not affected. And we're going to take steps to protect small businesses, so that they are not adversely affected by the changes.[168]

The Office of Legislative Research's report, *New Jersey and Connecticut Corporation Tax Laws* (December 16, 2002, #2002-R-1001), provides a useful description of provisions in the New Jersey business tax reform law and how they might be applied to Connecticut. OLR concludes that

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166 As discussed later, the State Treasurer of New Jersey recently reported that the corporation business tax reform bill not only generated substantial additional revenues, but also seemed to have spurred job growth and new business start-ups. Since the bill was targeted to help smaller businesses by requiring large multi-state corporations and out-of-state owners to pay their "fair share" of tax and concurrently reducing the tax rate on small companies, these outcomes, while significant, are not surprising.

167 For a more comprehensive listing of changes to the corporate and other major business taxes enacted in the 2002 legislative session to increase revenues (in Alabama, Arizona, California, Indiana, Kansas, Maine, Michigan, New Jersey, North Carolina, Ohio, Pennsylvania, and Virginia) see M. Rafool, *State Tax Actions 2002* (National Conference of State Legislatures, January 2003).

168 Gov. McGreevey's *Budget Address to the Joint Session of the Legislature* (March 26, 2002), available at http://www.nj.gov/governor/speeches/budget_address_032602.htm.

"Connecticut's corporation tax has many of the same elements as New Jersey's and any or all of the 12 provisions listed…could be applied in Connecticut."

1. Key Provisions. A brief summary of New Jersey's key provisions (and current Connecticut law with regard to each) follows. It is based in large part on OLR's summary.[169]

a. Revised Nexus Standard. New Jersey broadened the nexus standard for its business tax from one that applies only to corporations "doing business" in New Jersey (e.g., employing persons, owning capital, maintaining an office) to one that also includes corporations that are engaged in economic activity (e.g., "deriving receipts" from sources in New Jersey or "engaging in contacts" within New Jersey), subject to United States' constitutional limitations.

Connecticut's current nexus standard for its corporation tax is similar to New Jersey's *old* and more narrow standard, but *could* be expanded to also include an "economic benefit" standard for nexus.

b. Alternative Minimum Assessment. The centerpiece of the New Jersey reforms was a new graduated Alternative Minimum Assessment (AMA) tied to a company's gross receipts or gross profits. The AMA, which is *temporary*, sought to impose tax on those taxpayers that have a small amount of New Jersey *taxable* income or a tax loss. A corporation's tax liability is *the larger* of New Jersey's income-based Corporation Business Tax (including its increased minimum tax) or the AMA. Partnerships, S Corporations, investment companies, professional corporations, and cooperatives are exempt from the AMA, as are taxpayers with gross receipts of $2 million or less or gross profits of $1 million or less (effectively shielding about 70% of corporate taxpayers from this assessment).

The AMA is calculated using a formula and the taxpayer's AMA liability would be the *lower* of the taxes calculated based on New Jersey gross receipts or New Jersey gross profits.[170] The AMA is capped at $5 million for a single taxpayer and $20 million for an affiliated group of 5 or more taxpayers. If a taxpayer's AMA in one year exceeds its Corporation Business Tax (CBT) for that year, the taxpayer can apply the difference between its AMA and CBT as a credit to reduce its CBT liability in future years. An expansion in New Jersey's corporation business tax nexus standard (noted above) allows the AMA to be imposed on some businesses previously not liable for a net income-based tax.[171] *New Jersey estimated that this provision could generate as much as $300 million in FY 03.*[172]

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169 Other sources for this analysis are J. Rothstein, I. Chung, and K. Houghton, "A Tax Practitioner's Perspective on New Jersey's Business Reform Act," *State Tax Notes* (June 23, 2003), pp. 1043-1051; M. Forsberg, *Corporate Business Tax Reform in New Jersey* (New Jersey Policy Perspective, April 23, 2003); Treasurer J. McCormac, *Testimony Before the Assembly Budget Committee* (Office of the New Jersey State Treasurer, May 27, 2003), available at www.state.nj.us/treasury/news/2003/p30527a.html. For a critique of this reform act, see H. Hyans and A. Nogid, " 'A View from the Front Line': New Jersey's Business Reform Act – The Issues Abound," 2003 STT 134-26 (July 10, 2003).

170 By providing a gross profits method to calculate the AMA, this bill protects high-volume, low-margin industries like retailers, food stores, and other industries vital to the state's economy from bearing a disproportionate burden.

171 As Rothstein et al note, because the AMA is not a tax imposed on or measured by net income, PL 86-272 is not applicable and does not protect taxpayers from the AMA. However, "a question arises as to whether an independent nexus standard is permissible for a tax that is imposed only when it is greater than another tax." J. Rothstein, I. Chung, & K. Houghton, "A Tax Practitioner's Perspective on New Jersey's Business Tax Reform Act," *State Tax Notes* (June 23, 2003) at p. 1044.

172 The New Jersey State Treasurer and the non-partisan New Jersey Office of Legislative Services provided estimates of the revenue gains from the various components of New Jersey's corporate business tax reform initiative. They agreed that the new revenues would be approximately $1.823 billion in FY 03, an *increase* of $1 billion in corporate tax revenues

Connecticut has no AMA like New Jersey's, though it does have an alternative minimum tax ($250 with a temporary 20% surtax) and now prohibits tax credits from being used to totally offset tax liability (they may offset up to 70% of pre-credit liability).

c. Net Operating Losses. New Jersey suspended the state's Net Operating Loss deductions for 2002 and 2003 (and extended the state's carryforwards by two years). *New Jersey projected a temporary revenue gain of $260 million in FY 03 from this suspension.*

Interestingly, while New Jersey allows most companies to carryforward a NOL for 7 years (and for 14 years for qualifying high technology companies), Connecticut now allows a *20-year* NOL carryforward for income years starting January 1, 2000, provided the company was subject to the corporation tax in the year the NOL occurred (Conn. Gen. Stat. §12-217(a)(4)). Connecticut's carry-forward period is *longer* than in more than 20 other states. Indeed, in 1999 and years prior, Connecticut allowed only a *five*-year NOL carry-forward.

d. Throw-Out Rule. The New Jersey reform effort added a "throw out" rule for multi-state corporations operating in New Jersey. The "throw out" rule removes "no where" sales (the portion of sales made in states that do not tax them) from the company's total sales when calculating the New Jersey tax.[173] This increases the relative weight of in-state sales and thus the taxable income apportioned to New Jersey. To prevent this change from creating an exceptionally large new tax burden on an affiliated group of companies, New Jersey capped the additional tax liability attributable to the "throw out" at $5 million for any corporate group and allowed the group to spread the additional liability proportionately among its affiliates.

Connecticut currently has neither a "throw out" nor a "throw back" rule[174] (Conn. Gen. Stat. §§12-218, 218a, 218b).

e. Dividend Exclusion. New Jersey previously allowed a corporation to exclude from taxable income 100% of any dividends it received from companies in which it had at least an 80% ownership interest, and 50% of all other dividends. The reform act eliminates the exclusion for dividends received from companies in which the corporation subject to tax has less than 50% ownership. *New Jersey estimated a $50-$70 million revenue gain from taxing these dividends*.

Connecticut's current dividend exclusion is *even more* generous than New Jersey's *before* its reform law. Connecticut allows a corporation to exclude 100% of dividends received from any company in which it has a 20% interest or more, and 70% of dividends from any other company (Conn. Gen. Stat. §12-217(a)(1)(D)).

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for the year. Based on early revenue returns since passage of this reform bill, both the administration and the Office of Legislative Services have increased their revenue estimates for FY 03 from the reform initiative – the administration increased its estimate to $1.975 billion ($158 million more than originally projected) and the Office of Legislative Services to $2.125 billion ($358 million more). Both acknowledge that collections may be even greater than this in FY 04. M. Forsberg, *Corporate Tax Reform-The New Jersey Experience* (New Jersey Policy Perspectives, April 16, 2003).

173 In doing so, New Jersey became one of now 26 states to address the problem of "no where" sales. Twenty-four states have adopted throwback rules; New Jersey and West Virginia apply throwout rules.

174 As discussed earlier, a "throw back" rule requires a company to add no-where sales to its in-state sales in calculating the total share of sales within a state.

f. *Royalties and Interest.* New Jersey's reform act establishes a general rule that *dis*allows deductions for royalties and other "intangible" expenses paid between affiliated or related companies. It allows the state's tax director to allow deductions, by regulation or on a case-by-case basis, if the company can show that the transaction is not designed simply to avoid tax, if the expense is directly (or indirectly) accrued or paid to a related company that is located in a foreign country covered by a comprehensive US income tax treaty, or if the taxed corporation can show that the arrangement involves an unrelated third party. The law also bars deductions for inter-affiliate interest payments unless the taxpayer can show that the principle purpose of the transaction giving rise to the interest payment was not tax avoidance, the transaction was arm's length, the transaction was already subject to taxes approximating New Jersey's, or the disallowance is otherwise unreasonable. *New Jersey estimated that it would collect an additional $25 million to $40 million by disallowing royalty payments, and $25 million to $40 million by requiring that interest from an affiliated company be added back to New Jersey net income.*

Connecticut already restricts various deductions for royalties, intangible expenses, and interest expense payments between affiliated companies.[175] Such expenses must be added back in computing net taxable income unless the company establishes by clear and convincing evidence that the add-backs are unreasonable, the company and DRS Commissioner agree to an alternative form of apportionment, or the company establishes by a preponderance of the evidence that the affiliate paid the expenses to an unrelated third party in the same income year and the transaction's principal purpose was not to avoid Connecticut taxes (Conn. Gen. Stat. §12-218c). The DRS Commissioner also can disallow a deduction or expense if he determines it has no valid business purpose (Conn. Gen. Stat. §12-226a), though the reach of this authority is somewhat unclear after the Connecticut Supreme Court's ruling in the Carpenter Technology case (overruling the judgment of the DRS Commissioner), and the General Assembly's attempt to nullify this decision through PA 02-1 (MSS).

What Connecticut has *not* done is to follow New Jersey's lead and, by statute, *presumptively* disallow *all* royalties, interest and similar payments among corporate affiliates.

g. *Nonoperational Income Allocation.* New Jersey's reform act requires that the non-operational income of a corporation be assigned to the state in which that corporation is headquartered, rather than be allocated among all states in which the corporation does business. Therefore, companies headquartered New Jersey will be subject to New Jersey corporate tax on 100% of their "nonoperational" income (such as headquarters-managed investment income unrelated to the company's normal business operations). As discussed earlier, Connecticut currently requires corporations to apportion all business and *non*-business income according to the relevant apportionment formula, regardless of where the company is headquartered. Connecticut does *not* tax

175 Seven states, *including Connecticut*, already have enacted laws that deny a deduction from gross income for royalties and/or interest paid to related corporations. This issue also is not a problem in the 16 states that require combined reporting – the most comprehensive approach to nullifying a wide variety of corporate tax-avoidance techniques -- Alaska, Arizona, California, Colorado, Hawaii, Idaho, Illinois, Kansas, Maine, Minnesota, Montana, Nebraska, New Hampshire, North Dakota, Oregon, and Utah. However, 22 states with corporate income taxes could achieve significant growth in corporate tax revenue by enacting legislation as Massachusetts did that prevents corporate entities from shifting income to "passive investment companies" (PICs): Arkansas, Delaware, Florida, Georgia, Indiana, Iowa, Kentucky, Louisiana, Maryland, Montana, New Mexico, New York, Oklahoma, Pennsylvania, Rhode Island, South Carolina, Tennessee, Texas, Vermont, Virginia, West Virginia, Wisconsin, and Washington DC. See, M. Mazerov, *Closing Three Common Corporate Income Tax Loopholes Could Raise Additional Revenue For Many States* (Center on Budget and Policy Priorities, April 1, 2003), available at www.cbpp.org.

100% of the non-operational income of corporations based in Connecticut, as it constitutionally may.

h. *Foreign Tax Deduction.* New Jersey's reform act eliminates a deduction for taxes paid to foreign nations. Connecticut law allows a corporation to deduct those foreign taxes that a company could not deduct on its federal return because it took a federal foreign tax credit.

i. *Withholding for Pass-through Entities.* New Jersey (like other states) historically has failed to fully capture tax due based on revenues accruing to out of state partners/shareholders of pass-through entities such as LLPs, LLCs, and S-corporations. Although these owners were required to pay New Jersey income tax, New Jersey had no way to enforce this. To capture these revenues, the reform bill institutes a "processing fee" of $150 per owner, and takes a more aggressive approach to withholding for state income tax purposes. The New Jersey reform act requires pass-through entities (other than those listed on a national exchange) to remit to New Jersey a percentage of the income to be allocated to each non-resident partner/shareholder before distributing it: 9% of income for corporate owners and 6.37% for individual owners (New Jersey's corporate and top bracket personal income tax rates, respectively). These payments are then credited against the owners' tax liability. New Jersey estimated that new revenues from the processing fee *alone* would be $80 million; the actual number of pass-through entities with more than two owners was unknown.[176]

While Connecticut (like New Jersey) requires partners/shareholders of pass-through corporations to report their business income on their personal income tax returns, it has no similar withholding requirement to assure payment, and no processing fee for each owner (only the new $250 "entity" fee)(Conn. Gen. Stat. §12-701, PA 02-1, MSS).

j. *Minimum Corporate Business Tax*: New Jersey increased its alternative minimum corporate business tax from $200 to $500 for most corporations, and to $2,000 for corporations that are members of affiliated or controlled groups with total payrolls of $5 million or more, starting January 1, 2002. *New Jersey estimated that the revenue gain from this increase in the AMT would be about $45 million in FY 03.* Connecticut's alternative minimum tax is $250, set in 1982.

k. *A Lower Tax Rate for Small Businesses.* New Jersey reduced the corporation tax rate on businesses with net taxable income under $50,000/year from 7.5% to 6.5%. The revenues generated from the other provisions of its reform act (many of which ensured that large, multi-state corporations paid more in state corporate tax) helped offset the revenue loss from this initiative adopted to spur job growth and economic development. This rate reduction seemed to assume that the companies that would benefit are *small* companies, not large companies that have sheltered much of their New Jersey taxable income.

Additionally, New Jersey's *New Jobs Investment Tax Credit* Act, *1993* was amended to double the per job tax credit for creating new jobs in New Jersey and raise eligibility to allow mid-sized businesses to qualify for the credit. Prior to this change, about 15 corporations each year qualified for this incentive to create new jobs and the credit program cost the state about $200,000-$300,000 in lost revenues annually.

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176 M. Forsberg , *A Question of Balance: Taxing Businesses in the 21st Century* (New Jersey Policy Perspective, 2003), p. 25.

l. *Combined/Consolidated Reporting.* New Jersey did not enact mandatory combined reporting. Rather, the Director of the Division of Taxation is allowed "to require disclosure of inter-affiliate transactions, including transactions with related businesses that are not themselves corporate business taxpayers…."[177] The Director of Taxation may, on a case-by-base basis, require such corporate entities to file consolidated returns.

m. *Corporate Business Tax Commission.* The New Jersey reform act created a nine-member Corporate Business Tax Study Commission. The Commission is to produce a report by December 30, 2003, and is to evaluate the new corporate tax law changes by empirical analysis and feedback from public hearings. If the report is not produced by June 30, 2004, the Alternative Minimum Assessment will be suspended two years early – after December 31, 2004 instead of December 31, 2006. Among the issues that the Commission is to consider is whether the corporation business tax burden is fairly borne *among* corporations subject to the tax, whether profitable corporations doing business in New Jersey can still avoid paying their fair share of taxes using tax minimization or avoidance strategies, how the tax burden might be more equitably shared, if the reforms were sufficient to bring long-term structural balance to state finances, and whether New Jersey should mandate unified reporting.

The reform act also created a corporation business tax excess revenue fund into which revenues from this tax in excess of $1.823 billion are to be placed. Balances in the account are to be used in FY 04 and FY 05 to help cover shortfalls in corporate business tax collections from this target amount. If a balance remains in the fund on December 30, 2005, the Director of the Division of Taxation is to reduce corporate business tax rates accordingly.[178]

2. Estimated New Revenues. Prior to enactment, the New Jersey State Treasurer and the non-partisan New Jersey Office of Legislative Services provided estimates of the revenue gains from the various components of New Jersey's corporate business tax reform initiative. They concurred that there would be approximately $1.823 billion in FY 03 revenues in corporate tax revenues, an *increase* of $1 billion from this source in the year. A legislative fiscal estimate reported these additional revenues as follows:

New Jersey Corporate Business Tax Reform: New FY 03 Revenues		
Tax Change	New FY 03 Revenues	
Alternative Minimum Assessment	$300 million	Temporary
"Loophole" closers: interest, royalty, throwout	$220 million	Permanent
Net operating loss suspension	$260 million	Temporary
Pass-Through partner/shareholder processing fee	$60 million	Permanent
Corporate minimum tax increase	$45 million	Permanent
Requirement for larger corporations to pre-pay taxes	$140 million	Temporary
Source: Summarized in M. Forsberg, *Corporate Tax Reform: The New Jersey Experience* (New Jersey Policy Perspectives, April 16, 2003), p. 7.		

[177] M. Forsberg , *A Question of Balance: Taxing Businesses in the 21st Century* (New Jersey Policy Perspective, 2003), p. 22.
[178] New Jersey also delayed by four years its phase-out of the corporation business tax on S corporations. Connecticut began phasing out the tax on S corporations when the state enjoyed budget surpluses in the late 1990s; by 2001 no corporate business tax was imposed on Connecticut S corporations.

Based on actual revenues received since passage of the reform bill, both the administration and the Office of Legislative Services have *increased* their revenue estimates – the administration increased its estimate to $1.975 billion ($158 million more than originally projected) and the Office of Legislative Services to $2.125 billion ($358 million more). Both acknowledge that collections may be even greater than this in FY 04.[179]

3. Economic Impacts. Preliminary data about the economic impacts of these changes were provided in the testimony of New Jersey State Treasurer John McCormac to the Assembly's Budget Committee on May 27, 2003. He testified:

> While it is easy to dwell on the size and scope of our budget difficulties, we must remember that the problem would be insurmountably worse absent the restructuring of the Corporation Business Tax last year….These reforms were not easily accomplished. It was argued intensely that tax restructuring would trigger a mass exodus of employers and jobs from New Jersey and mass bankruptcies from companies doing business in our state….
>
> I am pleased to report that doom and gloom predictions have not materialized. New Jersey remains a favored location for new and expanding businesses due to its rock solid economic fundamentals, including its proximity to rails, seaports, airports, and interstate highways, access to markets, a large skilled and educated workforce and high per capita income; and the facts illustrate the point.
>
> New Jersey is coming off a record year for the number of companies registering to do business here. 66,000 companies filed to do business in 2002, a 13 percent increase over 2001. Even when you factor in business liquidations, New Jersey saw a net gain of 56,000 new business entities. We are already ahead of last year's record pace of new business filings. Through the first quarter of this year, New Jersey recorded 18,200 new business filings, compared to 17,250 over the same quarter in 2002.
>
> The positive economic news continues.
>
> Labor Commissioner Al Kroll announced earlier this month that New Jersey gained nearly 20,000 new jobs in April, following a jump of 14,300 jobs in March. With April's gain, the number of private sector jobs rose to its highest level – nearly 3.4 million – since July 2001….
>
> New Jersey remains economically strong due in large part to making the CBT a viable and reliable revenue source for the State after a 20-year pattern of erosion.[180]

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179 M. Forsberg, *Corporate Tax Reform-The New Jersey Experience* (New Jersey Policy Perspectives, April 16, 2003), p.7.

180 New Jersey State Treasurer J. McCormac, *Testimony Before the Assembly Budget Committee* (Office of the New Jersey State Treasurer, May 27, 2003), available at www.state.nj.us/treasury/news/2003/p30527a.html. By comparison, between May 2002 and May 2003, Connecticut *lost* 17,500 jobs and unemployment increased from 4.2% to 4.9%. In addition, net business formation (business starts less business stops) in the third quarter of 2003 declined by 27% compared to the same period in 2002 – there was a 2.5% decline in new business starts (from 11,657 to 11,360) and a 92% increase in business terminations (from 2,385 to 4,580). *The Connecticut Economic Digest*, 8(7) (June 2003), pp. 6-7.

B. New York's Repair Efforts. In its 2003 legislative session, New York enacted a number of repairs to its corporation business tax.[181] Most notably, it followed New Jersey's lead and adopted a new rule to capture tax due on income received from pass-through corporations by out-of-state owners and curbed the use of Passive Investment Corporation (PIC) structures to avoid New York tax.

1. *Capturing Tax on Income Pass-Through to Out-of-State and Corporate Owners.* New York now requires partnerships, LLCs, and S corporations to make quarterly estimated tax payments for New York income allocable to a non-resident or C corporation partner/member/shareholder. These pass-through entities must identify every owner who is a non-resident of New York or a C corporation, and apply the highest rate of tax to the portion of the entity's New York-source income that is allocable to the owner.

2. *Add-Back Requirements.* New York adopted measures to reduce corporate tax avoidance through passive investment company structures (PICs). Anti-PIC amendments to the state and New York City corporate tax, state personal income tax, and city unincorporated business tax disallow the deduction of certain items of related-party interest and royalty expense by requiring an add-back to federal income. That is, payers of certain interest and royalty payments to "related persons" must add back those expenses in computing taxable income for New York purposes. "Related person" is defined to include a variety of entities and arrangements that are at least 30% commonly owned. Payments subject to the add-back requirement include interest expense deductible under IRS section 163, and royalties and copyrights directly connected to the use of licenses, trademarks, copyrights, trade names, and similar intangible assets.

3. *LLC Fees.* The New York State fee payable by LLCs and LLPs with New York-income has been increased for 2003 and 2004 from $50 to $100 *per member*, and the minimum and maximum entity fees have been increased to $500 and $25,000 respectively. The fee is also imposed on single member LLCs, though the minimum fee for such entities is set at $100 (not $500).

4. *De-Coupling From Federal Depreciation Rules.* Unlike Connecticut, New York initially conformed to the 2002 federal bonus depreciation deduction changes. This year, New York joined Connecticut in decoupling from federal bonus depreciation changes,[182] with some minor exceptions.

5. *Personal Income Tax Rate Increase.* Because profits of pass-through corporations are taxed at personal income tax rates, it is important to note that New York also increased its top bracket personal income tax rate to a maximum of 7.7% and the New York City top bracket rate to a maximum of 4.45% (for income years 2003-2005). In addition, under both the state and city personal income taxes, the benefit of lower-rate brackets is eliminated for high-income taxpayers. In sum, a person subject to both the New York State and New York City personal income tax now faces a top bracket personal income tax rate of 12.15% (more than double Connecticut's 5% top bracket rate).

C. Massachusetts' Repair Efforts. Massachusetts also followed New Jersey's lead, recently adopting legislation to repair its corporation tax."[183] These changes were proposed by Governor

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181 See C. Lee & J. Lipari, *Recent Tax Law Changes in New York State and New York City* (June 13, 2003)(2003 STT 120-33).

182 Connecticut de-coupled from previously-enacted federal bonus depreciation changes. Whether this change to state law is sufficient to provide de-coupling from the new 2003 federal tax changes must be assessed.

Mitt Romney in January and approved by the legislature in the last week of February to address the FY 03 shortfall.

Most significantly, Massachusetts now denies corporations (with some limited exceptions) an income tax deduction for payments made to a "related member" for interest expenses or for the use of intangible assets, thereby curbing the use of passive investment corporations for tax avoidance purposes. In addition, repair legislation clarified existing law to ensure that financial institutions and business corporations that own 15% or more of the voting stock of a real estate investment trust (REIT) pay taxes on dividends they receive from the trusts, and that businesses organized as S corporations must continue to pay a 3% tax surcharge on net income if gross receipts exceed $6 million but are less than $9 million, and 4.5% if gross receipts are $9 million or more. In addition, the legislation gave the Commissioner of the Department of Revenue "in his discretion" authority to disallow the asserted tax benefits of transactions that he regards as invalid or sham transactions. If challenged, *the taxpayer* bears the burden of demonstrating by clear and convincing evidence (as determined by the commissioner) that the transaction possessed both a valid, good-faith business purpose other than tax avoidance and economic substance apart from the asserted tax benefit. The taxpayer also bears the burden of demonstrating by the same standard of proof that the asserted non-tax business purposes are commensurate with the tax benefit claimed.[184]

While legislation requiring unified reporting in Massachusetts enjoys considerable support in both the House and Senate, it remains unclear when, or if, this change will be adopted.[185]

D. Other States' Repair Initiatives

In addition to the many changes states have *enacted* in the past two years to repair their corporation business tax, others have been *proposed* by Governors in a variety of other states.[186] A sampling of these initiatives follows.
As Pennsylvania Governor Edward Rendell explained in his 2003 budget address:

> *…[I]t is time to treat all businesses fairly. Today in Pennsylvania, some businesses pay corporate taxes, while others use the protections of loopholes in our corporate tax system to escape paying their fair share.*
>
> Governor Edward G. Rendell, March 25, 2003 [187]

Governor Rendell proposed to: a) limit related-party transactions, closing the loophole through which companies transfer profits to states such as Delaware, and thus avoid paying Pennsylvania corporate taxes on those profits (estimated revenue gain $100 million in FY04 corporation taxes); b) require pass-through businesses to withhold income taxes for all non-resident partners/shareholders; and c) broaden the tax base to address the inherent inequity in the state corporation tax arising from the fact that only 22% of Pennsylvania businesses pay corporate taxes.

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183 See Chapter 4 of the Acts of 2003 (SB 1949) at http://www.state.ma.us/legis/laws/seslaw03/sl030004.htm.

184 See J. Dubitsky, W. Halmkin, D. McLaughlin, & D. Nagle, Massachusetts Increases Business Taxes, Empowers Commissioner to Deny Tax Benefits, *State Tax Notes* (March 17, 2003), pp. 1007-1010.

185 Communication with Jeff McLynch, Massachusetts Budget Project, April 15, 2003.

186 Nicholas Johnson, *Many Governors Are Proposing Tax Increases And Other Revenue Increases Are Necessary To Protect Basic Services* (Center on Budget and Policy Priorities. March 31, 2003).

187 Governor Edward G. Rendell, 'Budget Address To The General Assembly Of The Commonwealth Of Pennsylvania', March 25, 2003. http://www.state.pa.us/budget/cwp/view.asp?a=3&q=433268.

Missouri Governor Holden proposed eliminating a number of exemptions and special provisions in the corporation business tax and broadening the tax base, while lowering the overall tax rate. With Iowa Governor Tom Vilsack, Holden would require corporations to include income of out-of-state subsidiaries in their corporate tax returns. Michigan Governor Jennifer Granholm proposed eliminating a variety of tax exemptions and credits for business.

Ohio's Governor Taft proposed broadening the base of the state's corporate franchise tax. Kentucky's Governor Patton proposed replacing the corporate income tax with a business activity tax to raise more revenue. The Governors of Maryland and Alaska proposed increasing their states' minimum filing fees for corporations.

Interestingly, even 'tax haven' states (Delaware and Nevada) proposed significant increases in corporate taxes. Delaware's Governor Minner proposed increasing taxes and fees paid by corporations by an average of 17%, while Nevada's Governor Guinn proposed a new business gross receipts tax and a tripling of the state's business license fee (presently set at $100 per employee).

XI. Conclusion

On a variety of measures of business vitality, Connecticut currently ranks among the top states in the nation – 2nd best in the nation on overall economic development,[188] 3rd best in the nation in manufacturing competitiveness,[189] and 4th best on the Milkin Institute's *Knowledge-Based Economy Index*.[190]

Connecticut also enjoys very high national rankings on education – the factor deemed most essential to Connecticut's future economic competitiveness in this new knowledge-based economy. On the recently-released *National Assessment of Educational Programs*, for example, Connecticut shared the #1 ranking on Grade 4 student performance with only Vermont and Massachusetts[191] and has ranked consistently in the top 5 in the nation in the proportion of its adult population with four-year college degrees.

While the current state budget crisis results in part from the slow-down in the economy, a significant contributing factor to current state deficits are the more than $2 billion in tax cuts enacted in the late 1990s. What is at risk if Connecticut does not review these various tax cuts with the same vigor as

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188 Corporation for Enterprise Development, *Development Report Card for the States: Economic Benchmarks for Decisionmakers* (December 2002). Connecticut was given "straight As" on the Performance, Business Vitality, and Development Capacity Indices (as were Colorado, Massachusetts, Minnesota, and Virginia). It received "C" grades on the sub-indices of "Infrastructure Resources," "Amenity Resources," "Entrepreneurial Energy," and "Employment." The low ranking on "Employment" results from Connecticut's last place finish in long-term employment growth and 47th place ranking in short-term employment growth. The low ranking in "Entrepreneurial Energy" results from its 50th place ranking in "new business job growth." Contributing to the low ranking in infrastructure resources are bridge deficiencies, poor urban mass transit, and sewage treatment needs. High energy costs, poor air quality, and the conversion of cropland to other uses (sprawl) are the cause for the lower ranking on "amenity resources." Available at http://drc.cfed.org/.

189 CT Center for Economic Analysis, CT Economic Resource Center (CERC) & the Manufacturing Alliance of Connecticut (MAC), *MAC 2003 Index*, cited in S. McMillan, "Manufacturing: Reports of Its Demise Are Greatly Exaggerated," *The Connecticut Economy* (Winter 2003), p.8.

190 See http://www.milkeninstitute.org/research/research.taf?cat=indexes&function=detail&ID=19&type=NEI.

191 National Assessment of Educational Progress (NAEP), available at http://nces.ed.gov/nationsreportcard.

it is reviewing, and reducing, state spending is the quality of our educational system, the adequacy of the infrastructure important to business, and Connecticut's high quality of life.

Structural reform of Connecticut's state and local taxes is necessary not only to assure *adequate* revenues, but also to assure greater *stability* and *equity* in the collection of those revenues. Modernizing and repairing our state tax base also is essential to Connecticut's long-term economic competitiveness. As the Corporation for Enterprise Development concludes in its *Development Report Card for the States:*

> Though the temptation is to create patchwork solutions, the challenge is to find creative ways of preserving and improving those elements that are essential to good economic health. Quite simply, the higher quality of a state's human, financial, technological, infrastructural, natural and social capital, the better its overall economic performance. No state can be completely protected from the troughs that are part of our cyclical capitalist economy. But a jurisdiction with solid development resources can avert disaster and ride through the rough weather.[192]

An essential component of any tax reform initiative is repair of Connecticut's corporation business tax. This is necessary not only to provide needed revenues, but also to re-level the playing field between the state's largest multi-national corporations and its smaller businesses, and between corporations and private citizens. While currently *all* businesses in Connecticut benefit from its superb public education system and high quality of life, many are no longer paying their fair share for state-funded services. It is time to reverse this trend.

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[192] Corporation for Enterprise Development, *Development Report Card for the States: Economic Benchmarks for Decisionmakers* (December 2002).