

Testimony Supporting

H.B. No. 7316 – An Act Concerning Evaluation of Business Assistance and Incentive Programs
H.B. No. 7313 – An Act Imposing a Surcharge on Income Derived From Investment Management

Derek Thomas
Finance, Revenue and Bonding Committee
April 11, 2017

Senator Fonfara, Senator Frantz, Representative Rojas and members of the Committee,

I am testifying today on behalf of Connecticut Voices for Children, a research-based child advocacy organization working to ensure that all Connecticut children have an equitable opportunity to achieve their full potential.

At Connecticut Voices for Children, we view the state budget as the clearest statement of Connecticut's policy priorities. We believe that these priorities should advance long-term inclusive economic prosperity, equity of opportunity, and support for our most vulnerable residents. We believe that an effective revenue system can advance these core priorities by adhering to five principles: equity, neutrality, adequacy, transparency, and simplicity.

- **Equity** means that those with a greater ability to pay, pay more (vertical equity) and those in similar situations with the same ability to pay, pay equally (horizontal equity).
- **Neutrality** means that our tax system avoids unintentionally influencing private decisions.
- **Adequacy** means that our tax system raise sufficient revenue to continue to provide the level of public services that society desires in the near- and long-term. Stability and elasticity both contribute to an adequate system; stability means that revenues grow predictably, while elasticity means that a particular tax grows in tandem with the economy.
- **Transparency** means that the impact of particular tax policies, as well as processes for administering and complying with the tax system, can be easily assessed.
- **Simplicity** means that taxpayers can easily understand how the government raises revenue and spends their tax dollars.

In accordance with these principles, today's testimony will focus on H.B. No. 7316 (An Act Concerning Evaluation of Business Assistance and Incentive Programs) to promote **transparency**, and H.B. No. 7313 (An Act Imposing a Surcharge on Income Derived From Investment Management) to promote **equity and neutrality**.

I have also attached our revenue options brief¹ to our online testimony, which provides a menu of options to avoid painful cuts to critical programs now² and to restore **adequacy** and predictability to our revenue system so that we can continue to create opportunity for all children in the future.

¹ See our Revenue Options brief: <http://www.ctvoices.org/revenue2017>

² See our analysis of the Governor's biennial budget: <http://www.ctvoices.org/ChildrenFY18Governor>

H.B. 7316 – An Act Concerning Evaluation of Business Assistance and Incentive Programs

Connecticut, like all states, employs two primary sets of tools to develop its economy: strategic investments and financial incentives. The first toolkit focuses on people, places and things: strategic general fund investments in human capital and infrastructure that provide businesses with an educated workforce, roads to transport their goods, and other benefits.¹ The second, less transparent to most citizens, consists of financial incentives that states allocate to grow or retain jobs in existing industries and spur investment in and development of new ones. These incentives come in the form of direct aid, such as discounted loans and grants, and business tax breaks, such as tax credits, which reduce the tax liability for investors, industries, and individual firms.

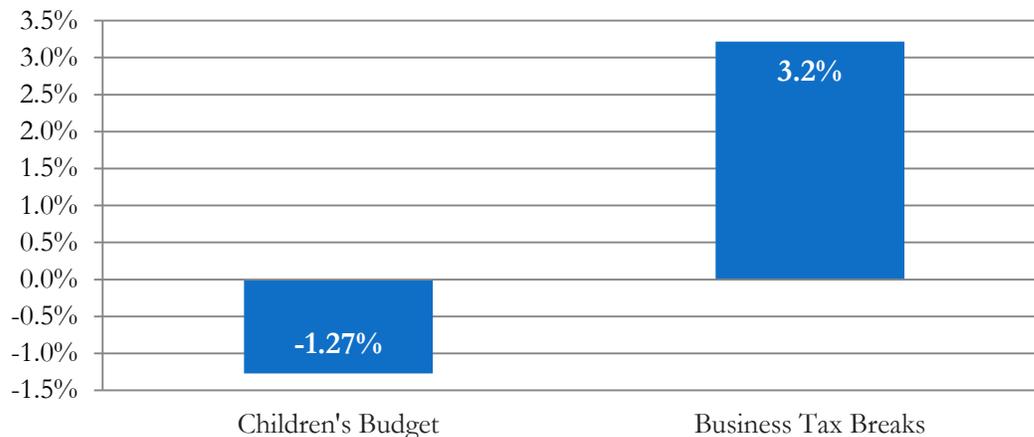
Of these two economic development strategies, only general fund spending is fully transparent to taxpayers. A more efficient, transparent, and fair budget process would include regular reviews of all economic development incentives, which reduce revenue that could otherwise be used to invest in education, transportation, and other building blocks to a healthier economy. As such, we are in the process of examining growth in business tax breaks; preliminarily, we find that **from fiscal year (FY) 2002 to FY 2017, the cost of business tax breaks increased by 43 percent – from \$494 million to \$706 million.**

Because labor costs account for a much higher share of the cost of doing business than taxes, state policies aimed at creating educated and productive workforces can provide a greater economic growth bang for the businesses buck. Indeed, according to a report prepared by Ernst & Young for the Council on State Taxation, a trade association consisting of more than 600 multistate corporations, Connecticut businesses reap the benefits of high quality public systems such as education.² The report found that for every dollar of government spending that benefits business in Connecticut, business pays only 80 cents.³ That's considerably less than the \$1.12 businesses paid nationally – third lowest in the nation, in fact – and the \$1.20 businesses paid in Massachusetts and New York.³

Yet, over the last two fiscal years, when resources have been most scarce, the percentage change in business tax credits and deductions for economic development purposes outpaced that of spending on children. In absolute dollars, spending on the Children's Budget decreased by \$81.2 million while the cost of business tax breaks increased by \$12 million.

Credits and Deductions for Economic Development Grew While Spending On Children Declined

Change in Spending, 2016 to 2017



CT Voices analysis of state budget trends and OFA tax expenditure reports

³ See more on the COST study at CT Mirror: <https://ctviewpoints.org/2017/01/06/in-lean-budget-year-invest-in-connecticuts-people/>

Unlike general fund spending on education, roads, and other spending on the building blocks to a healthy economy, business tax breaks lack transparency. Once on the books, they can remain for years, or even decades, without scrutiny. **A more efficient, transparent, and fair budget process would include regular reviews of all economic development incentives to ensure that tax expenditures are yielding the promised economic development benefits.** The proposed legislation does just that by ensuring that business tax breaks undergo regular scrutiny to determine their effectiveness.

H.B. 7313 – An Act Imposing a Surcharge on Income Derived From Investment Management

The governor's proposed state budget asks more from those who can least afford it. Of the new revenue in the governor's budget, 40 percent is generated by eliminating the property tax credit and cutting the state Earned Income Tax Credit (EITC).

The state EITC, which reaches about 200,000 low- and moderate-income households, builds on one of the most powerful tools for helping working families make ends meet. When layered on top of the federal credit, the Connecticut EITC boosts about 6,600 people over the poverty line (about \$23,990 for a family of three) and eases poverty for another 99,000. The state property tax credit was fashioned to offset the unfairness of the property tax for some 800,000 low- to moderate-income residents. Combined, the two proposals would amount to an average tax increase of \$93 for low-income families and \$157 for middle-income families.⁴

As if tax increases weren't enough, low- and moderate-income families would also suffer from cuts to critical services. For example:

- Cuts to child-care subsidies, known as Care 4 Kids, will exacerbate educational inequities and create barriers to employment for parents who can't afford the prohibitive costs of child care.
- Cuts to essential school-based wraparound services, such as school health centers and family resource centers, will worsen child health, lead to a decreased use of key early interventions and will lead to lower academic achievement statewide.⁵
- Cuts to the Governor's Scholarship program could mean fewer high-achieving low-income students would be able to afford public university in Connecticut.
- Finally, cuts to HUSKY A, which provides health insurance for children, low-income parents and pregnant women, would push as many as 9,500 low-income working parents out of the program — in some cases the very same parents at risk of losing their child-care subsidies.

Each of the proposals listed above – both tax increases and program cuts – build upon prior reductions.

At the same time, the budget proposal includes a tax break of \$100,000, on average, for some 600 taxpayers through changes to the estate tax.⁶

A recent report from the Center on Budget and Policy Priorities⁷ (CBPP) finds that Connecticut's income distribution is the third most unequal state in the nation. The report cites upside down total state and local tax systems and the growth in the share of investment income (from dividends, capital gains, and interest) to total income that goes primarily to high-income households, as contributing factors.

⁴ See our analysis of the Governor's biennial budget: <http://www.ctvoices.org/ChildrenFY18Governor>

⁵ See our brief, Care 4 Kids in CT: The Impact of Program Closure on Children, Parents, and Providers: <http://www.ctvoices.org/C4Kclosing>

⁶ See our testimony regarding S.B. No. 787 – An Act Concerning Revenue Items To Implement the Governor's Budget: http://www.ctvoices.org/sites/default/files/030917_fin_sb787_revenueitemsgovbudget.pdf

⁷ McNichol, Liz. CBPP. How State Tax Policies Can Stop Increasing Inequality and Start Reducing It. December 2016: <http://www.cbpp.org/research/state-budget-and-tax/how-state-tax-policies-can-stop-increasing-inequality-and-start>

Indeed, Connecticut's upside down tax system imposes a higher effective rate on lower income taxpayers' (including income, property, and sales and excise taxes, minus federal deductions) and allows the most powerful among us to pay a much lower percentage of their income in taxes. For example, a family making less than \$25,000 a year pays an estimated 11 percent in state and local taxes while a family making over \$1,331,000—the top 1 percent—pays 5.5 percent. If the top 5 percent of Connecticut households paid the same effective tax rate as the remaining 95 percent of households, the state could raise more than \$2 billion in state revenue annually.

To the state's credit, Connecticut employs several of the recommendations from CBPP's report, such as a state EITC to boost working families' incomes, and maintaining estate taxes to reduce wealth inequality. Both measures, however, are weakened in the Governor's budget proposal.⁸

The report also recommends levying higher rates on high-income taxpayers. Our Revenue Options brief (attached) proposed a half percentage point increase on the top two personal income tax brackets – 95 percent of which would fall on the top 1 percent of taxpayers – which would generate an estimated \$217.3 million in new state revenue, and higher rates on dividends and capital gains, which would generate an additional \$142 million.

Likewise, the state can ensure tax equity by joining the regional compact to close the carried interest loophole – which benefits a relatively few of the state's highest-income earners – to ensure that hedge fund and private equity managers pay the same tax rate as ordinary taxpayers.

The legislation calls for Northeastern states to impose a tax rate on carried interest sufficient to capture each state's share of the increased federal income tax liability that would be incurred if the loophole were closed at the federal level. Both states' proposals call for a 19 percent "carried interest fairness fee" until the loophole is closed at the federal level. By definition, the compact would not go into effect until all states (New York, New Jersey, Massachusetts, and Connecticut) enacted the same provisions. It is estimated that Connecticut could raise \$535 million by doing so.

Private equity and hedge funds compensation structure is often referred to as “2 and 20” – a 2 percent management fee and 20 percent of profits beyond a promised benchmark. The management fee is taxed as regular labor income (up to 39.6 percent for the highest marginal tax rates) while the share of profits – known as carried interest – is taxed as capital gains, thus taxed at a rate of 20 percent. Private equity and hedge funds are managing investments, not investing their own money or assuming any of the risk that actual investors take. According to Greg Mankiw, former Chair of the Council of Economic Advisers under President Bush, “carried interest should be taxed the same as other compensation for services.”⁹

According to an example from the Center on Budget and Policy Priorities, “If a manager made \$500 million from a carried interest, had no other income, and claimed no deductions or exemptions, his effective federal income and payroll tax rate (in 2007) would be 15 percent. By comparison, the effective tax rate for a single individual earning a \$45,000 salary would be 20 percent.”¹⁰

Thank you for this opportunity to submit testimony today.
Please feel free to contact me if you have questions or need additional information.
I can be reached at dthomas@ctvoices.org or (203) 498-4240 (x 114).

⁸ See our analysis of the Governor's biennial budget: <http://www.ctvoices.org/ChildrenFY18Governor>

⁹ Aron-Dine, Aviva. CBPP - An Analysis Of The Carried Interest Controversy. August 2007:
<http://www.cbpp.org/sites/default/files/atoms/files/7-31-07tax.pdf>

¹⁰ *ibid*

APPENDIX: Revenue Options are Key to Addressing Budget Shortfalls and Supporting Thriving Communities¹¹

In confronting budget deficits of more than \$3 billion in the upcoming biennial budget, the commonsense choice for Connecticut should be a balanced approach that includes revenue, rather than a cuts-only approach that threatens an already fragile recovery. Last year, lawmakers chose an “austerity” approach, balancing the budget with \$850 million in spending cuts. As a result, the Children’s Budget—a measure of the state’s investments in children and families—fell to a **record low 29.5 percent** of total General Fund spending.¹² While such cuts may offer a short-term solution, they do so at a significant cost to the long-term economic structure of the state.

On the revenue side, there are opportunities to invest in Connecticut’s future by modernizing an outdated sales tax system, strengthening taxes on corporations, and reforming wealth and income taxes. This brief highlights revenue options discussed and/or recommended by the State Tax Panel—a body of experts who met over the course of two years to evaluate Connecticut’s state and local taxes. While the Panel’s final recommendations were required to be revenue neutral, the policies themselves can be adapted to yield new revenue to support essential investments in our future.⁴ By combining increased revenue, new strategic investments, and smaller budget cuts, the Governor and the Legislature can both balance the budget and position the state for a more prosperous future.

Revenue Options

Modernize Outdated Sales Tax	Apply sales tax to services*	\$730 million to \$1.5 billion
	Collect a larger share of taxes due on internet sales*	\$65 to \$75 million
	Apply the sales tax to digital downloads*	\$7 to \$11 million
Reform Wealth and Income Taxes	Increase personal income tax by a half a percentage point for top earners	\$217.3 million
	Higher rates on dividends and capital gains	\$141.8 million
	Repatriation of deferred management fees	To be determined
	Join regional compact to close carried interest loophole	\$535 million
	Improve enforcement of existing tax laws	\$40 million
Strengthen Corporate Income Tax	Adopt throwback rule to eliminate “nowhere income”*	\$12 to \$25 million
	Eliminate the corporate income tax capital base system and replace with a value-added tax as an alternative minimum tax*	To be determined
	Renew efforts to regularly review business tax breaks*	To be determined
Support Critical Programs	Enact sweetened beverage tax	\$85 to \$141 million
	Institute a low-wage employer fee	\$305 million

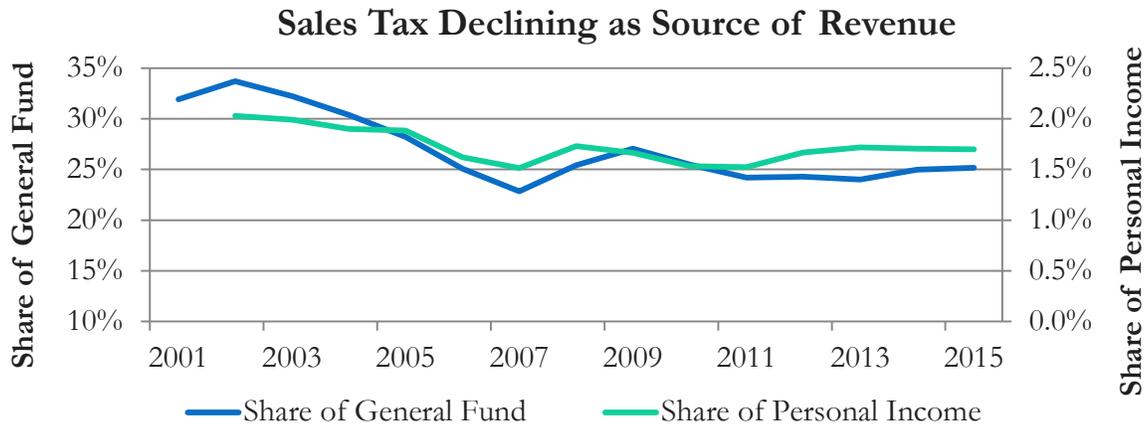
*Asterisk denotes policies discussed and/or recommended by State Tax Panel

¹¹ Our Revenue Options brief is available online: <http://www.ctvoices.org/revenue2017>

¹² To determine if the state has met its responsibility to children and families, our Children’s Budget tracks state investments such as early care and K-12 education, health care, and health and human services. See our interactive “Tracking the Children’s Budget” visualization for more details, to assess appropriations over time, and compare spending on children to other parts of the budget. In FY 1992, Connecticut spent nearly 40% of its General Fund on the Children’s Budget; now, that share has decreased to a record-low 29.5%: <http://www.ctvoices.org/issue-areas/budget-and-tax-fiscal-policy-center/tracking-childrens-budget>

MODERNIZE CONNECTICUT’S OUTDATED SALES TAX SYSTEM

Failure to keep our laws up to date with the 21st century economy has weakened the sales tax as a stable source of revenue. Households spend more on services and online sales – purchases often outside of the current tax structure – today than in the past. Services are often tax-exempt, in part because they have been deemed difficult to collect. And while taxes are legally due on online purchases, retailers are not required to collect them. From 2001, the sales tax revenue decreased from nearly a third (31.9 percent) of total General Fund revenue to a quarter (25.2 percent) in 2015. Thriving in a modern economy will not be possible without a stable and modern revenue system. The following reforms could generate up to \$1.5 billion while also ensuring revenue stability:



Inflation adjusted using CPI-AUC seasonally adjusted, annual averages 2008 – 2015. 2016 and 2017 based on estimated growth of 0.5 and 0.12%

Broadening the Base of the Sales Tax (\$730 million to \$1.5 billion): Over the past 40 years, the share of household spending on services has increased from one third to close to half of household budgets. During that same time, spending on durable and non-durable goods has *decreased* nearly the same amount. Yet, services – such as legal fees, interior design, tennis lessons, haircuts, car washes, pet grooming, bowling alleys, taxi rides, and limousine services – continue to remain largely untaxed, in part because in the past it was easier to identify tangible goods and because they made up the vast majority of personal consumption. Broadening the sales tax base to include services reduces volatility, creates a fairer tax system, and would generate \$1.5 billion in new revenue under the current sales tax rate of 6.35 percent. Reducing the rate to 5.5 percent and including services would still generate \$730 million in new revenue.

**Modernizing Sales Tax to Include Services
Would Generate up to \$1.5 Billion**

Rate	Additional Annual Revenue
6.35%	\$1.5 billion
6.00%	\$1.18 billion
5.50%	\$730 million

Institute for Taxation and Economic Policy. Analysis does not include business to business and exempts education, health, and shelter.

Collect a Larger Share of Taxes Due on Internet Sales (\$65 to \$75 million): Due to U.S. Supreme Court rulings, Connecticut cannot require out-of-state companies with no employees or facilities in the state to charge sales tax to in-state buyers. This puts local businesses that have to charge sales tax at a competitive disadvantage and, according to a 2009 estimate, costs the state an estimated **\$65 to \$75 million** in uncollected revenue.⁵ Even if they are not charged a tax by out-of-state sellers, however, Connecticut law requires consumers to pay sales tax on untaxed purchases directly to the state. Connecticut could collect a greater share of the taxes due from buyers if it enacted a version of a Colorado law that requires Internet, catalog, and other out-of-state sellers not charging state sales tax to provide information about the tax due on those purchases to the buyer and the Department of Revenue Services.⁶ The law (also recently enacted by Louisiana) would require out-of-state retailers to remind buyers that they are legally obligated to pay the tax even if the seller does not collect it, and provide information to the state that would enable it to seek payment of the tax from people who purchase big-ticket items upon which significant sums of tax are due. In December 2016, the U.S. Supreme Court effectively upheld the constitutionality of the Colorado law by declining to review a lower-court opinion upholding it, and numerous states are therefore likely to enact similar laws during their 2017 legislative sessions.⁷

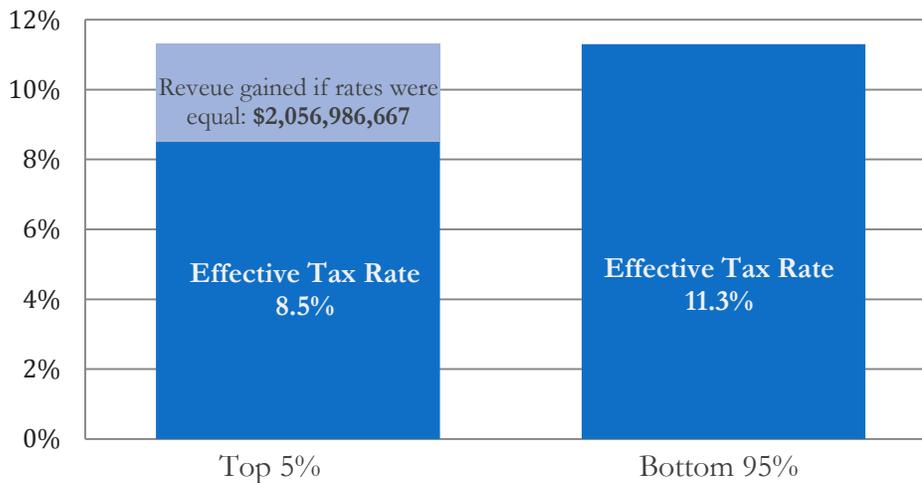
Apply the Sales Tax to Digital Downloads (\$7 to \$11 million): Update the state sales tax law and regulations to apply the sales and use tax to digital goods and services, such as downloaded computer software and online books, music and movies. Currently, in-store purchase of these items sold in physical form are taxed at a 6.35 percent rate while their digital equivalents are assessed a one-percent “computer services tax.”⁸ Applying the sales tax to digital downloads would have generated **\$7 to \$11 million** in revenue in 2011 (latest estimates available).⁹ This adjustment would also slightly reduce the extent to which the sales tax falls on lower-income households, since digital goods are disproportionately purchased by upper-income households that are more likely to have Internet access, as well as credit cards with which to make online purchases.

REFORM WEALTH AND INCOME TAXES

A recent report from the Center on Budget and Policy Priorities finds that Connecticut’s income distribution is the third most unequal state in the nation.¹⁰ The report cites upside down total state and local tax systems (which impose a higher effective rate on lower income taxpayers) and the growth in the share of investment income (from dividends, capital gains, and interest) to total income that goes primarily to high-income households, as contributing factors

Indeed, Connecticut’s overall tax system (including income, property, and sales and excise taxes, minus federal deductions) allows the most powerful among us to pay a much lower percentage of their income in taxes. For example, a family making less than \$25,000 a year pays an estimated 11 percent in state and local taxes while a family making over \$1,331,000—the top 1 percent—pays 5.5 percent.¹¹ If the top 5 percent of Connecticut households paid the same effective tax rate as the remaining 95 percent of households, the state could raise more than \$2 billion in state revenue annually.

Revenue Foregone as a Result of Unequal Effective Tax Rates
(state and local taxes)



Institute on Taxation and Economic Policy

Combined, the following changes could raise **more than \$1 billion** while also creating a fairer tax system and reducing wealth inequality:

Increase Top Tax Rate for Top Two Tax Groups (\$217.3 million): A half percentage point increase on the top two personal income tax brackets would result in an estimated \$217.3 million in new state revenue—95 percent of which would fall on the top 1 percent of taxpayers. Over a third of this tax increase would be offset by larger federal income tax deductions typically available to high-income earners, meaning that of the \$217.3 million in new revenue, the state would raise \$139.2 million from taxpayers, while the other \$78.1 million would be picked up by the federal government.

Increase Capital Gains and Dividends Taxes for Top Three Tax Groups (\$141.8 million): Carried interest is the share of earnings that investment managers receive from a profitable return of their client’s investment. The federal government treats carried interest as investment income, or capital gains, rather than as wages or commissions. This preferential treatment results in a federal tax liability that is 50 percent less than it would be for ordinary income. This is known as the carried interest loophole. Despite bipartisan support, little hope exists that Congress will take action. By increasing the tax on capital gains and dividends at the state level, Connecticut could redress the large preferences these two types of income enjoy in the federal tax code and raise \$141.8 million, based on the rates proposed in the table below.

Fixing the Upside-Down Tax System Could Generate a Half Billion in New Revenue

1. Higher Capital Gains and Dividends Rate on Top 3 Income Groups: 6.5% to 7%; 6.9% to 7.5%; 6.99% to 8%						
	Top 5%		State Tax Change	Federal Offset %	Federal Tax Change	Net Tax Change
	Next 4%	Top 1%				
<i>Average Tax Change</i>	\$50	\$7,869	\$141.8 million	33%	-\$46.4 million	\$95.4 million
<i>Share of Total Change</i>	2%	97%				
<i>% Facing Tax Increase</i>	39%	93%				
2. Higher Personal Income (PIT) Tax Rate on Top 2 Income Groups: 6.9% to 7.4%; 6.99% to 7.49%						
	Top 5%		State Tax Change	Federal Offset %	Federal Tax Change	Net Tax Change
	Next 4%	Top 1%				
<i>Average Tax Change</i>	+162	+11,734	\$217.3 million	36%	-\$78.1 million	\$139.2 million
<i>Share of Total Change</i>	5%	95%				
<i>% Facing Tax Increase</i>	25%	99%				
3. Higher PIT Tax Rate on Top 2 Income Groups: 6.9% to 7.9%; 6.99% to 7.99%; and Higher Capital Gains and Dividends Rate on Top 3 Income Groups.						
	Top 5%		State Tax Change	Federal Offset %	Federal Tax Change	Net Tax Change
	Next 4%	Top 1%				
<i>Average Tax Change</i>	+368	+27,451	\$507.8 million	35%	-\$179.3 million	\$328.5 million
<i>Share of Total Change</i>	5%	95%				
<i>% Facing Tax Increase</i>	42%	99%				

Institute on Taxation and Economic Policy

Taxing capital gains and dividends would represent a return to historical treatment of unearned income. When Connecticut’s income tax was enacted in 1991, taxes were also cut for higher-income earners by eliminating a 7 percent tax on capital gains and a 14 percent tax on dividends and interest. Thereafter, investment incomes were subjected to the state income tax at a much lower rate of 4.5 percent. While the top income tax rate has increased to 6.99 percent, it is still below pre-1991 levels for unearned income. Moreover, any increased taxes on unearned income, like any increase on earned income, would be offset in part by larger federal income tax deductions.

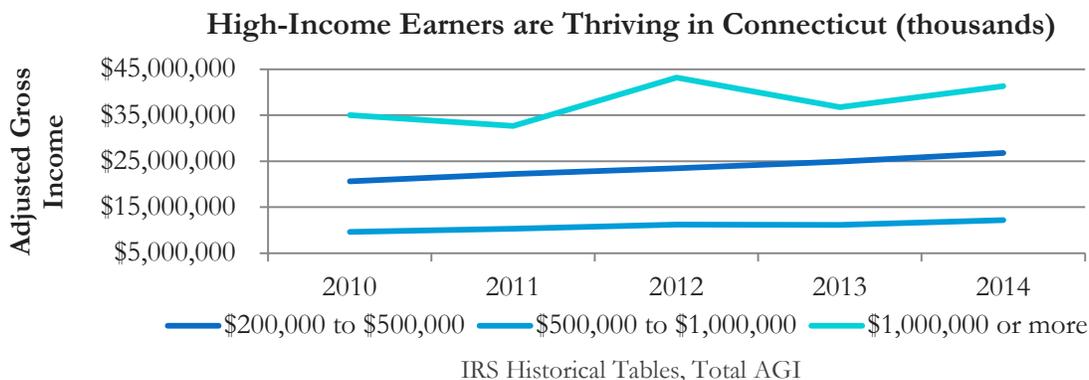
Millionaires Thrive in Connecticut Thanks to Public Investments

Anti-tax advocates have been inaccurately citing Internal Revenue Service (IRS) data in an effort to convince their audience that higher taxes have resulted in a “mass exodus” of residents seeking low tax states.¹² They assert that the income of residents who moved out of the state is income lost to another state, therefore depleting Connecticut’s finances. It is a claim that former Tax Foundation economist Lyman Stone has written rests “on an egregiously wrong use of the data” by analysts who “have either failed to perform the most basic due diligence...or else actively mislead their readers.” In other words, the vast majority of people who leave a state hold jobs that will be filled by people joining the labor force from within the state or moving in, resulting in no “loss of income” at all.¹³

Indeed, a 2016 study found that millionaires were much less likely to move than the rest of the population and that there was only a very small influence of income tax rates on the probability of moving. This study, based on 13 years of IRS tax data from all millionaires in the U.S., found that millionaire mobility and the low levels of responsiveness of millionaires to taxes meant that top tax rates would only start to decrease revenue if they were significantly higher than the single digit rates of Connecticut. A half percent, one percent, or two percent increase in the top tax bracket would not have a negative impact on revenue due to migration.

Florida is the main destination for migration from high and low tax states in the Northeast. The limited effect of tax rates on millionaire migration and the minimal effect on the tax base are not surprising given that the only evidence of millionaires moving to a low-tax state were those who moved to Florida.¹⁴ Indeed, 38 percent of all residents leaving Connecticut moved to Florida, the leading destination for virtually all Northeastern and Rustbelt states—including New Hampshire, which does not have any broad-based income tax. Common sense says many of these people leaving Connecticut are retirees seeking warmer weather, who likely would move regardless of Connecticut tax levels. For those that do leave, a younger more productive worker is likely to replace the retiree, which improves the businesses bottom line, raises taxable income, and improves the productivity of the state’s economy.

Despite the natural migration from state to state, Connecticut continues to produce high-income earners. According to filing data from the IRS, from 2010 to 2014, the number of returns filed by earners with incomes between \$200,000 to \$500,000 increased by 30.1 percent and their total adjusted gross income (AGI) increased 30.1 percent; the number of returns filed by earners with incomes between \$500,000 to \$1,000,000 increased by 26.7 percent and their AGI increased by 26.8 percent; and the number of returns filed by earners with incomes above \$1,000,000 increased by 18 percent and their AGI increased by 21.2 percent.



The following table compares top personal income and capital gains tax rates in Connecticut with those in New Jersey and New York. As shown, Connecticut’s top rate of 6.99 percent on personal income and capital gains is nearly two percentage points lower than New York’s top rate – not including New York City’s income tax rates.

Top Tax Rates in CT, NY, MA, and NJ

State	Single Filer		Married Filing Jointly		Capital Gains
	Rate	Bracket	Rate	Bracket	
CT	6.90%	\$250,000	6.90%	\$500,000	6.99%
	6.99%	\$500,000	6.99%	\$1,000,000	
NY	6.85%	\$214,000	6.85%	\$321,050	8.82%
	8.82%	\$1,070,350	8.82%	\$2,140,900	
NJ	8.97%	\$500,000	6.37%	\$150,000	8.97%
			8.97%	\$500,000	
MA	5.10%	\$0	5.10%	\$0	5.2 and 12%*

Tax Foundation. MA taxes a narrow category of "collectables and pre-1996 installment sales" at 12%. Both short- and long-term gains have a rate of 5.25 percent. New York City collects its own income taxes in addition to those collected by the state.

The city’s tax rates range from 2.9% of taxable income to 3.88% for top earners.

Join Regional Compact to Close Carried Interest Loophole (\$535 million): Another way in which states could act to close the carried interest loophole in light of inaction in Washington D.C. would be to form a regional compact. Already raised by the New York and New Jersey legislatures, the proposed legislation calls for Northeastern states to impose a tax rate on carried interest sufficient to capture each state's share of the increased federal income tax liability that would be incurred if the loophole were closed at the federal level. Both states' proposals call for a 19 percent "carried interest fairness fee" until the loophole is closed at the federal level. By definition, the compact would not go into effect until all states (New York, New Jersey, Massachusetts, and Connecticut) enacted the same provisions. It is estimated that Connecticut could raise \$535 million by doing so.^{15,16}

Repatriation of Deferred Management Fees: In addition to enjoying preferential tax treatment, investment managers have found a loophole that enables them to park their earnings offshore for investment to avoid taxation. However, as a result of a 2008 federal law, this loophole is scheduled to close, at which point the profits will be "repatriated". In other words, money parked abroad will be brought back home and subject to taxation. The Joint Committee for Taxation estimated a total U.S. windfall of \$8 billion in 2017. Revenue estimates have been wide ranging, but because of their high share of investment managers, Connecticut and New York are expecting a significant influx of taxable income in 2018.¹⁷

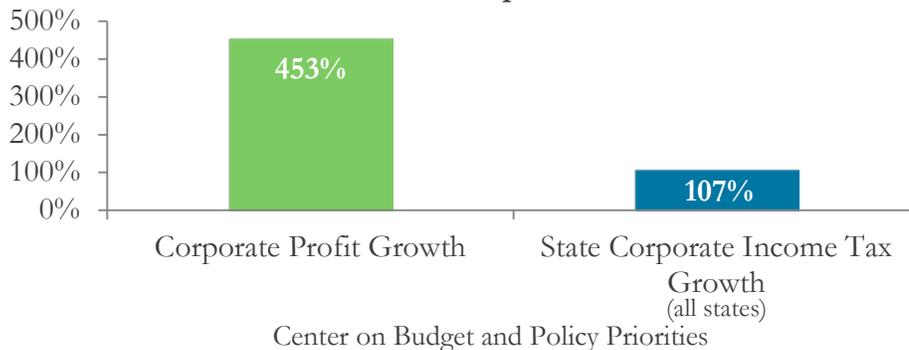
Improve Enforcement of Existing Tax Laws (\$40 million): Ensuring sufficient staff at the Department of Revenue Services (DRS) improves tax collections without raising taxes and levels the playing field for honest taxpayers. Without sufficient staff, some individuals (and companies) are not paying what they owe through tax avoidance strategies.

According to a 2006 Program Review and Investigations Committee study, state revenue auditors bring in much more money than they cost.¹⁸ The report found that each auditor generated approximately \$1 million in assessments annually, but that staff reductions contributed to fewer audits. According to a 2010 report from the same committee, the number of auditor jobs declined by 12 percent from 2000 through 2010.¹⁹ The Committee's findings suggest that an additional 50 auditors—to ensure everyone is paying what they owe—should increase revenue by at least \$40 million, accounting for salary and benefits. Updated data on what additional staffing at DRS could generate could be requested as a part of the budget process.

STRENGTHEN CONNECTICUT'S CORPORATE INCOME TAX

Income tax collections on corporate profits have dropped from 13.2 percent of General Fund revenue in 1991 (when the individual income tax was enacted) to less than 4 percent of overall tax collections in 2015—significantly less than New York (6 percent) and Massachusetts (9 percent). The decrease in corporate tax revenue cannot be attributed to a decline in business profits. From 1991 to 2015, national corporate profits increased by more than 400 percent, while state corporate income taxes increased by only 107 percent.²⁰ Rather, the decline in corporate tax revenue can be explained in large part by the growth in business tax credits and sophisticated corporate tax avoidance.

State Corporate Tax Collections Have Lagged Behind National Corporate Profits



Business tax breaks are worth hundreds of millions of dollars but are rarely evaluated and subjected to public scrutiny like spending on K-12 education and healthcare. According to a report presented to the State Tax Panel they “lead to revenue erosion [and] add complexity to the system.”²¹

Businesses that do not file as C-corporations pay taxes on their profits at the individual owner level—known as “pass-through” treatment—and are taxed at personal income tax rates, a lower rate than the 7.5 percent corporate income tax (9 percent for top rates with surcharge¹³). The growth in the number of pass-through businesses (partnerships, limited liability companies, and S-corporations) relative to the growth in the number of C-corporations has contributed to the decline in corporate income tax returns and revenue. Because pass-through income is concentrated among the top 1 percent of earners, the rise of passthroughs has contributed significantly to growing inequality.²² Many pass-through businesses are large and, because all or most of their owners are not liable for the businesses’ debts, are not meaningfully different from many C-corporations that are subject to the corporate income tax; large passthroughs should therefore be subject to a general business tax as well.

The following reforms would have the added benefit of leveling the playing field for all businesses and taxpayers by broadening and strengthening the corporate income tax:

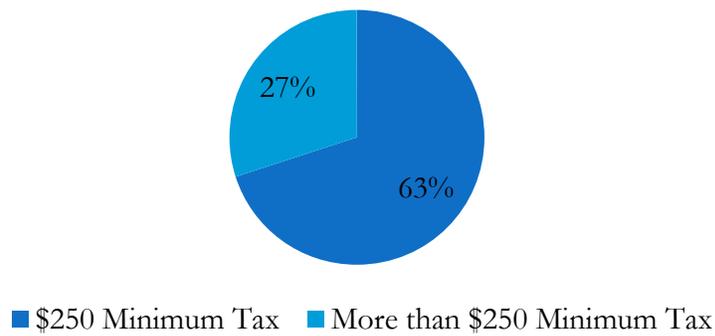
Adopt “Throwback Rule” to Eliminate “Nowhere Income” (\$12 to \$25 million): Just last year, the state legislature extended “single sales factor apportionment”—a formula determining how much of a company’s profits are taxable in the state—to most firms.²³ (Single sales factor has been imposed on manufacturers, financial services companies, and broadcasters since 2000²⁴). Prior to last year’s change, the formula took into account the location of a firm’s sales, wages paid, and property value to estimate how much business was done in each state. This in turn determines the share of the company’s nationwide profits that would be subject to tax in Connecticut. Under the new formula, only the sales share is taken into account. So, for example, if 90 percent of a firm’s nationwide property is in Connecticut and 90 percent of the firm’s payroll is in Connecticut, but only 10 percent of its sales are in Connecticut, Connecticut would only tax 10 percent of the firm’s profits. Moreover, in some instances, a corporation that manufactures products in Connecticut but sells them to an individual or firm in another state will not be taxable in the customer’s state due to an obscure federal law (Public Law 86-272). This results in “nowhere income”—profit that is not taxed by any state.

¹³ See Luna and Murray, *An Evaluation of Connecticut’s Corporate Income Tax* (pg. 19). A surcharge of 20% brings the top rate to 9.0 percent for companies that have more than \$250 in corporate tax liability and either (1) have at least \$100 million in annual gross income or (2) file combined or unitary returns. The surcharge will equal 10 percent in 2018 before phasing out thereafter.

Allowing large corporations to have nowhere income places smaller business, which generally have to pay tax on 100 percent of their incomes, at a competitive disadvantage. More than 20 states have enacted the throwback rule to eliminate nowhere income, including Vermont, Maine, New Hampshire, and Rhode Island.^{25,26} The throwback rule would effectively allow Connecticut to tax the profits of manufacturers that sell into states in which they are not taxable. Assuming a 2 to 4 percent increase in corporate income tax revenue, as has been estimated by other states, Connecticut could raise an additional **\$12 to \$25 million** by applying the throwback rule to nowhere income.

Eliminate the Corporate Income Tax Capital Base System and Replace with a Value-Added Tax as an Alternative Minimum Tax (to be determined): Companies subject to the corporate income tax calculate their tax liability using two systems—on a “net income basis” and on a “capital basis¹⁴”—and pay the higher of the two.²⁷ The net income calculation uses the company’s federal taxable base as a starting point, while the capital basis includes stocks, profits and reserves in its calculations. If tax liability for each is less than \$250, an “alternative minimum tax” equal to \$250 is applied.¹⁵ In 2013, 63 percent of all non-exempt businesses submitted the minimum tax, accounting for just 3.2 percent of total corporate income tax collections.²⁸

63 Percent of Businesses Pay the Minimum Tax of \$250
2013 Corporation Business Tax Returns



Connecticut DRS FY 2014/2015 Annual Report

Eliminating the capital base option and replacing it with a broader “value-added tax” like the one in effect in New Hampshire (known as the Business Enterprise Tax (BET)) would result in a broader range of businesses—such as large passthroughs—contributing to the public services from which they benefit, including our legal system, an educated workforce, and infrastructure.¹⁶ A value-added tax (VAT), which taxes only the additional value added at each stage of production, would also ensure that large C-corporations that are able to slash their tax liability by engaging in aggressive tax avoidance strategies or taking advantage of numerous tax breaks would pay their fair share. Finally, adoption of this system would result in less volatility during business cycles.²⁹

¹⁴ More on each calculation from the Office of Legislative Research <https://www.cga.ct.gov/2003/rpt/2003-R-0397.htm>

¹⁵ See Luna and Murray, *An Evaluation of Connecticut’s Corporate Income Tax* (pg. 19). A surcharge of 20% applies to the alternative minimum tax through 2018.

¹⁶ The New Hampshire model can be seen as an alternative to New York’s unincorporated business tax—a 4% tax on pass-through entities and sole proprietorships—without the disadvantages if being vulnerable to tax shelters.

Compensation paid to employees, interest paid to lenders, and dividends paid to stockholders would make up the base of the value-added tax and would be apportioned to Connecticut using an equally weighted property-payroll-sales formula.

Renew Efforts to Regularly Review Business Tax Breaks (to be determined): Bipartisan legislation in 2016 called for stronger review of the hundreds of millions of dollars spent on business tax breaks, but ultimately failed to become law. Without regular review to ensure these tax breaks are achieving their desired goal, they may become a permanent cost to the state even when changing economic conditions or policy priorities would suggest that they should be modified or repealed. **Just like spending on education, infrastructure, and social services, business tax breaks should be subject to public debate.**

SUPPORT CRITICAL PROGRAMS

Finally, two new revenue sources could be adopted which would serve to reduce the budget gap but also to advance public health and wellbeing.

Create a Sugary Drink Tax (\$85 to \$141 million): A growing body of research indicates that increasing the price of sugar-sweetened beverages reduces consumption and the associated adverse health impacts, especially for low-income individuals.³⁰ In response, Berkeley, California, Philadelphia, and Cook County, Illinois have all enacted a per-ounce tax on sweetened beverages. In Connecticut, legislation proposed in 2015 called for a tax of one cent on each fluid ounce of soda and would have raised more than **\$85 million** in the current fiscal year (FY 2017). The legislation would have required the revenue to be used for “education and outreach regarding obesity, heart disease and diabetes.”³¹ Estimates from the Rudd Center find that a similar penny-per-ounce tax would raise nearly \$141 million.³²

Institute a Low-Wage Employer Fee (\$305 million): Impose a fee on large corporations that pay employees less than \$15 an hour to recoup state costs attributable to low-wage employers. The rise in low-wage work undermines the state fiscal’s health in two ways. First, as low-wage jobs grow faster than high-wage jobs (a 20 percent increase since 2000 in industries that typically pay less than \$15 per hour, which also represent 43 percent of job growth since 2010³³), decreased worker pay translates into decreased income tax revenue. Second, some of the largest and most profitable employers in industries that have seen the strongest growth during the recovery are relying on public assistance programs to subsidize the low wages they pay their employees. A low-wage employer fee will help support programs that meet the needs of the low-income families and/or encourage such companies to raise employee wages. According to the state Office of Fiscal Analysis, the 2015 proposal to recoup state costs attributable to low-wage employers was estimated to generate **\$305 million** in revenue in the coming fiscal year. Legislative changes following this estimate, such as a phase-in of the fee and the size of the affected company, would have resulted in less revenue.³⁴ **Connecticut Voices for Children support this proposal only in the absence of a broader increase in the minimum wage of \$15 per hour. Moreover, funds raised should be dedicated to the programs for which low-wage employers rely on.**

Estimated Revenue Raised by Applying Sales Tax to Services.

The table below includes the estimated revenue that could be generated by expanding the sales tax to different services in Connecticut. It does not represent a comprehensive list of all services, and the revenue estimates below are approximations. These estimates include business-to-business purchases. Some of the items listed below, such as legal services, architectural services, engineering, accounting, bookkeeping, payroll, and advertising, are consumed more by businesses than by individuals. The table is based on data provided by the Institute for Taxation and Economic Policy.

Description	FY17 Revenue (\$ Millions)
Total	1,342.3
Computer and data processing services	198.3
Attorneys / Legal Services	192.3
Architectural and Engineering Services	176.1
Investment counseling and portfolio management	119.8
Accounting and bookkeeping	101.7
Intrastate courier service	80.8
Amusement and recreation services	66.3
Website creation, hosting, and maintenance	57.8
Advertising agencies, advertising time/space, and direct mail	52.5
Utilities for agricultural production or manufacturing	44.8
Renovation and Repair for Residential Real Property	32.8
Barber shops and beauty parlors	32.1
Veterinary services (doctors and hospitals)	29.7
Travel agent services	18.1
Calibration Services and ISO Services	16.6
Health club and athletic club services (certain services only)	15.7
Environmental consulting services (analysis, management, public relations)	15.7
Funeral services	14.3
Check and debt collection	13.7
Laundry and dry cleaning services	12.8
Taxi fares	8.1
Interior design and decorating	6.5
Motion picture leasing or rental	6.3
Sale of repair or maintenance on vessels	4.6
Tax preparation services	4.5
Massage therapist and electrolysis services	2.9
Media Payroll Services	2.9
Land surveying	2.8
Winter boat storage	2.5
Diaper service	2.5
Fur and clothing storage	2.2
Bowling alleys	2.0
Coin operated video games and pinball machines	1.1
Gift and package wrapping services	0.7
Campground rentals	0.6
Shoe repair services	0.2

Institute on Taxation and Economic Policy

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