Connecticut Tax Panel

Final Report of Policy Recommendations

Volume 1

Final Report Transmitted to the Connecticut General Assembly and Governor

December 31, 2015

CONNECTICUT TAX PANEL

Contents of *Volume 1*

PREFACE

The work of the Connecticut Tax Panel is published in three volumes. Volume 1 has two parts. The first is the Connecticut Tax Panel *Final Report* that includes the policy recommendations as transmitted to the Governor and the General Assembly on December 31, 2015. The second part of Volume 1 is a separate *Staff Report* designed to give context to the Panel's recommendations. The *Staff Report* draws on a series of eighteen consultant research papers that were presented to the Tax Panel during its policy deliberations, and as such does not necessarily represent the view of either the Tax Panel as a whole, or any member thereof. The only document that represents the Panel's views is the *Connecticut Tax Panel Final Report of Policy Recommendations.*

Volume 2 is also presented in two parts. For purpose of completeness and continuity, the first part of Volume 2 presents the full text of the Panel's *Final Report* Recommendations as transmitted on December 31, 2015. The second part is a compendium of consultant papers that provides background research on the Connecticut economy and its revenue system, and then proceeds to an analysis of the state's major state revenue sources.

Volume 3 again leads with the Tax Panel's *Final Report*. This *Final Report* section is followed by a set of consultant and staff papers on the topics relating to the local revenue system—the property tax and local revenue diversification. As with the other two volumes, the staff and consultant research papers represent only materials presented to the Tax Panel, and thus do not necessarily represent the view of either the Tax Panel as a whole, or any member thereof.

In making its recommendations, the Tax Panel adopted a strict rule of *revenue neutrality*. There are two facets to this rule. The first, pertains to the analysis of options for changing the structure of each type of state or local tax examined. Thus, when a tax policy option was identified that broadened (narrowed) the base of a specific tax, the rule required that the statutory tax be reduced (increased) in order to generate an equal-yield amount of tax collected. This allowed the Panel to make statements regarding how well a policy option for a given tax would meet the tests of *Guiding Guidelines and Criteria for Evaluating Changes to the Connecticut State and Local Revenue System* that the Panel adopted on May 12, 2015. This statement of the Panel's normative policy criteria is presented as the first paper in Volume 2.

Second, there is the principle of "revenue neutrality" as applied to the Panel's overall set of policy recommendations. Here the rule was applied that recommended changes in the state and local tax system as a whole must generate the same amount of revenue as the current system. Thus, in circumstances when there was a recommended change in a tax or taxes that led to an overall increase (decrease) of revenues to the state/local system, the Panel did not have the option to make recommendations for compensatory changes on the expenditure side of the budget. Rather, it set the rule that it must identify what other revenues might be decreased (increased) to maintain a tax system equal-yield of tax collections in the aggregate.

Tax Panel *Final Report* Transmittal of Final Recommendations
To the Governor and the Connecticut General Assembly

December 31, 2015

State of Connecticut

GENERAL ASSEMBLY

STATE TAX PANEL

ROOM 501 STATE CAPITOL
HARTFORD, CONNECTICUT 06106

December 31, 2015

Governor Dannel P. Malloy
State of Connecticut

The Honorable Brendan Sharkey
Speaker of the House

The Honorable Martin Looney
Senate President

The Honorable Joe Aresimowicz
House Majority Leader

The Honorable Bob Duff
Senate Majority Leader

The Honorable Len Fasano
Senate Republican Leader

The Honorable Themis Klarides
House Republican Leader

The Honorable John Fonfara
Senate Chair, Finance, Revenue and Bonding Committee

The Honorable Jeff Berger
House Chair, Finance, Revenue and Bonding Committee

The Honorable Scott Frantz
Senate Ranking Member, Finance, Revenue and Bonding Committee

The Honorable Christopher Davis
House Ranking Member, Finance, Revenue and Bonding Committee

Re: State Tax Panel

By this letter we transmit the condensed final report of the State Tax Panel as is required pursuant to PA 14-217 (Section 137). This report will be available in its entirety as of February 28, 2016.

The recommendations are the result of hearings and meetings over many months and represent the consensus reached on the major elements of the Connecticut tax code. In some cases there were dissenting votes, as noted.

We wish to thank the members of the Tax Panel for their invaluable service. We also wish to thank the Panel's staff leaders, Robert D. Ebel and Michael E. Bell, and the chief administrator Mary E. Finnegan.

Sincerely,

William H. Nickerson
Co-chair

William R. Dyson
Co- chair

TAX PANEL MEMBERSHIP & STAFF
2015

Co-chairs: William Dyson and William H. Nickerson

Voting Members:

1. Melinda A. Agsten, Partner, Wiggin and Dana LLP
2. Alfred Casella, Partner, Murtha Cullina, LLP
3. Alan Clavette, CPA, Clavette and Company, LLC
4. William Dyson, Co-Chair, Former O'Neill Endowed Chair, CCSU
5. John Elsesser, Town Manager, Town of Coventry
6. Marian Galbraith, Mayor, City of Groton
7. Christiana N. Tiana Gianopulos, Senior Counsel, Day Pitney, LLP
8. Howard K. Hill, Founder, Howard K. Hill Funeral Services
9. Anika Singh Lemar, Clinical Associate Professor, Yale Law School
10. Donat C. Marchand, Partner, Ivey, Barnum, and O'Mara. LLC
11. William H. Nickerson, Co-Chair, CEO, Eugene A. Hoffman Management
12. David Nee, Board Member, CT Voices
13. Louis B. Schatz, Partner, Shipman and Goodwin, LLP
14. Robert Testo, Principal, RJ Testo and Associates

Ex-Officio Members:

1. Rep J. Brendan Sharkey, Speaker of the House
2. Sen. Marty Looney, President Pro Tempore of the Senate
3. Ben Barnes, Secretary, Office of Policy and Management
4. Kevin Sullivan, Commissioner, Department of Revenue Services
5. Sen. John Fonfara, Senate Chair, Finance, Revenue and Bonding Committee
6. Rep. Jeff Berger, House Chair, Finance, Revenue and Bonding Committee
7. Sen. Scott Frantz, Ranking Member, Finance, Revenue and Bonding Committee
8. Rep. Chris Davis, Ranking Member, Finance, Revenue and Bonding Committee

Other: Patricia Widlitz, Former House Chair, Finance Committee (2014)
Sean Williams, Former House Ranking Member, Finance Committee (2014)

Staff: Robert D. Ebel, Executive Director
Michael E. Bell, Director, Intergovernmental and Local Finance
Mary E. Finnegan, Administrator

Recommendations of the Connecticut Tax Panel
As Transmitted to the Connecticut General Assembly and the Governor on December 31, 2015

1. Connecticut Personal Income Tax
2. Connecticut General Retail Sales Tax
3. Connecticut General Business Taxation
4. Connecticut Estate and Gift Taxation and Probate Fees
5. Property Tax and Local Revenue Diversification

1. The Connecticut Personal Income Tax
December 2015

Recommendation 1. **Taxation of Retirement Income**

Other than federally excluded income, tax all retirement income including military and teacher retirement income similar to the state's treatment of social security income.

- o Revenue Implications: Base broadening will allow for a reduction in statutory tax rates due to the long run capture of the trend of a growing segment of the Connecticut population that is of retirement age (Age 65 and older increasing from 18.6% in 2015, to 20.7% in 2020, to 23.5% in 2025).
- ▪ Adopted with Panel Members Galbraith, Schatz, and Testo dissenting

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The following three draft options do not have a significant revenue impact that differs from the current set of revenue projections.

Recommendation 2. **Connecticut Definition of Adjusted Gross Income**

- o Retain the Connecticut definition of Adjusted Gross Income as the starting point for calculating the Connecticut Personal Income Tax.
- ▪ Adopted without dissent.

Recommendation 3. **The Earned Income Tax Credit (EITC)**

- o Retain the Earned Income Tax Credit. Increase the credit from an amount equal to 27.5% to 30% of the federal earned income tax credit (Current Connecticut law phases in this increase by FY 2017).
- ▪ Adopted without dissent

Recommendation **4. Net Capital Gains Income**

- o Retain the tax treatment of taxing net capital gains income at the same rate as all other income in the Connecticut income tax.
- ▪ Adopted without dissent

2. The Connecticut General Retail Sales Tax
December 2015

Recommendation 1. **Remote Sales Transactions**

Connecticut should remain aggressive in the taxation of remote purchases (e-commerce, mail order, cross-border shopping) destined for Connecticut residents by pursuing opportunities to expand the definition of *nexus* through administrative procedures and, if needed, through legislation. As part of its enforcement the state should require sellers to collect and remit the tax.

- o Revenue Implication: Systematic and uniform capturing of such transactions will exert a downward pressure on statutory tax rates.
- ▪ Adopted without dissent

Recommendation 2. **Digital Downloads**

Tax retail consumption of digitized versions of goods at the same standard retail sales tax rate as other goods. As part of the enforcement strategy the state should look to use sellers, wherever they are located, to collect and remit the sales tax.

- o Revenue implication: Base broadening overtime to allow for lower statutory tax rates.
- ▪ Adopted without dissent

Recommendation 3. **Shared Economy**

Ensure that the sharing economy is taxed similarly to the traditional economy. Recognizing that the sharing economy is still in its early stages of development, the General Assembly should provide legislative support to the Department of Revenue Services in its efforts to identify the size of the tax base as well as to capture the tax due at retail by requiring the sharing economy organizing business entity to collect and remit tax due.

- o Revenue Implication: Base broadening overtime to allow for lower statutory tax rates.
- ▪ Adopted without dissent

Recommendation 4. **General Application of Sales and Use Tax**

Adopt the presumption that the Connecticut sales tax on final consumption be broadly applied to all goods and services sold at retail. If exclusions, exemptions or credits are to be allowed, the General Assembly must be explicit in its rationale for such treatment.

- o Revenue Implication: Base broadening overtime to allow for lower statutory tax rates.
- ▪ Adopted with Panel Members Clavette, Marchand, and Schatz dissenting

Recommendation 5. **Eliminate Sales Tax Holidays**

Eliminate the practice of a sales tax holiday

- o Revenue Implication: An increase of $5.2 m in retail sales tax yield would result in a less than 0.2% reduction in the standard statutory rate (FY 2014)
- ▪ Adopted without dissent

3. Connecticut General Business Taxation
The Corporate Net Income (Profits) Tax and Its Alternatives
December 2015

Analysis of Replacing the Corporate Net Income (Profits) Tax with a Broad Based/Low Rate General Business Tax Alternative

Recommendation 1. **Alternatives to the Corporate Net Income Tax and Business Taxes**

The Tax Panel finds that the taxation of the current corporate net income tax base violates many its adopted criteria for a high quality tax system. Therefore, the state shall undertake, through the Department of Revenue Services, a study of the structural impacts and tradeoffs of replacing the corporate net income tax with a broad based/low general business tax to be imposed uniformly on corporate and non-corporate businesses alike. In carrying out this study, which will include an examination of both a gross receipts tax and a value added tax, the state shall also examine how the adoption of a broader base and lower rate tax can become a vehicle for a single-business-tax strategy for further modernizing and stabilizing the current business tax system. This single-business tax analysis will include (i) eliminating the capital base system; (ii) phasing-out the proliferation of tax credits that can now be applied against the corporate net income tax; and (iii) phasing-in the exemption of business-to business transactions from the retail sales tax, and (iv) applying a less stringent ownership rule for business-to-business purchases when services are sold between a parent and a subsidiarity.

- o Revenue implications: The analysis is to be carried out on an equal-yield/revenue neutral basis of the alternatives *vis-à-vis* the current tax treatment of corporate and non-corporate entities alike.
- ▪ Adopted without dissent.

Relating to the Existing Corporate Net Income Tax

Recommendation 2. **Capital Base System**

Eliminate the capital base (stock) tax that serves as an alternative method of calculating taxpayer corporate income tax liability.

- o Revenue implications: since, at present, the corporate taxpayer is required to pay the higher of the two tax liability calculations -- capital base and net income -- any revenue losses would be made up by raising the corporate net income tax rate and/or placing limits on the issuance of new credits against the net income tax.
- ▪ Adopted without dissent.

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***Recommendation 3*: Proliferation of Tax Credits**

Discontinue the practice of issuing new tax credits that erode the base of the corporate net income tax, and also evaluate existing credits as to whether they are achieving their intended objectives. If credits are intended to provide general tax reduction, then phase out the credits and lower the statutory rate. If credits are intended to promote economic development, then efforts are to be made to identify alternative and transparent policies that can promote economic growth at lower revenue costs to the state.

- Revenue Implications: Elimination of credits paid in 2012 would have reduced the corporate statutory rate by 1.9 percent. The elimination of credits and credit carry forwards will put long term downward pressure on corporate income tax rates.
- Adopted without dissent

***Recommendation 4.* Mandatory Unitary Reporting**

Maintain mandatory combined reporting for business entitles that are part of a unitary business; require that unitary groups be broadly inclusive.

- Connecticut requires unitary reporting commencing with the 2016 tax year. Only a modest revenue gain is anticipated from adopting mandatory reporting.
- Adopted with Panel Member Galbraith dissenting.

***Recommendation 5.* Apportionment of Multi-state Income.**

Broadly adopt single sales apportionment factor based on market (destination) sourcing for the taxation of corporate and non-corporate business activities alike.

- Revenue Implications: The adoption of market sourcing is not projected to result in a significant change in revenue yield
- Adopted without dissent

***Recommendation 6:* Claiming of Net Operating Loss**

Reinstate full use of Net Operating Losses.

- Revenue implications: With an estimated annual revenue loss of $90.1 million in FY 2016, revenue neutrality will require raising the standard corporate tax rate of 7.5% to 8.2%. These numbers do not address the treatment the current unfunded contingent liability of claimable net operating losses totaling $78 billion.
- Adopted without dissent

4. The Connecticut Estate and Gift Tax and Probate Fees
December 2015

- All Recommendations Approved Without Dissent

***Recommendation* 1. Basic Structure and Effect on Taxpayer Migration Effect**

For the present retain the current estate tax exemption level of $2 million of the adjusted estate. The State should then (i) further examine the option of phasing in the level of tax exemption in conformity with federal law and (ii) continue to monitor data for tax induced taxpayer migration flows.

***Recommendation* 2. Portability**

Provide "portability" of the Connecticut estate tax exemption between spouses such that the unused exemption of the first to die may be claimed by the second-to-die's estate as permitted for federal estate tax purposes.

***Recommendation* 3. Qualified Terminable Interest Property**

Review current practice to ensure the full implementation of a Connecticut Qualified Terminable Interest Property (QTIP) election regardless of whether a federal QTIP election is made and independent from a federal QTIP election such that married couples can defer state estate taxes until the second death.

***Recommendation* 4. Gift Tax**

Repeal the Gift tax; continue to apply a rule that gifts made in contemplation of death are included in the value of the estate.

- Revenue Implications: Taken together, portability, QTIP, and elimination of the Gift Tax reduce E&G revenues by about 50% of current yields ($207m to $106m in FY 2014).

***Recommendation* 5. Estate Filing Dates to Conform to Federal Law**

Replace the Connecticut deadline for filing an estate return from the current practice of six (6) months following the decedent's death to conform to the federal practice of nine (9) months.

- Revenue Implications: A delay in Estate and Gift tax revenues in the fiscal year of implementation. For the Probate Court, a reduction in $7.4 million in probate fees is anticipated for the year in which the transition occurs (FY 2016 estimate). In addition, there is an ongoing annual loss of interest revenue to the Probate Court. For FY 2016 the interest loss is estimated to be $200,000.

***Recommendation* 6. Probate Fee Structure**

Revise the current formula of the probate fee for decedents' estates so that it reflects an appropriate level as a direct user fee for estate settlement rather than a vehicle for paying for essential judicial services unrelated to decedents' estates.

- Revenue Implications. The present treatment whereby probate fees are designed to fully cover the cost of Probate Court Administration results in a highly unstable revenue source to the Probate Court. This revenue instability reflects the uncertainty of the length of time an estate may be in probate. In some years the Court may largely cover its operating costs; in others it may be required to cover net operating losses through temporary borrowing from other state agency funds.

5. Property Tax and Local Revenue Diversification
December 2015

Administrative Issues

***Recommendation 1*: Fractional Assessment.**

Eliminate the 70 percent fractional assessment and define assessed value as 100 percent of estimated market value. When this transition is made, all municipalities must lower their property tax mill rate to raise the same amount of revenue as they raise currently.

- o Revenue Implications: Revenue Neutral.
- ▪ Adopted without dissent

***Recommendation 2*: Assessment Cycle**

Eliminate the 5-year reassessment cycle and institute annual reassessment. To ensure an accurate description of each property retain the 10-year physical inspection requirement. This recommendation should be implemented over a five-year period. The Tax Study Panel recognizes there may be some cost implications for municipalities and recommends ways to mitigate increased costs resulting from moving toward annual reassessments should be explored. For example, 13 municipalities have already joined together for regional revaluations.

- o Revenue Implications: During the five-year transition revenue neutrality can be accomplished by reduced mill rates to accompany base broadening as properties reassessed to reflect current market value.
- ▪ Adopted without dissent

***Recommendation 3*: Local Fiscal Disparities**

The Tax Study Panel's mandate is to review the state's overall state and local tax structure. The Panel affirmed at its May 2015 meeting it would not look at state and local expenditure policy. Accordingly, addressing the magnitude and design of state grants to local governments in Connecticut is beyond the Panel's scope of work. However, in view of evidence presented to the Panel that there are significant differences in property tax capacity of municipalities (fiscal disparities) across municipalities, the Panel concludes that state grant policies should be re-examined in an effort to further relieve pressure on the property tax and to equalize fiscal disparities.

1. Property taxes are regressive.
2. The property tax fails to meet requirements of horizontal and vertical equity.
3. The property tax system is detrimental to Connecticut's economic competitiveness
4. State grant policies should be re-examined in an effort to further relieve pressure on the property tax to address fiscal disparities across municipalities.
5. The State needs to look at the distribution formula which addresses closing the "need-capacity gap."

    - o Revenue Implications: Revenue Neutral
    - ▪ Adopted without dissent

Tax Exempt Properties

***Recommendation 4: Payments in Lieu of Taxes* (PILOT)**

The Panel recommends retention of Connecticut's existing statutory scheme for *payment-in-lieu-of-taxes* (PILOT) grants from the state to municipalities that is designed to recognize that state properties, hospitals, and colleges and universities serve regional and statewide communities. The Panel acknowledges that funding of this existing program is outside the scope of the Panel's charge, and it consequently makes no recommendation as to the funding of this program.

The Panel notes that municipalities in Connecticut are free under existing law to develop voluntary traditional PILOT programs. These programs can generate revenues from tax exempt properties to help finance the delivery of local public services benefiting those properties. A municipality considering development of such a voluntary program could model its program on the Boston model or develop a model that better reflects its community and its exempt organizations. A municipality could use the portion of its budget that finances goods and services that benefit all properties as a starting place for conversations with exempt organizations about voluntary PILOT payments, and the Panel recommends that the Office of Policy and Management develop estimates of the value of locally provided services to provide a framework for informing such a discussion. A municipality that develops a traditional PILOT program should consider exempting organizations with real property valuations below some threshold amount to protect small nonprofits.

- Revenue Implications: Revenue Neutral.
- Adopted without dissent

Direct Property Tax Relief

***Recommendation 5*: Low Income Tax Credit "Circuit Breaker"**

Eliminate the more than 100 state and local option partial property tax exemptions and replace them with a single unified state circuit breaker mechanism that provides property tax relief targeted to homeowners and renters whose property taxes are high relative to their household income. Such a circuit breaker would be a single threshold type circuit breaker implemented as a refundable credit through the Connecticut state income tax to provide targeted relief, replacing the current property tax credit. The circuit breaker could be designed so that this recommendation is revenue neutral.

- Revenue Implications: Implement this replacement on a revenue neutral basis.
- Adopted without dissent

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Agricultural Land Use Valuation

***Recommendation 6*: Agricultural Land**

Tighten up the implementation of the PA490 use value assessment program so the program is more aligned with the intended purpose of the program by

1. Implementing an objective test of agricultural use in order to qualify for participation in the program (e.g., establish a *de minimis* level of gross income from agricultural production)
2. Rationalizing use value assessment computation methods using more accurate income measures and more realistic capitalization rates
3. Requiring forest land participating in the program to be adjacent parcels
4. Allowing towns to remove land from the program if it has been rezoned for subdivision
5. Expanding the time period which land must remain undeveloped from 10 to 15 years
6. Increasing the penalties for early withdrawal from the program
7. Moving away from general tax relief for agriculture broadly and move toward strategic use of use value assessment to protect and preserve land that provides ecosystem services that are a form of public good or generates positive externalities.

    - Revenue Implications: Base broadening will increase revenues over time and allow property tax rates to be reduced.
    - Adopted without dissent

Revenue Diversification

***Recommendation 7*: Local Non-Property Taxation**.

Allow for a local sales tax of 1 percent to be implemented on a statewide basis with the revenue to be collected by the Department of Revenue Services (DRS), which will act as the collection agent for all local governments. The local tax will be piggybacked to the standard state sales tax rate. The funds shall be deposited in the Municipal Revenue Sharing Account and then distributed to municipalities in a manner that is fiscally equalizing (e.g., on the basis of fiscal needs such as documented by the Federal Reserve Bank of Boston, 2015)

- Revenue Implications: An increase of approximately $600 million is intended to be applied to a reduction in property tax rates. Under this arrangement the local sales tax will lead statewide property tax reduction of 6 to 7 percent.
- Adopted with Panel Members Clavette, Nickerson, and Schatz dissenting

Personal Property Taxes

***Recommendation 8*: Taxation of Business Tangible Property**

Exempt the first $10,000 of personal property from taxation thereby eliminating 56 percent of personal property accounts. The Panel recognizes that for zero tax due accounts there must be a mechanism put in place so that each municipality will continue to be able to identify individual businesses located in their jurisdiction.

- Revenue Implications: Reduces administrative costs for taxpayers and local governments and would result in reduced revenues by $19 million, or three (3) percent of personal property tax total collections. Revenue neutrality can be accomplished by a small increase on the remaining taxable tangible property tax base or through revenue diversification.
- Adopted without dissent

***Recommendation 9*: Personal Property Tax Revenue Administration/Implementation**

The Office of Policy and Management or other research agency should revisit the implementation of the personal property tax by

1. Periodically examining depreciation schedules and the 30 percent residual value
2. Improving audit procedures and practices
3. Strengthening the role of OPM in overseeing uniformity of assessment administration
4. Requiring all municipalities to use the same OPM standard form for filing information
5. Periodically estimating economic and functional obsolescence in at least chemical products manufacturing and other industries where standard depreciation schedules are inadequate.
    - Revenue Implications: Revenue Neutral.
    - Adopted without dissent

Motor Vehicle Tax

***Recommendation 10*: Motor Vehicles ("Car Tax")**

The Panel supports the changes in the motor vehicle tax made in 2015 and recommends that the impact of these changes on the equity, efficiency and administration costs of the motor vehicle tax should be evaluated after they have been in place for a period of no more than three years. This will also provide time to see how the Municipal Revenue Sharing Account works to hold harmless those municipalities that experience a decline in motor vehicle tax revenues because of the ceiling placed on the mill rate applied to motor vehicles.

- Revenue Implications: Revenue Neutral.
- Adopted without dissent

***Recommendation* 11: Antique Vehicles**

The assessed value of antique vehicles should be set at current market value rather than the current assessment limit of $500, but shall not exceed a valuation of $50,000.

- Revenue Implications: Broadening the property tax base over time will lower statutory tax rates.
- Adopted without dissent

Conveyance and Controlling Interest Taxes

***Recommendation* 12. Conveyance and Controlling Interest Taxes**

To assure inter-community equity the local real estate conveyance (REC) tax rate shall be set at the same rate statewide as the targeted community rate (0.5 percent). The state rate shall remain unchanged.

- Revenue Implications: Will raise approximately $40 million in additional revenues for local governments.
- Adopted without dissent

Memoranda of Comment by Panel Members to Accompany Panel Recommendations

- *Memorandum of Comment* submitted by Panel Members Elsesser, Lemar, Galbraith, and Nee relating to the Local Revenue System.

- *Memorandum of Comment* Submitted by Senator Scott Frantz Relating to the Connecticut Estate and Gift Tax and Scope of the Panel's Activity

- *Memorandum of Comment* submitted by Panel Member Marchand relating to (i) claim of refund for overpayment of income taxes: to enable a taxpayer to secure a refund 2 years from the date of payment, in addition to 3 years from the due date of the return, and (ii) sales tax refunds and deficiency assessments: to change the standard of proof borne by a taxpayer in tax litigation from "clear and convincing" to "preponderance of the evidence."

- *Memorandum of Comment* submitted by Panel Member Schatz Relating to the Connecticut Personal Income Tax: Taxation of Retirement Income and the Connecticut Retail Sales Tax, the General Application of the Sales and Use Tax, and the Local Sales Tax Revenue Diversification

- *Memorandum of Comment* submitted by Revenue Commissioner Kevin Sullivan

Memorandum of Comment

Submitted by Panel Members Elsesser, Lemar, Galbraith, and Nee

Relating to the Local Revenue System

We have repeatedly opined that the Tax Panel, of which we are all members, failed its statutory charge "to review the state's overall state and local tax structure" because it refused to consider the structure of the property tax. This Memorandum sets forth some major concerns with our current property tax system and urges the Connecticut General Assembly to undertake a major overhaul of that system in the interest of improving the economic prospects of our state.

Expert after expert told the Tax Panel that Connecticut is singular in regard to (a) the degree to which our towns rely on the property tax to fund all local functions and (b) the sheer number of towns in the state. The latter singularity creates massive inefficiencies that increase local property tax burdens. The former distorts local policymaking, as towns seek to maximize property tax revenue while limiting local expenditures. The primary local expenditure is public education. As any reader of our local newspapers knows, towns regularly make land use decisions intended to prohibit any influx of school-age children and, by extension, their parents. By over-regulating housing production, these towns intentionally make housing more expensive thus driving recent college graduates and young families, our emerging workforce, to urban centers in neighboring states.

But young families and recent college graduates are our state's future. They pay a disproportionate percentage of the sales tax. They provide workers for Connecticut's employers and pay their fair share of income taxes. And their children represent Connecticut's long-term prospects. The young adults most likely to settle in Connecticut are those who grew up here. Artificially inflating property values through zoning, thus making it harder for young families and college graduates to find housing in the state, is bad economic policy. In fact, in his presentation to the Tax Panel on economic competitiveness, Professor Michael Wasylenko concluded that while changing tax policy cannot significantly improve Connecticut's economic competitiveness, changing our housing policy can. He specifically recommended that Connecticut increase housing production and decrease housing costs by easing zoning restrictions in order to compete economically with our neighboring states. Unfortunately, our towns will never allow this so long as their fiscal interests lie in inflating property values and decreasing education costs. As a result of our dysfunctional property tax structure, the towns work against the state's economic interests.

Our cities, on the other hand, have worked to increase zoning density and housing production. They are striving to create the kind of economic environment that contemporary employers seek: dense innovation districts with a concentration of high-technology companies and highly-educated employees. But state taxation policy handicaps local policy. Because Connecticut, with its 169 small municipalities, is the most economically-segregated state in the country, our cities have exorbitant property tax rates. By way of example, Bridgeport's property tax rate is nearly twice that of neighboring Fairfield and nearly three times that of nearby Darien. And even Darien's rate is higher than Boston's residential rate. These high rates severely limit the ability of our cities to compete with cities in our neighboring states. In today's competitive environment, our property tax system ties our hands behind our backs. It is well past time to do something about it.

Memorandum of Comment
Submitted by Senator Scott Frantz, *Ex Officio Panel Member*
Relating to the Connecticut Estate and Gift Tax and Scope of the Panel's Activity

As a non-voting, Ex officio member of the State Tax Panel, I would like to make the following suggestions to the Panel:

1) Immediately Raise the Estate and Gift Tax Exemption to the Federal Level and Consider Their Repeal

Although the Tax Panel recommendations include a provision to repeal the gift tax, I would like to further emphasize that the gift tax should be eliminated this coming legislative session. Connecticut currently has an exemption level of $2,000,000 that should be raised to the 2016 federal level of $5,450,000 if the estate and gift taxes are not done away with completely. An argument can be made that the estate tax along with an onerous probate fee (tax) that applies to all estate assets, including those that do not have to go through the probate court, is driving tax payers out of the state and that we are losing a greater amount of value in lost economic development contributions, future income tax payments to the state and philanthropy than amounts raised by taxing estates. With respect to the gift tax, Connecticut is the only state in the country to have one. It is one more significant tax that wealthy individuals see as a deterrent to remaining in the state or moving to the state, and it should be repealed. As income tax revenue to the state continues to fall significantly short of projections, it is imperative that Connecticut preserve as much of its tax base as it can in order to stay solvent.

2) Encourage Any Future Panels or Commissions Analyzing the Tax Code to Review All Taxes to Determine if They Pay for Themselves

One of the original intentions of the legislator who suggested we create a tax panel was to look at all 387 taxes and fees that the state imposes on taxpayers to see if they all were feasible and economical. Fully recognizing the Tax Panel only had so much time to complete its work, I think it would be a valuable exercise to scrutinize each one of these taxes in the future.

Memorandum of Comment
Submitted by Panel Member Marchand
Relating to refund for overpayment of income taxes and sales tax refunds and deficiency assessments

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February 1, 2016

MEMORANDUM

To: Robert D. Ebel and Members of Connecticut State Tax Panel

Re: **Two Inequities in Administration of Connecticut Taxes**

The direction given to the State Tax Panel in § 137 of P.A. 14-217 was to "consider and evaluate options to modernize tax policy, structure and administration with respect to … (3) equity,… (12) overall public policy." There are two practices imposed by statute or judicial decision that are highly inequitable in the administration of the Connecticut Tax System and are bad public policy:

(1) The limitation under §12-732 for a claim of refund for overpayment of Connecticut income taxes, now three years from the due date of the return, should provide at alternate period of two years from the date of payment, the limitation governing refunds in neighboring states and for federal income taxes. The change would enable Connecticut taxpayers to secure a refund when taxes are determined not to be due during negotiations with the Department of Revenue Services after the three year period from the date of assessment has expired.

A similar problem should be corrected with respect to refunds of sales and use taxes under §12-425 which now mandates a refund claim must be filed within six months of the assessment. An alternate period of two years from the date of payment should be provided for the filing of claim for a refund of Connecticut sales and use taxes.

(2) The burden of proof for a Connecticut taxpayer to prevail on a refund claim should be changed from "clear and convincing evidence" to "the preponderance of evidence," the standard for tax cases in neighboring states and in the federal tax system.

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Member
State Tax Panel

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Memorandum of Comment

Submitted by Panel Member Louis B. Schatz

Relating to the Connecticut Personal Income Tax, the Connecticut Retail Sales Tax and the Local Sales Tax Revenue Diversification

At our meeting on December 15, 2015, I voted against three of the recommendations that were ultimately adopted by the State Tax Panel. This Comment Memorandum sets forth my reasons for dissenting.

1. <u>Connecticut Personal Income Tax. Recommendation 1: Taxation of Retirement Income.</u>

The adoption of this recommendation would expand Connecticut's taxation of retirement income to include, among other items, the taxation of military retirement income. The taxation of retirement income that is currently exempt from taxation in Connecticut will lead to the unwelcome result of encouraging retirees to relocate to States that do not tax similar types of income. Specifically, it is my understanding that most of Connecticut's neighboring States do not tax military retirement pension income.

2. <u>The Connecticut Retail Sale Tax. Recommendation 4: General Application of Sales and Use Tax.</u>

Historically, services in Connecticut have been presumed to be exempt from sales tax unless they are specifically identified as taxable in the statute. This is the approach that is followed by virtually all other states that have a sales tax on services. Even with such presumption, Connecticut's sales tax on enumerated services is viewed as one of the broadest (and least business friendly) in the country. By expanding the sales tax to all services (subject to enumerated exceptions) Connecticut will become a much less desirable business location relative to other states. Such an extension of the service tax will also penalize headquarter companies in Connecticut by taxing services entirely in Connecticut that may benefit multiple locations.

3. <u>Property Tax. Recommendation 7: Local Non-Property Taxation</u>.

An increase by 1% in the State sales tax rate would mean that since 2011 the sales tax rate will have increased from 6% to 7.35%, an increase of almost 23%. In light of Connecticut's other business taxes, a rate increase such as this will increase the perception that Connecticut is an anti-business competitive State and will have the effect of discouraging out of state companies from relocating to Connecticut and discouraging businesses in general from expanding their investment in Connecticut.

Memorandum of Comment

Submitted by

Kevin B. Sullivan, *Ex Officio Panel Member*

Commissioner of Revenue Services

As an ex-officio member of the State Tax Panel, I did not participate in the vote on any of the recommendations. I do, however, appreciate the work of the Panel members, the information provided by our consultants and the opportunity to engage in a wide-ranging discussion of state tax policy. As was pointed out in the final Report of Governor Malloy's Business Tax Task Force a few years ago, Connecticut needs to see taxes not as the means to spending but as a matter of sustainable fiscal and economic policy.

Staff from DRS and OPM have already met to review and consider the Panel's recommendations for appropriate action.

Before commenting on specific recommendations, let me offer an observation on our process. The scope of review, established in the enabling legislation, was simply too broad for the time available. As a consequence, the Panel (now disbanded) never actually reviewed or approved any narrative or summary other than the recommendations submitted as our "final report." Hopefully, a narrative will be produced by the consultants that includes all of the topical papers as an appendix. While there is no opportunity for the Panel to issue such a report, all the background information would thus be captured, transmitted and available as the consultant's final report to the Panel. Since the Panel did not actually review and approve any of the consultant reports and working papers in final form, these cannot be represented as the action of the Panel. But it would be a shame to lose all of that content and context for the final recommendations already submitted on behalf of the Panel.

I also cannot help but note with some amusement, the inordinately deep dive that the Panel took with respect to Connecticut's Uniform Gift and Estate Tax. In terms of both the time taken up and the detail of the recommendations, we would have done better to focus a bit more on the bigger tax picture. After all, the UGE (not "huge") tax is actually a relatively minor and highly concentrated part of Connecticut's general tax burden.

As to the specific recommendations, I offer only the few following comments:

Connecticut General Retail Sales Tax – Recommendation 5: Eliminate Sales Tax Holidays. Had I been a voting member of the Panel, I would have dissented on this recommendation at this time. Recent changes in the Corporate Income Tax will fairly but significantly impact out-of-state retailers. We should allow time to absorb those changes. At the very least, it does appear that Connecticut's modest "sales tax holiday" pays for itself and serves as an important retail marketing tool.

Connecticut General Business Taxation – Recommendation 1: Alternatives to the Corporate Net Income Tax and Business Taxes. Given the significant Corporate Income Tax reforms enacted this year, it is important that those changes be given an opportunity to settle in as the state economy continues to improve. So, in the very near term, this is not the time for a new debate over the direction of business taxation. In the longer term, it makes sense to consider moving away from taxation based on choice of business formation. But that should be based on sufficient prior understanding of the consequences of any proposals and prior engagement with Connecticut's business community.

Connecticut General Business Taxation – Recommendation 5: Apportionment of Multi-State Income. Moving to market (destination) sourcing makes sense for Connecticut and for Connecticut businesses. Perhaps we should endeavor to prove this assumption first perhaps by collecting real financials on the basis of an informational filing. In any event, DRS does intend to continue the work of an informal, external working group that is already advising on implementation of unitary reporting and the topic of sourcing is part of the groups agenda.

Connecticut Estate and Gift Tax and Probate Fees. Recommendation 1: Basic Structure and Effect on Taxpayer Migration. For every complex issue, there is a simple solution – and it's usually wrong. There may be many good reasons to reform Connecticut's Uniform Gift and Estate Tax. However, Connecticut estate taxation is at least regionally competitive as indicated by no lessening of net taxpayer and income out-migration from the state of New York to our state. Indeed, based on the most recent available federal census data, only one of the states among the top net outmigration destinations (in terms of taxpayers and federal AGI) does not have an income tax or an estate tax. In fact, a quick profile of taxpayer net outmigration among the states suggests only one strong correlation: Sunshine. This is clearly an area where assumptions and anecdotes need to be tested by unbiased factual analysis.

Staff Report: Context for the Panel's Recommendations

Part I: Connecticut Economy and the Policy Framework

Part II: Connecticut State Revenues

Part III. Local Revenues: The Property Tax and Local Revenue Diversification

Connecticut Tax Study Panel Staff Report [1]

The Tax Panel took as its task that of providing to the citizens of Connecticut a *Final Report* that will establish goals and directions for state and local revenue policy not only for a next session of the General Assembly, but also for the State as it enters the 2020s. The Panel also determined that in order to accomplish this task that their recommendations for revenue policy must be informed and framed by a data and evidenced-based knowledge of Connecticut's economic, demographic, and institutional arrangements and trends. To generate such a knowledge base, the Panel engaged the services of several technical experts to prepare research papers on a wide range of concerns relating to Connecticut's revenue system.

The purpose of this second section of Volume 1 is to provide in summary manner the context to the Panel's recommendations by drawing on the consultant research papers.[2] As with this staff summary, the research papers are organized into three Parts.

- Part I. Connecticut Economy and the Policy Framework
    - Guiding Principles and Characteristics of High Quality Tax system
    - The Connecticut Economy
    - State Revenue Overview
    - The State and Local Revenue System: How Does Connecticut Compare
    - What Makes Connecticut Competitive (or Uncompetitive)
    - Fiscal Architecture: Looking Ahead to the 2020s
- Part II. Connecticut's State Revenues
    - The Connecticut Personal Income Tax
    - Sales and Use Taxation in Connecticut
    - General Business Taxation: The Corporate Net Income Tax and Its Alternatives
    - Connecticut Estate and Gift Taxation
    - Probate Fees
- Part III. The local Revenue Structure: The Property Tax and Local Revenue Diversification.
    - Overview of Property Taxes in Connecticut
    - Properties exempt from Paying Property Taxes in Connecticut
    - Direct Property Tax Relief
    - Diversifying Municipal Revenue
    - The Personal Property Tax in Connecticut
    - The Taxation of Registered Motor Vehicles in Connecticut
    - Conveyance and Controlling Interest Taxes

As noted in the Preface to this staff summary, the consultant research summaries do not necessarily represent the view of either the Tax Panel as a whole, or any member thereof. The only document that represents the Panel's views is the *Final Report* of Policy Recommendations as transmitted in December 2015 and as detailed in the preceding section this volume

[1] Bell, Michael E. and Robert D. Ebel (2015). *Connecticut Tax Study Panel Staff Report, 2015*. (Hartford: Connecticut General Assembly, Office of Legislative Management).

Part I: Connecticut Economy and the Policy Framework

The Connecticut Economy and Policy Framework

Guiding Principles and Characteristics of a High Quality Tax System

At the start of its work, the Tax Panel adopted a set of *Guiding Principles* that frame a high-quality Connecticut revenue system and a statement on its *Criteria for Evaluating Changes to the Connecticut Revenue Sys*tem. These principles and characteristics of a high quality tax system were then used to guide the Panel's discussions and recommendations. These principles and criteria are presented in summary form below. The full statement of the Panel is Chapter 1 of Volume 2.

Exhibit 1. Principles for Guiding Connecticut Revenue Policy: Statements of the Panel's Overarching Philosophical Framework

Principle	Discussion
Avoid Fiscal Obsolescence	A state/local revenue system should be designed to make "fiscal sense" over the long term so as to minimize reliance on revenue sources that will become obsolete due to a failure to capture the fiscal benefits (and minimize the fiscal downside) of changes in medium and long term trends in the state's economic structure, demographic, and institutional arrangements—trends that are largely beyond the control of state and local policymakers.
Revenue policy is intergovernmental (state and local) system.	Connecticut revenue policy should be composed of elements that function together as a system of state and local government finance. Although the State is ultimately responsible for determining the functions of local governments and the taxes localities levy, it should minimize actions that limit local fiscal autonomy. The State should also recognize that because it often has inherent access to more productive revenue sources than its localities, there is a necessary and important role for a well- designed and fiscally certain system of intergovernmental aid.
Revenue Diversification & Tax Mix	All taxes have inherent structural inefficiencies and inequities, which if relied upon too intensively will make such defects intolerable. Accordingly, a revenue system should rely on a mix revenue bases so as to not lead to an overreliance on one or a few tax sources. If transparent and coordinated for simplicity, the overlapping of local with state revenues sources need not be competing or contradictory.
Broad Bases, Low Rates	In order to minimize distortions in economic decision making for individuals and business entities alike, policymakers should begin their tax policy deliberations with a presumption in favor of broad bases and low statutory rates.
Public values built into the tax law should be explicit.	In adopting a presumption in favor of broad bases and low statutory rates, the Panel also recognizes that giving tax relief to classes of taxpayers is not inherently wrong if such treatment can be shown to satisfy an agreed upon and explicit set of policy goals and there is full disclosure in the granting of such preferential treatment.
Transparency	Revenue legislation should be based on sound legislative procedures and careful analysis and taxpayers should be informed (and make themselves become informed) regarding how tax assessment, collection, and compliance works.
Public Accountability	There should be an explicit linking of state and local legislative decisions to the decision makers so that the citizens of Connecticut understand the relationship between the governmental unit that provides public services and the unit of government that levies taxes to pay for those services.
Uniformity	A revenue system should be administered professionally and uniformly throughout the State.

Adopted May 12, 2015. Connecticut Tax Panel. Hartford, Connecticut.

Criteria for Evaluating Changes in the Connecticut Revenue System

The Panel adopts the following set of criteria of evaluating the quality of the Connecticut state and local revenue system and recommends their use in future revenue policy discussions.

Certainty and Reliability. *The Connecticut system should produce revenues with a high degree of reliability and certainty.*

The primary role of a state/local revenue system is to produce revenues in a manner that balances the tradeoff between a mix of sources that allows the system to automatically capture the fiscal benefits of economic growth (an "elastic" revenue) and those that provide a degree of stability ("inelasticity") in the flow of revenue collections. A relatively elastic revenue system helps one avoid frequent rate and/or tax base changes during periods of economic expansion; but during an economic downturn will tend to cause a drop in revenue collections thereby likely leading to unplanned cutbacks public services, the costs of which tend to be rigid in a downward direction in the short term. In turn, a system that is highly revenue inelastic may require discretionary upward adjustments to revenues as the economy grows in order to maintain the scope and quality of a current expenditure program structure. Even though the Panel has adopted a rule of "revenue neutrality" in making its recommendations, and, thus, will not be making judgments as to the expenditure side of the public budget, the Panel nevertheless recognizes that for any given level of public spending, the Connecticut revenue system must have a mix of elastic (relatively responsive to economic base changes) and inelastic (relatively unresponsive to economic base changes) revenue tools. A system that balances the mix of elastic and inelastic revenue sources meets the tests of reliability and certainty.

Economic Efficiency (Neutrality). *Taxes should be designed to avoid unintended interference with private (consumer, worker, producer) decisions.*

Efficiency or "neutrality" in taxation requires that taxes accomplish their intended objectives, but beyond this should minimize interference with –be neutral with respect to--the working of the private market system. This criterion applies to individuals/households and businesses alike. In technical terms, "distortions" to the economy are to be avoided. In adopting this criterion, special attention should be placed on the word "intended". In some circumstances an efficient solution will be one whereby a government explicitly uses tax policy to discourage or encourage a specific activity by raising or lowering the "tax price" of an activity. In all such circumstances, the nature of the intent should be made explicit and transparent.

Equity (Fairness). *The structure of the tax system should treat taxpayers in similar circumstances similarly as well as achieve an overall proportional to progressive distribution of the tax payment among residents.*

The question of Equity or Fairness in taxation is a proper concern for revenue policy. There are two facets of the fairness (who should pay?) criterion. *Horizontal Equity* requires that taxpayers in similar circumstances be taxed similarly ("equal treatment of equals"). With respect to the taxation of persons, horizontal equity requires that if the accepted tax base standard is income, consumption or wealth, then it follows that those taxpayers with the same amounts of income, consumption, or wealth should be taxed the same. Horizontal equity is also achieved by the application "benefits received" principle (also referred to as the "matching principle"). Here the logic argues that revenue policy should be designed such that it is the beneficiaries of a flow of services who are required to pay for those services. If well designed, the benefits approach is both horizontally equitable and economically efficient. Moreover, with the benefits standard, it is recognized that some who benefit from public services may not reside in the tax

or fee levying jurisdiction. If it is the case that non-residents are benefiting from Connecticut public services, there is a corresponding case for some degree of "tax exporting". Note that the tests of similar circumstances and, thus that of horizontal equity, may be applied to the taxation of business enterprises as well as to persons.

The second facet, *Vertical Equity*, addresses the "fairness" of the distribution of the payments among persons who are not in similar circumstances. Here the most common index of equality is that of income, and thus discussions of vertical equity typically focus on whether the tax system is "progressive" (the effective tax rate increases with income), "regressive" (effective tax rates and income are inversely related), or "proportional" (no change in effective tax rate as income changes). As this criterion applies to only to the tax treatment of people in their role of consumers, factor suppliers and/or earners of income, vertical equity is associated with the fairness concept of "ability to pay".

Competitiveness. The Revenue System should be evaluated for their effects on growth of the economic and employment base and on residential mobility.

"Competitiveness" refers to the interplay between Connecticut's fiscal structure and decisions that impact income and employment growth and residential location. State fiscal policy can contribute to a growing economy in a number of ways: raising the public sector's revenues in a manner that is broadly accepted and therefore likely to achieve a high degree of voluntary compliance; a system that implements tax law consistently; and is a revenue regime that is evidence based and transparent. Connecticut's competitiveness will also take into account the level and quality of services that the State finances through its revenue system.

Within this context, it is often argued that if a state and its localities (a) levy taxes that are "too high" relative to other jurisdictions and/or relative to the level and quality of services that are provided; (b) structure certain taxes or a package of revenues so as to unduly distort private economic transactions in an unintended manner; and/or (c) create a revenue system that is characterized by a high degree of uncertainty, the result is to discourage private investment and job development within the state. If it is determined that for one (or more) of these reasons the Connecticut revenue structure unintentionally hinders or distorts job development that residents care about, then the revenue system would not be competitive.

Simplicity. *The revenue system should be easy to understand by the taxpayer so as to minimize the costs of both taxpayer compliance and of revenue administration.*

As a tax or set if taxes increases in its complexity, the cost borne by taxpayers in keeping records, filing returns, and undergoing audits increases. Another result of complexity is that taxpayer understanding of and trust in, the government decreases, which is a matter of serious concern in a democracy. In a similar manner the more complex a revenue system, the greater is the cost of revenue administration. However, it is also true that while avoiding reliance on a complex maze of taxes, forms and filing requirements is clearly desirable, some level of complexity is inevitable. Thus, the principle of simplicity will sometimes conflict with other principles discussed in this Panel statement and thereby force policymakers to make difficult tradeoffs. However, when all other things are the same, it makes tax sense to be tax simple.

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Recognizing the need to make policy tradeoffs.

It is important to recognize that in selecting or modifying one tax or set of taxes over its alternatives, policy tradeoffs will have to be made—and balanced—among the criteria. There is no single revenue source that will satisfy all the of the Panel's criteria.

The Connecticut Economy [3]

Population

Population changes in terms of overall growth and distribution by age, race, and family size are among the useful set of variables that describe a state and have potential impacts on state revenue. Highlights include:

- Small size and proximity to markets. With a total resident population of 3.6 million (2014), Connecticut ranks 29th among the states. New York has a population of 19.8 million, New Jersey 8.9 million, Massachusetts 6.8 million, New Hampshire 1.3 million, Rhode Island 1.1 million, and Vermont 0.6 million.; the United States (US) is 318.9 million. More than one-quarter of the total population of the United States (US) and more than 50% of the Canadian population live within a 500-mile radius of Connecticut.

- Educated. Educational attainment data show 89.2% of Connecticut residents 25 years and older are high school graduates or higher, compared to 86.0% nationally. Connecticut ranks 5th in percent of 25 year olds and older with at minimum a bachelor's degree (36.5%), behind the District of Columbia, Massachusetts, Colorado, and Maryland (US Census Bureau, American Community, selected years).

- Population growth: For the period 1930 to 1970, population growth in Connecticut was on pace with or exceeded national growth; however, Connecticut has witnessed reduced growth in population since the 1970s. Current projections suggest the state will gain slightly more than 100,000 residents over the next ten years (2.8 percent growth, a rate less than half that of national projections.). The relatively slow pace of growth may signal sluggish growth in revenues including income tax.

- Age Distribution: The aging of the Connecticut population is an important demographic trend with significant implications for the state revenue system. Connecticut (along with the New England Region) is getting older. Although the share of the state's young population up to age 24 is about the same in 2014 as it was in 1994 (33.2 and 33.9 percent, respectively), the workforce aged population is declining (44.1% to 39.9%) and those near or in the retirement years are increasing (from 22% 1994 to 27% in 2014) Moreover, between 2015 and 2025, the age dependency ratio will increase from 23.9 percent to 31.9 percent. In the absence of a tax policy response, this demographic change will dampen the natural growth in tax bases that exclude pension and retirement income and health, and transportation services.

- Race and ethnicity: The racial and ethnic composition of the population can affect the expenditures via the type and variation in public service demands. Consumption patterns are also influenced by race and ethnicity, which can affect sales tax bases. Connecticut is currently more homogenous in this regard than the average U.S. state, but global movements of people and businesses could change this in the future.

[3] This section draws on Srivastava (Vol.2, Chapter 2) and Wallace (Vol. 2, Chapter 7)

Employment and Output

Employment and output (production) are important drivers of the revenue system. The composition and trends of these factors affect the level of compensation (affecting tax revenue), consumption (and sales tax), as well as the demand for public services. A rapidly changing concentration of employment and output could signal a healthy economy that is taking advantage of changes in worldwide economic trends. Such trends could also signal substantial human capital and infrastructure needs to support sustained growth. Some kinds of economic activity are associated with strong tax handles (meaning an easier identification of taxable economic activity—think manufacturing) versus weaker tax handles (services and internet commerce). All else equal, it is less costly for the tax administration to identify and value physical output and assets than it is when the produced good is a less tangible service.

Employment Trends

Connecticut's employment and output composition have changed, in some cases substantially since the 1980s, a change that reflects the changes in both the regional and the national economy.

The decade of 1980's was a period of rapid economic growth and prosperity in Connecticut. Between pre-recession peaks, July 1981 to February 1989, Connecticut gained 234,100 jobs, or 16.2% of employment. About 60% of the job growth over this period was in the Services sector, followed by about 30% from Trade, and 20% from Finance, Insurance, and Real Estate. Government accounted for approximately 11% growth over this period. The Transportation Equipment subsector of Manufacturing, which provides defense related goods, held steady over the decade. Manufacturing was the only industry to lose employment.

The 1980's decade also drove growth in Connecticut's Gross State Product (GSP) and Personal Income (PI), impacts which have lasted to today. Ranked against the other states and the District of Columbia, as of 2014 Connecticut is currently second in per capita PI, right behind DC, and sixth in per capita GSP. Since the 1990's, Connecticut has ranked second in per capita PI and between third and fourth in per capita GSP.

The recessions of 1990-91 and 2001 revealed a changing economic structure for Connecticut, the region and the US. In Connecticut, in terms of employment, manufacturing has almost halved -- from contributing to 21.0% of total employment in 1990 to 11.5% in 2014. Finance, Insurance and Real Estate has declined employment importance (9.3% to 7.7%) due to convergence of factors that have led to restructuring of the sector. Construction and Mining and Transportation and Public Utilities have also declined as a share of employment, but relatively modestly so (respectively: 3.9% to 3.4% and 4.5% to 3.2%) whereas the Trade sector has held steady (about 22.2 to 22.4% over the past quarter century).

So, where have the jobs gone in terms of share of employment? For Connecticut as well as the US, to the Service sectors: education, health, leisure, and hospitality, and professional scientific and technical services all with the important exception of professional/scientific/technical relatively low wage. Just how Connecticut manages - or is able to manage - this mix of low vs. high wage service occupations over the next decade is high on the state's policy agenda.

The employment forecast through 2022 for Connecticut shows the continuing -- but not complete tracking - of the trends of the past quarter century. The growth sectors will be that construction, healthcare and

social assistance, professional, scientific and technical services and information management (e.g., general operations, marketing, financial, engineering).[4]

There is less certainty around the growth in the knowledge economy, for which there will be demand, but with substantial competition and long gestation periods. The growth in the service-sector economy will also give rise to increased demand for technical training in the areas of health and education (as well other service sectors) while the knowledge-industry growth will demand specialized infrastructure and the ability to attract and retain very highly skilled and educated workforce.

Given the increasing use of technology in all facets of employment, most all of the sectors of the economy rely more and more on digital communication and demand speed and quality in wireless and other communication.

Output (Income and Production)

A look at Connecticut's output performance tells a similar story to the employment data as the nation and the state appear to be entering a period of post-Great Recession economic restructuring and slower (than by recent historical standards) growth.[5] In Connecticut as well as nationally, the output growth industries have been in the service sectors.

Given the increasing use of technology in all facets of employment, most all of the sectors of the economy rely more and more on digital communication and demand speed and quality in wireless and other communication which raises four issues that will require close tracking by, and coordination across, the community of Connecticut macro-economists and revenue policymakers and practitioners. And that is the increasing role of the return to capital in the production function and, thus, the composition and distribution of income.

- Capital Mobility. Capital is a mobile factor of production that makes it a difficult subject of taxation. Competition and globalization have only made that more difficult: competition will continue to increase internationally as well as locally for employment, residents, and economic activity. This, in turn, dampens ability of states to raise taxes on conventional business-related income (profits) and capital investment activities as well as increases tax avoidance opportunities through vehicles such as shelters, the business model shift to non-corporate pass through entities, and transfer pricing.

- Globalization. Greater globalization means that consumers and producers have fewer barriers to conduct business throughout the world. Competition for labor and capital and consumer markets means that governments need to consider reaction to its fiscal decisions from near and far. Global real estate capital is also looking for a home that is understandable and predicable. Globalization and competition also increases the need to produce public goods competitively to attract and keep residents and businesses.

[4] Connecticut Department of Labor, 2012-2022 CT Occupational Projections., https://www1.ctdol.state.ct.us/lmi/projections.asp

[5] U.S. real GDP is projected to increase from $15.7 trillion in 2014 to $18.3 trillion in 2022, an annual growth rate of 2.5 percent. Connecticut real GDP is projected to increase from $227.8 billion in 2014 to 256.6 b billion in 2022, an annual growth rate of 1.8 percent. Office of Policy Management, February 3, 2016.

- Technology. Internet commerce will continue to challenge state and local governments' sales tax revenue. Increased ease of doing business and investing on-line will increase the administrative burden of collecting income taxes as well as sales taxes. Technology will also affect how industries work—how collaboration happens (remotely), the relative capital to labor ratios, the types of output produced, how much and where inventory is kept, and marketing of products. As more economic activity occurs remotely, tax handles become scarcer.

- Income distribution. In part reflecting the above developments Connecticut is experiencing a change in the distribution of income as the gap between median and mean income is widening: from $25,000 in 2005 to $30,000 in 2013. A similar trend is occurring nationwide but the spread is not as great—about $20,000 in 2013 (Wallace, Vol 2, Ch7, Fig.2). The continued increase in disparities coupled with the anticipated growth in relatively low-wage industries has several implications for the revenue system. For example, the personal income tax will be affected if, on balance, income earners at the low end of the tax distribution increase as a share of total taxpayers thereby putting pressure on policymakers to increase income taxes paid at the high end. The distribution of sales tax burden may also become more skewed as lower income households spend more money on basic goods and services including items like food which are not taxed for home consumption (for the most part). Then there is the property tax, which is a tax on wealth (housing) that disproportionately falls on low income families. There are remedies that the Panel examined relating to all of these developments

State Revenue Overview[6]

Recent Revenue Performance

General Fund tax are derived primarily from the collection of State taxes, including the personal income tax, the sales and use tax and the corporation business tax.[7] In addition to these "big three" the Panel also examined, and made recommendations regarding the Estate and Gift Tax and the related topic of Probate Fees. In all cases the Panel not only examined the performance of the current structure of each of these revenues, but also addressed alternative revenue structures

Over the past decade and a half, General Fund revenue has grown in conjunction with the state economy, increasing during expansionary periods and decreasing during recessions. Revenue peaked in FY 2001 prior to the 2001-2002 recession, hit a trough in 2002, and then recovered to grow with the state's economy (Pellowski, Vol. 2, Ch. 3, and Chart 1). But then came the Great Recession, baseline revenues (estimates controlling for the estimated impact of *ad hoc* policy adjustments) declined in both Fiscal 2009 and 2010. Since 2010 revenues have recovered, exceeding their pre-recession peak in the last two fiscal years as reported to the Panel (FY 2013 and 2014).

The long term performance shows a dramatically changing State Tax Profile (Table1), which, as Sullivan shows (Tax Panel, 1/29/15) reflects the old world/new world economy (Exhibit 1). This essay as well as the research paper by Pellowski (Vol.2, Ch.3) includes an Appendix that presents in detail the composition of General Fund Revenues, 2010-2014.

[6] This section draws on Pellowski (Vol, 2, Ch. 3).
[7] Taxes net of refunds account for 84.2% of total general fund revenues. Pellowski, Vol 2, ch.3, Appendix A.

Table 1. Connecticut's Changing State Tax Composition, Fiscal 1984 and 2014

Type of Tax	1984	1994	2004	2014 [1]
Personal Income[2]	0%	37%	49%	56%
General Sales and Use	46%	32%	30%	26%
Corporate	14%	10%	5%	5%
Estate and Gift[3]	____	____	2.3%	0.9%

Source: Presentation of Revenue Commissioner Kevin Sullivan to the Tax Review Panel, January 29, 2015.

1. 2014 data from Pellowski (Vol 2, Ch. 3, Appendix A). Total taxes = $15.5 bn.
2. The Personal Income Tax was enacted effective January 1, 1991. Beginning January 1, 1992 a separate tax on capital gains, dividends and interest was repealed.
3. The Estate and Gift Tax was enacted effective January 1, 2005 replacing the separate "pick-up: state separate gift tax with its present unified estate and gift tax. It also replaced the succession tax (inheritance tax); thus the Estate and Gift Tax data is for 2005 (Conway and Rork, Vol.2, Ch. 11).

Exhibit 1: The Connecticut Revenue System's Old World vs. New World

- Production Economy → Service Economy
- Wage Earners → Mobile and Contingent Workforce
- Geographic Boundaries → Cyberspace
- Physical Presence → Economic Presence
- Tangible Property → Intangible Property
- Separate Entities → Combined Reporting
- Cost of Performance → Market Based Sourcing
- "C" Corporations → Pass Through Entities

Source: Kevin Sullivan, *Tax Basics.* Presentation to the Tax Review Panel, January 29, 2015.

Tax Volatility, Uncertainty

Over the past decade Connecticut's tax revenue has fluctuated dramatically creating year-to-year uncertainty for taxpayers and tax administrators alike. This tax *volatility* is not just that of inconveniencing tax planning or revenue estimating. Overtime tax uncertainty can also hamper investment and job creation (Luna and Murray, Vol. 2, Ch.8).

Two common measures of tax volatility are tax buoyancy and tax elasticity. Tax buoyancy measures a revenue source's response to economic growth by comparing changes in tax receipts to changes in gross state product (GSP). Tax elasticity measures the same phenomena while controlling for changes in tax policy. Buoyancy models do not control for changes in tax policy – a major limitation to these types of models. However, tax buoyancy is still commonly used as a measure of tax volatility due to the complexity and uncertainty of analytically estimating (isolating from the aggregated data) the impacts of policy changes (Pellowski, Vol.2. Ch.3)

The Office of Policy and Management has conducted tax buoyancy analyses of the "Big Three" General Fund: the personal income, sales and use, and corporation taxes. The Buoyancy Coefficients are reported below (Table 2).

Table 2. Tax Volatility 2001-2014, the Big Three General Fund State Taxes

Type of Tax	**Buoyancy Coefficient**
General Fund	1.18
Personal Income Tax	1.80
Corporation Tax	1.43
Sales and Use Tax	0.60

Source: Pellowski (Vol2. Ch. 3).

The estimated coefficients show that 1% change in Connecticut gross state product resulted in a 1.8% change in the yield of the personal income tax, a 1.4% change in corporation tax, and a 0.6% change in (the stable) sales and uses tax. The net effect on the General Fund Revenue is a 1.2% change during the period from fiscal year 2001 to 2014. In reviewing the estimate, keep in mind that the coefficients (i) can be either positive (in expansions) or negative (downturns) and (ii) since they are estimated over a fourteen year period, in any one year the coefficient may be higher or lower that that shown in Table 2. But, that said, the finding of a volatile tax system is clear.

The degree of volatility (even as measure of buoyancy rather elasticity) is largely driven by the nature of the tax base and/or statutory tax rate structure that is applied to that base, or both—that is, it is built into the tax structure rather than being due to legislated *ad hoc* legislative actions. As the table indicates, two taxes contribute to overall Connecticut tax volatility. The first is the personal income tax (PIT). That the PIT incorporates a graduated (progressive) rate structure—as the tax base increases the tax is designed to generate revenues that grow relatively faster that the base—explains some of the tax buoyancy, but it is not all that a significant driver of tax uncertainty since it is a factor that the tax planers as well as state revenue officials can estimate with a high degree of certainty. The primary source of uncertainty stems from the net capital gains component of the tax, which is subject to the swings of the financial markets. As Pellowski's analysis shows -- refer to his Chapter 3, Chart 4 --in times of steady and predictable economic growth (e.g., 2004-2008), the capital gains component of the PIT was also steady and predictable However, the numbers during periods of recessions and expansions tell quite a different story of sudden capital gains component dips and peaks. This volatility was particularly dramatic and problematic during the Great Recession (2007-2009) market crash and decline in the national income and output.

The second source of Connecticut tax uncertainty is the tax on business net income (profits), a tax base that is especially notable for its capriciousness. In their work for Panel, Luna and Murray track the historical pattern of revenue performance for Connecticut's corporate income tax as well as total tax collections (Luna and Murray, Vol 2., Ch. 10). Their analysis shows that not only were corporate revenue collections especially volatile during the years centered around the 1990-91, 2001, and 2007-2009 recessions but also that the corporate tax revenue in Connecticut was more volatile than other states between 1975 and 2014.

Tax Incidence: Who Pays Connecticut Taxes?

One of the most common and significant topics in public finance is how taxes are distributed across income groups once the taxpayer/tax paying entity that has a legal liability to pay a tax (initial tax incidence or tax impact) has, through the market mechanism, shifted or passed on the tax initially paid to individuals in their role as consumers of final products and/or suppliers of the factors of production of land (rent received), labor (salaries and wages), capital (interest, profit). This question of final tax incidence --that of "who pays?"—goes to the question as to whether the final incidence is regressive, progressive, or proportional in effect. A tax is "progressive in effect" if higher income earners pay more than lower income earners as a percentage of their income; "proportional" if higher income earners and

lower income earners pay a similar amount as a percentage of their income; or "regressive" if higher income earners pay less than lower income earners as a percentage of their income. The degree of "gressivity" goes to the Panel's criterion of "vertical equity",

In order to assess the equity of Connecticut's tax system, the Department of Revenue Services (DRS) published the *Connecticut Tax Incidence* study in December 2014. The study, which utilizes tax year 2011 data, found the Connecticut tax system to be regressive in effect (Pellowski, Vol 2. Ch. 3).[8]

The DRS study is especially informative as uses a statistical technique that allows one to rank the various types of major Connecticut state *and local* taxes by type of tax. This measure, the "Suits Index", assigns to each state tax a number ranging from negative one to positive one where regressive taxes have negative values, progressive taxes have positive values and a proportional tax would be equal to zero. The degree of a tax's progressive or regressive nature increases the further it is from zero. The most progressive tax with a Suits Index of 1.0 would have the single Connecticut household with the highest Connecticut AGI paying all of the taxes. The most regressive tax would have a Suits Index of -1.0 and have the single Connecticut household with the lowest Connecticut AGI paying all of the taxes. In reality, neither of those scenarios would exist and, thus, a Suits Index will lie somewhere on the spectrum between 1.0 and -1.0. The Suits Index for the taxes studied in the report is presented below (Table 3).

Table 3. Measuring the Gressivity of Connecticut State and Local Taxes

Type of Tax	**Suits Index**
Gift and Estate	0.76
Personal Income	0.11
Corporation Business	-0.02
Real Estate Conveyance	-0.14
Insurance	-0.35
Gross Earnings	-0.38
Local Property Taxes	-0.39
Sales and Use	-0.39
Excise	-0.67
Total	-0.22

Source. Department of Revenue Analysis, 2014

The Personal Income Tax (0.11) and the Gift and Estate Tax (0.76) are the only two taxes classified as progressive. Some of the features that contribute to the progressivity of the Personal Income Tax are its graduated rates that increase with Connecticut personal income, tax recapture at higher personal income levels, and the Earned Income Tax Credit and other "means tested" credits that phase out at higher income levels (Pellowski, Vol. Ch.3; also, Cordes, Vol 2, Ch.8). The Gift and Estate Tax, which is borne entirely by the highest decile of taxpayers is the most progressive of the taxes reported.

[8] This conclusion of overall regressivity is supported by an annual 50 state study that provides estimates for each of the fifty States and the District of Columbia. Institute of Taxation and Tax Policy (ITEP). *Who Pays: A 50 State Report* (Washington, DC: ITEP) http://www.itepnet.org/. This report was discussed with the Panel at its Sept 16 and November 17 meetings.

The State and Local Fiscal System: How Does Connecticut Compare?[9]

Among the most frequently raised issues in state/local fiscal policies are those pertaining to the fiscal budget "pressure" and/or the "burden" of taxes on household and businesses. The question is usually posed as "are tax costs higher in this state than in the others?" Although this question is not new to Connecticut, it is getting increasing attention as a result of a growing concern that the state is becoming a less attractive place for new business investment and residents making housing location choices.

There are several measures that have been devised to address the fiscal comparison question, each with merits and shortcomings. In making and interpreting these numbers, two key methodological matters matter. The first is that it the analyst must turn to data for which there is a consistent definition of what is being measured. Thus, in the case of state fiscal comparisons one typically turns to the definition-standardized data of the US Bureau of the Census. Second, comparisons should be reported for state plus local governments as a system of government. Because one state may perform functions that in another state are left to localities, comparisons of state-only or local-only finances may be quite misleading (however, for purposes of intra-state or local comparisons "own" state budget, the detail of which is likely to be more accessible, is acceptable).

This Panel's research report on *Connecticut Fiscal Comparisons* is presented in two parts. (Bourdeaux and de Zeeuw, Vol 2. Ch. 5) The first section examines Connecticut's state and local revenue and expenditure portfolio, comparing Connecticut to neighboring states, as well as to selected other states around the country for fiscal years 2002, 2005, 2009 and 2012. The analysis uses U.S. Census Bureau data to compare revenues and expenditures on a per capita basis, and as a share of personal income. The second part of the report assesses Connecticut's rank on several key business climate and tax indices produced by national non-profit and advocacy organizations.

How Connecticut Compares

Depending on whether per capita or personal income measures are used, Connecticut is either a high- or low-spending and revenue state compared to others. The state has the highest personal income per capita in the country, which affects its rank when using personal income metrics. The state ranked 6th (highest) when measuring general revenues per capita but 45th (a low rank) when measuring general revenues as a percentage of personal income.

Even with its high wealth, the state was 8th in *tax revenue* as a percentage of personal income. The difference between the *general revenue* and *tax revenue* ranking can be explained by the state's relatively limited receipt of federal funds (48th in federal funds as a percentage of personal income), and the state's limited reliance on charges and other forms of non-tax revenues (50th in charges and miscellaneous general revenue as a percentage of personal income). Many states increasingly rely on user fees and charges, and this may be an area that warrants further investigation.

Connecticut's state and local revenue portfolio is dominated by the property tax and the individual income tax, which make up 46.5 percent of the total governmental revenues. In contrast, nationally, these two revenue sources make up around 30 percent of overall state and local government revenues. Connecticut ranks in the top ten states when considering these taxes on a per capita basis and also ranks in the top ten when considering these two tax types as a percentage of personal income. While almost all of Connecticut's neighboring states also derive significant revenues per capita from property taxes, there is substantially more variation in income tax receipts.

[9] This discussion draws on Bourdeaux and de Zeeuw (Vol.2, Ch.5)

In terms of expenditures, a national concern is the pressure that health care, debt and long-term liabilities are placing on state budgets, potentially crowding out investment in physical and human capital. Based on the U.S. Census data, public welfare, a category dominated by Medicaid, does appear to be putting pressure on Connecticut's overall state and local expenditures; it grew by 45 percent on a real per capita basis between 2002 and 2012. At the same time, the state has continued to make significant investments in education and to some degree in infrastructure. Education expenditures grew by 22 percent (real per capita), and highway spending grew by eight percent on a real per capita basis, with a noticeable jump in investment between 2009 and 2012. Meanwhile, a number of other smaller segments of the state and local expenditure portfolio have seen declines in real per capita terms. Connecticut is also notable for carrying some of the largest per capita unfunded long-term liabilities in the country – an issue that is not captured in these U.S. Census' survey numbers.

Ranking "Business Climates"

This second section reviews in summary five tax and economic competitiveness indices, four of which are efforts to measure and compare states' business climates, and one of which compares tax fairness across the income distribution. While the tax and economic competitiveness rankings often receive considerable media attention, to date, there is no research-based evidence that these indices actually predict economic growth in a state.

The Ernst & Young LLC partnership with the Council on State Taxation (EY/COST) produces several metrics that measure tax revenues collected from businesses relative to the state's private-industry gross state product or business tax base. What makes the E&Y/COST different from other tax ranking reports is that it includes in the tax numerator indirect as well as direct taxes on the business enterprise.[10] Connecticut generally ranks quite low on the resulting total effective business tax rate among the 50 states and the District of Columbia. The most recent E&Y/COST ranking (FY 2014) outs Connecticut at number 49.

The state has a low effective tax rate in part because of its high private sector gross state product, which is highly correlated with the state's overall wealth. The state also has a low effective tax rate because it collects a small share of tax revenues from businesses relative to individuals or households. This is particularly notable with respect to property taxes, where the EY/COST report finds that only 30 percent of the state's property tax revenues come directly from businesses. By way of contrast, 40 percent of Massachusetts' and 38 percent of New York's property tax revenues come from businesses.

The annual Tax Foundation's State Business Tax Climate Index (SBTCI) focuses on specific features of a state's tax structure rather than aggregate taxes paid. In many respects, the index is heavily concerned with distortions in behavior that might be caused by a tax system. Recognizing that tax-induced distortions are inevitable, the authors propose a tax system that minimizes instances where (private) economic decisions are influenced, micromanaged, or even dictated by the tax system. The authors state that the "more riddled a tax system is with politically motivated preferences, the less likely it is that business decisions will be made in response to market forces".[11] Such a principle is consistent with the Panel's adopted principle of broad based, low rate taxation.

[10] The EY/COST report defines business taxes as including: business or commercial property taxes, general sales taxes on business inputs, corporate and individual income taxes on business income, unemployment insurance, excise taxes including public utilities and insurance premium taxes, business and corporate licenses, severance taxes, and a collection of other smaller taxes including gift and estate taxes. For a discussion of the methodology see Bourdeaux and de Zeeuw (Vol 2, Ch. 5).

[11] Drenkard and Henchman (2015) as cited by Bourdeaux and de Zeeuw (Vol 2, Ch. 5).

However, the SBTCI index is not without controversy. This controversy is particularly evident in the way the Tax Foundation construct its personal income tax measure. Here, the SBTCI identifies three aspects as likely to be distortionary: the top marginal tax rate, a graduated statutory rate structure, and standard exemptions, which are treated as a zero percent bracket. Whether or not these are distortionary is the subject of some debate in the research literature. Additionally, under this approach, states that do not impose an individual income tax will have a perfect income tax score, and states with a flat, low rate tax with no deductions and exemptions will also receive a "high" score. This perfect score on a particular tax applies to other tax components that make up the final index score. With respect to the personal income tax, Connecticut's rank is 32nd, which is well ahead of New York and New Jersey at 48th and 49th respectively, but also well below the non-income tax states such as Alaska, Florida, Nevada, South Dakota, Texas, Washington, and Wyoming.

When the income tax score is combined with the other tax components (corporate income, sales, property, and unemployment insurance), Connecticut is in the bottom 10 of the SBTCI rankings, meaning the state has a less favorable business tax climate. The individual income, corporate income and sales tax component rankings place the state in the bottom 20, and the state's very low score on the property tax component causes Connecticut to drop into the bottom ten. The property tax component incorporates property taxes as a percentage of personal income and per capita, and unlike EY/COST it does not distinguish between the tax revenue collected from businesses versus individuals.

The Small Business and Entrepreneurship Council produces a small business tax index and Connecticut typically scores in the bottom ten states on this index as well. A low rank indicates a state that is less supportive of small business compared to other states. This score is heavily influenced by the top marginal personal (and corporate) income tax rates, regardless of the income level at which it is levied. This feature of the tax system makes up 63 percent of Connecticut's overall score.

The Beacon Hill Institute State Competitiveness Index (SCI) measures substantially more than tax competitiveness, capturing government and fiscal policy, as well as security, infrastructure, human resources, technology, business incubation, openness, and environmental policy. Connecticut was 40th lowest (a low rank means the state is less competitive) on this index in 2014. However, in other years, going back to at least 2006, the state was in the middle of the pack, scoring 24th in 2006 and 27th in 2013. Connecticut has very bifurcated rankings across the sub-indices. The state scores in the top ten states in terms of openness (5th), technology (8th) and security (6th), and in the upper ranks in human resources (15th). The state has a low rank on government and fiscal policy (47th), business incubation capacity (50th), infrastructure (41st), and environmental policy (42nd). The recent decline in rank appears to be driven in part by a change in the state's infrastructure rank.

Last, the Institute for Tax and Economic Policy's Tax Inequality Index ranks the distributional impact of Connecticut's tax structure – or the extent to which income inequality has narrowed or grown after the application of the state and local tax system. Here, some of the features that count against the state in the Tax Foundation's SBTCI index and the small business tax index, now count as positives. Connecticut is in the middle of the pack based on this index, ranking 26th. The state's progressive income tax structure helps offset the regressivity of its sales and property taxes, though the system as a whole nevertheless remains regressive.

What Makes Connecticut Competitive (or Uncompetitive)?[12]

As useful as they can be as a "first-cut" glance as to how state and local systems compare, the fiscal comparisons indicators are not to be interpreted as indicators of "competitiveness". That is the fiscal comparison numbers are not systematically and statistically associated with outcome variables such as state economic growth or job creation. Accordingly, to complement the foregoing reports on the Connecticut Economy, its revenue system, and how the state fiscal compares, the Panel commissioned research on the topic of *Competitiveness: The Factors that Contribute to Economic Growth in States with Special Reference to State and Local Spending and Taxes* (Wasylenko, Vol.2, Ch. 6).[13]

Strengths

Connecticut has inherent economic strengths. It is an advanced state economy with a per capita Gross State Product that is 31% higher than the U.S. average and one of the highest in the nation. Plus, it has a highly educated workforce; the percentage of persons between the ages of 25 and 60 who have a bachelor's degree or higher is 39.6 percent and ranks second to Massachusetts. Twenty-one percent of Connecticut's workforce is employed in the high-productivity, high-earnings knowledge-based industries, where Connecticut's workers annual earnings average $105,000 in 2013. (Nineteen percent of the U.S. workforce is in knowledge-based industries; the figure is 25 percent for Massachusetts. The comparable earnings figure in these same industries for the U.S. overall is $77,000.)

Knowledge industries are located throughout the state's Metropolitan Statistical Areas (MSAs). All three of Connecticut's MSAs have about 21 percent of their employment in knowledge-based industries. Since 2012 the Hartford-West Hartford-East Hartford MSA has had a higher employment growth rate for knowledge-based industries than the other two MSAs in Connecticut. The high earnings industries also have a large multiplier and create as many as five local service jobs for each high earning job. The nearby competitors for the high earning industries are Massachusetts and New York.

Vulnerabilities

As a relatively small state economy, national trends in trade, automation or recession can buffet Connecticut's industries and affect livelihoods in Connecticut more than in larger states.

Connecticut's economy has grown more slowly than neighboring states since 2007. It experienced a larger downturn in its economy during the Great Recession than the nation overall, and Connecticut economic recovery from the recession has not kept pace with the national recovery. The lagging recovery in Connecticut is broadly present across industry groups, although professional business services; and education, health and social assistance show signs of stronger growth since 2013. And the sluggish economic growth pattern is similar across its three metropolitan areas. Whatever has caused the low growth rate in Connecticut since 2007 appears to affect the entire State and does not appear to be confined to a particular area or industry.

Competiveness

State and metropolitan areas compete most often with nearby or neighboring states. Put another way, businesses come to the Northeast for its workforce and largely go to other regions for the workforce in those regions. The implication for fiscal variables is that differences in taxes or public services have the most effect on business expansion and locations decisions when competition is between nearby states and

[12] This discussion draws on Wasylenko (Vol.2, Ch.6).
[13] Wasylenko (Vol. 2, Ch.6)

not across regions of the country; and findings in this report and others in the Panel's research series reveal that Connecticut is not a high tax state relative to its fiscal capacity. However, it is a relatively high property and personal income tax location.

Do Taxes and Expenditures Matter for Economic Growth?

Empirical estimates done for this Connecticut report find that high property taxes and individual income taxes depress growth. The estimates also show that states that spend more on elementary and secondary education have higher economic growth. That said, the simulations also indicate that the property tax and the individual income tax have modest effects on growth and that reducing reliance on those taxes would help growth but that fiscal reform by itself would not have a dramatic effect on a lagging economy. At the same time, doing nothing to reform those two would continue to hinder growth. However, keep in mind that the Connecticut state and local sectors are a system; thus cutting property taxes and paying for the cuts by increasing revenues from the individual income tax could have a neutral or even negative effect on economic growth. Similarly, some combinations of tax and spending reforms might hurt growth. Cutting property and/or individual income taxes and paying for the cuts by reducing spending on elementary and secondary education would harm growth.

In a similar manner Connecticut's underfunded public employee pension system is problematic. Although not confirmed in the Panel's research analysis on growth, the pension situation is unlikely to help future growth, because to some it represents an unfunded liability and higher future taxes.

Concluding Comments

In examining the competitiveness question, it is useful to reflect back to the themes that emerge from the Panel's adopted set of *Guiding Principles and Criteria for Evaluation*—viz., that (i) in designing an efficient (e.g. competitive) revenue system, policymakers must look at the fiscal system as a whole as well as at its individual components and that (ii) a tax system should be designed to enable enabling investment and job creation, a goal that for a state like Connecticut argues for a policy of broaden bases and lower tax rates so as to reduce the disincentives that occur when there are high nominal tax rates for some taxes and low rates elsewhere in the system. More balanced tax systems create the best environment for growth.

Further important "take aways" from this and other studies of state competiveness are that (i) most growth occurs when states retain and grow their existing industries. That is, while economies do evolve, most economic growth or decline stems from a state's current employers and expansion in existing industries; (ii) knowledge workers learn from one another and through their interaction create new ideas and that enhance economic growth; thus economic "clusters" cannot only lead to growth of the "core cluster' activity, but that there is also a measurable multiplier-effect" of spin-off of added investment and employment and that (iii) competitiveness is not just about financial policy, but also about regulatory policies as well as economic development policies that address the broader goals of a civil society.

Fiscal Architecture: A Look at the 2020s?[14]

The term "fiscal architecture" refers to identifying the long term demographic, economic, and institutional trends are largely beyond the control of a state/local fiscal policy but that nevertheless that frame options for reforming the public finances on both the expenditure and revenue sides of a state/local fiscal system. In a paper that brings together the Panel's research on the Connecticut Economy and the Policy Framework as well as in the papers on specific revenue, Wallace takes the next step of

[14] This discussion draws on Wallace (Vol.2, Ch.7).

systematically laying out the state/local revenue policy implications of these trends as Connecticut looks to the 2020s (Wallace, Vol. 2, Ch. 7). The question that is being posed what makes fiscal sense for tax policy as Connecticut as it approaches and enters the 2020s? That is, what trends must Connecticut policy makers be alert to in order for the state and local revenue system to "keep up with the times".

Key Messages

The matrix below *illustrates* the way of thinking about the state's fiscal architecture and revenue policy choices (Table 4). A classification of the trends is listed in the first column; examples of the trends are identified in the second column, and the implications for revenue policy are in the third column. This is neither a policy decision matrix for Panel voting on recommendations, nor a substitute for the Panel's weighing of options *vis-à-vis* the normative criteria for evaluating changes to the Connecticut revenue system. But, what the matrix does do is to alert policymakers to the reality that (some of) the policies that work today may become obsolete in that they do not capture the potential "tax handles" of the near term future.

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Table 4: Illustration of State and Local System Fiscal Architecture and Implications for Revenue Policy

Classification of Trends	Connecticut Trend/Condition	Revenue Implications
Demographic	Population Size: Connecticut has witnessed a reduced growth rate in population since 1980s, a trend that is projected to continue over the next 10 years.	Population growth will in general lead to increase revenue for all taxes; but growth; but this is dampened by the slowing of the growth rate projections that the age-dependency ratio is increasing.
	A population that is aging (the age cohort 65 and older increases from 18.6 % of population in 2015 to 3.5% in 20.7% in 2202 and 23.5% in 2025).	Relative growth in elderly reduces the tax buoyancy of the "big three" state taxes: personal income, sales and property (Buoyancy refers to the growth of revenue relative to the growth in the economy). Income Tax: exempt status of many forms of pension and retirement income will reduce the productivity of the personal income tax. Concern: without off-setting rate reductions other state border effects may be negative. Sales Tax. Exempt status of the now exempt parts of the service sector will failure to capture the "natural" tax base of the emerging new economy. Similarly, continued specific exemptions for home consumption, prescription and non-prescription medicines erodes the base. Means test sales tax credits for low income persons. Property Tax. Reduced demand for high value large properties. As incomes decline for some, means test direct property tax reduction programs.
	Reduced share of the 0-19 age group (24.5% in 2015 to 22.0% in 2025)	Sales Tax: This cohort spends more on their budget that other cohorts on some items that are now sales tax exempt; e.g., education and training services. Failure to broaden the base will reduce sales tax productivity. Tax regressivity of due to base broadening may be addressed with means tested sales tax credits in lieu specific exemptions.
Economic	Decline in Manufacturing (an estimated 0.8 growth in sector GDP over the period 2012-2022)	Downward pressure on the business component of the real property implies higher taxes on direct and indirect (non-property tax) options, and /or finding new local revenue sources. And/or consider broadening the general business tax base and, with that, examine multistate apportionment rules.
	Globalization of Markets	Capital is a mobile factor of production making it increasingly problematic to tax on the basis of the return to capital (net income). Reduce reliance on corporate income/profits base. GRT or VAT alternatives.
	Increase in service sectors including health, education, accommodation-- lower wage jobs	Mix of activity toward services and toward lower wage jobs reduced the natural growth of the personal income tax. Property tax declines as service sectors are less property intensive than goods producing entities.
	Increase in professional services away from production of goods.	Connecticut's continued focus on knowledge industries including bio-tech and advanced manufacturing could offset impacts of public finances associated with growth of lower paid services sectors. But such sectors, especially professional services, can be hard to track and administer. And, the degree of competition for attracting those in the high wage STEM sectors (Science, Technology, Engineering, and Mathematics will be high). Broad based, low rate taxation of income and professional services considered an option.
	E-Commerce including tax treatment of on line travel companies; digital downloads	Reaching the new economy of e-commerce requires legal authority for tax administrators to be aggressive in enforcing *nexus:* if the sale is in (destined to) Connecticut then the market activity is in the state.
Institutional	Sharing Economy: peer-to-peer and collaborative consumption	Help with shopping, house and office cleaning, moving, ride sharing; home sharing; matching of vacation properties. Same response as with E-Commerce, *inter alia*, to use sellers as a conduit for tax collection.
	Pension liability and debt	Resolution of liability and debt may constrain needed reform may hasten or constrain responses to deal with the long term revenue reform. Today's contingent liabilities may be tomorrow's tax increase absent services delivered.
	Intergovernmental fiscal relations	Research reveals Connecticut to be the most centralized of all of the 50 state/local systems. Implications for reduced public sector efficiency (tax and spending).
	Technology	3-D Printing (final goods); Robots (capital substitute for labor); self-operating consumer durables (cars and/or fleets?)

Appendix A
GENERAL FUND REVENUES

TAXES ($K)	FY 2010	FY 2011	FY 2012	FY 2013	FY 2014
Personal Income	$6,586,099	$7,246,431	$8,310,820	$8,719,245	$8,718,659
Sales and Use	3,203,988	3,353,230	3,830,117	3,896,998	4,100,564
Corporation	667,132	794,473	716,522	742,515	782,239
Public Service Corporation	267,945	269,806	250,397	266,647	293,303
Insurance Companies	226,550	220,626	237,609	260,858	240,666
Inheritance & Estate	177,601	237,573	191,699	439,519	168,075
Cigarettes	387,435	404,111	421,005	399,822	376,835
Oil Companies	123,018	169,163	146,067	175,526	35,580
Electric Generation	-	-	69,532	66,823	15,315
Real Estate Conveyance	100,267	94,822	107,531	113,830	180,511
Alcoholic Beverages	48,196	48,923	60,595	60,406	60,644
Admissions, Dues, Cabaret	34,379	34,456	34,398	36,544	39,935
Miscellaneous	141,892	140,506	536,810	523,028	498,260
Total - Taxes	$11,964,502	$13,014,119	$14,913,103	$15,701,763	$15,510,588
Less Refunds of Taxes	(1,061,433)	(956,054)	(1,105,171)	(1,144,993)	(1,182,397)
Less Refunds of R&D Credit	(8,937)	(8,599)	(3,563)	(4,086)	(5,055)
Total - Taxes Less Refunds	$10,894,132	$12,049,467	$13,804,369	$14,552,684	$14,323,136
OTHER REVENUE					
Transfer-Special Revenue	$289,314	$293,108	$313,757	$315,452	$323,219
Indian Gaming Payments	384,248	359,582	344,645	296,396	279,873
Licenses, Permits & Fees	257,569	250,442	283,414	262,068	314,722
Sales of Commodities & Services	33,678	35,506	35,007	36,298	40,523
Investment Income	4,062	29	964	(792)	(336)
Rents, Fines & Escheats	252,792	157,771	123,424	144,141	130,875
Miscellaneous	142,910	178,728	191,965	163,818	206,782
Less Refunds of Payments	(1,189)	(1,875)	(85,377)	(74,016)	(66,625)
Total - Other Revenue	$1,363,384	$1,273,291	$1,207,780	$1,143,366	$1,229,032
OTHER SOURCES					
Federal Grants	$4,066,314	$4,235,178	$3,607,163	$3,733,910	$1,243,861
Transfer from Tobacco Fund	102,898	95,304	96,100	103,100	107,000
Transfer From/(To) Other Funds	1,261,800	54,215	(153,799)	(128,028)	106,528
Total - Other Sources	$5,431,012	$4,384,697	$3,549,464	$3,708,982	$1,457,389
GRAND TOTAL	$17,688,529	$17,707,454	$18,561,633	$19,405,031	$17,009,556

TAXES	% of Total	% of Total	% of Total	% of Total	% of Total
Personal Income	37.23	40.92	44.77	44.93	51.26
Sales and Use	18.11	18.94	20.63	20.08	24.11
Corporation	3.77	4.49	3.86	3.83	4.60
Public Service Corporation	1.51	1.52	1.35	1.37	1.72
Insurance Companies	1.28	1.25	1.28	1.34	1.41
Inheritance & Estate	0.96	1.34	1.03	2.26	0.99
Cigarettes	2.19	2.28	2.27	2.06	2.22
Oil Companies	0.70	0.96	0.79	0.90	0.21
Electric Generation	-	-	0.37	0.34	0.09
Real Estate Conveyance	0.57	0.54	0.58	0.59	1.06
Alcoholic Beverages	0.27	0.28	0.33	0.31	0.36
Admissions, Dues, Cabaret	0.19	0.19	0.19	0.19	0.23
Miscellaneous	0.80	0.79	2.89	2.70	2.93
Total - Taxes	67.64	73.50	80.34	80.92	91.19
Less Refunds of Taxes	(6.00)	(5.40)	(5.95)	(5.90)	(6.95)
Less Refunds of R&D Credit	(0.05)	(0.05)	(0.02)	(0.02)	(0.03)
Total – Taxes Less Refunds	61.59	68.05	74.37	74.99	84.21
OTHER REVENUE					
Transfer-Special Revenue	1.64	1.66	1.69	1.63	1.90
Indian Gaming Payments	2.17	2.03	1.86	1.53	1.65
Licenses, Permits & Fees	1.46	1.41	1.53	1.35	1.85
Sales of Commodities & Services	0.19	0.20	0.19	0.19	0.24
Investment Income	0.02	-	0.01	(0.00)	(0.00)
Rents, Fines & Escheats	1.43	0.89	0.67	0.74	0.77
Miscellaneous	0.81	1.01	1.01	0.84	1.22
Less Refunds of Payments	(0.01)	(0.01)	(0.01)	(0.38)	(0.39)
Total - Other Revenue	7.71	7.19	6.51	5.89	7.23
OTHER SOURCES					
Federal Grants	22.99	23.92	19.43	19.24	7.31
Transfer from Tobacco Fund	0.58	0.54	0.52	0.53	0.63
Transfer From/(To) Other Funds	7.13	0.31	(0.82)	(0.66)	0.63
Total - Other Sources	30.70	24.76	19.12	19.11	8.57
GRAND TOTAL	100.00	100.00	100.00	100.00	100.00

Part II: Connecticut State Revenues

1. The Connecticut Personal Income Tax[15]

Connecticut is a relative latecomer to the ranks of states with a personal income tax. However, since its enactment effective January 1, 1991, the Connecticut PIT has steadily grown in importance as a source of state revenue to the point where Connecticut ranks 2nd among the states in its reliance on the PIT as a source of state revenue.

Drawing on the Panel's adopted normative guidelines and criteria for a high quality tax system (Vol.2, Ch. 1) the Panel's research report evaluated the Connecticut Personal Income Tax (CPIT or PIT) along the following key dimensions: (Cordes, Vol.2, Ch. 8).

1) The certainty and reliability of the CPIT as a source of state tax revenue, where certainty and reliability pertain not only to breadth of the personal income tax base relative to Connecticut's financing needs, but also to the degree to which the structure of the CPIT allows it to grow with the economy.

2) The fairness of the CPIT, where fairness is defined in terms of the (i) equal of treatment taxpayers in similar circumstances in terms of income received (horizontal equity, the "equal treatment of equals") and (ii) and distribution of the CPIT relative tax liability across income classes (vertical equity, the "ability to pay" criterion).

3) The simplicity of the CPIT defined in terms of the degree of complexity that confronts both the government (revenue administration) and taxpayers in imposing, collecting, and paying taxes (taxpayer compliance).

4) The economic efficiency of the CPIT defined in terms of the incentives created by the tax for workers, business owners, and investors, as well as the tax cost of the CPIT as compared with the tax costs nationally, and in neighboring states.

Certainty and Reliability

Due to its substantial conformity with the federal definition of Adjusted Gross Income (AGI), the Connecticut PIT is imposed on a broad base, which has the potential to grow apace with Connecticut personal income over time. There are, however, three potential limitations on the ability to rely on a certain and reliable Connecticut PIT base overtime: (i) the aging of the Connecticut population combined with the exclusion of all or part of social security, 100% of military pay and other forms of retirement income; (ii) that reliance on the PIT is reducing the "competitive space" between Connecticut taxes and those of its neighboring states (Wasylenko, Vol 2. Ch. 6); and (iii) and that a significant portion of Connecticut earnings of Connecticut residents is earned in and taxed by other jurisdictions.

Fairness (Horizontal and Vertical Equity) and Efficiency

Because the Connecticut PIT is levied on a broad base, the burden of the Connecticut PIT is distributed in a manner that is generally consistent with the principle of horizontal equity. Aside from the exclusion of retirement benefits from Connecticut AGI, and the provision of three fairly minor tax credits, the Connecticut PIT taxes most sources of income at the same rate.

[15] This discussion draws on Cordes (Vol. 2, Chap. 8)

The Connecticut PIT also has a progressive distribution of tax liability. This has merit as it serves as a tool for offsetting the overall regressivity the Connecticut state and local tax system (Pellowski, Vol.2, and Ch.3). Moreover, the progressive nature of the Connecticut personal income tax is not judged to be the source of the concern that, overall, the current level of the PIT is negatively associated with the change in Connecticut's Gross State Product. (Wasylenko, Vol 2. Ch. 6).[16]

The Connecticut Earned Income Tax Credit (EITC), the structure of which conforms to the federal ETIC, is an effective means of providing added income support to working poor individuals and families. There is evidence from the IRS that perhaps as much as a 25% of the benefits paid out through the Federal EITC are questionable due to complexity of the rules the credit (taxpayer compliance complexity, not fraud). Barring any additional effort by Connecticut authorities to verify eligibility for the Federal EITC, this error rate is likely to carry over to the Connecticut EITC.

With regard to work incentives/disincentives, the EITC provides positive incentives to work for those who are not in the labor force, and negative incentives (resulting from means testing) for those who are presently working. Much of the empirical evidence suggests that the positive labor supply effects of the EITC roughly offset the negative effects.

Administration and Compliance Costs

Conforming the definition of the Connecticut income tax base to the Federal income tax does much to reduce the cost of administration of and compliance with the Connecticut PIT. Two alternatives to the existing Connecticut PIT, conforming to Federal taxable income, and replacing the current tax rate structure with a single tax rate (as is the case in Massachusetts) would modify the progressive structure of the Connecticut PIT, but would likely yield only small to modest benefits in reductions in the burden of complying with the Connecticut PIT.

The current set of exemption phase-outs and low tax rate recapture in the Connecticut PIT has the advantage of ensuring that the taxpayer's average effective tax rate moves closer the taxpayer's actual tax bracket rate as income increases. A disadvantage of this structure is that it creates rather high "shadow marginal tax rates" as income increases. Whether these shadow tax rates affect behavior will depend on their salience to the taxpayer, but they do introduce an element of non-transparency into the Connecticut PIT.

Economic Neutrality, Horizontal Equity, and Competitiveness

Like any other state personal income tax, the Connecticut PIT adds to the disincentives to work and to save resulting from the Federal income tax. The best empirical evidence on the magnitude of such disincentives, however, suggests that the impact of taxing income at the state level is likely to be small in the case of work incentives, and uncertain in the case of saving incentives.

And, like all of its neighbors, except for Massachusetts (which taxes capital gains at higher rates than ordinary income), income from capital gains is fully included in taxable income, and is taxed at the same rate as other income. Some stakeholders have suggested that consideration be given to taxing capital gains at lower rates than apply to other income, as is done under the Federal income tax. While there is agreement that taxing capital gains at preferential rates favors the receipt of income that takes the form of capital gains, there is considerably less agreement, and no strong evidence that lower tax rates on capital gains significantly encourage risk-taking and entrepreneurship

[16] A 2015 study of the progressivity of the Connecticut Personal Income Tax shows a smooth progression over all income classes. The overall total progressivity tends to regressive at the lowest and highest income levels (quintiles) but the proportional over the mid-range of incomes. Institute on Taxation and Tax Policy (ITEP, 2015). *Who Pays? A 50 State Report* (Washington, DC: ITEP). This data was presented to the Panel at its September 16 and November 17, 2015 meetings.

As for tax competitiveness, by a variety of measures, Connecticut's overall tax system is competitive with that of its neighbors. However, two taxes that make up part of this overall system have been judged negatively associated with the growth in Connecticut's Gross State Product and, thus, policymakers must look for ways to reduce reliance on each tax. The first is the level of the real property tax, a topic—and Panel response—that is addressed in the section below that addressed the topic of the real property tax. The second pertains to the level of the CPIT, which since its 1991 enactment is taking on an increasing relative role in General Fund revenues (Sullivan, 2015; Pellowski, Vol.2, Ch.3; Bourdeaux, Vol 2, Ch. 5, Wasylenko, Vol 2, Ch., 6). One of the best ways to minimize this association of the PIT with economic growth is to pursue a broad base, low rate strategy for not only the PIT, but also for other state tax sources—an adopted principle of the Panel (Vol 2, Ch.1).

Panel Recommendations

Recommendation 1. **Taxation of Retirement Income.** Other that federally excluded income, tax all retirement income including military and teacher retirement income similar to the state's treatment of social security income.

- Revenue Implications: Base broadening will allow for a reduction in statutory tax rates due to the long run capture of the trend of a growing segment of the Connecticut population that is of retirement age (Age 65 and older increasing from 18.6% in 2015, to 20.7% in 2020, to 23.5% in 2025).
- Adopted with Panel Members Galbraith, Schatz, and Testo dissenting

Under current tax system arrangements, an aging population imposes a constraint on future growth in the tax base. The revenue impact of this constraint can be further exacerbated if states grant preferential tax treatment to income received by senior citizens. Unlike some states, Connecticut does not contain provisions that, for example, exempt entire portions of income from individual income taxation. However, Connecticut does make adjustments in computing Connecticut AGI that exempt Social Security and military retirement benefits from taxation. At present, the revenue effects of these exemptions are relative small. However, as the Connecticut population ages, these provisions, especially the Social Security exemption, could become more significant; and consideration should be given to treating these forms of income in the same way as they are treated under the federal income tax

Recommendation 2. **Connecticut Definition of Adjusted Gross Income**. Retain the Connecticut definition of Adjusted Gross Income as the starting point for calculating the Personal Income Tax.

- Retain the Connecticut definition of Adjusted Gross Income as the starting point for calculating the Connecticut Personal Income Tax.
- Adopted without dissent.

While "full conformity" by using Federal Taxable Income as the starting point for determining Connecticut taxable income might seem like a means for further simplifying compliance with the Connecticut PIT, the disadvantages of doing so outweighs the advantages. Most notably, using Federal taxable income would narrow the base of the Connecticut PIT, requiring the enactment of higher statutory tax bracket rates in order to raise the same amount of revenue as from taxing a broader base linked to Federal AGI. Any benefits from less time required to compute Connecticut tax liability would be small to nonexistent, since it is likely that additions to and subtractions from Federal taxable income would still be necessary in order to arrive at Connecticut AGI.

***Recommendation 3*. The Connecticut Earned Income Tax Credit EITC.** Retain the Earned Income Tax Credit. Increase the credit from an amount equal to 27.5% to 30% of the federal earned income tax credit.

- Retain the Earned Income Tax Credit. Increase the credit from an amount equal to 27.5% to 30% of the federal earned income tax credit (Current Connecticut law phases in this increase by FY 2017).
- Adopted without dissent

To the extent that Connecticut citizens wish to supplement the efforts of the federal government by providing income support to working poor Connecticut residents, the state EITC, despite its error rate, is still the most proven effective means of delivering the benefit. These considerations would support retaining the EITC in its present form and returning the percentage supplement to the Federal EITC to 30%.

***Recommendation 4*. Net Capital Gains Income.** Retain the tax treatment of taxing net capital gains income at the same rate as all other income.

- Retain the tax treatment of taxing net capital gains income at the same rate as all other income in the Connecticut income tax.
- Adopted without dissent

In light of the uncertain evidence about the effects of preferentially taxing capital gains on risk-taking and entrepreneurship, the case for taxing capital gains at a lower rate under the Connecticut PIT is not a strong one. This conclusion is further buttressed by the fact that none of Connecticut's neighboring states tax capital gains preferentially. Moreover, since there is no compelling evidence that cutting the tax rate on capital gains is "self-financing" a capital gains cut would need to be made up by increasing tax rates applied to other sources of income.

2. The General Retail Sales and Use Tax[17]

The General Retail Sales tax is a tax on the disposition of income (consumption) rather than a tax on the sources of income (such as income, estate and gift taxation). General sales taxes are intended to apply broadly to an inclusive base of goods and services sold at retail[18], [19] Retailers engaged in business in Connecticut are required to collect and remit the tax to the state. A consumption tax has three key features: (i) its basis is the d*estination principle* of taxing goods and services consumed by Connecticut households and visitors in the state as well as goods shipped into Connecticut for consumption; (ii) the intent is to capture all Connecticut sales at retail regardless of the location of the seller; and (iii) exempting from the tax sales by Connecticut firms is appropriate when the good or service sold is delivered out-of-state (Fox, Vol. 2, Ch. 9).[20]

Tax Structure

The tax base breadth (defined as taxable sales divided by state personal income) is narrower than the average state, but this may arise in part as buyers make many purchases out of state or online. Under current arrangements the sales tax base is headed for decline unless steps are taken to capture the changing composition of retail consumption associated with the shift new retail of economy (Wallace, Vol 2. Ch. 7). If the tax base is allowed to become obsolete, then, for a given revenue yield, the statutory rate will increase thereby exacerbating the existing tax inequities and non-neutralities.

Multiple Tax Rates. Connecticut's sales tax structure is complicated in the sense that policy changes have been relatively frequent and a large number of tax rates are imposed. For example, most states have one or two sales tax rates while Connecticut has seven. Multiple tax rates require decisions both on whether the transaction is taxable and at what rate thereby increasing the cost of revenue administration and vendor cost of compliance alike.

Revenue and short vs. long run volatility.

The sales tax generated $ 4.10 billion in 2014, which accounts for a 26% of state tax revenues. The average US state sales tax generated closer to a third of total state revenues (31.2%). Connecticut's standard 6.35 percent sales tax rate is below the median state and local sales tax rate of about 6.9 percent Connecticut's short run revenue elasticity is 0.6, which means sales tax revenues grow much

[17] This discussion draws on Fox (Vol. 2, Ch. 8)

[18] Selective sales taxes are levied on specific commodities such as alcohol, motor fuel, tobacco, and transient accommodations are often used simultaneously. The Panel did not consider this class of taxes in its study agenda.

[19] Forty-five states and the District of Columbia levy a general sales tax. The non-sales tax states are Alaska, Delaware, Montana, New Hampshire and Oregon

[20] All states that levy a general retail sales tax (RST) also levy some form of compensating use tax. The use tax applies at the same rate as the sales tax and is imposed on the purchase of taxable items made outside the state for use within the state or when items purchased for a tax exempt purpose are transferred to a taxable purpose. The use tax is complementary to the sales tax and does not apply if the sale already has been, or will be, subject to the sales tax.

more slowly than the economy. However, over the past ten years the sales tax has also exhibited periods of volatility, indicating a potentially unstable tax characteristic of narrowly- based sales taxes.

Equity

Horizontal Inequity. The current Connecticut sales tax is rife with horizontal inequities, some intended (sales tax holiday, specific exemptions from the tax base, reduced rates for legislatively favored activities) and others unintended (difficulty in taxing transactions such as internet sales and the shared economy).

Vertical Inequity. Because of the convergence of twin realities that (i) the ratio of consumption/income decreases as household incomes increase and (ii) the tax is imposed on broad sets of goods and services, the sales tax is regressive. However, to efficiently and effectively eliminate this vertical inequity by legislating changes in the base of the tax is sure to fail since sellers cannot effectively target sales to the situation of individual purchasers and households. What can work, however, is for Connecticut to view vertical equity as a goal for the tax system rather than a goal for each tax, and then use taxes linked directly to households, such as the personal income tax, to achieve the vertical equity goals. Moreover, a policy of enacting exemptions from the sales tax base tends to exacerbate regressivity since such tax base erosions require higher tax rate on non-exempt items for a given amount of revenue. Higher tax rates can also lead to perverse effects such as (i) encouraging more online purchases to evade the Connecticut sales tax (which likely makes the tax more regressive); (ii) encouraging additional purchases of non-taxed items; (iii) creating retailer complexity and therefore higher costs of compliance, and (iv) providing greater incentives for sellers and buyers to evade or avoid the sales tax.

Efficiency/Non-neutralities.

Because the RST is intended as a tax on final retail consumption there is one broad class of exemptions that makes sense, and that is for business-to-business sales of intermediate inputs in the production and distribution process. Nonetheless, 35 percent of the State's sales taxes are currently collected on such transactions.[21] Taxation of intermediate purchases not only raises the cost of doing business in Connecticut but also changes relative prices that affect consumption decisions. There is also the problem of "tax pyramiding" whereby the same item is taxed more than once in the production and distribution process.

Fiscal Obsolescence?

As one of the "big three" of state and local taxation (the income and the property tax are the other two), a state cannot allow its sales tax to become fiscally obsolete. As a response to state revenue needs in the Great Depression and its immediate aftermath (1929-1938), 24 states adopted a general sales tax (Connecticut was a Post WWI adopter in 1947). For the economies of that time (even as late as 1969 when Vermont was the last state to enact) when the retail economy was largely "goods" rather than "services" based, it was a good 20th century way to generate revenue. But, as well documented for this Panel and by others, the "old" economy in which tangible property was typically manufactured and physically delivered is giving way to the 21st century, which is that of the internet, software,

[21] Council on State Governments & Ernst and Young LLP, Total State & Local Business Taxes, 2015. Cited in Fox (Vol 2. Ch. 9)

technologies that do not require a presence where the retail consumer is located, and changing business models such as the sharing arrangements of TaskRabbit, Uber, Airbnb, and HomeAway. This is only a partial list of what one sees going on today. It is hard to neatly predict what the 2020s and beyond will be like as technology and innovation arrive at a fast pace. But what Connecticut can do in order to be in a position to adjust to these new economy changes is to stick with the principle that if the final retail consumer in Connecticut, then the sale is in Connecticut.

Panel Recommendations

Panel Recommendation 1: **Remote Sales Transactions**. Connecticut should remain aggressive in the taxation of remote purchases (e-commerce, mail order, cross-border shopping) destined for Connecticut residents by pursuing opportunities to expand the definition of nexus through administrative procedures and, if needed, through legislation. As part of its enforcement the state should require sellers to collect and remit the tax on behalf of the buyer.

- o Revenue Implication: Systematic and uniform capturing of such transactions will exert a downward pressure on statutory tax rates.
- ▪ Adopted without dissent

Remote sales—both catalogue mail order and E-Commerce sales over the internet—have expanded rapidly over the past decade. At present, Connecticut, like other states are limited by US Supreme Court decision [*Quill v. North Dakota* (504 US 298 (1992], which says that a remote seller cannot be required to collect the tax on behalf of the state to which the sale of a good or service is destined. To be clear, however, *Quill* does not say that the tax is not due. Accordingly, states, Connecticut along with several other states have become aggressive in forcing voluntary collection, arguing that if a sale is destined (delivered) to the state, there is *nexus*.

Recommendation 2. **Digital Downloads.** Tax retail consumption of digitized versions of goods at the same standard retail sales tax rate as other goods. As part of the enforcement strategy the state should look to use sellers, wherever they are located, to collect and remit the sales tax.

- o Revenue implication: Base broadening overtime to allow for lower statutory tax rates.
- ▪ Adopted without dissent

Digitized transactions can be considered using the same logic as remote sales. The intent is to tax all retail consumption and to tax highly substitutable items similarly (e.g., download music should be taxed the same as a CD; digitized moves the same as DVD).

Recommendation 3. **Shared Economy**. Ensure that the sharing economy is taxed similarly to the traditional economy. Recognizing that the sharing economy is still in its early stages of development, the General Assembly should provide legislative support to the Department of Revenue Services in its efforts to identify the size of the tax base as well as to capture the tax due at retail by requiring the sharing economy organizing business entity to collect and remit tax due.

This recommendation is similar to that on digital downloads; however in this case the issue is not only remote sales, but also how to get at the sales transactions of the rapidly emerging in-state "Sharing Economy". Taxing emerging entities such as Airbnb (which compete with the local BNB that chooses a business model outside of the Airbnb network) and UBER (require the company, not the driver, to collect the tax) is one step in the process. The overall goal is to ensure that the (i) traditional and (ii) now emerging sharing business models are being taxed similarly.

- Revenue Implication: Base broadening overtime to allow for lower statutory tax rates.
- Adopted without dissent

***Recommendation 4*. General Application of Sales and Use Tax**. Adopt the presumption that the Connecticut sales tax on final consumption be broadly applied to all goods and services sold at retail. If exclusions, exemptions or credits are to be allowed, the General Assembly must be explicit in its rationale for such treatment.

- Revenue Implication: Base broadening overtime to allow for lower statutory tax rates.
- Adopted with Panel Members Clavette, Marchand, and Schatz dissenting

The sales tax is intended as a broad tax on consumption and should exempt as little consumption as possible to allow a lower revenue neutral tax rate and to limit the tax's impact on consumption choices. The exemption a poorly targeted/blunt instrument for mitigating regressivity Moreover, other more effective means-targeted strategies are available. A broad base-low rate sales tax strategy promotes several goals for high quality tax system as adopted by the Panel (Vol. 2, Ch.1): revenue reliability, horizontal equity, vertical equity, and simplicity. In its decision making the Panel determined to maintain the exemption for food for home consumption, including food stamp purchases.

***Recommendation 5*. Eliminate Sales Tax Holidays.** Eliminate the practice of a sales tax holiday.

- Revenue Implication: An increase of $5.2 m in retail sales tax yield would result in a less than 0.2% reduction in the standard statutory rate (FY 2014)
- Adopted without dissent

Connecticut is one of 18 states that allows a sales tax holiday and along with Massachusetts is the only state north of Maryland with a holiday. The Connecticut "holiday" is typically scheduled as an August back-to-school" event and limits the tax free status to single purchases below some stated amount. Tax holidays are generally justified as a way to enhance vertical equity. In fact, tax holidays are unlikely to achieve this objective as they (i) are poorly targeted to low income households; (ii) are more likely to change the timing of purchases rather than the total amount of purchases

3. The Connecticut Corporate Net Income (Profits) Tax General Business Tax Alternatives[22]

Connecticut has one of the highest corporate income tax rates in the region at 9 percent including the temporary surcharge. Despite the surcharge (which applies to firms with over $100 million in gross income or those filing combined/unitary returns) and limits on the extent to which credits can offset income taxes due (currently limited to 50.01 percent of pre-credit tax liability), corporate income tax collections dropped by more than $125 million between 2006 and 2012. The Corporate tax share of General Fund Revenues has declined from 14% of General Fund Revenues in 1984, to 10% in 1994, and 5% in 2014.

The Net Income Tax Structure

Connecticut levies an income tax on C Corporations, but does not levy an entity-level income tax on pass-through entities such as S Corporations, LLCs, LLPs, partnerships. C-Corporations pay the greater of the net income tax, the alternative capital base tax, or the $250 minimum tax. In 2012, 41,290 corporate taxpayers filed returns compared to 44,277 in 2003. In 2012, approximately 97 percent of corporate taxpayers (40,290 firms) filed single entity returns, with the remainder filing combined (998) or unitary (232) returns. Connecticut uses a broad nexus standard that asserts taxing authority on all corporations with property or payroll in the state or with at least $500,000 in sales in the state, whether or not the corporation has property or payroll in the state. For most corporations, income is apportioned to Connecticut using a three-factor formula of property, payroll and double weighted sales. Manufacturers, financial service companies and broadcasters use the single factor sales formula. A small number of sectors confront unique apportionment rules. Sales of services are sourced to Connecticut when the services are performed in Connecticut, and are not based where the customer resides. Connecticut levies a preference tax on taxpayers who file combined returns. Businesses subtract the combined tax liability of businesses filing as separate entities from the tax liability of the combined group and pay the difference, up to a maximum limit, as a preference tax.

The Connecticut corporate tax regime is complex but in many respects similar to the structures in other states in the northeast region. Tax rates in the region range from 7.1 percent in New York and 7.0 percent in Rhode Island (roughly comparable to the Connecticut rate of 7.5 percent without the surcharge) to 10 percent in Pennsylvania. The surcharge creates a progressive rate structure; the only other state in the region with a progressive corporate income tax rate structure is Maine. One notable difference is that several states in the region (e.g. Pennsylvania, New York, Delaware, Maine, Massachusetts and Rhode Island) source services based on the location of the customer, instead of where the services are performed. This market-based sourcing method if adopted in Connecticut would exclude from Connecticut tax any exported services and will tend to decrease the income tax burden of in-state firms providing services in other states. Market-based sourcing will levy a destination tax on services consumed in Connecticut but produced in other states.

Tax Credits

Tax credits are a significant element of the Connecticut corporate tax structure. They lead to revenue erosion, add complexity to the system and policy changes lead to instability and uncertainty in business tax liabilities. Business taxpayers claimed approximately $150 million in tax credits in 2012, a significant increase from the $93 million claimed in 2003. More significant, Connecticut taxpayers are carrying forward an estimated $2.5 billion in tax credits, almost four times the total net corporate

[22] This discussion draws on Luna and Murray (Vol 2. Ch. 10)

income tax receipts in 2014. To stem the magnitude of lost revenue, the state passed legislation in the summer of 2015 that limits tax credits for years beginning on or after January 1, 2015 to 50.01 percent (down from 70 percent) of pre-credit tax liability. Furthermore, while the number of taxpayers claiming tax credits has declined by about 50 percent from 2003 through 2012, the value per credit increased by 225 percent during the same period to approximately $42,000 per credit and $151 million in total credits claimed in 2012. Elimination of all credits in 2012 would have supported rate reduction of 1.9 percentage points. The annual use of credits and the large overhang of credit carry-forwards will put downward pressure on corporate income tax collections for the foreseeable future.

Revenue Performance

Connecticut is ranked 19th nationally in total corporate income tax collections which is broadly consistent with its GDP ranking of 23rd in the country. Compared to the northeast region, Connecticut collects less per person and relies on corporate income taxes for a smaller share of total revenues than its nearby competing states. Also consistent with most corporate income tax systems, the tax is highly volatile and more volatile than other revenue sources, with collections booming in economic expansion, peaking most recently at approximately $900 million in 2007, but then plummeting to less than $450 million in 2009 according to Census data. Furthermore, revenues have been flat or declining on a long-term basis despite a number of piecemeal fixes in recent years, such as restricting the use of credits, introduction of the surtax in 2003, an increase in the maximum preference tax for combined returns in 2003, and the introduction of economic nexus for corporate filers in 2009. These measures have helped stem losses from the corporate income tax but indicate a growing and long-term problem with the corporate income tax as a stable and dependable source of revenue for Connecticut. Corporate income tax collections were only 3.9 percent of overall state tax collections in 2014 and would have been far less without the special provisions mentioned previously that have enhanced yield. For neighboring states, corporate tax collections represent larger shares of total tax revenue, and range from approximately 6.3 percent of total collections in New York to around 9 percent for Delaware and Massachusetts.

Business Tax Options: Major Structural Reform and Elimination of the Corporate Tax

The states have taken numerous steps in recent years to shore up the corporate income tax, including the introduction of combined reporting. However, due to base erosion and the volatility of the traditional corporate income tax, a number of states have moved to business taxes that tax business activity rather than profits or taxable income. These alternatives are best thought of as options on a continuum with the options varying by the deductions allowable under each system. On one end is the corporate income tax that allows all “ordinary and necessary” expenses as deductions, has a relatively small tax base of profits, and relatively high rates. On the other end is a gross receipts tax that includes all or most business receipts in the tax base and allows for few or no deductions. This results in a larger and more stable base than the corporate income tax and allows for far lower tax rates (typically less than 1 percent) to raise revenues comparable to the corporate income tax. Between the two extremes are value-added taxes and gross margin taxes that allow for some deductions such as purchases from a third party in the case of a subtraction value-added tax and material and labor typically part of cost of goods sold for some existing gross margin taxes. These subtractions necessitate a higher tax rate. Generally these taxes are levied on all businesses, corporate and non-corporate alike.

Any variant of the currently-implemented activity taxes would be a dramatic change in the approach to business taxes and would set Connecticut apart from its competitors in the region. These activity-based taxes have several important advantages over the corporate income tax. The taxes are levied on a much larger base and thus support much lower rates, which reduces distortions including the payoff for many tax planning efforts (since it is more difficult to shift sales than net income); are more stable during expansions and recessions; show stronger base growth over time; and fall on virtually all businesses in the state.

A disadvantage of the gross receipts tax is that it can have a pyramiding effect as goods move through the supply chain with a tax levied at each step of the production and distribution process. This benefits the vertically integrated firms and may encourage consolidations within a supply chain. However, the low tax rates minimize this distortion. The value added tax, which like the Gross Receipts Tax is also applied at each stage of the extractive, production and distribution avoids this pyramiding problem since its tax base is calculated allowing the taxpayer as each stage the process to deduct purchases from other firms, including taxes imbedded in the cost of those purchases.

Estimates developed for Connecticut indicate that a revenue neutral gross receipts tax (based on pre-credit corporate tax collections) would have required a 0.22 percent rate in 2012 while an addition VAT would have required a rate of 0.64 percent. The resulting simplifications and the lower rates would enhance the state's attractiveness as a place to do business. The gross receipts tax and VAT bases were more stable and showed stronger growth than corporate tax collections between 2007 and 2012. Stronger base growth would mitigate the need for ongoing structural changes that have been intended to enhance corporate income tax yield. Moving to an entity activity-based tax will pose transitional problems due to the presence of net operating loss carryovers and the large income tax credit carry-forwards in Connecticut. These problems have been effectively addressed in other states.

Tax Panel Recommendations

Recommendation 1. **Alternatives to the Corporate Net Income Tax and Business Taxes.** The Tax Panel finds that the taxation of the current corporate net income tax base violates many its adopted criteria for a high quality tax system. Therefore, the state shall undertake, through the Department of Revenue Services, a study of the structural impacts and tradeoffs of replacing the corporate net income tax with a broad based/low general business tax to be imposed uniformly on corporate and non-corporate businesses alike. In carrying out this study, which will include an examination of both a gross receipts tax and a value added tax, the state shall also examine how the adoption of a broader base and lower rate tax can become a vehicle for a single-business-tax strategy for further modernizing and stabilizing the current business tax system. This single-business tax analysis will include (i) eliminating the capital base system; (ii) phasing-out the proliferation of tax credits that can now be applied against the corporate net income tax; and (iii) phasing-in the exemption of business-to business transactions from the retail sales tax, and (iv) applying a less stringent ownership rule for business-to-business purchases when services are sold between a parent and a subsidiarity.

- Revenue implications: The analysis is to be carried out on revenue neutral basis of the alternatives *vis-à-vis* the current tax treatment of corporate and non-corporate entities alike.
- Adopted without dissent.

Recommendation 2. Eliminate the capital base tax system. Eliminate the capital base tax that serves an alternative method of calculating corporate income tax Liability.

- Revenue implications: since, at present, the corporate taxpayer is required to pay the higher of the two tax liability calculations -- capital base and net income -- any revenue losses would be made up by raising the corporate net income tax rate and/or placing limits on the issuance of new credits against the net income tax.
- Adopted without dissent.

The requirement to calculate tax liabilities under two systems (the net income and capital base methods) and pay the higher of the two leads to higher administrative and compliance costs and creates taxpayer uncertainty regarding tax liabilities.

***Recommendation 3*: Proliferation of Tax Credits.**

Discontinue the practice of issuing new tax credits that erode the base of the corporate net income tax, and also evaluate existing credits as to whether they are achieving their intended objectives. If credits are intended to provide general tax reduction, then phase out the credits and lower the statutory rate. If credits are intended to promote economic development, then efforts are to be made to identify alternative and transparent policies that can promote economic growth at lower revenue costs to the state.

- Revenue Implications: Elimination of credits paid in 2012 would have reduced the corporate statutory rate by 1.9 percent. The elimination of credits and credit carry forwards will put long term downward pressure on corporate income tax rates.
- Adopted without dissent

The credit system narrows the base, is complicated, and subject to ongoing change which creates tax liability and tax revenue uncertainty. Further, many of the credits are used only by a small number of firms. In some cases the credits simply reward businesses for decisions that they would have made regardless of the structure of taxation. The state continues to implement tax credits that erode corporate revenue performance while at the same time placing restrictions on their use. Base broadening could be undertaken to support corporate rate reduction.

***Recommendation 4.* Mandatory Unitary Reporting.**

Maintain mandatory combined reporting for business entitles that are part of a unitary business; require that unitary groups be broadly inclusive.

- Connecticut requires unitary reporting commencing with the 2016 tax year. Only a modest revenue gain is anticipated from adopting mandatory reporting.
- Adopted with Panel Member Galbraith dissenting.

The Panel recommendations confirms current policy: for tax years beginning on or after January 1, 2016, Connecticut will have mandatory combined reporting for entities that are part of a unitary business. Connecticut will also require add-backs of related party interest and intangible expenses.

***Recommendation 5.* Apportionment of Multi-state Income.**

Broadly adopt single sales apportionment factor based on market (destination) sourcing for the taxation of corporate and non-corporate business activities alike.

- Revenue Implications: The adoption of market sourcing is not projected to result in a significant change in revenue yield
- Adopted without dissent

Enact a market-based sourcing rule in lieu of the current cost-of-performance rule for apportionment of the sales factor for service providers. This can minimize distortions through taxation at destination rather than at origin and harmonize sourcing with the treatment of tangible goods. A single factor sales apportionment for all taxpayers. This will help realize numerous policy goals including simplicity and neutrality and lower the tax cost on in-state production.

***Recommendation 6:* Claiming of Net Operating Loss.** Reinstate full use of Net Operating Losses.

- Revenue implications: With an estimated annual revenue loss of $90.1 million in FY 2016, revenue neutrality will require raising the standard corporate tax rate of 7.5% to

8.2%. These numbers do not address the treatment the current unfunded contingent liability of claimable net operating losses totaling $78 billion.

- Adopted without dissent

Recent legislation will impose limits on net operating loss (NOL) carry- forwards and tax credits. Beginning with the 2015 tax year, the amount of the NOL deduction will be limited to 50 percent of Connecticut net income. An alternative limit is available for corporations that are part of a combined group with over $6 billion in unused NOLS from tax years prior to 2013. Tax credits used to reduce corporate tax liability will be limited to 50.01 percent (currently 70 percent) of the amount of tax due in any income year prior to the application of credits.

4. The Connecticut Estate and Gift Tax[23] and Probate Fee Structure[24]

The passage of the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA), the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010) and the American Taxpayer Relief Act of 2012 fundamentally altered the structure of the federal estate tax. Gone was the state pick-up tax which allowed for a federal tax credit for state Estate, Inheritance and Gift (EIG) taxes paid. The federal estate tax exemption has been raised from $675,000 to $5.43 million, and is now indexed to inflation. The federal estate tax and gift tax are now unified, so that any gifts given beyond the annual limit (currently $14,000 per recipient) count against the exemption. Portability, which allows a spouse to use any unclaimed exemption by his/her deceased spouse, is now a permanent feature of the tax code.

For the states, the immediate effect of the loss of the pick-up tax was a loss in revenues. Some states responded by decoupling their EIG tax from the federal code in order to maintain the tax; by not decoupling, other states effectively let their EIG tax fade away. Other states went one step further by officially eliminating their EIG tax altogether.

At the time EGTRRA was enacted, Connecticut had a succession (inheritance) tax as well as an additional estate/'pickup tax' that was designed to 'pick up' any unused portion of the federal tax credit. In 2005, Connecticut replaced the separate ('pickup') estate tax and separate gift tax with a unified gift and estate tax; it also repealed its succession tax.

With the elimination of Minnesota's gift tax in 2014, Connecticut is the only state imposing a stand-alone gift tax. Similar to federal law, Connecticut's gift tax is a unified tax; all gifts that exceed the annual tax-free limit count against the amount that is exempt from eventual estate taxation.

The current estate exemption level of 2 million dollars places Connecticut in the middle of all states nationally. Its highest tax rate of 12% is the second lowest in the nation. Connecticut has one of the lowest tax impacts in the Northeast for large estates.

EIG tax revenue is notoriously volatile and hard to predict. Not only does the tax depend on people dying, but it also can be paid many years later than the year death occurs. This means that in a given year, EIG revenue is raised from both the estates of recently deceased, as well as those who deceased in years past, which can span numerous years. Since 2001, Connecticut's EIG tax revenue as a share of total tax revenues has exhibited a decreasing trend, from a high of 2.5% to currently below 1%. Only in 2013 is there a significant departure from this trend path.

The Panel's research evaluated the impact of Connecticut's EIG tax on the state through a variety of means. Data from the US Bureau of the Census and the American Community Survey show that Connecticut has experienced a fairly steady net-outflow of elderly migrants since 1980. Given that EIG tax policies have changed a great deal during this period, the stability of these migration patterns suggest they are influenced little by EIG taxes (Conway and Rork, Vol 2, Ch. 11). The data also show that behavior of high income elderly migrants (those most likely to face EIG taxes) have been similar

[23] Refer to Conway and Rork, Vol 2. Ch. 11 for Panel's research on the Estate and Gift tax.
[24] Refer to Knierim and Russo. Vol. 2, Ch. 12 for the Panel's research on Probate Fees

to the general elderly migrant population. These stable patterns are verified in data from the Internal Revenue Service (IRS) are consistent with the established literature that shows little to no migration effects from EIG taxes. In sum, there is no evidence of migration effects from data on federal estate tax returns or Connecticut personal income tax filings.

Connecticut's EIG tax also appears to have limited impact on annual economic growth in the state, regardless of how growth is measured. Connecticut growth falls in line with all its neighboring states and does not appear affected by changes in its EIG tax policy. Even in comparison to Southern states that have experienced large amounts of population growth over the last 30 years, Connecticut's per capita growth rate would not be considered an outlier. A similar pattern emerges when Connecticut is compared to Midwestern states without EIG taxes. Connecticut's growth appears to be more volatile than some states, but that pattern has been consistent since 1978, making it hard to blame EIG taxation for any growth pattern we witness.

Policy Recommendations

Estate and Gift Tax:

***Recommendation 1*. Basic Structure and Effect on Taxpayer Migration Effect. For the present retain the current estate tax exemption level of $2 million of the adjusted estate. The State should then further examine the option of phasing in the level of tax exemption in conformity with federal law and (ii) continue to monitor data for tax induced taxpayer migration flows.**

The EIG tax is only one of two progressive taxes in the Connecticut tax system and the total (federal plus Connecticut) tax on estates is lower currently than it has been at any time in recent history. However, its small revenue role in the General Fund minimizes its effect on the Connecticut distribution of income. While only 20 states impose an EIG tax, nearly all of the states in the region do so and Connecticut's tax is near the bottom in terms of tax liability; however, this policy is in flux and so the landscape could change rapidly.

***Recommendation 2.* Portability. Provide "portability" of the Connecticut estate tax exemption between spouses such that the unused exemption of the first to die may be claimed by the second-to-die's estate as permitted for federal estate tax purposes.**

Federal law has three key features that distinguish it from Connecticut. (i) a higher exemption level (currently $5.43 million), which is indexed for inflation; (ii) portability (such that a married couple effectively faces an exemption twice as large), and (iii) a unified gift tax. At present, Connecticut has only the third feature and it is the only state that does. Changing Connecticut law to conform to the federal law would simplify estate tax planning and therefore likely reduce compliance costs

***Recommendation 3.* Qualified Terminable Interest Property.** Review current practice to ensure the full implementation of a Connecticut Qualified Terminable Interest Property (QTIP) election regardless of whether a federal QTIP election is made and independent from a federal QTIP election such that married couples can defer state estate taxes until the second death.

- Revenue Implications: Due to the high degree of volatility in the Estate and Gift Tax proceeds, providing a given year revenue impact is an exercise in uncertainty. Taken together, portability, QTIP, and elimination of the Gift Tax reduce E&G revenues by about 50% of current yields (a reduction by about $130m in 2015). The bulk of this revenue impact will result from adopting portability.

At present, Connecticut does not allow for a state specific QTIP election. For situations where the value of the estate is more than the Connecticut exemption but less than the federal exemption, the lack of a state specific QTIP election prevents married couples from deferring state taxes without

forgoing the full federal exemption when the first spouse dies. Allowing a state specific QTIP will simplify estate planning for Connecticut residents.

***Recommendation 4*. Gift Tax. Repeal the Gift Tax**; continue to apply a rule that gifts made in contemplation of death are included in the value of the estate.

- Revenue Implications: Taken together, portability, QTIP, and elimination of the Gift Tax reduce E&G revenues by about 50% of current yields ($207m to $106m in FY 2014).

The gift tax generates a relatively small amount of revenue (about 4% of all EIG tax revenues in 2013-14). Eliminating the gift tax increases the opportunity for 'deathbed' gift planning, in which large transfers are made in contemplation of death to avoid the estate tax, although the federal unified gift tax law would still apply to larger estates. Eliminating the gift tax will therefore likely significantly reduce EIG tax revenues, especially if no other 'gifts-in-contemplation-of-death' rules are enacted.

***Recommendation 5.* Estate Filing Dates to Conform to Federal Law**. Replace the Connecticut deadline for filing an estate return from the current practice of six (6) months following the decedent's death to conform to the federal practice of nine (9) months.

- Revenue Implications: A delay in Estate and Gift tax revenues in the fiscal year of implementation. For the Probate Court, a reduction in $7.4 million in probate fees is anticipated for the year in which the transition occurs (FY 2016 estimate). In addition, there is an ongoing annual loss of interest revenue to the Probate Court. For FY 2016 the interest loss is estimated to be $200,000.

Probate Fees

***Recommendation 6.* Probate Fee Structure.** Revise the current formula of the probate fee for decedents' estates so that it reflects an appropriate level as a direct user fee for estate settlement rather than a vehicle for paying for essential judicial services unrelated to decedents' estates.

- Revenue Implications. The present treatment whereby probate fees are designed to fully cover the cost of Probate Court Administration results in a highly unstable revenue source to the Probate Court. This revenue instability reflects the uncertainty of the length of time an estate may be in probate. In some years the Court may largely cover its operating costs; in others it may be required to cover net operating losses through temporary borrowing from other state agency funds.

The state budget for fiscal years 2015-16 and 2016-17 brought about two significant changes in the manner that Connecticut funds the Probate Courts. First, the budget eliminated all general fund support for the Probate Courts. Second, probate fees were increased significantly as a substitute for an appropriation from the General Fund. Fees on decedents' estates, which are calculated as a percentage of all of the decedent's assets, changed most dramatically. The new fee structure doubles the rate on estates larger than $2 million and eliminates the fee cap (previously a maximum fee of $12,500). As a result, Connecticut's probate fees are now the highest in the nation. The new budget also puts the state in the unusual position of having a court that must operate exclusively on fee revenue. This exclusive reliance on the highly volatile fee revenue-- (the time it takes for the settlement of estates, a process that varies from estate-to-estate, can extend over a period of years--) leads to the perverse outcome that in a year that the Probate Court has an operating deficit it must then borrow funds from other state agencies. The solution is to return to General Fund support of the Probate court and revise the current formula of the probate fee for decedents' estates so that it becomes a user charge to cover only administrative processing costs (e.g., fees to cover staff time of document processing). Probate fees should not become a vehicle for paying for judicial services unrelated to decedents' estates.

Part III. Local Revenues: The Property Tax and Local Revenue Diversification

5. Property Tax and Local Revenue Diversification[25]

A Context for Reform

Local governments provide the goods and services that impact the daily lives of all citizens, e.g., the road network, sewerage systems, provision of potable water, public safety, public schools, etc. The ability of local government to pursue policies and programs that respond to the preferences of local residents requires own-source revenues that a local government can use as it sees fit. The only revenue source capable of ensuring a strong and vibrant local government is the property tax[26], the major source of locally raised revenues in Connecticut.

The property tax base in Connecticut is relatively broad compared to the property tax base in most other states because it includes selective personal property and motor vehicles. In addition, Connecticut provides very limited property tax relief and has avoided constraints on and distortions of the property tax including property tax caps, levy limits, assessment limits and the like.

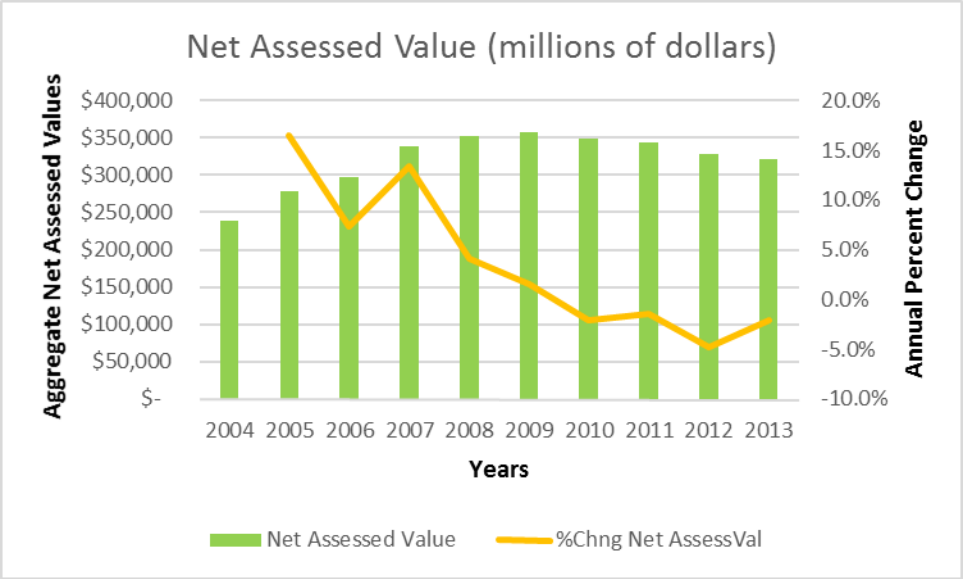
By most metrics reliance on property taxes by local governments in Connecticut is high, in large part because it is essentially the only tax available for local governments. Over-reliance on any single tax source tends to obscure its virtues and make more obvious its defects.[27] For example, one strength of the property tax is revenue stability because taxes are based on an asset value, not annual streams of income or sales. As a consequence of virtually sole reliance on the property tax for local tax revenues, a structural deficit is created where revenues grow more slowly than income, but expenses grow the same as income or faster. This tendency can be exacerbated by a lag in bringing assessed values into line with market values, e.g., the 5-year assessment cycle in Connecticut. Diversifying local revenues provides a balance between stable revenue sources that grow more slowly than income and revenue sources that are more responsive to changes in income.

In the aggregate, Net Grand Lists in Connecticut have been declining since 2009, albeit the decline is not uniform across municipalities. For example, between 2007 and 2012 sixty-four towns experienced increases in their Net Grand Lists, but 105 towns experienced declines. Between 2012 and 2013 the aggregate Net Grand Lists in Connecticut declined 2.1 percent, albeit 94 municipalities experienced increases averaging 0.6 percent and 75 municipalities experienced declines averaging 7.7 percent. Property tax revenues, however, continued to grow over this period as local governments increased mill rates.

[25] This section draws on research papers by Anderson (Direct Property Tax Relief), Bell Overview and Tax Exempts), , Collins (Conveyance and Controlling Interest) , Walters (Tangible Business Property and Motor Vehicle Taxes) , Sjoquist (Local Revenue Diversification) and Zhao (Fiscal Disparities) . All of these reports may be found in Vol.3 of the set of Panel documents

[26] Brunori, David. 2013. *Local Tax Policy: A Federalist Perspective*, Washington DC: Urban Institute Press.

[27] Shannon, John. 1987. "State Revenue Diversification – The Search for Balance," in *The Quest for Balance in State-Local Revenue Structures,"* edited by Frederick D. Stocker, Tax Policy Roundtable, and Property Tax Papers Series #TPR-16, Cambridge, MA: Lincoln Institute of Land Policy.



Increasing Property Tax Revenues in Connecticut		
Years	**Property Tax Revenues (millions of dollars)**	**%change**
2008	**$ 8,123.39**	
2009	**$ 8,521.27**	**4.9%**
2010	**$ 8,700.69**	**2.1%**
2011	**$ 9,005.30**	**3.5%**
2012	**$ 9,222.58**	**2.4%**
2013	**$ 9,501.44**	**3.0%**

Variation in real estate markets since 2009 exacerbates significant fiscal disparities across municipalities in Connecticut making it difficult for many municipalities to raise sufficient revenues to provide a given level of goods and services to their citizens. For example, revenue raising capacity as measured by the Net Grand List per capita varies across municipalities from a high of $494,018 in Greenwich to a low of $27,873 in Hartford. There is significant variation across Connecticut municipalities in property taxes per $1,000 personal income ranging from a high of $123.00 in Hartford to a low of $41.50 in Putnam.

Heavy dependence on property taxes, declining property values with increasing property tax revenues result in high and increasing effective property tax rates. The competitiveness study presented to the tax panel found that high property taxes in Connecticut may be a drag on economic growth, at least at the margin. In addition,

- high property tax rates, if not balanced by high service levels, decrease property values.
- high property tax rates, if not balanced by high service levels, discourage families and businesses from locating or expanding in a jurisdiction.

- high property tax rates in older city centers may contribute to urban sprawl when surrounded by suburban communities with lower property tax rates resulting in inefficiency and cost of inadequate public infrastructure such as roads, water, sewers.
- high property rates burden low-income homeowners.

The state, in conjunction with local governments, provides a large number of property tax relief programs, but very limited actual property tax relief. High effective property tax rates and limited property tax relief contribute to the property tax in Connecticut being regressive. In part, regressivity reflects the fact that spending on housing declines as a share of income as income increases, but it is exacerbated in Connecticut by high effective property tax rates, which tend to be in municipalities with high concentrations of low income people, and limited property tax relief which is generally not targeted to taxpayers according to need.

In order to address these concerns, the Tax Study Panel approved the following property tax reform and revenue diversification recommendations.

Administrative Issues: Fractional Assessment

Fractional assessment in Connecticut is an historical artifact from the early 1970s. Assessment ratios varied widely by municipalities across the state and were generally well below 100 percent of market value. The state imposed the 70 percent fractional assessment ratio to bring uniformity to assessment levels across the state.

Fractional assessment undermines transparency, results in inequities, and hurts taxpayer understanding of property taxes. Therefore, eliminating fractional assessment

- reduces the possibility of sloppy, politically oriented or corrupt assessments;
- increases uniformity, thereby improving horizontal equity of the property tax;
- eliminates "undervaluation illusion" that covers up apparent inequities;
- promotes taxpayer understanding since taxpayers are likely to be familiar with market values; and
- assigns political responsibility for increased property taxes to elected officials who set the tax rate.

***Recommendation 1*: Fractional Assessment.** Eliminate the 70 percent fractional assessment and define assessed value as 100 percent of estimated market value. When this transition is made, all municipalities must lower their property tax mill rate to raise the same amount of revenue as they raise currently.

- Revenue Implications: Revenue Neutral.
  - Adopted without dissent

Administrative Issues: 5-year Reassessment Cycle

Assessed values are determined at a point in time and then maintained for the next 4 years as a result of the 5-year reassessment cycle in Connecticut. This creates significant inequities across towns, across land uses in each town and within each land use in a town because real estate markets change at

different rates in different communities, but assessed values stay the same.[28] Fairness is undermined when a certain class of property, or a certain section of town, is either appreciating or depreciating at a different rate than other properties in town. In addition to undermining the equity of the property tax, the 5-year reassessment cycle also distorts the usefulness of the assessment/sales ratio done annually by OPM because it does not capture or reflect differences in assessment practices. Most municipalities have their own computer assisted mass appraisal model and could conduct annual assessments.

***Recommendation 2*: Assessment Cycle.** Eliminate the 5-year reassessment cycle and institute annual reassessment. To ensure an accurate description of each property retain the 10-year physical inspection requirement. This recommendation should be implemented over a five-year period. The Tax Study Panel recognizes there may be some cost implications for municipalities and recommends ways to mitigate increased costs resulting from moving toward annual reassessments should be explored. For example, 13 municipalities have already joined together for regional revaluations.

- Revenue Implications: During the five-year transition revenue neutrality can be accomplished by reduced mill rates to accompany base broadening as properties reassessed to reflect current market value.
- Adopted without dissent

Local Fiscal Disparities

One way to reduce reliance on property taxes is to increase state aid to local governments. For example, it is often argued that the state should fully fund state grants that reimburse local governments for property tax revenues foregone because of state mandated property tax exemptions. While the paper prepared on exempt properties put forward an argument for why state government should reimburse a portion of property tax revenues foregone because of state mandated exemptions, it is difficult to determine what the "right" level of reimbursement should be.

Increasing state grants, if used to offset property taxes dollar for dollar, results in government revenues becoming more centralized at the state level. Such centralization means local revenues from state aid must compete with other state priorities like Medicaid, transportation and education and are vulnerable during periods of economic downturn. This converts local government advocates into special interest pleaders rather than partners in the governing system. In addition, increased dependence on state aid can result in local governments becoming less autonomous which could cause local government to be less responsive to local preferences as well as a reduction in local control and efficiency of resource allocation.

Finally, increasing state aid does not address current concerns with the property tax in Connecticut. Specifically, increasing existing state aid programs does not address the fiscal disparities across municipalities in Connecticut because current state grants do not have an equalizing component. A study of fiscal disparities across municipalities in Connecticut by the New England Public Policy Center at the Federal Reserve Bank of Boston concluded that fiscal disparities across municipalities in Connecticut are a result of differences in capacity to raise revenues. This suggests the need for a state grant program that would be equalizing across municipalities. In addition, simply increasing state aid does not address the regressivity of the tax. Addressing the magnitude and design of state grants to local government in Connecticut is beyond the scope of this project, but the Tax Study Panel thought this was an important topic and approved the following recommendation.

[28] Jeffrey P. Cohen and Michael J. Fedele (2012). *Where in Connecticut is the Best Location for a Split Rate Tax? An Analysis of Land Assessment Equity in Several Cities.* Lincoln Institute of Land Policy Working Paper, WP12JC1.

***Recommendation 3*: Local Fiscal Disparities.** The Tax Study Panel's mandate is to review the state's overall state and local tax structure. The Panel affirmed at its May 2015 meeting it would not look at state and local expenditure policy. Accordingly, addressing the magnitude and design of state grants to local governments in Connecticut is beyond the Panel's scope of work. However, in view of evidence presented to the Panel that there are significant differences in property tax capacity of municipalities (fiscal disparities) across municipalities, the Panel concludes that state grant policies should be re-examined in an effort to further relieve pressure on the property tax and to equalize fiscal disparities.

6. Property taxes are regressive.
7. The property tax fails to meet requirements of horizontal and vertical equity.
8. The property tax system is detrimental to Connecticut's economic competitiveness
9. State grant policies should be re-examined in an effort to further relieve pressure on the property tax to address fiscal disparities across municipalities.
10. The State needs to look at the distribution formula which addresses closing the "need-capacity gap."

    - Revenue Implications: Revenue Neutral
    - Adopted without dissent

<u>Tax Exempt Properties</u>

The Tax Panel adopted a set of criteria for evaluating changes in the system of financing state and local governments in Connecticut. The criteria included

- taxes should be designed to avoid unintended interference with private economic decisions; and
- the structure of the tax system should treat taxpayers in similar circumstances similarly.
- exempting individual properties from paying the real property tax violates these criteria because eliminating property taxes for some uses and property owners provides an incentive to buy more real property, or more expensive real property, than would be the case if the property were not exempt from paying property taxes; and
- exempting some properties from paying property taxes means the cost of providing government services must be spread across a smaller tax base requiring a higher tax rate to collect a given amount of revenue resulting in higher taxes, on properties not receiving preferential treatment, than they would pay if the property tax had a broader tax base and collected the same revenue with a lower tax rate. As a result, two similar properties, one exempt the other not, are not treated equally.

The relative importance and composition of exempt properties varies significantly across municipalities in the state. Nineteen municipalities in the state were identified as being representative of the different types of municipalities in Connecticut for more in-depth analysis.

In terms of the relative importance of the number of parcels exempt from paying property taxes, there is not much variation across these 19 representative municipalities. There is more variation across these municipalities in the relative importance of exempt properties in terms of their share of total gross assessed value. In all cases, except for Union and Guilford, the exempt share of total gross assessed value is significantly higher than the exempt share of the number of parcels.

In order to address the non-neutrality and equity concerns associated with exempting individual properties from paying property taxes, the Tax Study Panel approved the following recommendation in an effort to change incentives for individual exempt property owners and start to address equity concerns.

***Recommendation 4: Payments in Lieu of Taxes* (PILOT).** The Panel recommends retention of Connecticut's existing statutory scheme for *payment-in-lieu-of-taxes* (PILOT) grants from the state to municipalities that is designed to recognize that state properties, hospitals, and colleges and universities serve regional and statewide communities. The Panel acknowledges that funding of this existing program is outside the scope of the Panel's charge, and it consequently makes no recommendation as to the funding of this program.

The Panel notes that municipalities in Connecticut are free under existing law to develop voluntary traditional PILOT programs. These programs can generate revenues from tax exempt properties to help finance the delivery of local public services benefiting those properties. A municipality considering development of such a voluntary program could model its program on the Boston model or develop a model that better reflects its community and its exempt organizations. A municipality could use the portion of its budget that finances goods and services that benefit all properties as a starting place for conversations with exempt organizations about voluntary PILOT payments, and the Panel recommends that the Office of Policy and Management develop estimates of the value of locally provided services to provide a framework for informing such a discussion. A municipality that develops a traditional PILOT program should consider exempting organizations with real property valuations below some threshold amount to protect small nonprofits.

- Revenue Implications: Revenue Neutral.
- Adopted without dissent

<u>Direct Property Tax Relief</u>.

Efforts to reduce property tax liabilities include both *direct* and *indirect* property tax relief for property owners:

- *Direct* property tax relief reduces the tax liabilities for individual property owners; and
- *Indirect* property tax relief reduces reliance on property taxes generally by providing local governments' access to alternative own-source revenues and increasing reliance on state grants.

Direct property tax relief programs reduce or eliminate the property tax liability for individual properties depending on the use of the property and the characteristics of the owner. Connecticut has a plethora of existing programs, both state and local option, designed to reduce property tax liabilities by reducing assessments for some households depending on the characteristics of the property and the property owners. For example, the main programs include state and local option programs to reduce assessments for

- The disabled
- The blind
- Veterans (standard and additional exemptions)
- Disabled veterans
- Severely disabled veterans

- Property deferral programs.

The vast array of programs to reduce property taxes for qualifying homeowners in Connecticut actually provide very modest actual reductions in property taxes. For example, in a large city like Bridgeport, the effective property tax rate for residential properties, without any reduction in their assessed values, is 2.95 percent. For properties that have their assessments reduced by these programs the effective tax rate is reduced to 2.90 percent. Similarly, in a smaller city such as Manchester, the effective property tax rate for residential properties not qualifying for reductions in assessments was 2.76 percent, and that for residential properties receiving a reduction in assessments was reduced to 2.61 percent. Very modest relief is provided which does not address the regressivity of the property tax in Connecticut.

Between the current property tax credit in the personal income tax and the estimated cost of the other programs designed to reduce property taxes for some households by reducing assessments, the total cost of property tax reduction is approximately $189 million -- $143 million for the $200 tax credit and $46 million for the other programs designed to reduce property taxes.

Property tax relief targeted on those with property tax liabilities high relative to income can be provided by a circuit breaker program. The distinctive element in providing property tax relief via a circuit breaker is that the property tax relief falls as income rises. The cost of a single-threshold circuit breaker was estimated assuming that 60 percent of the property tax in excess of 3.5 percent of total household resources, subject to a cap of $1,200. For renters, 20 percent of rent is counted as property taxes paid. Households with total resources in excess of $50,000 are not eligible for the circuit breaker. It was estimated that 195,409 households would receive the tax credit, benefits to 149,937 of those households would be constrained by the cap, and the total cost to the state would be $211 million.

***Recommendation 5*: Low Income Tax Credit "Circuit Breaker".** Eliminate the more than 100 state and local option partial property tax exemptions and replace them with a single unified state circuit breaker mechanism that provides property tax relief targeted to homeowners and renters whose property taxes are high relative to their household income. Such a circuit breaker would be a single threshold type circuit breaker implemented as a refundable credit through the Connecticut state income tax to provide targeted relief, replacing the current property tax credit. The circuit breaker could be designed so that this recommendation is revenue neutral.

- o Revenue Implications: Implement this replacement on a revenue neutral basis.
- ▪ Adopted without dissent

<u>Agricultural Land Use Valuation</u>

Another form of direct property tax relief is provided in Connecticut through the use-value assessment law known as Public Act 490 (PA490). Under this program some landowners pay tax based on the current use value of their property rather than based on the "highest and best use," or market value of the property.

The stated purposes of Connecticut's PA490 are to recognize (a) that it is in the public interest to encourage the preservation of farmland, forest land and open space land in order to maintain a readily available source of food and farm products close to the metropolitan areas of the state, to conserve the state's natural resources and to provide for the welfare and happiness of the inhabitants of the state,

and (b) that it is in the public interest to prevent the forced conversion of farmland, forest land and open space land to more intensive uses as the result of economic pressures caused by the assessment thereof for purposes of property taxation at values incompatible with their preservation as such farmland, forest land and open space land. There are no minimum acreage requirements or specific income requirements for farmland to qualify for PA490 preferential tax treatment.

Many towns are severely impacted by the presence of PA490 properties. The Town of Coventry provided data for 129 properties benefiting from PA 490 preferential treatment in 2014 and the Town of Union provided data for 462 properties receiving beneficial treatment under PA 490. PA490 reduces the value of 129 properties participating in the program in Coventry by 45.9 percent and by 96.5 percent in Union.

The income capitalization method is used to estimate use-value assessments in Connecticut, as is done in most states. Income estimates are obtained from a survey of rental values. The average rental value for each type of land is then capitalized using capitalization rates based on several methods. A capitalization rate of 12.5 percent is used to compute use value.

There are two difficulties with this method of estimating use value. First, by relying on a survey of rental values, there may be a systematic downward bias in the use-value estimation. Rental values for land may be systematically lower than net incomes generated by owner-operators. Second, the capitalization rate used is biased upward which has the effect of reducing the estimate of use value. A capitalization rate of 12.5 percent in 2015 bears no direct resemblance to the actual opportunity cost of capital in that market circumstance.

The effect of these estimation methods is to produce use values that are very low, reducing the property tax base and shifting the property tax burden to other classes of property.

***Recommendation 6*: Agricultural Land.** Tighten up the implementation of the PA490 use value assessment program so the program is more aligned with the intended purpose of the program by

8. Implementing an objective test of agricultural use in order to qualify for participation in the program (e.g., establish a *de minimis* level of gross income from agricultural production)
9. Rationalizing use value assessment computation methods using more accurate income measures and more realistic capitalization rates
10. Requiring forest land participating in the program to be adjacent parcels
11. Allowing towns to remove land from the program if it has been rezoned for subdivision
12. Expanding the time period which land must remain undeveloped from 10 to 15 years
13. Increasing the penalties for early withdrawal from the program
14. Moving away from general tax relief for agriculture broadly and move toward strategic use of use value assessment to protect and preserve land that provides ecosystem services that are a form of public good or generates positive externalities.

    - Revenue Implications: Base broadening will increase revenues over time and allow property tax rates to be reduced.
    - Adopted without dissent

<u>Revenue Diversification</u>

Local governments in Connecticut have a high reliance on the property, but they have a low reliance on user charges, other taxes and state grants. In 2013 current charges accounted for 27.5 percent of total local own-source revenues in the US; the comparable figure for Connecticut was 10.1 percent. Alternatively, in 2013 property taxes accounted for 72.8 percent of total local taxes in the U.S.; the comparable figure for Connecticut was 98.7 percent. Finally, intergovernmental transfers accounted for 36.3 percent of total local general revenues nationally in 2013, but just 30.7 percent in Connecticut. In short, local tax and own-source revenues in Connecticut are less diverse than local government tax and own-source revenues nationally. This is statistically confirmed by calculating the Herfindahl Index which is a comprehensive measure of revenue diversification – the lower the index the greater the diversification. Using census data from 2012 the Herfindahl Index was computed for all states. The value of the index for all local governments in the US was 0.189, suggesting substantial diversity in local government revenue sources. For Connecticut the index was 0.776 making it the least diversified revenue system in the U.S. Twenty-seven states have indexes below 0.200 and the five states with the highest indexes are Connecticut and its neighbors – New Hampshire (0.729), Rhode Island (0.676), Maine (0.661) and Massachusetts (0.605).

Diversifying municipal revenues in Connecticut would

- allow towns to better capture local revenue raising capacity;
- reduce reliance on the property tax; and
- collect revenue from tourists and commuters who impose costs on local governments but do not pay any property taxes to local government.

The major counter argument is that by diversifying revenues local governments will increase their revenues, and thus expenditures, beyond what are desired by citizens. However, the empirical support for this concern is mixed.

Towns in Connecticut are not allowed to use local sales or local income taxes. Other states allow local governments to adopt local option taxes. As of 2012, local governments in 34 states relied on sales taxes. The reliance on local sales taxes varies; local sales tax revenue as a share of local tax revenue ranged from 1.6 percent to 48.5 percent. In 2012, local income taxes were imposed in 12 states; local income tax revenue as a share of local tax revenue ranged from less than one percent to 33.3 percent.

***Recommendation 7*: Local Non-Property Taxation**. Allow for a local sales tax of 1 percent to be implemented on a statewide basis with the revenue to be collected by the Department of Revenue Services (DRS), which will act as the collection agent for all local governments. The local tax will be piggybacked to the standard state sales tax rate. The funds shall be deposited in the Municipal Revenue Sharing Account and then distributed to municipalities in a manner that is fiscally equalizing (e.g., on the basis of fiscal needs such as documented by the Federal Reserve Bank of Boston, 2015)

- o Revenue Implications: An increase of approximately $600 million is intended to be applied to a reduction in property tax rates. Under this arrangement the local sales tax will lead statewide property tax reduction of 6 to 7 percent.
- ▪ Adopted with Panel Members Clavette, Nickerson, and Schatz dissenting

Personal Property Taxes

The personal property category in the Connecticut property tax system includes tangible personal property owned or leased by businesses. It does not include registered motor vehicles which are assessed separately. It also excludes business inventories and intangible personal property. The

personal property category accounts for just over 5% of total taxable property in the state and generates over $590 million in tax revenue each year.

Comparing the relative importance of personal property and business real property, the value of taxable personal property in Connecticut is currently over 40% of the value of all commercial, industrial and public utility real property in the state. There is a national downward drift in taxing personal property. States have expanded exemptions and several have or are attempting to replace the tax on personal property with other tax revenues.
Personal property exemptions in Connecticut currently represent 20.4% of total personal property taxable value.

The personal property tax is challenging to administer because of the difficulty in identifying personal property, valuing it for tax purposes and auditing to insure compliance.
Personal property is valued using the historical purchase price less depreciation for age. The use of standardized depreciation schedules provides only a very rough estimate of current market value and does not reflect the practices employed by private fee appraisers. In particular, the historical cost less depreciation approach does not consider the possibility of economic obsolescence.

Compliance appears to be variable across the state. The tax is reported to be difficult to collect in some jurisdictions because of the rate of business turnover. Auditing practices appear to be highly variable. There is evidence suggesting enforcement efforts are laxer in jurisdictions with high levels of personal property per capita.

Personal property as a percent of total taxable property varies across cities and towns in the state from 0.88% to 24.3%. Mill rates also vary markedly, from 10.7 to 74.29, with an average of 29.47. Consequently, the tax burden placed on personal property varies markedly as well.

Analysis of over 30,000 individual personal property accounts in 13 different jurisdictions shows that

- Nearly 89% of the taxable personal property value is found in only 7.2% of personal property accounts
- More than 52% of the value is found in only 0.22% of the accounts
- At the other extreme, 93% of all tax accounts total only 11.5% of taxable value
- The median tax obligation for all accounts valued at less than $1 million is $251

For the majority of businesses, the personal property tax is more nuisance than financial burden. It is likely that it costs firms more to comply and cities more to administer the tax than can be justified by the amount of revenue collected from the large majority of taxpayers.

The treatment of business personal property in Connecticut does not appear to set Connecticut apart from other states. Effective overall (real and personal) property tax rates do not differ nationally between states which tax personal property and those which do not. There is no evidence that tax burdens are higher for firms in states that tax any of the types of tangible personal property.

While there is substantial variation in tax burdens within the state, Connecticut tax rates are similar to other jurisdictions around the country. The overall median in Connecticut is slightly higher than the national average for urban areas. These findings relate to relatively large businesses. For the large majority of Connecticut businesses, the property tax on business personal property appears to be an administrative nuisance but not a significant cost in terms of the amount of tax paid.

***Recommendation 8*: Taxation of Business Tangible Property.** Exempt the first $10,000 of personal property from taxation thereby eliminating 46 percent of personal property accounts. The Panel

recognizes that for zero tax due accounts there must be a mechanism put in place so that each municipality will continue to be able to identify individual businesses located in their jurisdiction.

- Revenue Implications: Reduces administrative costs for taxpayers and local governments and would result in reduced revenues by $18 million, or three (3) percent of personal property tax total collections. Revenue neutrality can be accomplished by a small increase on the remaining taxable tangible property tax base or through revenue diversification.
- Adopted without dissent

***Recommendation 9*: Personal Property Tax Revenue Administration/Implementation**

The Office of Policy and Management or other research agency should revisit the implementation of the personal property tax by

6. Periodically examining depreciation schedules and the 30 percent residual value
7. Improving audit procedures and practices
8. Strengthening the role of OPM in overseeing uniformity of assessment administration
9. Requiring all municipalities to use the same OPM standard form for filing information
10. Periodically estimating economic and functional obsolescence in at least chemical products manufacturing and other industries where standard depreciation schedules are inadequate.
    - Revenue Implications: Revenue Neutral.
    - Adopted without dissent

<u>Motor Vehicle Tax: General</u>

Registered motor vehicles represent 6.4% of the total net Grand List value in Connecticut. The Connecticut motor vehicle property tax system can be summarized as follows:

- In 2013, there were 2.856 million registered vehicles in Connecticut with an aggregate gross taxable value of $23,690 million. Net motor vehicle assessments as a percent of total net Grand List value varies across cities from less than 3% to over 16%;
- Vehicles are valued at 70% of average retail value based on NADA data as of October 1 each year. Vehicles acquired after October 1 and before July 31 are valued on a supplemental valuation list;
- Variations in local mill rates result in very large differences in the tax obligation associated with vehicles of the same value based solely on the address of the owner; and
- The new 32 mill state rate cap will result in about $67 million in lost revenue. About 74% of this amount will occur in 10 cities. The state has committed to replace the lost revenue with sales tax receipts.

Administration of the motor vehicle tax in Connecticut faces several significant challenges. As a result of the combination of these factors, the majority of resources in a local assessor's office are devoted to maintaining motor vehicle accounts and values because

- Assessors must estimate the average retail value for 2.856 million vehicles each year;
- About 70% of these values can be estimated using published NADA data;
- The remaining vehicles are often specialized or have specialized equipment for which valuation data is difficult to obtain;
- Vehicles sold during the year are often eligible for a prorated tax credit. Credits for approximately 360,000 vehicle sales each year must be processed manually;

- Vehicles relocating out of state are also eligible for a prorated credit. All of these approximately 75,000 credits must be processed manually; and
- There are claims that some Connecticut residents are registering their vehicles out of state to avoid the vehicle property tax. The evidence for this claim at this point is inconclusive.

***Recommendation 10*: Motor Vehicles ("Car Tax").** The Panel supports the changes in the motor vehicle tax made in 2015 and recommends that the impact of these changes on the equity, efficiency and administration costs of the motor vehicle tax should be evaluated after they have been in place for a period of no more than three years. This will also provide time to see how the Municipal Revenue Sharing Account works to hold harmless those municipalities that experience a decline in motor vehicle tax revenues because of the ceiling placed on the mill rate applied to motor vehicles.

- o Revenue Implications: Revenue Neutral.
- ▪ Adopted without dissent

Motor Vehicle Tax: Antique Vehicles

All antique cars in Connecticut have an assessment limit of $500 regardless of actual market value. The definition of antique has been expanded over the years. When the limit was originally adopted in 1973, it applied only to vehicles 25 years and older, of historical interest, conforming to the manufacturer's original specifications and not used for general transportation. (CGS §14-1(2)).

While these restrictions also apply for obtaining a specially designated license plate from the Department of Motor Vehicles, since 2008, a vehicle need not have the special plate to qualify for the assessment limit. Local assessors can require the owner of an antique that does not have a special plate to provide "reasonable documentation" that meets the statutory criteria for an antique vehicle. (PA 09-187 § 29) The statute does not specify what constitutes reasonable documentation.

The requirements to obtain the special plate were changed in 1979 to include motor vehicles other than automobiles and to eliminate the restriction on use for general transportation. In 2005, the age requirement was reduced to 20 years because the NADA values used to determine assessed value stop at that age.

The administrative challenge created by the state's approach to antique vehicles revolve around discovery and documentation. Unless the vehicle is registered, the assessor generally must rely on the taxpayer to declare the vehicle as personal property, or on the chance discovery of the vehicle while conducting other business. Assessors are left on their own to determine what constitutes reasonable documentation.

***Recommendation* 11: Antique Vehicles.** The assessed value of antique vehicles should be set at current market value rather than the current assessment limit of $500, but shall not exceed a valuation of $50,000.

- o Revenue Implications: Broadening the property tax base over time will lower statutory tax rates.
- ▪ Adopted without dissent

Conveyance and Controlling Interest Taxes

Transfer taxes are widely used throughout the United States with the tax imposed in 35 states. In Connecticut, The Real Estate Conveyance (REC) tax is the only tax imposed by both the state

government and municipalities. The tax is, by statute, paid by the seller when the deed is registered. The town clerk collects both the state and local portions of the REC tax and then transmits the state tax revenues to the state Department of Revenue Services. Both the state and municipalities consider these revenues as part of their general revenues.

Real Estate Conveyance (REC) tax, unlike property taxes, is imposed only when real estate is sold or transferred and is based on the value of the consideration paid for the property. As an ad valorem tax, tax revenues are sensitive to real estate market conditions. Therefore, tax yield is a function of both the number of transactions and the value of the property transferred.

Real Estate Conveyance (REC) tax is the only tax other than the property tax available to municipalities. The structure of the tax, including the rate and definition of taxable transactions, is set by state statute. State statute does provide some rate flexibility to certain designated municipalities, those identified as targeted investment communities. These 18 communities may impose an additional rate, up to a maximum rate. All designated communities impose their permitted optional rate.

Yet the REC is of additional importance beyond its capacity to generate revenue. Information garnered at the time the tax is paid plays a critical role in property tax administration. REC tax is based on the consideration paid for real estate. At the time a deed is registered and the tax paid, this information is available and provides the local assessor's office with up to date information as to the fair market value of the property for property tax purposes. Similarly, the state uses such information in an effort to equalize property values statewide.

The state tax rate is not a flat rate and the rate depends on the use of property with a graduated rate for single family properties. The maximum state rate, applied to the value of residential property in excess of $800,000 and all non-residential property, is 1.25 percent. All other transfers are taxed at 0.75 percent. The combined maximum state and municipal rate is 1.75 percent for transactions in targeted communities and 1.5 percent in all other municipalities.

Preliminary investigation suggests that higher local REC rates in targeted investment communities do not significantly impact on the price of real estate or the number of transactions. This finding is not consistent with other research that found that such taxes did have a negative impact on both sales and price. The differences in findings may be due, in part, to larger tax differentials in the studied localities than those in Connecticut.

The Controlling Interest Transfer (CIT) tax is imposed by the state when Connecticut real estate interests are transferred through the sale or trade of controlling interests of a corporation, partnership or similar type entity. Since the transfer is effectuated through transfer of interests in the property rather than the transfer of a deed, the REC does not apply. By design, the tax applies to those transfers that are not covered by the REC. As such, it incorporates much the same structure as the REC and a rate at the time of adoption was the maximum state rate and the general (but not the optional) local rate. By imposing both the REC and CIT, Connecticut real estate transfers are taxed by the state, regardless of how the transaction is structured. The CIT, however, is only a state tax and all revenues are state revenues.

***Recommendation* 12. Conveyance and Controlling Interest Taxes.** To assure inter-community equity the local real estate conveyance (REC) tax rate shall be set at the same rate statewide as the targeted community rate (0.5 percent). The state rate shall remain unchanged.

- Revenue Implications: Will raise approximately $40 million in additional revenues for local governments.
- Adopted without dissent