

Connecticut Tax Study Panel Briefing Note General Business Taxation: The Corporate Net Income and Its Alternatives

Introductory Comment

In sorting through its menu of policy options, the Panel will be examining three Types of Business Taxes: The current practice of taxing business net income (profits) along with two alternatives: taxing on the basis of Gross Receipts or Value Added. The choice the Panel makes will strongly affect the performance and the equity and efficiency of the Connecticut state revenue structure.

However, regardless of which of the three tax base options are recommended by the Panel, there are some practices that apply to all three. These practices are briefly discussed in the following section on the Conceptual Framework. From there this briefing noted proceeds to treat each tax base separately. The note concludes with a Policy Options Matrix.

Conceptual Framework

Why Tax Business Enterprise?

Tax Base Accessibility. The rationale for general business taxation is framed by both the Panel's adoption of the equity normative of the Benefits Received principle (sometimes referred to as the "matching principle) that *individuals* who receive the benefits of a flow of public goods and services should pay for those services. Note the emphasis in that above sentence on individuals, which serves to emphasize the axiom that ultimately only people—not institutions such as the business entity— pay taxes. This raises the logical follow up question of how one finds the people who benefit when those who benefit might live in, say, Bridgeport, Baltimore or Budapest. This is the question of *Tax Base Accessibility* and this is why states turn to general business taxation.

The role of a business entity in the flow of economic activity is that of organizing production and creating income. That is, the business firm is an institution through which individuals in their roles as consumers and suppliers of private sector factors of production (there are four of that are supplied by people: land, labor, capital and entrepreneurship) derive the benefits of economic activity. Once the firm produces and markets its products, the individual factor suppliers then receive "returns" in the form of payments of rents, wages and salaries, interest and profits. A just as important part of this arrangement is that there is a fifth factor of production that also provides a set of services that allows the business entity to carry out its activity, and that is the public sector that supplies services ranging from the provision of infrastructure and judicial systems to public safety and health and sanitation services.

The "catch" is that the people who are come together in a business activity and who therefore benefit from these fifth-factor services may, or may not, be Connecticut residents. Accordingly, the only way Connecticut governments can uniformly assess individuals, residents and nonresidents alike, who receive these "fifth factor" services, is to treat the business enterprise as a tax collecting agent. This, in turn, means levying a tax at the source where income or receipts are created—the business firm as an entity—rather than try to chase down all the individuals in an effort to find them where they live when as a consumer they buy a Connecticut produced product (which is accessed by their local sales tax) or, as a shareholder who receives Connecticut generated income, but which is accessed by taxing through individual's own state income tax (that may be Connecticut, but not necessarily so).

To tax income or receipts in this manner—at the source where it is created-- not only makes equity sense, but also promotes economic efficiency since now the costs of government services are incorporated into the pricing structure of business firm’s products and/or services. In short, by using the business entity as a tax collection agent, there are two meritorious practical outcomes. The first is that it satisfies the Panel’s “benefits received” criterion that people who receive government services should pay for those services. The second merit is that it addresses the problem of *tax base accessibility* – that of assessing individuals as consumers and factor suppliers who benefit from Connecticut state and local service, but who may live outside (and, indeed, may have never even visited) the state.

Raising two key issues and dismissing a third. That there is a benefits received rationale for the general taxation of business activity raises three important policy matters. The first is that for the very reason that Connecticut–imposed tax costs are incorporated in to the pricing structure of the goods and/or services a business entity provided, policymakers must now be focused on the structure of the tax: that is, “what is the right tax base” for taxing income or receipts at their source?

The second goes to the level of Connecticut imposed tax costs: “what is the right level? “ That is, if efficiency in taxation requires that the tax costs be incorporated into the business firms pricing structure, at what point might this process affect the firm’s competitiveness?¹

The third, which is worth making just make clear it is not part of the discussion of general business taxation, is that because ultimately only people pay taxes (remember the business entity is only a collection conduit) it follows that one cannot extend the equity criterion of “ability to pay” as it applies to individuals to the business entity.

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¹ In technical terms, at what point does the efficiency gain of pricing conflict with the efficiency goal of a maintaining competitive tax system? As Wasylenko (September 30’) and others have demonstrated there are ways to measure the impact of tax levels on state economic and/or employment growth—and that is what one means by measuring “competitiveness”.

Measuring the General Business Tax Base

Three Types of Tax Bases

There are three types of General Business Tax Bases.

Table 1: Taxonomy of Taxes on Business

| Tax Base | Description | Examples ¹ | CT Statutory Rate Required to Generate an equal Corporate Tax Yield (2012). | Appropriate apportionment factor(s) |
|--------------------------------|---|--|--|--|
| Gross Receipts Tax (GRT) | Total GR from sales of goods and services levied on Corporate and non-Corporate Taxpayers alike. Financial Institutions subject to in-lieu taxation on net income | Ohio CAT, Washington B&O, Nevada, Hawaii has a broad based GRT (Gross Excise Tax) that complements a corporate net income tax). | 0.221 % with no small business threshold 0.251% with \$1m threshold | <i>Destination/:</i> Sales |
| Value Added ² | <p><u>Subtraction method:</u> GR-all purchases from other businesses, including capital goods, which may be fully expensed (Consumption Variant) or deducted by using scheduler depreciation (Income Variant)</p> <p><u>Addition Method:</u> Sum of the returns /payments so to private factors of production (wages+ rent+ interest+ profit)</p> <p>Levied on Corporate and non-corporate taxpayers alike. Financial Institutions subject to in-lieu taxation on net income.</p> | <p>New Hampshire (a business enterprise tax complements a business profits tax)</p> <p>Now proposed in California (subtraction variant).</p> <p>Michigan Business Activities Tax (1953-1967); Michigan Single Business Tax (1976-2012)</p> | <p>0.640 % with no small business threshold</p> <p>0.730 % with \$1m threshold</p> | <i>Origin</i> Property and Payroll |
| | | | | <i>Origin (2/3) and Destination (1/3)</i> Property, Payroll and Sales |
| Corporate Net Income (Profits) | Traditional business entity Tax imposed in 45 states, including Connecticut. Applies to "C" corporations only | Connecticut along with 44 other states plus DC | 9.0 % ³ | Origin /cost of production |

Table notes: 1. Texas utilizes has a "Gross Margins Tax" [GR-Cost of Goods Sold] levied at 0.475 % for wholesale and retail trade and 0.975% for all other taxpayers. In the taxonomy this falls between the GRT and VAT. 2. The credit-invoice variant that widely used internationally at by central governments is not addressed here. 3. Includes the base rate of 7.5% plus the 20% surcharge. This estimate also allows for the continued use of existing business tax credits.

Apportioning the Total Taxable Base of the Multijurisdictional Firm. Once a tax base is selected, a question arises as to how apportion the tax base (business activity) of a firm that operates in Connecticut as well as other states. Here, in broad terms, there are two approaches. The first is to permit a firm to apportion its multistate income through separate accounting techniques whereby its operations are taxed in different states as if they are separate and distinct value-creating. ^{2, 3}

² Connecticut permits separate accounting in limited partnerships (non-unitary).

Because the results obtained by using separate accounting are often arbitrary, states, including Connecticut, rely on formula apportionment.⁴ With formula apportionment a taxpayer apportions the portion of its income by calculating a ratio of the level of a measure of business activity within the state to the firms' total corporate activity. There are three apportionment factors that are typically used: sales, property and payroll. They may be used separately (in practice, this only applies to the sales factor) or in combination; and in if in combination, different weights may be assigned to the different factors.^{5,6}

Different Approaches to Sourcing of Income.

The Destination Principle. To the extent a state uses sales ("receipts factor") as one of the apportionment factors, it is adopting the *destination principle* if income is apportioned according to where they are purchased or consumed. Thus, in Connecticut the numerator of the sales factor of the gross receipts from business carried on in Connecticut and the denominator is gross receipts from business carried on everywhere

Origin Principle If rather than rely on the sales factor a state uses payroll or property, it is choosing the *origin principle* of taxing goods and services produced on where they are produced rather on where they are sold.

Another matter arises regarding whether a state permits (or requires) a corporation to file on a combined or unitary basis.⁷ Filing a combined return allows a group of corporations engaged in business in Connecticut to file jointly. Their combined Connecticut tax liability is determined after each corporation apportions its income to Connecticut (DRS, annual Report, and 2013-14)

For tax years beginning on or after January 1, 2016, Connecticut will initiate mandatory combined reporting for entities that are part of a unitary business. Unitary filing entails identifying and aggregating those parts of a multistate corporation that have economic links with each other (operational independence, functional integration, centralized management, as span of control and purchasing policy). As the term suggests the corporation is treated as a unit. Under Connecticut law, the unit will be limited to the nation's "water's edge", which means that the reporting does not reach to non-US based affiliates but, rather, only entities within the United States.

The choice of the apportionment factors matters as it will change the character of the tax base from what it initially looks like "on paper" to a tax that has a quite different practical character. If, for example, a state adopts a tax on corporate net income and then requires apportionment formula that

³ There is also a related approach, infrequently used, of specific or direct allocation whereby the firm directly allocates different kinds of items to a geographical source. It is typically used when there is nonbusiness income that arises outside of the corporation's regular line of business (CCH, 2015).

⁴ In *Complete Auto transit vs. Brady*, 430, US 274 (1977), the US Supreme Court ruled that a corporation that is taxable in more than one state has the right to have its income fairly apportioned.

⁵ In most cases apportionment will not provide a uniform division of a corporation's income among the nexus states (that is, a corporations apportionment may not sum to 100%) because each state is free to choose the type, number, and weighting of the apportionment factors.

⁶ Luna and Murray provide a table showing apportionment factors used in the 45 states and DC. . Corporations are not subject to income based taxes in Nevada, Ohio (other than financial institution franchise tax), South Dakota (franchise tax on financial institutions), Washington and Wyoming.

⁷ If corporation is permitted to file a federal consolidated return, it may the petition to file a combined return in Connecticut. A consolidated corporate filing is defined federal tax rules.

will rely on the payroll and property factors, each of which reflects the origin principle, then the effect of the tax would be that as intended—taxing the production base that leads to net income (profits).

However, if the state were to apportion net income on the basis a sales-only factor with the ostensible intent of shifting the impact of the tax on out of state customers (individuals and/or businesses), then, in practice the net income tax has been transformed into a sales tax (Mclure, 1980; Gordon 1986; Edmiston, 2005). In a bit more technical jargon the apportionment factors are similar in their incidence to a set of implicit excises. That is, they mimic the effects of sales taxes, payroll taxes, and property taxes. A sales only factor transforms the income tax to a sales tax. If only payroll was used to apportion, the income tax in effect becomes a wage tax. If property were to be the single factor, the effect is to tax property.

At present 38 states, including Connecticut, utilize the sales factor in some manner for apportioning multistate income.⁸ This has come at the abandonment of what used to be widely accepted weighted three factor formula of property, payroll and sales (now 9 states)

There is empirical evidence that for early states who were early adopters of sales factor apportionment, that there was a positive impact of inducing new capital expenditures into the state. The effect on revenue productivity is a little less clear. The over-all revenue effect may be positive or negative depending on the specific state undertaking the policy change and its relative sales and production intensities (Edmiston, 2005)

Current Connecticut Practice

Performance of the CIT

Connecticut levies a net income tax on C Corporations (CIT), but does not levy an entity-level tax on non-corporate entities: S Corporations, LLCs, LLPs, and partnerships. Rather net income produced by these “pass throughs” is captured by the individual income 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 9.0 percent in Connecticut rate (7.5 percent plus the current applied 20 percent surcharge) and to 10 percent in Pennsylvania.

The CIT is an example of not only revenue obsolescence, but also a tax that violates nearly every principle of good taxation. It fails the benefits test (taxing only the profit-making entity), is non-neutral (taxing only capital) and capricious in its incidence (the debate regarding the shifting of the CIT goes on), has a widely unpredictable base (with Connecticut collections went from approximately \$900 million in 2007 to less than \$450 million in 2009). And, overtime, it has been shown to be a poor revenue producer. The Connecticut CIT has gone from providing 10% of state tax collections in 1994 (when the personal tax was initiated), to 5 % in 2004, and to 4% in 2014, which is a performance record that is similar to that of the other state CITs. Census data shows that the CIT was by far the worst performer of state taxes during the Great Recession.⁹

⁸ Twenty-one are sales only. Seventeen give added weight to the sales factor. Luna and Murray, Table 1, p 16.

⁹ There are three reasons behind the trend of declining revenue productivity: (i) the erosion of the tax base due the proliferation of economic development incentives (a trend that got its start in the 1980s and continue through

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. Moreover, Connecticut taxpayers are carrying forward an estimated \$2.5 billion in tax credits, almost four times the total net corporate 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.¹⁰

General Business Tax Options

There are two broad-based tax alternatives to the CIT: Gross Receipts (GRT) or Value Added (VAT). [Table 1]

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 statutory high rates. On the other end is the 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 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. Compared to the GRT these exclusions create administrative and compliance costs, enable tax planning and necessitate a higher tax rate.

GROSS RECEIPTS

today); (ii) the shift away from the once nearly uniformly applied, evenly weighted three-factor apportionment formula of property, payroll and sales toward the sales factor when applied to the multistate business enterprise (as of 1978 all 44 corporate income taxing states plus DC used the three-factor formula), and (iii) the trend by business entities to change their corporate model to a non-corporate pass-through model (Ebel, Peterson, Vu, 2013).

¹⁰ There is an interesting development relating to tax abatements such a Connecticut’s tax credit programs, and that is a new ruling by the Governmental Accounting Standards Board (GASB) that beginning as of 2017 state and local government financial reports must disclose in their financial reports the impact of tax abatements accorded to individual and entities regarding their “effects of tax abatements...on governmental “financial health and ability to raise revenues”. The list of illustrations in the GASB Statement include corporate tax credits as well as other abatements, including property. *Statement 77, 8.14.15.* www.gasb.org.

A disadvantage to the GRT (but not the VAT since it allows for the deduction of all inter-firm purchases) is that the tax can pyramid as goods move through the supply chain, with a tax potentially levied at each step - raw materials, finished goods, wholesaler, and retailer. This advantages vertically integrated firms and may encourage consolidations within a supply chain. However, the dramatically low tax rate (Table 1) would minimize this distortion. The GRT will shift the inter-industry impact away from predominately “goods producing” entities toward the service sector and high turnover, low profit margin businesses such as discount retail outlets and grocers. Again, however, the effect of this differential impact shift will be dampened by the reduced statutory tax rate.

VALUE ADDED: Somewhat like the GRT, but not quite.

Tax Base. The value-added tax (VAT) is levied on the business at each stage of the production and distribution process and is applied on the sale price of goods and services by the taxpayer net of the cost of all purchases from other firms, including on previous value-added tax paid on those purchases (thus the term “value added”). The VAT is therefore distinct from broader-based “gross receipts” or “turnover levy,” which is also applied at each stage of the extractive, production, and distribution process, but for which no provision is made for taxpayers to deduct purchases from other firms, including taxes embedded in the cost of those purchases.

The VAT ranks high on the several evaluative criteria:

Revenue Stability. Not only does a VAT have some of the same attributes as a GRT as a revenue producer—broad bases and low rates can do a lot in terms of reducing structural deficiencies inherent in any type of tax -- but also, the VAT has a record of stability over the business cycle. This countercyclical nature is explained by two factors. The first is labor compensation component of the tax base (about 70% of the tax base), which is largely sustained in periods of economic slowdown. The second is explained by the inverse relationship between the deductions for a firm’s capital purchases, which increase during prosperity. Conversely as the state’s economy slows so do capital deductions (Kenyon, New Hampshire; Hines Michigan).

(ii) *Benefits received/tax base accessibility.* Like the GRT, the VAT is levied on all types of organizational forms including zero profit entity. For policymakers who are concerned about the “no-profit/no-tax” issue a simple solution (again, for both the GTR and VAT) is to allow for zero-tax threshold for small businesses—that is a threshold that is based on entity size, not profitability. Of course, to achieve revenue neutrality a threshold policy requires a compensatory increase in the statutory rate of tax. (Table 1, Col. 3).

(iii) *The Fiscal Architecture of the early/mid-21st Century.* Again like the GRT, the VAT captures the long term Connecticut (and national) shift away from the good producing to the services producing economy.

Further Comments

What about federal tax conformity? With a net income regime, the definition of “net income (profits)”, is closely aligned with federal law. In many ways conformity has its merits as it serves as a starting point for calculating the Connecticut Tax base. But, too, there are problems. The first is that when the Congress makes a major change, which it often does for macro-stabilization purposes, the state is faced with a choice as to whether to conform to those changes (in which cases there is typically a reduction in the tax base, and therefore revenue yield of, the conforming Connecticut tax) or to “de-couple” from the

federal change, a decision that will avoid the revenue loss, but in doing so increase costs of tax administration as well as taxpayer compliance. This problem will not go away with a VAT since net income is part of the tax base (but, too, but to a much smaller extent since the profits component of the tax base is much smaller than the larger wage component). However, for the Gross Receipts tax Connecticut makes a clean break away.

Competitiveness. There are two empirical steps to judging a state/local system empirical competitiveness.

State/Local Indicators Compared. The first is to take a close and detailed look at a set of initial financial calculations of “How a State Compares” with other states for which it competes for residents, jobs and investment¹¹. This making of indicator comparisons requires looking at both expenditures (governments tax to spend) and revenues, a topic that has been examined in great detail for the Panel by (i) Bourdeaux (September 30); (ii) Wasylenko and, (ii) the research of Ernst & Young LLP and the Council on State Taxation.

In each of the three cases, when making state-by-state financial comparisons the analyst must rely on standardized data base, which, for the US, is provided in the US Census of State and Local Government Finances (various years). Furthermore, it is most important that these comparisons report on each state in terms of *a state and local system*. This is due to the reality that each of the states have their own/different ways of assigning expenditure roles and revenue authority between the state and local sectors.

As for the research findings, all three of these studies find that when all business state and local business taxes are taken into account, Connecticut is a low business tax state.¹²

As useful as this can be as a “first-cut” glance as to how state and local systems compare, these indicators are not to be interpreted as indicators of “business climate” or “competitiveness, which is a point that the Ernst and Young LLP and the Council on State Taxation (COST) make in their *Total State and Local Business Taxes: State –by-State Estimates* (2014). Indeed, the EY/COST report is quite explicit that state comparisons of the total effective business tax rates (TEBRT) “provide a starting point for comparing burdens across states, but they do not provide sufficient information to evaluate a state’s competitiveness”¹³

With specific reference to Connecticut EY/COST find that “ Connecticut’s economy generates a large amount of Gross State Product (GSP) per worker, meaning that while Connecticut imposes higher than average taxes per worker, its business taxes are significantly below the national average when measured per dollar of GSP” (EY/COST, 2015). The report goes on to say that that their findings (i) should not be interpreted that Connecticut is a low tax environment overall and (ii) that states that derive most of their

¹¹ The literature shows that the drivers of the subnational (state and local) competitiveness of business firms lies within domestic economy (OECD/Matthews: *What is a Competitive System, 2011*; Wasylenko, September 30). This finding is in no way to ignore that many in-state(Connecticut) firm operate globally, but rather than to note what matters in this context is the national , not the subnational (state, provincial, canton, oblast, governorate) policy

¹² When measuring state and local Direct Expenditures and General revenues across the 50 states Connecticut ranks 47 and 45, respectively (Bourdeaux, Sept 30)

¹³ EY/Cost, 2014, p 11. The study does argue for states that derive “most of” their business taxes from origin based taxes

business taxes from origin based taxes such as property and sales are not as competitive as states with higher TEBTRs that rely on taxes that have larger impact on out-of-state businesses.¹⁴

Competitiveness. Recognizing that a comparison of indicators does not adequately address the question of Connecticut competitiveness the Panel took the further step of carrying out an econometric study of the relationship between (i) Connecticut fiscal and economic variables (the independent variables) and (ii) their relationship to state GSP growth (the dependent variable). The details of this work are fully reported in the Panel's September 30 report (Wasylenko). To very briefly summarize, that report finds that (i) the property and individual income taxes are not good candidates for more intensive use as they are associated with a (slight) reduction in state economic growth; (ii) cutting property taxes and paying for the cuts by increasing revenues from the individual income tax would have neutral to negative effect on economic growth (negative if this leads to reducing spending on elementary and secondary education (an expenditure variable positively related to growth); and (iii) that the finding relating individual income tax refers to the level of the tax and not its effective progressive rate structure.

Financial Institutions. There is a problem with the adoption of either a GRT or VAT, and that is how to treat interest paid and received. That is, is interest to be interpreted as a payment to a factor of production or a cost of acquiring capital? A solution that the Panel may wish to consider (if, that is, there a recommendation to replace the CIT with one of these broader based "entity" taxes) continue to use *in lieu* net income taxation.

Who pays? As discussed in the introduction to this briefing note, the ultimate incidence of the tax is on people, not the entity. That is the impact of the tax is shifted "forward" consumers in the form of higher prices of the product the firm produces and sells in the *product market* and/or "backwards" to the *factor market* suppliers in the form reduced returns to capital (shareholders), labor (wages) or, land (owners).

Just how this all nets out in terms of the ultimate effects on vertical equity ("gressivity" of taxes), depends on a complex end-of-the line product and factor market arrangements. For example, the more competitive the product market in which the business firms sells, the more likely the final incidence of the tax will be "backwards". Regarding this "backward shifting" of the tax, it is unlikely that the incidence will fall on the most footloose of the factors (capital; thus shareholders) and, thus onto the less mobile factors—the suppliers of labor and land; that is the laborer worker and/or the landlord. The result is that regardless of the type of general business adopted, the tax incidence will be regressive in effect. Indeed, that is just what the DRS recent tax incidence of Connecticut's CIT tax shows (Pellowski, September 16).¹⁵

Are these three taxes all that different? Yes, as discussed....except in one subtle, but quite significant, ways. Had this question arisen several years ago—say way back in the 20th Century when the tax on corporate net income (profits) was apportioned using the property and payroll factors-- the CIT was, indeed, a tax on net income. But, now that the CIT is largely apportioned by a sales-only factor, it mimics a gross receipts tax only on corporate firms whereas the GRT would be applied to all business enterprises.

¹⁴ The Connecticut sales tax is examined by Fox (October 27). The findings on the property tax are reported by Wasylenko September 30. Further November (17). Note that a story is emerging that two business competitive options are to (i) embark on a policy to take the sales tax off B2B sales along with (ii) a single equal yield state property tax rate which would supplant part of the local property tax (but with the proceeds being returned locally on a derivation basis) that would, in turn, reduce the tax impact on Commercial and Industrial property (Sjoquist, Nov 17; Bell December 3)

¹⁵ To the extent that the tax can be exported to outside of Connecticut regressivity is reduced

Why are states reluctant to move away from taxing net income? Delving into the politics of change is risky, and outside the role of this report. However, there is some public finance literature that addressed this question, so here are some of the reasons set forth. The first is that there is comfort in “old ways are good ways” since existing tax practices do get capitalized in to business model decisions. Thus, as discussed in Murray and Luna, some adjustments will have be made in to transition from one type of tax to another (e.g., the carry forward of operating losses and the build- up of tax credit liabilities). Nevertheless, as other states have shown, such transitions are manageable. As OLR’s Rute Pinho discusses in a 2012 report (2012-R-0201), the Ohio GRT was enacted in 2006-07 but not fully phased in until FY 2010.

A second, explanation, which goes to the two Michigan experiences (though the 2012 repeal the SBT was a very close vote), was that overtime the Michigan VATs were adjusted to look more like the net income (profits) tax they replaced (and, that, subsequently replaced them). The result of all this tinkering was a hybrid that did not look like a either a VAT or a CIT.

However, with its GRT/Commercial Activities Tax, Ohio has managed to keep the statutory rate in initiated in 2010 at its low 0.26 percent.

The third reason is that switching to a GRT or VAT does change the differential impact by type of business. In terms of the initial tax impact there will be winners and losers. The winners especially for a GRT that is apportioned by single sales (receipts) factor will be the relatively property and land intensive firms. Those who will pay more will be (i) firms in the service sectors and (ii) businesses such as the “pass-throughs” that are not at present taxed as entities.

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Connecticut General Business Tax Options Matrix

Revenue Neutrality. All base broadening (narrowing) is understood to be made with the hard budget constraint of revenue neutrality. There are two ways to accomplish this: (1) a general business tax broadening (narrowing) that results in new (reduced) revenue triggers a reduction (increase) in the general statutory rate. And/or (2) a revenue gain (loss) can be offset by a change in the rate and/or base of another type of revenue that is part of the Connecticut State/Local tax system.

| Policy Option | Description and Impact | Evaluative Criteria and Comments |
|---|--|---|
| <p>Status Quo:</p> <p>Retain the Corporate Net (Income Tax pass-through (non- corporate) Income through the income tax and not as a business entity tax similar to corporations.</p> | <p>The Current Corporate Net Income Tax Rate is 9.0 % (this top rate does not apply to all firms).</p> <p>Changing Business Model. Though there is not detailed data for CT, that the state income tax code closely corresponds to the IRC allows one to look at national data to get good sense of one reason the CIT base is eroding.</p> <p>This national data reveals that proportion of firms organized as pass-through entities has increased substantially. In 1980, 83 percent of firms were organized as pass-through entities, accounting for 14 percent of business receipts. By 2007 those shares had increased to 94 percent and 38 percent. The Congressional Budget Office estimates that if the C-Corporation tax rules had applied to S corporations and LLCs in 2007 federal revenues would have been \$73 billion higher, an amount equal to nearly a fifth of federal CIT taxes collected that year (CBO, 2012).</p> | <p>The CIT is an example of not only revenue obsolescence, but also a tax that violates nearly every principle of good taxation. It fails the benefits test (taxing only the profit-making entity), is non-neutral (taxing only capital) and capricious in its incidence (the debate regarding the shifting of the CIT goes on), has a widely unpredictable base, And it is poor revenue producer. The Connecticut CIT has gone from providing 10% of state tax collections in 1994 (when the personal tax was initiated), to 5 % in 2004, and to 4% in 2014, which is a record that is similar to that of the other US states. Census data shows that the CIT was by far the worst performer of state taxes during the Great Recession</p> |
| <p>Retain the CIT with reforms</p> | <p>Eliminate the Capital Base System</p> <hr/> <p>Clarify the Corporate Tax Rate via elimination of the Corporate Surtax</p> | <p>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. Any revenue losses could be made up by raising the rate and/or placing limits on the future issuance of credits. Base broadening would be a superior solution.</p> <hr/> <p>The surcharge should be embedded as a statutory rate in the regular corporate income tax rate schedule. This would enhance policy stability, reduce tax-induced distortions and improve the transparency of the system.</p> |

| Policy Option | Description and Impact | Evaluative Criteria and Comments |
|--|--|---|
| <p>Retain the CIT with reforms (Topic continued from previous page)</p> | <p>Eliminate the proliferation of Credits</p> | <p>From the Tax Foundation <i>2015 State Business Tax Climate Index</i>: State lawmakers are always mindful of their states’ business climates, but they are often tempted to lure business with tax incentives as subsidies instead of broad based reform. Lawmakers create these deals under the banner of job creation and economic development, but the truth is that if a state needs to offer such packages, it is most likely covering for a woeful business climate. A far more effective approach is to systematically improve the business climate for the long term to improve the state’s competitiveness.” (Drenkard and Henchman, 2015, pg8).</p> |
| | <p>Evaluate whether tax credits are achieving their objective</p> | <p>If tax credits are intended to provide corporate tax relief, then broaden the base by phasing credits out and lower the statutory tax rate. If tax credits are intended to promote economic development, then greater efforts should made to identify policies that can promote economic growth at lower revenue costs to the state.</p> |
| | <p>Maintain mandatory combined reporting for entities that are part of a unitary business Unitary groups for combined reporting should be as inclusive as possible.</p> | <p>This can reduce distortions and opportunities for tax planning. Eliminating the election to file non-unitary will reduce administrative and compliance costs.</p> |
| | <p>Replace the single factor sales apportionment for all taxpayers and return to the equally weighted three factor payroll, property and sales formula</p> | <p>This is an attempt to move the CIT back toward an original cost of production based tax rather than the receipts based tax is has largely become. This will shift the tax impact to firms that are largely goods producers and away from the low profit margin services sector. If the panel finds that the arguments for staying the sales factor are merited, then it should consider abandoning the narrow CIT base to which the factor is now applied and go to a broader based/lower statutory rated general business tax (probably the GRT; the VAT is intended as an origin based tax that is apportioned by property and payroll, and, maybe sales).</p> |
| <p>Replace the CIT</p> | | |
| <p>Gross Receipts Tax</p> | <p>Explicit recommendation for moving to a Gross Receipts tax, unitary combination, single receipts (sales) factor apportionment. For neutrality: The tax would apply to corporate and non-corporate taxpayers alike.</p> | <p>These “business entity taxes (i) 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); (ii) are more stable during expansions and recessions; (iii) show stronger base growth over time; and (iv) fall on virtually all businesses in the state. A downside to the GRT is that the tax can pyramid as goods move through the supply chain; this advantages vertically integrated firm. However, the lower rates that come with a broader base help minimize this distortion. Replacing the CIT 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. .</p> |
| <p>Value Added Tax</p> | <p>Explicit recommendation for moving to a Gross Receipts tax, unitary combination, apportion multistate income using an equally weighted property, payroll and sales formula. For neutrality: The tax would apply to corporate and non-corporate taxpayers alike.</p> | |
| <p>Gross Receipts or Value added</p> | <p>Recognize the Corporate Tax as obsolete and be explicit that there needs to be a broad - based replacement for the CIT as the state approaches the 2020s. Recommend that the Executive and the Assembly undertake a detailed research activity on each these broad based general business tax alternatives to determinate “best fit” for Connecticut.</p> | |