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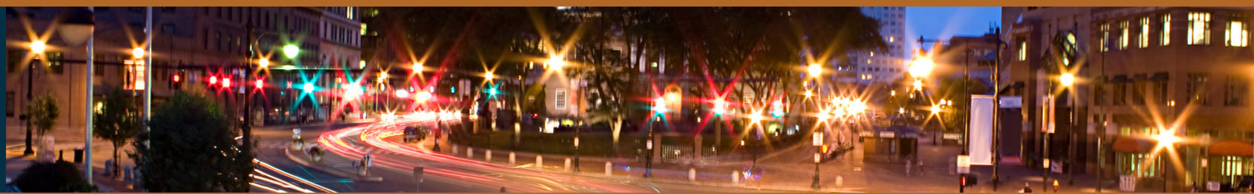
CONNECTICUT TAX ALERT



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Business Tax Policy Change Is In The Air (Again)

After enjoying a relatively quiet 2012 legislative session, Connecticut business tax policy again has become the focus of policymakers' attention with the release of the report and recommendations of the Governor's Business Tax Policy Task Force and a series of related and alternative recommendations from State Comptroller Kevin Lembo. The recommendations of each of the Task Force and the State Comptroller provide valuable insight into the business tax policy considerations of the current administration, and should be taken into account when planning strategically for future Connecticut business operations.

I. Governor's Business Tax Policy Task Force

On January 12, 2012, Governor Malloy signed Executive Order No. 17, which established the Governor's Business Tax Policy Task Force. The Task Force was charged with: (i) the establishment of a work plan identifying specific business tax areas and other issues, including business tax credits or other targeted business tax relief, that should be the focus of future legislative or economic policy action; (ii) the evaluation of the cost, benefit, efficiency, effectiveness and measurable performance of the current business tax credit structure with respect to economic development, business retention and growth, and employment retention and growth; and (iii) reporting its findings and recommendations to the Governor no later than October 1, 2012.

The Task Force was co-chaired by Commissioner Kevin Sullivan of the Department of Revenue Services ("DRS") and Commissioner Catherine Smith of the Department of Economic & Community Development ("DECD"). Members of the Task Force included the State Comptroller, representatives of the Department of Labor ("DOL"), the Office of Policy and Management, the Office of the State Treasurer and three at-large members appointed by the Governor. On September 27, 2012, the Task Force released a final draft of its report.

As part of its report, the Task Force articulated four economic principles regarding economic development. The Task Force posited that: (i) businesses create jobs and jobs create opportunities, and reducing taxes paid by middle and low income residents puts money back into state businesses; (ii) effective economic development policies focus on attracting and growing the types of businesses that offer good jobs with good benefits; (iii) a coherent and stable tax policy encourages businesses to locate and grow in Connecticut; and (iv) the coordination of the state's tax, economic and fiscal policies is necessary to secure a vibrant business climate within Connecticut. Although concluding that taxes are generally a modest factor in business decisions and that Connecticut's comparative tax burden is moderate (other than with respect to new investment, property taxes and business services), the Task Force leveled several criticisms at Connecticut's tax policy. According to its report, Connecticut's business tax policy is "insufficiently aligned with economic policy [and] inadequately reflects the emergent marketplace," "[b]usiness tax incentives are insufficiently aligned with state economic policy" and "Connecticut differentially [and] inequitably taxes similar enterprises solely on the basis of chosen forms of doing business."

The Task Force report then sets forth a series of recommendations, organized into three categories: (i) corporate income tax, business entity tax and pass-through personal income tax issues; (ii) tax credits; and (iii) other selected business tax issues.

With respect to the corporate income tax (i.e. the Corporation Business Tax), Business Entity Tax and Personal Income Tax, the Task Force's recommendations include:

- Clarifying the definition of "engaging in business" in order to assure a level playing field for in-state businesses;
- Phasing out the Corporation Business Tax "surcharge," the minimum Corporation Business Tax and the Business Entity Tax;
- Eliminating current business termination fees, but requiring an annual, combined on-line business and tax registration as a condition of legally engaging in business within Connecticut;
- Providing electronic filing for all business taxes and EZ filing for entities with lower taxable incomes;
- Establishing a DRS external advisory group to work on issues related to simplified business tax accounting and filing;
- Standardizing apportionment, factor weighting and sourcing; and
- Evaluating the impact and transitioning to a standard simplified, uniform business entity tax that gives all businesses access to all major tax credits.

With respect to business tax credits, the Task Force recommended:

- Having the DECD administer all major tax credits available to businesses;
- Phasing out tax credits that are little used or unused and consolidating related tax credits;
- Going forward, requiring that credits be better aligned with the state's overall economic strategy, with measurable performance and accountability;
- Rationalizing the terms and conditions of all credits, such as those governing transferability, the ability to carry forward but not back, and duration relative to investment return;
- Providing annual budget reports that track the total cumulative authorized and claimed tax credits;
- Providing a searchable DECD database that incorporates periodic reporting of entity, purpose, amount, required performance and status of performance, plus a dynamic analysis of net direct and indirect economic benefits to the state economy, "but protect[ing] confidential tax and proprietary business information";
- Establishing an interagency working group led by the DECD to simplify the process for approving tax credits and improving interagency cooperation; and
- Limiting the expansion of credits that can be used to offset personal income tax in order to protect core state revenue stability.

Finally, the Task Force made the following recommendations with respect to other business tax issues:

- In relation to the Sales and Use Tax, the Task Force recommended:

    - Phasing down the sales tax on consumer purchases;
    - Phasing out the taxation of business-to-business computer and data processing, analysis, management and management consulting services;
    - Clarifying the definition of “engaging in business” in order to level the playing field for in-state businesses;
    - Clarifying the application of the manufacturing exemption for mixed use businesses and repairs; and
    - Establishing a DRS and DECD working group to address the taxation of e-commerce.

- In relation to the Personal Income Tax and the Gift and Estate Tax, the Task Force recommended:

    - Providing domicile “safe harbors” for charitable activity, limited business activity and pro-rata residence;
    - Eliminating the gift tax;
    - Limiting individual estate tax liability; and
    - Establishing a DRS, DECD and DOL working group on worker classification and contingent employment.

- Establishing a working group on business property taxation with representatives from DRS, DECD and the Office of Policy and Management; and

- In relation to the administration of the Connecticut tax code, the Task Force urged:

    - Improving the analytic capabilities of DRS and DECD by identifying appropriate revenue and economic modeling and establishing a partnership for tax and economic research with one or more institutions of higher education;
    - Bringing the tax delinquency interest rates in line with the market-based IRS tax delinquency interest rates;
    - Implementing a lean process improvement project for DRS tax rulings;
    - Establishing an external group to provide editorial advice related to forms and publications;
    - Implementing a DECD-led online “business portal;” and
    - Offering, annually, an informational program for state legislators about the interrelationship of state business tax and economic policies.

II. State Comptroller’s Recommendations.

In connection with the proceedings of the Governor’s Business Tax Policy Task Force, State Comptroller Lembo released a letter dated August 20, 2012, to the chairs of the Task Force setting forth his policy recommendations. Although there is meaningful overlap between these recommendations and those of the Task Force, Connecticut taxpayers should be aware of all of the State Comptroller’s recommendations as a number of them would have

serious consequences for their Connecticut tax liability. To summarize, the State Comptroller's recommendations were as follows:

- Create an on-line searchable database for business tax credits available to the public
- Require combined reporting for all corporations
- Encourage municipalities to regularly produce publicly available reports on existing property tax abatements
- Produce an annual tax incidence analysis report
- Produce an annual effective tax rate report for businesses
- Publish an annual report reviewing the current status of each firm in the DECD business assistance portfolio
- Enhance the Office of Fiscal Analysis' biennial tax expenditure report
- Create a permanent commission of tax and policy experts to review all tax expenditures on an ongoing basis
- Require all future tax credits to include an annual limit on the total dollar amount that can be claimed under the credit
- Move to market sourcing for all service industries subject to the Corporation Business Tax
- Move to market sourcing for businesses subject to the Personal Income Tax
- Analyze the potential for moving all industries to single factor sales apportionment
- Create a committee with the sole purpose of developing and evaluating property tax reform alternatives

III. Where Do We Go From Here?

Given the current state unemployment rate and the fragile nature of the state's economy, it remains to be seen whether the Governor's budget for the next biennium (July 1, 2013 - June 30, 2015), which will be submitted for the consideration of the General Assembly during the 2013 legislative session, will reflect any of the recommendations made by either the Task Force or the State Comptroller. It is important to note in that regard, with great irony, the Task Force's conclusion that "[t]o the extent that the annual legislative process continuously raises tax or tax policy questions, discussions and revisions, the result can be unsettled business expectations that undermine a positive business climate." We can only hope, therefore, that both the Governor and the Connecticut General Assembly will take to heart the potential impact of unsettled business expectations on the state's economy when they consider how business tax policy and the recommendations outlined above will be addressed during the legislative session and thereafter.

Questions or Assistance?

If you have questions about these recommendations or how they will impact your business, please contact one of the following members of our State and Local Tax Practice Group listed on page 1 of this alert.

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