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GOVERNOR'S BUSINESS TAX POLICY TASK FORCE
Testimony of Alan E. Lieberman, Esq.

To the Distinguished Members of the Task Force:

I. Introduction

My name is Alan E. Lieberman. I am a partner in the law firm of Shipman & Goodwin LLP and chair of its Tax and Employee Benefits Practice Group.

At the request of the Task Force, I am here today to testify, not in a representative capacity on behalf of the Tax Section of the Connecticut Bar Association, my firm or my firm's clients, but rather as a tax practitioner in his thirtieth year of practice. My practice has as a significant focus the counseling of clients regarding state and local tax issues and representing them before the Connecticut Department of Revenue Services (the "DRS"). Throughout my legal career, I have devoted considerable time and effort to maintaining and improving communications between the taxpayer and tax practitioner community, on the one hand, and the Connecticut General Assembly and the DRS, on the other. I have served on, and sometimes chaired, Connecticut General Assembly and DRS committees and task forces on a variety of tax-related topics such as the taxation of the financial services industry, the Streamlined Sales and Use Tax initiative, the taxation of limited liability companies and partnerships, and the application of single-factor apportionment. I attend liaison meetings with the Commissioner of Revenue Services and help organize liaison events between the tax practitioner community and the DRS. As a lecturer at the University of Connecticut Income Tax School, the Connecticut Society of Certified Public Accountants Tax 360 Conference and the Connecticut Business and Industry Association Connecticut Tax Conference, I regularly invite DRS representatives to speak with me on selected tax topics. It is because I have witnessed first hand, and am a strong believer in, the benefits of a collaborative, public-private tax policy development process that I appear before you today.

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II. Focus of Testimony

I understand that my charge is "to focus on up to three specific state business taxes (including tax benefits) that could improve tax policy and economic development policy without destabilizing state finances."[1]

1 DRS Media Advisory dated March 23, 2012

I believe that the State of Connecticut can effectively leverage tax policy reform to maximize economic development by focusing on the nurturing of businesses already doing business in Connecticut. According to my clients, an efficient way to maximize results from marketing efforts is to try to drive additional revenues from existing customer relationships. Satisfied customers, through word of mouth and direct referrals, create opportunities with new customers. So, too, here, Connecticut has the opportunity to encourage economic development in a more dramatic and cost-effective manner if it reforms state tax policy to better foster increased investment by Connecticut businesses in labor and fixed capital. This approach also better ensures that businesses lured to Connecticut by the state's other economic development initiatives, such as the First Five Plus Program, remain in Connecticut. The tax policy reform necessary to take advantage of this opportunity would focus on three goals:

- Greater Transparency in the Development and Application of Tax Policy
- Improved Predictability in Tax Policy
- Increased Public-Private Collaboration with A Greater Focus on Economic Development Consequences

Let me illustrate the issues to be addressed, and the methods by which these goals may be attained, through the following suggestions.

A. Greater Transparency in the Development and Application of Tax Policy

Goals. As a tax practitioner, I believe that greater transparency in the development and application of tax policy generally involves the following:

- Tax laws and their application are easily determined and understood by taxpayers
- Guidance on tax issues is easily and promptly obtained by taxpayers
- The tax legislative, regulatory and compliance processes are more collaborative than combative

Issues. There has been much debate in recent years about the relative tax burdens of different states. To the extent that this debate has focused solely or principally on tax rates, it is incomplete. Important considerations in the tax burden analysis are how a particular tax is applied and whether that application easily can be determined and understood by taxpayers. When confusion or uncertainty in the tax practitioner and/or taxpayer community results from how a tax law is written by a legislative body, or applied by a taxing authority, the associated tax burden rises exponentially regardless of the underlying rate.

Let me give two examples to illustrate my point, with reference, first, to the Connecticut sales and use tax and, second, to the Connecticut corporation business tax. When the general Connecticut sales and use tax rate was recently increased to 6.35%,[2] much was made of the fact that the new rate was lower than or comparable to the general sales and use tax rates of New York City and Massachusetts. When considering the sales tax burden, however, it is important to note that Connecticut is one of only a very small handful of states,[3] none of

2 Conn. Gen. Stat. §12-408.

3 These states include Hawaii, New Mexico, South Dakota and West Virginia.

them neighboring jurisdictions, that applies the sales and use tax to a wide range of services (more than 40 categories of services at last count, plus numerous subcategories). Most taxpayers associate a sales tax with the sale of tangible personal property, not with the provision of a service. Compounding the problem is the ambiguous statutory language describing certain enumerated taxable services, such as "computer and data processing services" or "business management" services or, my personal favorite, "Miscellaneous personal services included in industry group 729 in the Standard Industrial Classification Manual, United States Office of Management and Budget, 1987 edition, or U.S. industry 532220, 812191, 812199 or 812990 in the North American Industrial Classification System United States Manual, United States Office of Management and Budget, 1997 edition, exclusive of (i) services rendered by massage therapists licensed pursuant to chapter 384a, and (ii) services rendered by an electrologist licensed pursuant to chapter 388 . . . ."[4] Even the most experienced DRS auditors and tax practitioners will confess that they often cannot describe with certainty how our sales and use tax laws should be applied to particular business activities.

Uncertainty also can arise in how a taxing statute is to be applied. By way of example, in 2003, the Connecticut General Assembly adopted legislation, currently codified as Section 12-218d of the Connecticut General Statutes, that provides generally that, when calculating a corporation's liability for the Connecticut corporation business tax, a corporation may be required to add back otherwise deductible interest expense and costs that arise from transactions, such as loans, with related parties.[5] Since the statute is broadly written, taxpayers were uncertain as to how it would be applied to common business arrangements among affiliated companies, such as a central treasury function whereby the available cash reserves of related companies may be swept daily into a single entity which invests the funds on behalf of the corporate group. Taxpayers were required to incur the time and expense associated with independently petitioning the DRS for guidance under the statute.[6]

Uncertainty in the nature and application of tax laws not only gives rise to greater noncompliance, it creates significant hurdles for economic development, including the following:

- **Burden on Small Businesses**. Small businesses often do not have the resources to understand the application of complex tax laws to their operations or to keep apprised of and assimilate tax law developments. Too frequently these taxpayers first learn of the application of certain taxes, such as the sales tax on one or more enumerated services, in connection with a sales and use tax audit. In addition to a large tax assessment (which, if the small business is a service provider, it may not be able to back-charge and collect from a customer), interest is imposed on the tax assessment at the fixed statutory rate of 12% per annum[7] and, more often than not, a negligence penalty of 15% of the tax assessment is added to the tax bill.[8] The Connecticut General Assembly stripped courts of their equitable power to mitigate or eliminate the interest charge, even when the assessment is due

4 Conn. Gen. Stat. §§12-407(a)(37)(A), (J) and (BB).
5 Conn. Pub. Act No. 03-6 (June 30 Spec. Sess.), §78.
6 See, *e.g.*, Massachusetts Department of Revenue Technical Information Release (TIR) 03-19 (that provided guidance under a similar interest addback provision).
7 See, *e.g.*, Conn. Gen. Stat. §12-419(a).
8 Id.

to ignorance or an innocent misinterpretation of the law, or the delay in finalizing the assessment is not attributable to the taxpayer.[9] The result too often is an angry, frustrated taxpayer, who now must devote cash reserves to pay interest and penalties rather than to invest in the taxpayer's business (assuming that the taxpayer has the wherewithal to pay the assessment and does not become insolvent).

- **Financial Reporting and Reserves**. Corporations whose stock is publicly-traded, and many private companies whose financial statements are prepared in accordance with generally accepted accounting principles, face an additional problem when accounting for tax uncertainties. In 2006, the Financial Accounting Standards Board ("FASB"), published FASB Interpretation No. 48, "Accounting for Uncertainty in Income Taxes," an interpretation of FASB Statement No. 109. In general, the interpretation, known as "FIN 48," prescribes a method by which an uncertain tax position should be measured and recognized in a company's financial statements. Uncertainty as to how tax laws are to be, or will be, applied requires the company to determine with its legal and/or accounting advisors whether, and to what extent, a disclosure must be made in its financial statements. Such a disclosure, if meaningful, can impact how those statements are viewed by investors, lenders and the public, and could require the maintenance of reserves when that capital could instead be employed in further investment in labor and fixed capital. Based on my interactions with my clients, tax uncertainties, and the impact of FIN 48, are becoming an increasingly important factor when a business plans for where and how it conducts its business activities. My experience and that of other practitioners with whom I have discussed this issue would suggest that Connecticut economic development efforts suffer to the extent that uncertainties about Connecticut tax law require business decisionmakers to focus on Connecticut tax issues as part of a FIN 48 analysis.

- **Impediment to Investment**. Economic development initiatives also suffer when uncertainty exists as to the application of tax benefits or incentives intended to encourage investment in Connecticut. The enactment of a new business tax credit, intended to foster investment in labor or fixed capital, can only succeed if there is sufficient confidence in the business community that the credit will remain in place for the time necessary to realize the benefit of the investment, and the requirements that must be satisfied in order to claim the credit are reasonably attainable, easily understood and implemented, and applied consistently by the authority overseeing the credit. If there is uncertainty as to whether the full benefit of the credit will be realized due to legislative or administrative repeal or amendment, or as to how the credit is to be obtained and used, the tax incentive will not have the positive economic development result intended by the General Assembly. In addition, the imposition of the statutory 70% limitation on the use of tax credits penalizes only those businesses that have invested in Connecticut, and undercuts the willingness of businesses to make future investments due to the ongoing discussion of additional credit limitations.[10]

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9 Conn. Gen. Stat. §12-33a.

10 Conn. Gen. Stat. §12-217zz.

Recommended Action Items. Making Connecticut tax law more transparent and accessible to taxpayers cannot be accomplished overnight. Nevertheless, I would submit that the Executive Branch (including the Office of Policy and Management, the DRS and the Department of Economic and Community Development), the Connecticut General Assembly and tax practitioners and other taxpayer representatives could work collaboratively in a number of ways to try to achieve this goal, including the following:

- **Simplify Connecticut's Tax Laws**. An effort should be made to identify and address the Connecticut tax laws that give rise to the greatest uncertainty amongst taxpayers. Using the Connecticut Sales and Use Taxes Act as an example, the State should reduce the number of enumerated services subject to tax. Not only is the tax on services anti-competitive (which I will discuss in greater detail later), it is a major source of non-compliance and audit dispute.

- **Issue More Regulatory Guidance**. There is a need for more regulatory guidance on a wide range of tax issues. The current administration is to be commended for meeting with representatives of various industries and issuing a bevy of short administrative papers and answers to frequently asked questions in the wake of last year's avalanche of tax law changes enacted as part of the current biennial budget. Nevertheless, the publication of state tax regulations and rulings has dried up almost completely. Special notices or policy statements cannot supplant the issuance of regulations, which are subject to public comment and legislative review, and can be relied upon by taxpayers because they have the force of law.

- **Streamline Guidance Procedures**. As a related matter, I would urge the State to work with tax practitioners to develop a more streamlined procedure for obtaining prompt guidance on tax issues. In the past, the tax practitioner community has offered to draft, or has drafted, such guidance for the State's consideration to identify issues and to propose a possible resolution of those issues. For example, when faced with broadly-drafted and ambiguous legislation attempting to codify an economic nexus standard for the corporation business tax and the personal income tax,[11] the DRS worked with the business community and tax practitioners to fashion guidance providing clear guidelines regarding the application of the legislation.[12] This collaborative procedure should be employed on a regular basis. There also is a need to provide for the more expedient issuance of private letter rulings, particularly given the rapid pace of changes in the business world. I understand that the provision of increased guidance to taxpayers may require the allocation by the State of additional resources, but the positive economic development impact of such guidance is likely to produce a favorable return on that investment.

- **Substitute Federal Interest Rates for Current State Interest Rates**. Given the complexity of the state's tax laws, the current fixed interest rate of 12% on underpayments is unnecessarily punitive, particularly since the DRS has the authority to impose any one of a number of civil and criminal

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11 Conn. Pub. Act No. 09-3 (June Spec. Sess.), §§90-91.

12 DRS Information Publication 2010(29.1).

penalties if it concludes that a particular taxpayer has negligently or intentionally violated our tax laws. The Internal Revenue Service publishes on a quarterly basis interest rates for underpayments and overpayments of federal tax, which rates still allow the Service to discourage tax avoidance, but which interest rates better reflect current interest market conditions and do not unduly punish taxpayers whose errors are ones of ignorance or reasonable misinterpretation.[13] Both New York and Massachusetts similarly have interest rates for underpayments and overpayments of tax that change based upon changes in the federal short-term interest rate.[14]

- **Greater Public-Private Collaboration**. Finally, as discussed further below, I would urge the Task Force to focus on the importance of collaboration in the development and implementation of tax policy. Tax policy cannot be developed in a vacuum. It requires the input of those parties who will be affected so that the full implications of a policy will be understood before the policy is adopted. Too often, tax laws are adopted at the tail end of a legislative session, and the DRS and taxpayers are left to speculate as to what was intended by the legislature. The resulting uncertainty is a problem for any state seeking to incentivize economic development.

B. Improved Predictability in Tax Policy

Goals. I believe that improved predictability in tax policy generally would involve the following:

- Greater consistency in the manner in which the tax laws are written to affect similarly-situated taxpayers
- Greater consistency in the application of tax laws
- Reasonable stability in our tax laws and the way they are applied

Issues. My experience is that when a business decides where and how it will invest in labor and fixed capital, it will be influenced by a number of factors, of which tax is only one. When tax issues are examined, however, an important consideration is the predictability of the tax regime or, put another way, whether the tax laws are applied consistently and are relatively stable. The more a tax regime appears to be uncertain, the more likely that the tax regime will be perceived as an impediment to making a long-term investment that is based on tax-related assumptions (such as the availability of a tax credit, method of taxation, etc.). Let me illustrate this point with a few examples:

- **Corporations v. Pass-Through Entities**. Connecticut tax law currently provides for the inconsistent tax treatment of similarly-situated businesses based on whether a business is organized as a Subchapter C corporation or a pass-through entity, such as a Subchapter S corporation, a limited liability company or a partnership. To a certain extent, that inconsistency is both intended and desired; the business profits of a Subchapter C corporation are subject to the Connecticut corporation business tax while the business profits of a pass-through entity are subject to the Connecticut

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13 See generally Internal Revenue Code §6621.

14 See N.Y. Tax Law §684, M.G.L.c. 62C, §32.

corporation business tax in the hands of owners who are C corporations and the Connecticut personal income tax in the hands of owners who are individuals. However, there are inconsistencies in tax treatment that act as a tremendous disincentive for economic development. Take, for example, a typical manufacturer or service provider that is based in Connecticut, but does business in a number of states. Under our tax laws, as currently applied, that manufacturer or service provider, when calculating its Connecticut tax liability, will be required to allocate and apportion, and pay tax on, its multi-state income differently depending upon whether it is a C corporation or a pass-through entity. Unlike the laws of many of our neighboring states, Connecticut law generally will require the Connecticut-based pass-through entity to allocate and apportion its multi-state income to a greater extent to Connecticut than to the jurisdictions where the entity's out-of-state customers are located and from where the entity's revenue is derived.[15] This often can lead to the double taxation of certain business revenue: by Connecticut, the location of the entity's home office; and by the market states where the entity's customers are located. The inconsistency creates a significant financial incentive for the pass-through entity to relocate its headquarters to an adjoining state which allocates the multi-state income of a pass-through entity on a market or destination approach. The inconsistency also undercuts the ability of Connecticut to use the recently-enacted economic nexus legislation, as intended by the Connecticut General Assembly, to tax the profits earned in Connecticut by out-of-state pass-through entities.

- **Consistency in Application**. An important component of achieving greater certainty in our tax laws is consistency in their application. It is crucial to any system of taxation that taxpayers believe that tax laws are applied uniformly and consistently regardless of whether a particular application will generate more or less tax revenue to the state. The application of different standards for determining in-bound and out-bound nexus, Connecticut and non-Connecticut domicile and residency or in the application of any Connecticut tax undermines a sense of fairness and a feeling that a tax system is sufficiently predictable to make assumptions as part of an investment decision. Published regulatory guidance can help reduce such inconsistency.

- **Perceived Instability in Tax Policy**. As a tax practitioner, I understand that tax policy and tax laws cannot remain static, and that a state government necessarily must act from time to time to address such matters as budgetary needs, perceived abuses of the tax laws or changes in the way business is conducted. However, when a state government, on an annual basis, conducts public studies or hearings to make wholesale changes in tax policy, including changing tax regimes and eliminating all or substantially all deductions, exemptions, credits and/or other tax benefits, it creates an instability that can have a significant "chilling effect" on business-related investment. Meaningful business decisions, including a relocation, an expansion or a substantial investment, typically are made as part of a long-term strategic plan, that, in turn, is based upon a number of assumptions, including assumptions regarding the multi-year stability of tax costs and benefits. The more difficult it is to make assumptions regarding the future of taxes and tax benefits in Connecticut, because of the

15 See Conn. Agencies Reg. §12-711(c)-4.

threat of annual changes in the law, the harder it is for a business to include Connecticut in its long-range strategic plan.

Recommended Action Items. Rather than repeat at length the foregoing, I would summarize the relevant recommendations regarding improved predictability in tax policy as follows:

- The State should work collaboratively with tax practitioners and other tax representatives to identify inconsistencies in our Connecticut tax laws or in their application that impair economic development in this state.
- As recommended above, the State should publish additional guidance on tax issues to reduce the potential for the inconsistent application of our tax laws.
- To the extent that a comprehensive review of all or a portion of our tax laws is desired, such a review should be conducted only periodically and with meaningful input and participation by representatives of taxpayers.

C. Increased Public-Private Collaboration with A Focus on Economic Development Consequences

Many of the issues outlined above can be addressed through increased collaboration by the Executive Branch, the General Assembly and representatives of the taxpayer community. As one example, in the late 1990s, the General Assembly and, then, the DRS convened a committee to review the taxation of the financial services industry because of the growing loss of financial service companies and jobs. Each committee was co-chaired by both a representative of the State and me, and was constituted with representatives of government and industry. After studying the tax issues associated with the financial services industry, the committee was able to draft legislation that rationalized and modernized the tax treatment of the industry in a manner that did not give rise to a negative fiscal note. Committee members then worked to draft guidance with the DRS, the Department of Banking and other state agencies that was published promptly after the enactment of the legislation, and the State and taxpayer representatives jointly conducted public information sessions to explain and answer questions regarding the legislation prior to its effective date. The result of this collaborative effort was that, prior to the effective date of the legislation, most affected taxpayers were informed and prepared to implement the new law, and the state realized an immediate positive economic impact as financial service companies began to expand their activities in Connecticut.

A similar approach can be taken to address many of the tax issues we face, and if coupled with a focus on economic development, can further the State's strategic initiative. For illustration purposes, I offer the following sample of possible topics for collaborative review and action:

- The rationalization and modernization of the application of the Sales and Use Taxes Act to manufacturers -- the application of multiple rates of tax, and the limited availability of exemptions, is a trap for the unwary, and the older guidance published under the Act, predicated on an assembly-line industrial model, does not reflect properly the modern state of manufacturing.

- Expand the ability of the owners of pass-through entities to claim against the personal income tax

the same economic development tax credits that are currently available to Subchapter C corporations to claim against the corporation business tax. Given the fact that the overwhelming percentage of new businesses being formed in Connecticut are pass-through entities,[16] Connecticut is missing an opportunity to maximize the economic development benefits of these credits. To the current administration's credit, certain of the tax credits adopted during the last legislative session, including the new Job Expansion Tax Credit,[17] may be used against the Connecticut personal income tax. This trend should continue.

- The Connecticut sales and use tax is applied to a number of business expenses, including the purchase of taxable enumerated services, that increases the cost to Connecticut businesses of producing products and services and, thereby, makes these businesses less competitive. In certain instances, the anti-competitive impact is compounded because the service being taxed would assist the Connecticut-based business to be more competitive. By way of example, a Connecticut business must pay sales tax on costs related to training its employees, retaining a computer consultant to update its technology, or engaging a consultant to implement LEAN principles or other business process improvements. Connecticut should look to incentivize such activities, and not to tax them.

III. Conclusion

I want to conclude my testimony by expressing my gratitude to the Governor for convening this Task Force and for the efforts of the members of the Task Force to address this difficult topic at a time of meaningful economic distress. I wish to emphasize that many of the issues highlighted in my testimony have been in existence for a long time, and that there is unlikely to be a "silver bullet" that can ameliorate these issues overnight. Although certain of the recommendations contained in my testimony will have a fiscal cost to the State, I have tried to balance those costs with proposals that will raise revenues and that will increase compliance, thereby further increasing revenues. Any effort on the part of the Administration to work collaboratively to better align state tax policy with the goal of increased economic development would be greatly appreciated by many. For my part, I would be happy to be of assistance in those efforts. Thank you for your time and patience.

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16 According to information on the website of the Office of the Secretary of the State: (i) the aggregate number of domestic stock corporations incorporated in Connecticut in 2009, 2010 and 2011 is 4,617; and (ii) the aggregate number of limited liability companies, limited partnerships and limited liability partnerships organized in 2009, 2010 and 2011 is 56,848. The foregoing numbers do not include sole proprietorships and partnerships who are not required to register with the Office of the Secretary of the State.

17 Conn. Pub. Act No. 2011-1 (Oct. Spec. Sess.), §19.

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