STATE TAX PANEL FINAL REPORT

December 31, 2015 Final

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 Agsten, Partner Wiggin and Dana
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
December 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
6. Memoranda of Panel Member Comment

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.

- 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**

- 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)**

- 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**

- 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

<u>Administrative Issues</u>

***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, 74 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 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 $6 million, or about 1 percent of 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

6. Memoranda of Panel Member Comment
December 2015

Panel members will have the opportunity to submit additional Comments that will be included in the Final Report to be submitted to the Governor and General Assembly.

To date, Panel Members Donat C. Marchand, Anika Singh Lemar and Louis B. Schatz have each submitted a Memorandum of Comment.

- *Memorandum of Comment* submitted by Panel Member Lemar relating to the Local Revenue System.

- *Memorandum of Comment* submitted by Panel Member Marchand relating to 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.

- *Memorandum of Comment* submitted by Panel Member Marchand relating to 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 and Dissent* submitted by Panel Member Schatz relating to a dissent regarding the Personal Income Taxation of Retirement Income.

- *Memorandum of Comment and Dissent* submitted by Panel Member Schatz relating application of the General Sales Tax on services.

- *Memorandum of Comment and Dissent* submitted by Panel Member Schatz relating to the Local Non-Property Taxation of retail sales transactions.