**GOVERNOR'S BUSINESS TAX POLICTY TAX FORCE**
**TESTIMONY OF PATRICK J. DUFFANY, J.D., CPA**
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I. Background:
- Good afternoon.
- My name is Patrick Duffany
- I'm a CPA and an attorney and am a partner with J.H. Cohn LLP – a regional CPA firm.
- I lead our firm's State & Local tax practice and have more than 20 years of tax experience.
  - My practice focuses on both Connecticut and multi-state taxation and I work with a broad range of clients, including large public companies, international organizations, and closely held businesses in a variety of industries, including – financial services, manufacturing, distribution, pharmaceutical, and others.
- I also serve and have served on a number of professional tax committees and have chaired the CSCPA's state tax committee for 3 terms.
- Thank you
  - I wanted to thank you for giving me the opportunity to comment on state and local tax matters and Connecticut taxes specifically.
  - My discussion will focus more on practical matters that policy makers should consider as they look to change existing tax laws and regulations.
- There are winners and losers in every tax policy decision, but it is often difficult to gauge at the onset who will benefit or detriment from tax law changes.
- I am not here to represent any specific interests, groups, or taxpayers, but hope that my comments provide insight into why tax policy (or the lack of tax policy) can negatively affect economic development and tax revenue growth – or if done right – facilitate both economic development and tax revenue growth.
- My discussion today represents my own personal views.
- Please feel free to ask questions at any point during my presentation.

II. Overview of taxation:
- I wanted to start with a few opening remarks:
  - The tax compliance system in the US is a "voluntary" system.
  - The more difficult and complex the rules, the more likely there is to be noncompliance – which can occur for any number of reasons, including:
    - Uncertainty regarding the rules, or
    - Excessive costs of compliance.
- Complexity:
  - State taxation is an extremely complex area.
  - I've been doing state tax for nearly 20 years and state and local taxes are more complex now than ever – and state tax professionals expect the complexity to increase as states continue to look for revenue.
  - My opinion is that taxpayers and practitioners would like to get it right, however, we often find well meaning taxpayers who don't fully understand the rules or don't have the resources necessary to fully comply with the rules.

- Further, confusion regarding tax rules creates economic disincentives to invest in a specific jurisdiction, which does not foster economic development, and it also increases both the costs of complying with the rules and of administering the rules.

- In addition, the costs of compliance and the costs of non-compliance are significantly increasing.
    - Penalties for non-compliance are increasing as are technology costs and the costs of personnel needed to comply with the disparate rules.
    - Most non-tax professionals are not aware of the complexity of issues taxpayers face or of the costs.
    - In fact, I believe that most non-tax professionals believe that it is a simple matter to comply with these rules.
        - And in some cases that is true.
        - But in many, many situations, especially in situations involving small to mid-size businesses, the costs of compliance have a dampening effect on economic growth.
- Significantly, small to mid-size businesses often have many of the same issues as larger businesses, but typically do not have the resources of larger taxpayers, so compliance places a much larger burden on these businesses.
- Tax policies that allow for straightforward compliance and enforcement are critical to encouraging economic development, regardless of the size of the business.
- Finally, before discussing specific Connecticut business tax policies, I thought it would be helpful to discuss certain attributes of what I consider "good" tax policies. (My discussion is primarily from a tax-compliance perspective, but I do comment on some theoretical aspects as well during my concluding comments):
    1. The tax laws should be uniform in the applicability to taxpayers and are consistently applied by the administrators;
    2. The tax laws are clear and understandable;
    3. Compliance with the laws is "straight forward";
    4. The tax policies are stable and the topic is not revisited year after year; and
    5. The tax revenues are fairly stable.
- I acknowledge that not all of these factors are always achievable, but they should all be considered whenever tax changes are being contemplated.
- I will provide brief examples of most of these principles:
    - Uniformity
        - For example – A manufacturer should use the same apportionment rule regardless of type of legal entity.
            - In Connecticut the rules differ significantly depending on the type of legal entity – creating confusion, non-compliance, and taxpayers, especially small businesses, are very frustrated with these rules.
                - This specific provision clearly creates a disincentive to create or retain Connecticut jobs.
    - The tax laws should be clear and understandable;

  - o For example – Consider the sales and use tax rules relating to the taxation of business analysis, business management, and business management consulting services under Connecticut's sales tax rules.
    - Definitions of these terms are not clear and create traps for the unwary.
    - Also, Connecticut is the only state that I am aware of that imposes this tax and I feel that this provision significantly increases costs on businesses who would like to enter some type of joint venture with a Connecticut based business.
      - o This type of rule creates a disincentive to invest in Connecticut jobs.
- o Lastly, compliance with the tax laws should be "<u>straightforward</u>" . . .allowing taxpayers to comply (and, accordingly, the tax returns are then easier to audit by the tax authorities)
  - o For example, modifications required to determine Connecticut taxable income.
    - Depreciation is a typical modification to state taxable income, but takes significant time to correctly prepare.
    - This type of modification does not raise any revenue – it is merely, what we refer to as a "timing difference" - in one year increasing the tax, only for the state to give all of the tax back in the next year. Overall, this type of modification simply unnecessarily increases the cost of compliance, is burdensome on taxpayers, and is extremely difficult to for administrators to audit.
  - o Complexity in tax compliance is expense both for taxpayers and the government. Taxpayer's often struggle to figure out how to comply with the rules and the state must spend significant funds on training, enforcement, audit, appeals, legal, and collections.
  - o A "straight forward" system creates more efficiencies – both for taxpayers and the state.

III. <u>Turning to the specific matters we were asked to discuss today</u>:

- We were asked to focus on three specific state business taxes (including benefits) that could improve tax policy and economic develop policy without destabilizing state finances.
- Taxes generally are a significant factor in most business' decisions on where to grow and expand and it is difficult to identify one specific tax or policy that is more significant than others.
- Rather it is the entire tax picture in a jurisdiction that is significant.
- Accordingly, the provisions and policies that I will discuss today generally have broad applicability and affect many Connecticut taxpayers. Today, I will briefly touch on:
  - o Connecticut's sales taxes (which I briefly touched on earlier)
  - o Consistency in application of Connecticut's tax rules, specifically relating to Tax credits and apportionment provisions.
  - o Also, if time permits, I will also spend a few minutes on the importance of taxes in financial statement reporting. An issue that is critical to businesses preparing financial statements and firms reviewing and signing them.

- <u>Sales taxes</u>
  - 45 states and thousand of localities impose sales/use taxes.
  - Generally, sales tax is imposed on all sales of tangible personal property, unless specifically exempt, while services are generally exempt unless specifically taxable.
  - Connecticut's rules pertaining to the taxability of tangible personal property are comparable to rules in most other states, but are not always easy to comply with.
  - However, Connecticut's sales tax differs from other states in a couple of significant ways:
    - For example, we now have 5 different sales tax rates:
      1. A 6.35% general sales tax rate;
      2. A 7% rate on the sale of luxury goods;
      3. A 3.175% tax rate on certain manufacturing materials [due to the MRA exemption];
      4. A 1% tax rate on computer and data processing services and
      5. A 4.5% tax rate on certain sales of motor vehicles to active duty members of the armed forces
         - <u>The simple fact is, the greater the number of tax rates, the more complex the system and the more likely there are too be errors</u>.
    - Significantly, we are fairly unique among the states with respect to our taxation of services.
      - Today, nearly all states that impose a sales tax also tax certain services.
        - Our sales tax on services has existed for many years and has undergone many changes.
        - However, my sense is that we tax more services than any other state.
        - Presently we have more than 40 statutory provisions regarding the taxation of services – many of which contain multiple services.
        - And our rules are often very difficult to understand.
        - Because of the ad hoc basis on which the sales tax changes were made and laws were adopted, we are left with is a confusing maze of complex and often hard to understand rules regarding what services are taxable and what services are exempt.
      - For example - Earlier I briefly mentioned the sales tax on business analysis, business management, and business management consulting services.
        - This provision has been around for years, but we often see situations where taxpayers are unsure as to whether a service falls within the definition of business analysis, business management, or business management consulting . . . or would be included as a different service (such as an whether a services is more appropriately classified as a consulting service under the computer and data processing services provisions).

        - Here, the rules are complex – they are hard for taxpayers to figure out and I think equally hard for the DRS to audit and enforce.
        - This specific provision is <u>both</u> a trap for the unwary and, for those taxpayers fortunate enough to be aware of the rule, a barrier for job creation and economic development in Connecticut.
    - <u>I'm not here to say that we should not tax services</u> or this specific service.
    - In fact, I expect that the sales tax on services will continue to <u>evolve</u> both in Connecticut and nationally as we continue to move to a service based, digital economy.
    - <u>What I am saying is that if you choose to tax services, one must make the rules easy to understand and comply with</u>.

- <u>Tax Credits</u>
    - Tax credits play a key role in attracting, retaining, and growing the Connecticut businesses benefiting from the credits.
    - Note that I am not here to support any specific credit or industry.
    - Rather my comments are intended to highlight:
        - That tax credits should <u>uniformly apply to the targeted businesses</u> – <u>regardless of form</u> of entity and
        - They should be <u>easy to comply with</u> so that the targeted businesses can effectively claim the credit.
    - For example, in Connecticut partnerships and individuals generally cannot claim tax credits –
        - Tax credits are primarily tailored to regular corporations and insurance companies.
        - Why would we say that a regular manufacturing corporation that has 100 employees deserves these benefits, but the exact same business in the form of a partnership, sole proprietorship, or small business corporation, does not?
        - Significantly, many businesses today would like to do joint ventures with other businesses – but Connecticut's policies regarding tax credits and certain other tax provisions say not here, or at least not in partnership form
    - <u>I do think</u> that it is ok to target the desired jobs and industries to encourage the corresponding economic development – <u>that is the prudent thing to do</u> - but to have different rules based on type of legal entity does not seem to align with the reason for having these provisions – which is to encourage job growth.
    - Tax credits should also be easy to claim for the targeted jobs the state is looking to develop:
        - First, let me state that we need to applaud the administration's focus on job creation.
        - The revamping of the small business jobs credit into the much more generous job expansion credit is a great example of good tax policy targeted to helping businesses grow.
        - However, the process for qualifying for the new jobs expansion credit is burdensome - especially for small business with limited resources.

        - Simply put, a credit applicant must jump through too many hoops to receive this benefit.
        - For example, for the JETC, in order to qualify for a credit, a business needs approval from the DECD before it makes a new hire. The approval process requires a business to:
            1. Complete and submit an application w/DECD (<u>before</u> hiring any new employees);
            2. Include with the application a Certificate of Incorporation;
            3. Include with the application a schedule of Existing Employees at Time of Application with Names and Titles and Date of Hire (Updated Yearly);
            4. Include with the application a Department of Labor Information Release Form;
            5. Obtain and include with the application a Letter of Good Standing from the Secretary of State,
            6. Obtain and include with the application a Letter of Good Standing from the Department of Labor;
            7. Obtain and include with the application a Letter of Good Standing from the Department of Revenue Services
    - Significantly, these 7 steps are only the preapproval process – and they must be done before you hire even 1 employee.
    - At the end of the applicant's tax year more reporting is required.
  - There is no question that the state has an obligation to track and monitor the revenue incentives it offers.
    - However, this pre-hire application process is daunting, especially for small business,
    - and the decision to hire often needs to be made rapidly – especially in a small business setting.
    - Quite simply, mandating a pre-hire approval process with certifications from three other state agencies is simply too tedious and slow for any business.
  - Due to the readily available employment and other business records, this process could easily, and should be, greatly streamlined.
- <u>Apportionment provisions</u>:
  - As with most tax credits, apportionment rules are based on form of entity – not type of business.
    - From a tax policy perspective – the apportionment rules for individuals and corporations should be the same and should be based on <u>type</u> of business and <u>not</u> form of entity.
  - Why would we say that a regular corporation that has 100 employees deserves to use a single sales factor to apportion its sales within and without Connecticut, but individuals and small business corporations who operate an identical business can not?
  - As with tax credits, it <u>is appropriate</u> to target industries and jobs to encourage job growth and economic development, but to differ based on type of legal entity seems contrary for the reason to have apportionment provisions designed for specific industries, such as manufacturers.

    - We have had many clients that were shocked to learn that the apportionment rules were different for s corporations and regular corporations
        - Their question to us was – so if we move our high paying, decision making jobs from Connecticut, then we owe no tax? The answer to them was yes.
        - How does this help economic development?
- Financial Statement Reporting:
    - Before wrapping up, I wanted to mention financial statement reporting.
    - Changes that you make to nearly any corporate business tax provision have financial statement implications.
    - Significant tax changes can have a "multiplier" effect on the income that the these companies report
        - What I'm saying is that even if there is no cash tax cost to some businesses, the changes made could significantly negatively (or positively) affect the business.
    - Further, uncertainly regarding tax provisions creates significant burdens on financial statement reporting – often significantly driving up the cost of preparing financial statements.
    - This is a complex area, but is something that legislators must consider when looking at revenue options.

IV. In Conclusion:

- Connecticut does not seem have a long-term tax policy vision.
- Our tax changes seem to be changes simply to raise revenue, often with little regard to how the changes impact taxpayers or whether the taxes can even be administered.
- Most taxpayers need certainty and are looking for stable tax policies over 5 or more years so they can make informed business decisions.
- Revisiting tax rules year after year, even if the tax provisions are not changed, creates instability and uncertainty and doesn't allow for Connecticut businesses to plan for the future.
- My point is not only does revisiting the same tax policy issues year after year slow future business growth – my opinion is that it actually drives business away.
- That is not to say that the legislature cannot look at revenue increases – it must.
- But to constantly look at tax credits, sales tax base expansion, and personal income tax rate increases year after year, tells businesses that Connecticut does not have stable finances and they are entering an unstable tax landscape at their peril.
- In order attract, retain, and grow jobs, and to spur economic development, our tax policies must be:
    - Stable;
    - Our revenues must come from fairly stable revenue sources.
    - And the rules enacted to support these policies must be
        - Clear and understandable
        - Uniformly applied to similarly situated taxpayers and be enforced in a consistent fashion;
        - And be "straightforward" allowing taxpayers to comply and administrators to enforce.

- Lastly, the tax and business community, has partnered with the State of Connecticut in the past and those discussions have yielded great results for Connecticut and its taxpayers – for example the financial services task force and the clarification regarding the economic nexus rules.
  - The state needs better collaboration between legislators, administrators, taxpayers, and tax professionals, and we welcome the opportunity to make Connecticut a great state in which to grow.
- Thank you for giving me this opportunity to present my views.
- Are there any questions?