2005

Taxing Smarter and Fairer: Proposals for Increased Accountability and Transparency in the Connecticut Tax Structure

Richard Pomp
University of Connecticut School of Law

Follow this and additional works at: https://opencommons.uconn.edu/law_papers

Part of the Taxation-State and Local Commons, and the Tax Law Commons

Recommended Citation
https://opencommons.uconn.edu/law_papers/573
I. Introduction

The Connecticut tax structure is under assault by sophisticated lawyers and accountants, armed with the latest weapons. The State’s rickety tax structure is no match. The Legislature has done little to equip the Division of Revenue Services with a statutory regime that could repel this attack or to adopt the latest in defensive maneuvers. In fact, the Legislature’s own actions have further eroded the tax base. Through tax cuts and the adoption of special exemptions, deductions, and credits, the Legislature has helped gut the corporate income tax. Consciously or not, the Legislature has ignored its own law calling for a periodic review of corporate tax credits. The most recent study shows that these credits cost $175 million annually. These credits are a form of invisible, backdoor spending that takes place through the tax system. In the aggregate, such tax expenditures constitute $4 billion of spending, more than any other category in the budget. Tax expenditures escape Legislative scrutiny because they remain outside the normal budgetary processes.

This Report identifies some of the more glaring defects in the State’s tax structure. Particular emphasis is placed on the corporate income tax. The Legislature has allowed it to hemorrhage to the point where it has become, for many of the largest corporations in the State, a voluntary tax. Part One identifies three major defects with the corporate tax: the lack of combined reporting; the single-factor apportionment formula for manufacturers; and the failure to utilize a throwback rule. These structural weaknesses allow many of the largest corporations in Connecticut to pay less in income tax than those who sweep their floors at night. The State raises less from the corporate income tax than from gambling. The corporate income tax can—and must—be revitalized.

Part Two focuses on one aspect of the sales tax: the erosion that has resulted from the growth of the Internet and mail order sales. One estimate for Connecticut places

---

1 Alva P. Loiselle Professor of Law, University of Connecticut Law School, former Director, New York Tax Study Commission.

the revenue loss for 2003 at around $230 million.\(^3\) Whatever the reliability of these estimates, there is a fundamental issue of fairness to our local merchants. It is simply unfair to make local merchants collect the sales tax on local sales when their Internet and mail order competitors do not. While U.S. Supreme Court doctrine limits Connecticut in what it can do legislatively, the Legislature can nonetheless be more proactive rather than passive.

Part Three exposes the $4 billion of invisible, backdoor spending that occurs through the tax system through special provisions, exemptions, credits, and the like, known as tax expenditures. Although the State draws up a tax expenditure budget,\(^4\) it is not integrated into the explicit spending budget. If it were, tax expenditures would represent the largest component of state spending. Quite shockingly, tax expenditures are not capped or limited in amount. They represent programs whose cost is a function only of how many taxpayers take advantage of them, and the evidence is quite clear that they have grown exponentially over time. Unless tax expenditures are constrained, the Legislature cannot claim to have control of the budget. Unexplainably, given the stakes at issue, the Legislature has chosen to ignore its own law requiring overview of tax expenditures.\(^5\)

Part Four analyzes one of the ubiquitous issues that permeate much of the legislative debate over tax reform: the effect of Connecticut taxes on economic development. It is almost a legislative mantra that cutting State taxes is an effective tool for encouraging economic development. Part Four summarizes the extant literature that challenges this commonly held, albeit erroneous belief about the role that taxes can play. Decades of research suggest the opposite of what is taken as gospel: reducing taxes is not the most effective way of finding the holy grail of jobs and economic growth. The Legislature should heed the research and not the self-serving anecdotes of lobbyists and their clients.

Finally, because sunlight is the best disinfectant, this Report concludes with a discussion about whether legislators and the public have a right to know how much each corporation pays—or doesn’t pay—in corporate income taxes. The Legislature has rejected bills in the past that called for the disclosure of the amount of corporate income taxes paid by specific corporations in Connecticut. This Part of the Report

---

\(^3\) Donald Bruce and William F. Fox, State and Local Sales Tax Revenue Losses from E-Commerce: Estimates as of July 2004 (U. of Tenn. Center for Business and Economic Research, July 2004).


concludes that such bills would bring accountability and transparency to the State system, slogans that are bandied about but rarely translated into action.

To avoid any misunderstanding at the outset, this Report is not about raising taxes. Any revenue that might be raised from the proposals discussed below can be returned to taxpayers through a lowering of State taxes or used for property tax relief. Alternatively, it can be used to finance existing spending or new initiatives, such as campaign reform. The decision about how to spend increased tax revenue, or whether it should be spent at all, is a political question that is outside the scope of this Report. This Report is about taxing smarter, fairer, and eliminating wasteful and inefficient provisions. There should be greater accountability, transparency, and fairness in the Connecticut tax structure, no matter what the level of taxation the Legislature desires. I hope that the Report is read in that vein and not dismissed as a polemic in favor of increased spending.

II. The Connecticut Corporate Income Tax

A. The Disappearing Connecticut Corporate Income Tax: Where’s Waldo?

The State’s corporate income tax has virtually disappeared in Connecticut over the last decade. In 1992, gross corporation tax revenues were 10.6% of total state tax revenues and net corporation tax revenues were 9.8%. By 2002, gross corporation tax revenues dropped to 4.2% of total state tax revenues and net revenues plummeted to 1.7%. These statistics rank us below Louisiana and Mississippi, not the cohort group with which we usually like to be compared. Put differently, in 1992 nearly one in every ten dollars in Connecticut taxes came from the corporate income tax; by 2002, less than one in every 50 dollars came from the corporate income tax.7

Some of the decline is attributable to actions of the Legislature: rate cuts and new exemptions, deductions, credits and other tax expenditures.8 Some is also due to the

---

6 Obviously, this Report is not meant to serve as a comprehensive, detailed, or rigorous discussion of the State tax structure. For the sake of a readable and accessible presentation, certain generalizations are inevitable. For a more systematic, less simplified, presentation, see 2005 Guidebook to Connecticut Taxes (CCH, Richard D. Pomp, ed.). The most knowledgeable practitioners in the State authored the various chapters in this Guidebook.


8 Office of Fiscal Analysis, Synopsis of Tax Reductions for Business and Worker’s Compensation Reductions (January 2001).
Legislature’s inaction and failure to appreciate the changing world of state taxation.

B. The Changing World of State Taxation and the New Challenges to the Connecticut Tax Structure ⁹

Once upon a time, issues of state and local taxation played to a small audience. Federal tax matters held center stage; state issues were relegated to the wings. But in the last twenty years or so, state tax matters have emerged from their secondary status and have moved into the spotlight.

Two federal tax acts helped move state tax issues onto center state. The first was the Economic Recovery Act of 1981 (ERTA), which gutted the federal corporate income tax by revamping the treatment of depreciation and by introducing safe-harbor leasing. Many of the largest corporations in the United States paid no federal corporate income tax for several years because of ERTA.

If ERTA’s rules on depreciation and safe-harbor leasing had been incorporated into state tax laws, many states would have suffered significant losses of tax revenue without receiving commensurate benefits. Accordingly, many states, including Connecticut, refused to embrace fully the federal changes and “decoupled” from ERTA’s rules on depreciation and safe-harbor leasing, similar to what some states have recently done with respect to the new federal bonus depreciation and estate tax changes.

ERTA had severe repercussions for state tax practitioners. By decreasing the impact of the federal income tax on many corporations, ERTA substantially increased the relative significance and prominence of state taxes, especially in states that had decoupled. In many cases, a corporation’s state income tax was greater than its federal tax—a situation that did not escape notice by CEOs, CFOs, or corporate tax managers. Corporations that had typically treated state issues as secondary to federal concerns started to shift their emphasis from compliance to planning.

⁹ This section is based on Richard D. Pomp, The Future of the State Corporate Income Tax: Reflections (Confessions) of a Tax Lawyer, in The Future of State Taxation (David Brunori, ed. 1998); reprinted in 16 State Tax Notes 939 (1999).
The second of the two federal changes was the Tax Reform Act of 1986. By lowering the federal marginal tax rates, the Act increased the after-tax cost of deductible state taxes. The Act generated additional pressure on lawyers and accountants to reduce state taxes through planning. This pressure was exacerbated by increases occurring in state taxes across the country.

The 1986 Act also eliminated many of the federal tax lawyer’s bread and butter issues, altering the complexion of a federal tax practice. Since 1986, my impression is that the real job growth in the tax profession has taken place in two areas: international tax and state taxation—and much of that growth has taken place in the accounting firms and not in the law firms or corporations.

The larger corporations have always had first-rate persons in their state tax departments. But the recent emphasis on downsizing, coupled with a corporate mentality that often views the tax department as overhead and not as a profit center, has kept in-house departments small.

There are a small number of well known, highly competent law firms with active, full-time state tax practices. They are staffed with the luminaries in the field. These firms, however, are the exception. Many large, prominent firms with traditionally strong federal tax practices have been late in recognizing the potential of the state tax market. Such firms have displayed the common bias of federal tax lawyers who traditionally have looked down on their state counterparts as the Rodney Dangerfields of the profession. But times have changed and these firms are now playing catch up; nonetheless, overall the amount of new hires by the law firms pales by comparison to the accounting firms.

The bigger accounting firms are no longer content to do compliance work and now have dynamic and growing state practices geared to planning and tax minimization strategies. Actively recruiting from law firms, industry, and government, and wooing recent graduates with attractive starting salaries (often commensurate with those of law firms), these accounting firms now claim some of the brightest minds in the business, people who combine technical virtuosity with a creativity and a boldness that were more commonly associated in the past with the federal tax bar. With their extensive network of offices, their computer simulation models, their
large staffs that can handle an array of state tax issues from challenges to property
tax valuations to unemployment compensation ratings, and everything in between,
and their increased willingness to become involved in dispute resolution issues, the
accounting firms have changed the nature of a state tax practice and have emerged
as major players.

Unlike most law firms, the bigger accounting firms typically have groups devoted
to developing multistate tax minimization strategies, which go well beyond dealing
with only issues of local law. The firms market these strategies to corporations,
sometimes for a fee based on the tax savings. This type of marketing places a
premium on: pressing formal rules to their limits, aggressively exploiting
weaknesses in state tax structures, shifting income and deductions among the states,
identifying and capitalizing on gaps in the interfacing of state laws and the lack of
harmonization, restructuring corporate entities, and the use of pass through entities.
The firms also bring to bear on state issues many of the techniques that have been
developed in the international and federal context. The only clouds on the horizon
are the new constraints imposed by Sarbanes-Oxley.

Having worked closely over the years with some of the tax maestros in the law
firms, accounting firms, and corporations, I know the intellectual firepower that the
private sector can bring to bear on the corporate income tax. The private sector is a
repository of some of the finest talent in the tax profession, whose prowess and
sophistication I greatly respect. Because of the weaknesses in many state tax
structures, including Connecticut’s, taxpayers often can control their tax liabilities,
putting a new spin on the concept of “voluntary compliance.”

The corporate and sales taxes labor under enough weaknesses without being the
target of this formidable firepower. These taxes are built on a rickety foundation,
constructed during the first half of this century to deal with what, by today’s
standards, seems to be the rather mundane taxation of manufacturing and mercantile
activities. Those were simpler times, when substantial sectors of the economy, such
as transportation, communications, banking, insurance, and power generation were
either subject to regulation or subject to significant federal controls. Multinational
corporations and conglomerates were yet to emerge, and few corporations had
substantial amounts of foreign income. It was a world in which corporations did not
electronically transfer funds around the globe and did not make much use of
financial derivatives. Large mail order houses had not yet proliferated, 800 telephone numbers were not widespread. UPS and Federal Express were in their infancy, and the Internet did not exist. Limited liability companies, limited liability partnerships, and other pass-through entities were not commonly used.

For much of the early history of the states, their taxes were low enough (and state tax administrators passive enough) that litigation was infrequent. Low rates can bury many sins. Moreover, the corporate income tax dealt with changes in the economy primarily through the development of special apportionment formulas in response to the needs of particular industries.

Today’s challenges to the Connecticut tax structure from the expanding, aggressive, and sophisticated private sector pose a qualitatively different type of problem. The antiquated structure of the tax makes it difficult to repel attacks by tax lawyers and accountants who are using modern weapons.

The first line of defense is the Connecticut tax department. Many in the tax department can go head-to-toe with their counterparts in the private sector. The Connecticut tax department, however, is understaffed and overworked. The State’s civil service salary structure cannot easily accommodate the marketable skills and higher opportunity costs of those in specialized areas like taxation. Like most state tax departments, Connecticut often loses valuable personnel to the private sector. The surprising thing is how much the State manages to accomplish with so few resources.

The second line of defense is the Connecticut Legislature. The Legislature should be busy plugging holes in the tax base, discarding inefficient provisions, providing necessary oversight and vigilance, modernizing the tax, and providing tax administrators with the tools they need. The Legislature, however, has fallen way short of this action. The Legislature has been unable to even follow its own law requiring a review of tax credits, one of the major sources of the decline in the State’s corporate income tax.
C. How Connecticut Taxes Multistate Corporations\textsuperscript{10}

1. Overview

There are three major defects in the Connecticut corporate income tax: the lack of combined reporting; the single-factor apportionment formula; and the lack of a throwback rule. All three grow out of the way that the State taxes multistate corporations, that is, those corporations that have activities with Connecticut and with other states as well.

The U.S. Supreme Court has described the problem of taxing multistate corporations as bearing "some resemblance . . . to slicing a shadow."\textsuperscript{11} As described below, the states have developed a variety of approaches for dealing with this issue.

The problem of taxing a multistate corporation can be described in terms of slicing a pizza. A corporation’s total income from all of its activities in all states determines the size of the pizza. Connecticut must then determine how much of the pizza that it can tax, in other words, what will be its slice of the pie.

The primary method for slicing the pizza is known as formulary apportionment, which is used by Connecticut and every other state with a corporate income tax. As the name suggests, a formula is used to determine the State’s slice of the pizza pie. Connecticut uses various formulas.\textsuperscript{12} The formula used for manufacturers is simple and controversial. A manufacturer divides its Connecticut sales, if any, by its total sales. The resulting fraction is the percentage of the pizza that Connecticut taxes. If the manufacturer has no Connecticut sales, it will have a zero fraction and pay only the minimum corporate income tax of $250. This special formula for manufacturers is known as the single-factor sales formula. Other corporations use a more traditional formula, described below, that takes into account their sales, property,

\textsuperscript{10} For a fuller discussion, see 2005 Guidebook to Connecticut Taxes, supra note ???, Ch. 9-15. Dick Tomeo of Robinson and Cole, one of Connecticut’s leading practitioners, authored the chapters on the structure of the Connecticut corporate income tax.

\textsuperscript{11} Container Corp. of America v. Franchise Tax Board of California, 463 U.S. 159, 192 (1983).

\textsuperscript{12} Different formulas apply to manufacturers, motor bus companies, motor carriers, air carriers, securities brokerage services corporations, regulated investment company services corporations, corporate investments in Connecticut partnerships, credit card companies, financial service companies, and broadcasters. See Ch. 11, note ???
and payroll. Combined reporting, a methodology that the State does not use, is a logical extension of formulary apportionment and is described below.\textsuperscript{13}

2. The Development of Formulary Apportionment

Under the U.S. Constitution, Connecticut may tax that portion of a corporation’s income that has a sufficient connection or relationship (nexus) with the state. There are three approaches for determining the amount of a corporation’s taxable income that can be taxed: separate accounting, formulary apportionment, and specific allocation.

Formulary apportionment and combined reporting are best understood as a response to the defects inherent in separate accounting. Separate accounting is based on the premise that it is both possible and practical to isolate the taxable income of portions of the business that a corporation carries on within a state.

To illustrate the workings of separate accounting, consider a corporation that manufactures a product in Connecticut, warehouses it in New York, and sells it through a sales division in New Jersey to a customer in Massachusetts. In calculating its Connecticut tax using separate accounting, the corporation would assume that its manufacturing activities in Connecticut were conducted by an independent business entity that sells the manufactured good to a third party that will warehouse and sell it.

One approach to calculating the manufacturing entity’s taxable income in Connecticut is to determine the hypothetical price at which the assumed entity manufacturing the good would sell it to an assumed independent and unrelated third party. That hypothetical arm’s length sales price would determine the assumed entity’s sales proceeds, which in turn would determine the amount of its taxable income.

Both theoretical and practical problems limit the utility of separate accounting.

Administratively, determining the arm’s length transfer price is difficult, if not impossible, in many cases. One way to determine a hypothetical transfer price in the above example would be to examine the prices at which comparable manufacturers sell comparable goods to their independent distributors. But comparable manufacturers might not exist, or if they exist, they might not manufacture comparable products, or if they do, they might not sell them to independent distributors.

Even if comparable transactions exist, other hurdles remain. Comparable transactions provide only an estimate of the relevant transfer price. Such transactions may establish a range within which the appropriate transfer price might fall, but if this range is too wide, no useable information will be provided.

Establishing what might be hundreds or thousands of hypothetical transfer prices is another severe administrative problem. Separate accounting is an expensive system to operate for both the public and private sectors. A state tax department would not have the resources to police the large number of corporations engaged in cross-border transactions. Small and medium-sized businesses would not have the capacity to implement separate accounting and perhaps neither would larger corporations.

Moreover, under separate accounting a theoretical flaw arises whenever a corporation’s overall profitability is attributable to activities that are interdependent, integrated, or synergistic. In such a case, involving what is known as a unitary business, each activity of the unitary business contributes to the business as a whole, and reasonable efforts at imputing a transfer price for a hypothetical transaction might fail to capture the inherent transfers of value. As a common example, consider the transfer of value that occurs when a vice president of manufacturing telephones a vice president of research and design and resolves a problem in a way that will increase corporate profitability. Assume all of the manufacturing is done in upstate New York and all of the research and design activities occur in Connecticut. Separate accounting cannot impute a value to that telephone call in order to calculate Connecticut’s and New York’s appropriate share of the corporation’s tax base.
As a further illustration, consider a corporation that operates two stores. One store operates in Connecticut and the other operates in New Jersey. The corporation buys its inventory centrally on behalf of its two stores. On a separate accounting basis, the corporation reports a high profit to New Jersey and breaks even in Connecticut.

Suppose, however, that if the Connecticut store were closed, the profits of the New Jersey store would decline. This result might occur if the inventory sold by the Connecticut store allowed the corporation to obtain a volume discount on the entire inventory it purchased, including that sold by the New Jersey store. In other words, even though the Connecticut store appears based on separate accounting to break even, it actually contributes to the corporation’s overall financial profitability. Separate accounting might reach a misleading result under these circumstances. As the U.S. Supreme Court has recognized, separate accounting “often ignores or captures inadequately the many subtle and largely unquantifiable transfers of value that take place among the components of a single enterprise.”

3. A Detailed Look at Connecticut’s Formulary Apportionment

Because of the theoretical and administrative problems inherent in separate accounting, the states developed an alternative method—formulary apportionment—for dividing and sharing the tax base of a corporation. As the name suggests, a formula is used to apportion a corporation’s taxable income to those states in which it has activities. More specifically, a formula is used to generate an apportionment percentage that is based on the relative amount of a taxpayer’s in-state activities or “presence.”

Like many states, Connecticut employs various apportionment formulas. For non-manufacturers that derive income from the sale or use of tangible personal or real property the formula is as follows:

\[ T_{\text{CT}} - T_{\text{WW}} \times \frac{1}{4} (2 \times \frac{\text{Sales}_{\text{CT}}}{\text{Sales}_{\text{WW}}} + \frac{\text{Payroll}_{\text{CT}}}{\text{Payroll}_{\text{WW}}} + \frac{\text{Property}_{\text{CT}}}{\text{Property}_{\text{WW}}}) \]

Where:

\[ ^{14} \text{Container, supra note, at 164-65.} \]
\[ ^{15} \text{See Pomp and Oldman, supra note 9, at pp. 10-10 –10-28.} \]
(1) $T_{IW}$ is the amount of the corporation’s worldwide taxable income, computed under Connecticut law, which is apportioned to Connecticut;

(2) $T_{IC}$ is the amount of the corporation’s worldwide taxable income apportionable under Connecticut law;

(3) $Sales_{CT}$ is the amount of the corporation’s sales (or receipts) within Connecticut;

(4) $Sales_{WW}$ is the amount of the corporation’s worldwide sales (or receipts);

(5) $Payroll_{CT}$ is the amount of the corporation’s payroll in Connecticut;

(6) $Payroll_{WW}$ is the amount of the corporation’s worldwide payroll;

(7) $Property_{CT}$ is the amount of the corporation’s property located in Connecticut;

(8) $Property_{WW}$ is the amount of the corporation’s worldwide property.

Most manufacturers and corporations deriving income from other than the sale or use of tangible personal or real property use a single-factor apportionment formula, the numerator of which is gross receipts from business carried on within Connecticut and the denominator of which is gross receipts from business carried on everywhere. For these corporations, which includes security brokerage services, credit card income from certain banks, financial service companies, and broadcasters, the apportionment formula is as follows:

$$TI_{CT} = TI_{WW} \times (Sales_{CT}/Sales_{WW})$$

A corporation calculates its tax in Connecticut by first calculating its apportionable worldwide taxable income under Connecticut law. This amount represents a corporation’s preapportionment tax base, or the size of the pizza pie. The corporation then calculates its apportionment percentage, based on the above formulas. Next, the corporation multiplies its worldwide apportionable taxable income by the apportionment percentage. The result is the amount of the taxable income of the corporation that is apportioned to Connecticut or the slice of the pizza pie that the State can tax.

Connecticut has long employed a system of formulary apportionment for determining the Connecticut taxable income of a corporation that is operating within and without Connecticut through multiple divisions or branches. In adopting

---

19 See 2005 Guidebook to Connecticut Taxes, supra note ???, Ch. 11.
formulary apportionment, the Connecticut Legislature has implicitly concluded that apportioning income by payroll, property, and receipts (sales) is superior, as a system of tax accounting, to a system based on the separate transactions of the taxpayer, as reflected on its books of account. But what Connecticut does not do is follow this philosophy when a corporation conducts its activities through the use of related entities rather than through divisions. That is, if a corporation were to incorporate one of its divisions and operate it as a subsidiary, Connecticut now reverts back to using the separate books of accounts of each corporation. Put differently, Connecticut, unlike other states, does not utilize a technique of accounting known as combined reporting. Its failure to do so, along with the lack of a throwback rule and the single-factor apportionment formula, means the State is vulnerable to a panoply of orthodox tax planning techniques.

D. The Case for Combined Reporting

1. Combined Reporting Emphasizes Substance over Form

The case for combined reporting is a logical extension of the case for apportioning by formula the business income of an individual corporation. The central element of that case is that the substance of the business activities in the state should control, not the organizational structure of the business entity or entities conducting those activities. That is, whether a business enterprise chooses to have numerous divisions or whether it chooses to incorporate those divisions and operate them as subsidiaries should have as little impact as feasible on the amount of Connecticut income tax paid by that enterprise.

Consider, for example, the earlier example of a single corporation that manufactures a product in Connecticut, warehouses it in New York, and sells it through a sales division in New Jersey to a customer in Massachusetts. In calculating its Connecticut tax, that corporation would calculate its apportionment percentage by taking into account all of its factors in Connecticut, New York, New Jersey, and

---

17 Connecticut law refers to combined reports, but not in the sense that is discussed in the text. Connecticut uses the term "combined return" for what is usually called a "consolidated return." Essentially, the Connecticut combined return is a single return for a group of affiliated corporations in which the net income of each member is separately determined and apportioned and then combined. This approach does not deal with the problems identified in the text. See Ch. 13, para. 1503, note ???

18 See McIntyre, Mines, and Pomp, supra note 8, at 702-738.
Massachusetts. That percentage would be used to apportion its unitary business income to Connecticut.

Suppose, however, that the nonmanufacturing activities are incorporated in a new U.S. subsidiary. Assume the corporate structure now consists of a parent corporation, which manufactures in Connecticut, and the subsidiary, which warehouses the inventory in New York, and sells the product through a sales division in New Jersey, to a customer in Massachusetts. The parent sells the inventory to its subsidiary at a price set by the parent—a price that might have been purposely set to reduce Connecticut tax.

One way to deal with the above situation is to do essentially what Connecticut does and apportion the income of only the corporation that has a nexus itself with Connecticut. That is, only the income and factors of the parent corporation would enter into the calculation of the Connecticut income tax. States that calculate the taxable income and apportionment percentage of the parent and ignore the taxable income and factors of the subsidiary are known as separate entity states.

Separate entity states like Connecticut treat related corporations as if they were unrelated strangers. Because a stranger’s income and factors would not usually be taken into account in calculating another corporation’s income and factors, the existence of the subsidiary has no bearing on calculating the parent’s apportionable taxable income. Conversely, the income and factors of the parent would have no effect on calculating the subsidiary’s apportionable taxable income.

States that take the opposite approach, ignoring the formal corporate structure of a unitary business by treating unitary subsidiaries as if they were divisions or branches of the parent, are known as combined reporting states. California is the intellectual leader of this technique. A combined report would treat the parent and the subsidiary as if they were divisions of the same unitary business. Intercorporate transactions between them would be eliminated and the income reported on the books of the subsidiary would be added to the income reported on the books of the parent and modified pursuant to state law. Similarly, the apportionment percentage would be calculated by taking into account the factors of both the parent and subsidiary.
A combined report is an accounting document prepared on behalf of a group of corporations engaged in a unitary business. It contains a tabulation of the aggregate taxable income derived by the members of the group from that unitary business. The initial step in preparing a combined report is to determine the scope of the group’s unitary business. In computing the aggregate taxable income of group members from that unitary business, transactions between members of the group generally are eliminated. The combined report also includes a tabulation of each group member’s apportionment factors used in the apportionment formula. The corporations that are included in a combined report are sometimes referred to as a combined group or a unitary group.

A combined reporting state requires the unitary group to use the combined report to determine the amount of the group’s taxable unitary income apportioned to the state. That amount equals the aggregate taxable income of the group, which should then be multiplied by each member’s apportionment percentage. The apportionment percentage is determined by applying the apportionment formula to each corporation included in the group. If a corporation included in the group had a five percent apportionment percentage, it would apply this to the group’s unitary income. The tax is not imposed on the unitary group itself. Rather, each member of the group having nexus with the state is made taxable on its assigned share of the unitary income apportioned to the state under the apportionment formula.¹⁰

2. Combined Reporting is a Better Measurement of Connecticut Income

The U.S. Supreme Court has acknowledged that combined reporting is both a better method for measuring the income of a unitary business and a safeguard against taxpayer manipulation: “The problem with [formal geographical or transactional accounting, including separate accounting] is that formal accounting is subject to manipulation and imprecision, and often ignores or captures inadequately the many subtle and largely unquantifiable transfers of value that take place among the components of a single enterprise. The unitary business/formula apportionment method is a very different approach to the problem of taxing businesses operating in more than one jurisdiction. It rejects geographical or transactional accounting, and instead calculates the local tax base by first defining the scope of the unitary

¹⁰ Id. at 712-716.
business of which the taxed enterprise’s activities in the taxing jurisdiction form one part, and then apportioning the total income of that unitary business between the taxing jurisdiction and the rest of the world on the basis of a formula taking into account objective measures of the corporation’s activities within and without the jurisdiction.\textsuperscript{20}

The premise of combined reporting is that the synergies, interdependencies, and sharing of knowledge, know-how, and experiences that are typical features of a unitary business often cannot be properly captured by separate entity accounting. By taking into account only the income and factors of the corporation having nexus with the taxing state, separate-entity accounting often cannot provide an accurate measurement of the income of the unitary business that is properly attributable to that state. A combined reporting regime, in contrast, avoids this failing by automatically apportioning all of the unitary business income of a unitary group among the states where it is engaging in meaningful business activities.

Combined reporting also helps create a level-playing field for intrastate corporate groups, whether large or small and whether conducting an intrastate or an interstate business. A unitary group that is engaged in business only in Connecticut is taxable on all of its income. The imposition of combined reporting would not change that result. A multistate corporate group, however, is currently able to reduce its Connecticut apportionable income, and hence its Connecticut income taxes, by isolating highly profitable parts of its unitary business in corporations that are not taxable in Connecticut, or by moving assets into tax havens. Combined reporting would nullify those efforts.

3. **Combined Reporting Protects Against Tax Avoidance**

The many techniques that tax planners have developed to exploit the weaknesses of a separate reporting system like Connecticut’s are too numerous to catalog. One popular strategy for a corporate group is to isolate nexus-creating activities and property of its unitary business in one corporation. That corporation is taxable by Connecticut on an apportioned share of its taxable income. Other members of that group, however, have no nexus-creating activities or property in Connecticut, and

\textsuperscript{20} Container, supra note 7, at 164-65 (citations omitted). These sentiments were repeated in part in Barclays Bank, 512 U.S., at 303-04.
are thereby insulated from tax by the State on any part of their unitary income. As a result, Connecticut only gets to tax that portion of the income of the unitary group that appears on the books of account of the corporation having nexus with the State, even though all of the members of the corporate group are engaged in the same unitary business.

Another technique used by multistate and multinational corporate groups to minimize Connecticut income taxes is to create an intra-group expense, such as a management fee, on the books of a corporation having nexus with the State that is payable to another member of the unitary group located outside Connecticut, typically in a tax haven. Another technique is for the members of a unitary group to set the prices charged for the transfer or provision of goods and services to related persons in a way that allows them to shift income from Connecticut to low-tax states. Yet another technique is to transfer income-generating assets to a subsidiary located in a state with no corporate income tax, such as Nevada, or one that has favorable rules on the taxation of intangible income, such as Delaware. 21 Tax planners may use some or all of these techniques simultaneously.

A separate reporting state is not defenseless against these tax-planning techniques. Connecticut, for example, has adopted a statute that adds back Intercorporate interest and costs and expenses that are attributable to transactions in intangibles that occur between related parties, such as royalties. 22 While a useful change, this statute deals only with two situations and does not begin to address all of the other ways to exploit the lack of combined reporting. For example, the statute would not add back management fees and does nothing to address the strategy of moving income-generating assets to tax haven corporations.

Combined reporting directly blocks these techniques and other similar tax-minimization strategies. With combined reporting, the isolation of nexus-creating activities in a single corporation is impossible because the state imposes its income tax and an apportioned share of the aggregate income of the members of the unitary group. Deflecting income by manipulating transfer prices or by setting up inter-


22 See Ch. 10, para. 1002, note ??
company payables is unsuccessful because transactions between members of a unitary group are washed out in preparing the combined report.

The advantages of combined reporting in combating tax avoidance are nicely illustrated by examining the treatment of tax-haven holding companies under separate reporting and combined reporting. The use of a holding company is a common tax-minimization technique in Connecticut and other separate reporting states. In the typical approach, the holding company is domiciled in a state that has no income tax or that has favorable rules on the taxation of passive income. One state with these favorable rules is Delaware. Under Delaware law, a corporation is not subject to Delaware tax if its activities in that State are limited to maintaining and managing intangible assets that generate income such as capital gains, dividends, interest, and royalties.

One strategy involves moving income-generating assets to Delaware. Banks, for example, sometimes move their bond portfolio to Delaware, effectively sheltering their interest income from Connecticut income taxation. Combined reporting would nullify that strategy because the interest income would be included in a bank’s apportionable income.

A separate reporting state like Connecticut can assert a variety of arguments to defeat tax avoidance schemes, and as described above, the State has adopted a limited statutory response. The advantage of combined reporting is that it undercuts not only yesterday’s tax shelters, which the Legislature is typically responding to, but also tomorrow’s. The tax advantage of holding companies, for example, are nullified without the state having to prevail after long and costly ad hoc litigation and without always being in the position of reacting to yesterday’s problems. In a combined reporting state, the income of the holding company (often substantial) is added to the pre-apportionment tax base of the unitary group, and the factors of the holding company (often modest) would be taken into account in applying the apportionment formula.23

4. Combined Reporting is a Neutral Method of Accounting

23 Id.
A combined report is not biased against taxpayers and does not systematically lead to a higher tax than would separate entity reporting. Both a corporation’s taxable income and its apportionment percentage will change when a combined report is filed. Whether these changes will lead to a higher or lower amount of tax cannot be predicted a priori. To take an extreme example, suppose a parent corporation with nexus in Connecticut has a unitary subsidiary operating at a loss that is greater in amount than the profit of the parent. In this case, a combined report would reduce the parent’s liability to zero.

Because combined reporting undercuts so many orthodox tax planning techniques, its adoption is almost certainly likely to raise revenue. But the issue of what the State should do with this increased revenue is independent of whether combined reporting should be adopted. The State could, for example, give back whatever money is raised through reductions in the corporate tax rate.

5. Identifying a Unitary Business

Combined reporting with formulary apportionment is applied to unitary businesses. The term “unitary business” is a flexible concept. The U.S. Supreme Court has acknowledged that “the unitary business concept is . . . not, so to speak, unitary: there are variations on the theme, and any number of them is logically consistent with the underlying principles motivating the approach.” 24 Instead, it has identified some of the indicia of a unitary business. Those indicia include the following:

1. Unity of use and management; 25
2. A concrete relationship between the out-of-state and the in-state activities that is established by the existence of a unitary business; 26
3. Functional integration, centralization of management, economies of scale; 27
4. Substantial mutual interdependence; 28 and
5. Some sharing or exchange of value not capable of precise identification or measurement beyond the mere flow of funds arising out of a passive investment or a distinct business operation. 29

24 Container, supra note 7, at 167.
26 Container, supra note 7, at 166.
29 Container, supra note 7, at 166.
6. Opposition to Combined Reporting

If the case for combined reporting is so overwhelming, as the above discussion suggests, why have more states not embraced it? One possible answer is that it was not until the U.S. Supreme Court’s 1983 decision in Container and its 1994 decision in Barclays\(^{30}\) that constitutional doubts about combined reporting were eliminated. Secondly, the boom years of the 1990’s obscured the erosion of state corporate income taxes and the need for combined reporting.

But probably the major reason is business opposition. No one should expect that multinational and multi-state firms would embrace a proposal that puts some teeth into the corporate income tax. Many of them will oppose it for the same reason the Legislature should embrace it: because it is a fairer, better method of taxation that will convert the Connecticut corporate income tax from a voluntary one into a real one. Right now, the Legislature does not fully control the corporate income tax base: the largest corporations do. Why would these corporations want to give up that power?

Predicting the arguments made against combined reporting is easy. The debate is typically not over the merits of whether combined reporting is a better system or not. Instead, opponents sometimes argue that combined reporting will lose money in the short term because tax administrators will be unfamiliar with the method and taxpayers will game the system.

There are at least two possible answers. The first is to have a rule that if the Connecticut taxpayer is included in a combined report in any other state, it will presumptively have to file a combined report in Connecticut unless it can prove that separate entity accounting would produce a better result or that the Connecticut law is sufficiently different from the other states that a combined report is not required.

The second is to use combined reporting as an alternative tax to the existing corporate income tax. In other words, taxpayers will pay the higher of the tax calculated under the current rules or under combined reporting. In this manner, Connecticut cannot possibly lose money from adopting combined reporting.

In Connecticut, unlike in other states, businesses can argue that combined reporting is unnecessary because the Legislature has adopted a statute that deals with interest and royalties. But this statute has limited application and deals with two specific situations out of an arsenal of techniques that the private sector has for exploiting the lack of combined reporting.

Sometimes opponents of combined reporting cloak themselves with the banner of economic development. Adopting combined reporting will be bad for Connecticut's "business climate," will chase businesses out of the State, discourage new ones from coming to Connecticut, and reduce jobs. It is a wonder they do not predict that combined reporting will turn Connecticut into a pre-agrarian economy of pagan worship. At best, these charges are hyperbolic and unproven. At worst, it suggests that the only corporate tax that is compatible with a good business climate is a tax that corporations are able to avoid.

Unfortunately, as a political matter, business opposition cannot be ignored. Moreover, whether the issue is combined reporting, the single-factor apportionment formula, tax credits, or a panoply of other pro-business issues, the Legislature is faced with similar arguments. Because of the importance of this issue, it is comprehensively treated below in Part Five. However, some specific observations about the economic effects of combined reporting follows.

No rigorous empirical data exist on the economic effects of combined reporting. What limited evidence exists supports the discussion in Part Five and rebuts the negative claims of the business community that the adoption of combined reporting would be harmful to a state's economy.

---

31 In his Senate confirmation hearings, Treasury Secretary-designate Paul O'Neill stated: "As a businessman I never made an investment decision based on the tax code... If you give money away I will take it, but good business people don't do things because of inducements. Joseph Kahn, Treasury Choice Varies from Bush on Tax Outlook, N.Y. Times, Jan. 18, 2001, at A-1, A-16. Roger Smith, former Chairman of General Motors, whose Saturn plant was sought after by nearly every governor, stressed that tax breaks can't make a silk purse out of a sow's ear. Detroit Free Press, Mar. 18, 1985, at 1A. According to Smith, "we're going to be in business for the long term... you've got to look at more than just what the great big cookie is that's coming in on the plate." Id. Consistent with this philosophy, the first state GM eliminated as a site for the Saturn plant was Florida, a state that is perceived as having an extremely favorable tax climate (e.g., no personal income tax, no estate tax, a double-weighted receipts factor, and no worldwide combined reporting). For an overview of the business climate literature, see Peter D. Enrich, Saving the States, 110 Harv. Law Rev. 392-97 (1996).
The combined reporting states are disproportionately among the most economically successful. Since manufacturing employment peaked in the United States in 1979, combined reporting states constituted: 

Four of the top five states in manufacturing job growth,
Seven of the top ten states in manufacturing job growth, and
Ten of the seventeen states with positive manufacturing job growth.

From 1990 to 1995, manufacturing jobs in New Hampshire, a combined reporting state, grew 3% while manufacturing jobs in Massachusetts, a separate entity state, fell 2.3%.

Intel has located more jobs and investment in Oregon, a combined reporting state, than in any other state over the past 25 years. Finally, being the most aggressive practitioner of combined reporting did not stop California from becoming the high-tech capital of the country.

These statistics are particularly impressive given that only 16 states use combined reporting.

These observations, when combined with the robust literature on taxation and economic development reviewed in Part Five, point in the same direction: that a state probably should not fear adverse economic effects from the adoption of combined reporting. The debate will never be conclusive but certainly the burden of proof should be on the business community, which is advocating a position that is belied by approximately thirty years of studies plus anecdotal evidence.

Moreover, Connecticut would seem to have less reason to fear than other states. According to a recent study commissioned by the Council on State Taxation (COST), Connecticut is not a particularly high business tax state. When arrayed by “business share of all taxes,” Connecticut ranks dramatically lower than the rest of the country, and lower than its four contiguous neighbors (43rd in the country for

---

30 Data supplied by Michael Mazero of the Center on Budget and Policy Priorities.
Connecticut, compared to 20th for Rhode Island, 34th for New York, and 42nd for Massachusetts). "Business taxes per dollar of capital income" shows the same trend (40th for Connecticut compared to 25th for Rhode Island, 14th for New York, and 38th for Massachusetts). These numbers should be comforting for those who are the type to take comfort in statistical aggregates. Politically, they are useful, which is why many organizations generate such data. The limitations on the use of such data and their abuse and misuse are discussed in Part Five.

Businesses have recently modified the preceding argument a bit, by emphasizing how much they pay in all taxes, including sales and property taxes. Apparently, this strategy is supposed to deflect attention away from how little they might pay in the corporate income tax.

I have never understood why this strategy should work. If tax minimization strategies have emasculated the corporate income tax, it is no answer to point out that businesses also pay other taxes—even if these taxes are substantial. To be sure, whether business is somehow paying more than is appropriate under the property tax or the sales tax is certainly the subject of legitimate debate. But it does not answer the question of whether each business is paying its appropriate share of the corporate income tax.

For example, suppose a tax cheat were being prosecuted for tax evasion. His defense is that he pays high property and sales taxes. This defense would be laughed out of court. So why should we take a variation of it seriously when it is gussied up with fancy graphs and printouts showing how much corporations pay in other taxes?

Let legislators clean up the corporate tax; when that job is done, they can turn their attention to other taxes. Why should legislators be precluded from dealing with the corporate income tax because other taxes might need to be cleaned up as well? The media might be misled by this numerical legerdemain, but legislators should not.

E. The Single-Factor Apportionment Formula

As described above, the single-factor sales apportionment formula applies to manufacturers, security brokerage services, financial service companies, and
broadcasters:

$$TI_{CT} = TI_{WW} \times (Sales_{CT}/Sales_{WW})$$

For a manufacturer based in Connecticut, this formula is much more favorable than the State's traditional formula that takes into account property and payroll, in addition to sales. A manufacturer that sells only outside of Connecticut, such as a defense contractor, will have a zero numerator and consequently apportion none of its income to Connecticut, paying only the minimum tax of $250. The shift to a single-factor formula from a three-factor formula reduces the tax on in-state corporations and increases it on out-of-state corporations.\(^{34}\) No doubt that shift is part of the attractiveness of the single-factor formula. Similar observations apply to the other industries eligible for the single-factor apportionment.

The single-factor apportionment formula for manufacturers was adopted by the Legislature in response to a report submitted by an ad hoc committee chaired by the then-tax commissioner. Considering that the private sector members of the committee were manufacturing companies, business associations, and practitioners, the recommendation that the Legislature adopt single-factor apportionment was predictable. The report issued by the ad hoc committee is short on analysis but seems to assume that any tax reduction for manufacturers must be good for the State.\(^{35}\)

The single-factor sales apportionment formula has become fashionable and Connecticut has joined other states in adopting it. Nonetheless, this trend of single-factor apportionment raises a number of serious and troubling problems that were unaddressed by the Legislature. The OFA estimated that for fiscal year 2002 the shift from the double-weighted sales factor to the single-factor apportionment formula resulted in a loss of $60 million in corporate tax revenues and estimated that less than 50 taxpayers benefited from the change.\(^{36}\)

A recent national study, of which excerpts follow, heavily criticizes this trend

\(^{34}\) See Pomp and Oldman, supra note ???, at ???
\(^{35}\) Factor Relief for Manufacturers, Ad Hoc Committee Final Report (January 28, 2000).
\(^{36}\) OFA, Synopsis of Tax Reductions to Business and Worker’s Compensation Reductions (January 4, 2001).
towards a single-factor formula.\textsuperscript{37}

"If all states adopted a sale-only formula, most of the tax savings received by particular multistate corporations in particular states would be offset by higher tax payments by these same corporations in other states. That is why multistate corporations are pushing adoption of the single sales factor formula in a limited number of states but not on a nationwide basis. By creating a situation in which apportionment formulas are not uniform among the states, multistate corporations can minimize their aggregate tax liability for all the states in which they do business by ensuring that the tax cuts they receive in some states are not offset by tax increases in other states."\textsuperscript{38}

"A single sales factor apportionment formula undercuts one of the fundamental rationales for a corporate income tax, which is that a corporation should pay taxes to a state as compensation for the benefits it receives from state services. Corporations benefit from a wide range of governmental services that specifically relate to the extent of property and payroll in a state. States often underwrite local government police and fire protection for the corporation's property and employees. States provide roads and other transportation services to allow access to factories by suppliers and employees and the shipment of goods to markets. States also fund K-12 and higher education services that enable many businesses to find workers with adequate skills. The change from a property-payroll-sales formula to a salesonly formula substantially reduces the corporate tax burden of businesses that arguably are benefiting the most from public services in a state and unfairly shifts the tax burden to out-of-state businesses that benefit from state services to a lesser extent."\textsuperscript{39}

"It certainly is legitimate for a state in which a business' customers are located to tax a share of its profit even if the business does not engage in production in that state. After all, 'market states' also provide services that benefit out-of-state companies—such as the roads they use to transport their goods to their customers and a judicial system that ensures that customers pay their debts. But a single sales factor formula goes too far in imposing

\textsuperscript{37} See Michael Mazerov, supra note ???, at x.
\textsuperscript{38} Id. viii (emphasis in the original).
\textsuperscript{39} Id. xvi.
corporate income tax liability solely on the basis of customer location rather than in proportion to both customer and production location.

“Changing from a three factor apportionment formula to a single-factor, sales-only formula heightens tax inequities among other groups of corporations as well. For example, large corporations are much more likely to reap tax savings from a sales-only formula than are smaller corporations, many of which may be family-owned. If corporations are not taxable outside their home states, they typically are not permitted to apportion any of their profits to other states for tax purposes. Small corporations are less likely than large corporations to be taxable in more than one state; either all of their customers are in their home state or their out-of-state customers are served without setting up the out-of-state physical facilities that would obligate the business to pay corporate taxes to other states. If a corporation is not permitted to apportion some of its profit to other states, then by definition it pays tax on 100 percent of its profit to its home state and is not affected by changes in the apportionment formula. Since small corporations are more likely than large ones to fall into this category, large corporations are likely to obtain a disproportionate share of the tax savings that flow from the switch to a single sales factor formula.”

This description certainly applies to Connecticut. Surprisingly, the ad hoc committee that recommended the adoption of the formula was well aware that “[o]ver 90% of the manufacturers in Connecticut have 100 or fewer employees, and it is likely that a large number of such small manufacturers do not now qualify for apportionment of their income. Accordingly, 100% of their income is taxable by the State of Connecticut. That is, none of these small Connecticut manufacturers would benefit from single sales factor apportionment; the benefit is limited to corporations that are taxable in more than one state and thus are permitted to apportion their income. . .”

The shift to a single-factor formula is defended primarily on economic development grounds. Indeed, it has become routine to defend any pro-business change in a state’s tax system on economic development grounds. As a recent study suggests, however, any faith that jobs will be created or manufacturing expanded by a shift to

---

40 Id. xvii.
41 Supra note ???, at 7.
the formula is misguided.42

"Like many proposals to modify state corporate tax codes, the change to a single sales factor apportionment formula is being sold as an economic development incentive that will stimulate the creation of substantial numbers of new, high-paying jobs in any state that adopts it...a change from the traditional three-factor formula to a sales-only formula tends to cut the corporate tax payment of any corporation that is producing goods in a state but selling most of them outside the state where the production occurs. Accordingly, proponents of the change argue that adopting a single sales factor formula will:

- encourage businesses that tend to export most of their production to markets outside their home states to expand their existing facilities and payrolls rather than establish new plants in other states; and

- attract out-of-state businesses seeking sites for major new facilities that are expected to export most of their output to nationwide or worldwide markets."

"These claims are substantially overstated—if they have any validity at all...states adopting a single sales factor apportionment formula are likely to find it a relatively ineffectual incentive for job creation and investment."43

"The claim that adoption of a single sales factor formula is likely to be a potent economic development incentive is contradicted by a large body of research on the effect of state and local taxes on state economic competitiveness."44

"Massachusetts’ experience following its 1995 enactment of a single sales factor formula illustrates well the ineffectiveness and wastefulness of the formula as an economic development incentive. Massachusetts enacted the sales-only formula in response to a threat by the Raytheon Company—a major defense contractor and the

42 See Mazerov, supra note ???
43 Id. x (emphasis in original).
44 Id.
state’s largest industrial employer—to close plants in the state unless it were
granted substantial tax relief. A sales-only formula was high on the company’s wish
list as a mechanism for such relief. The Massachusetts legislature initially attempted
to limit the application of a single sales factor formula to defense contractors, but
this proved politically impossible. All non-defense manufacturers were also granted
a sales-only formula—albeit on a phased-in schedule.”

“What has Massachusetts received for its $80 million-plus annual ‘investment’ in
its manufacturing industries? Although the relatively brief experience of a single
state with a sales-only formula does not prove that it is an ineffective development
incentive, the initial experience in Massachusetts has not been encouraging:

Between 1995 and 2000, Massachusetts lost more than 10,000 manufacturing jobs.
This 2.3 percent decline was more than seven times larger than the 0.3 percent
decline in manufacturing jobs for the U.S. as a whole over the same five years.
Only seventeen states had a steeper rate of decline in manufacturing jobs than did
Massachusetts over this period. The Boston Globe concluded ‘More than four years
after Massachusetts enacted a controversial tax break to save manufacturing jobs in
the state, there’s scant evidence the policy has worked as advertised.’

The job-creation record has been just as disappointing in the defense industry,
which, unlike the rest of the manufacturing sector, was granted single sales factor
treatment immediately. Raytheon’s performance since 1995 includes the closure or
sale of several major Massachusetts facilities and a 3,000-person reduction in its
Massachusetts workforce. This has stirred up considerable anger on the part of
labor organizations that had supported the company’s demand for tax relief. In
order to qualify for single sales factor treatment (through 1999), defense contractors
were required to maintain their Massachusetts’ payrolls at 90 percent of their 1995
levels. In the face of massive layoffs of its blue-collar workforce in Massachusetts,
Raytheon managed to meet this requirement largely by increasing the salaries of
engineers and managers. This has sparked legislation to renew the job maintenance
requirement and to convert the 90 percent of 1995 payroll requirement to 90 percent
of 1995 employment. The sponsor of this legislation, State Senator Susan C. Fargo,
has labeled the single sales factor formula granted to defense contractors ‘payoffs for layoffs.’”

“Raytheon’s defenders assert that no matter how many Massachusetts jobs the company has eliminated, even more would have been lost had the state not enacted the sales-only formula. Raytheon has gone so far as to release data showing that the reduction-in-force in its Massachusetts facilities has been far lower in both absolute and relative terms than that in other states—suggesting that the state’s adoption of the sales-only formula was a wise investment nonetheless. There is a problem with this interpretation of the data, however. The state in which Raytheon reduced its workforce the most was Texas—a state with a single sales factor formula. Raytheon has not explained how the single sales factor formula is responsible for the preservation of Massachusetts jobs yet has not had a similar effect in Texas. Moreover, press reports indicate that Raytheon has shifted at least one major defense contract to facilities in Arizona—a state without a single sales factor formula.”

“Unarguably, Raytheon has suffered a considerable decline in its economic fortunes because of cutbacks in defense contracting since the end of the Cold War; some job reduction in Massachusetts may have been inevitable. But that really is the point. Corporations will accept tax breaks gladly if states offer them and will even lobby strongly to obtain such breaks. In the final analysis, however, corporations almost always will locate their investments and employees where fundamental business considerations demand. Most tax breaks simply confer wasteful windfalls on corporations, rewarding them for creating jobs they would have created anyway—or, in Raytheon’s case, even for eliminating jobs.”

“By 1995, five states had enacted a single sales factor formula for manufacturers—Iowa, Massachusetts, Missouri, Nebraska, and Texas. (Massachusetts implemented a sales-only formula immediately for defense contractors and phased it in between 1996 and 2000 for other manufacturers.) The subsequent experience of these states certainly does not indicate that the sales-only formula is a powerful stimulant to investment and job creation by such corporations.

45 Id. xi (emphasis in original).
• Massachusetts lost 2.3 percent of its manufacturing jobs (10,400 positions) between 1995 and 2000, and Missouri lost 4.1 percent of its manufacturing jobs (17,400 positions) over the same period. The rate of decline in manufacturing employment in the two states was more than seven times greater than the rate of decline in total U.S. manufacturing employment, which declined by 0.3 percent between 1995 and 2000.

• Nebraska, Texas and Iowa did experience net growth in manufacturing employment between 1995 and 2000 of 6.9 percent, 5.2 percent, and 4.3 percent, respectively. However, only Nebraska was among the top ten corporate income tax states with the fastest rate of growth in manufacturing employment between 1995 and 2000.

• Five of the ten states with the fastest manufacturing job growth between 1995 and 2000 still use the traditional property-payroll-sales formula that gives only a one-third weight to sales. This is hardly compelling support for the argument that the greater the weight a state's formula gives to the sales factor, the greater is its advantage in attracting "export-oriented" corporations.

• Recent data on major plant location and expansion decisions also do not lend much support to the argument that adoption of a single sales factor formula is likely to have a major positive impact on a state's economic competitiveness. According to Site Selection Magazine, 51 facilities valued at $700 million or greater were placed in states with corporate income taxes between 1995 and 2000. Three of the five states that had a single sales factor formula in effect or phasing in during this period—Indiana, Missouri, and Nebraska—did not capture a single one of these major plant locations/expansions. Only six of the 51 facilities were sited in single sales factor states. Texas lured four facilities, a rate of investment roughly in line with its share of overall U.S. economic output. Massachusetts had an above-average success rate in attracting major plants; its economic output constitutes 2.7 percent of the U.S. total, and in 2000 it landed two plants that comprised 4.5 percent of the 1995-2000 total. However, Massachusetts' disproportionate share was chiefly attributable to a decision by computer-chip manufacturer
Intel Corporation to build a major plant in the state. Between 1995 and 2000, Intel placed three and one half times as much investment in non-single sales factor states as it did in single sales factor states—suggesting that Massachusetts's success in luring the company in 2000 should not be attributed to the state's adoption of a sales-only formula.”

What is not fully appreciated, and what went unmentioned in the report by the ad hoc committee recommending single-factor apportionment, is that the shift in the formula might actually be counterproductive. An out-of-state corporation that would pay higher taxes under the single-factor formula than it previously did under the three-factor formula would have an incentive to close any Connecticut office but continue selling into the State. Under a federal statute, Public Law 86-272, an out-of-state corporation that solicits sales in Connecticut, sends orders out-of-state for acceptance or rejection, and ships goods into Connecticut to fill the order cannot be subject to an income tax if it has no office in the taxing state. Ironically, the single-factor formula provides an out-of-state corporation with an incentive to avoid opening an office in Connecticut or to close an existing office. An out-of-state corporation protected from Connecticut income taxation by Public Law 86-272, which was seeking a location for a new R&D lab, for example, would actually have a tax incentive to avoid Connecticut."  

The above discussion focused on the relationship between the single-factor sales formula and economic development. That relationship is part of a more general debate on the role that state taxes play in a state's economic development. Because this ubiquitous issue permeates much of the debate over state tax policy and is comprehensively treated in Part Five.

F. The Lack of a Throwback Rule

The single-factor sales apportionment formula underscores another defect in the corporate income tax: the lack of a throwback rule. The goal of formulary apportionment, whether implemented on a separate entity basis as Connecticut does, or on a combined reporting basis as other states do, is to apportion taxable income to jurisdictions that have the power to tax it. In some cases, however, taxable

\footnote{Id. xii-xiii; Pomp and Oldman, supra ??}
income may be apportioned to a state that cannot tax it, most commonly, because of the operation of a federal statute known as Public Law 86-272. Essentially this federal statute says that a state cannot levy its income tax on an out-of-state corporation if all it does is solicit orders for the sale of tangible personal property, send such orders outside the state for acceptance or rejection, and ships the goods into the state.\(^\text{47}\)

To deal with the problem of apportioning income to a state that does not have the power to tax it, one common approach is the use of a so-called throwback rule. Under this rule, a sale that is made in a state that cannot tax the corporation is treated as a sale made in the state from which the goods were shipped. (The throwback rule does not apply if the sale occurs in a state that has the power to tax but has declined to exercise that power.)

To illustrate, consider a corporation that manufactures goods in Connecticut and ships them to the federal government or customers in other states. Assume that all of the corporation’s property and payroll are in Connecticut and all of its sales are made outside the State. Finally, assume that the corporation is protected from taxation by any other state because of Public Law 86-272.

Recall the single-factor apportionment formula that Connecticut provides to manufacturers. That formula provides that:

\[ \text{TI}_{\text{CT}} = \text{TI}_{\text{WW}} \times \frac{\text{Sales}_{\text{CT}}}{\text{Sales}_{\text{WW}}} \]

Under the facts assumed above, the numerator of the ratio will be zero because no sales occur in Connecticut. Consequently, the corporation will apportion no income to Connecticut. Moreover, because of Public Law 86-272 and Connecticut’s lack of a throwback rule, the corporation will pay no tax anywhere.

Many other legislatures have concluded that a corporation should not be allowed to apportion income to states that cannot tax it. More than half the states with a

\(^{47}\) For a fuller discussion, see Richard D. Pomp and Oliver Oldman, State and Local Taxation???
corporate income tax utilize a so-called throwback rule. The Uniform Division of Income for Tax Purposes Act (UDITPA) has also adopted a throwback rule.\textsuperscript{48} Under a throwback rule of the type adopted by UDITPA and by other states, sales made outside of Connecticut in states that do not have the power to tax the corporation would be thrown back to Connecticut and treated as Connecticut sales for purposes of the numerator of the apportionment formula. Consequently, the corporation above would be taxed on 100\% of its income rather than on none of its income. The combination of a single-factor apportionment formula and the lack of a throwback rule allow manufacturers to reduce, if not eliminate, their Connecticut corporate income tax (except for the $250 minimum tax).

Even under the apportionment formula that applies to non-manufacturers, which takes into account property, payroll, and sales, the same problem arises as above, albeit less severe. Assuming the same facts as above, without a throwback rule a non-manufacturer would apportion 50\% of its income to Connecticut, rather than no income as would be true with single-factor apportionment.

The lack of a throwback rule results in further erosion of the corporate tax base. There is no empirical evidence that the State benefits at all from the loss in revenue.

Like most states, Connecticut’s rules for determining the taxable income of a corporation track those in the federal Internal Revenue Code.

III. Reforming the Connecticut Sales Tax\textsuperscript{49}

The number one problem in the Connecticut sales tax is its inability to deal with the pervasive problem of entity isolation, which is an outgrowth of the mail order industry and the Internet. To illustrate the problem, suppose a corporation owns at least one store in Connecticut. No one disputes that this so-called brick and mortar nexus requires that the corporation collect the Connecticut sales tax on transactions occurring at the store. Similarly, if the same corporation were to sell over the Internet, through the mail, or via the telephone and ship those goods into Connecticut, it would also have to collect the State’s sales (use) tax. But what if the

\textsuperscript{48} UDITPA, Sec. 16.
\textsuperscript{49} For a fuller discussion, see 2005 Guidebook, supra note ???, Ch. 16-21. Laura R Wyeth of Pricewaterhouse Coopers and Chris Hill of Day, Berry & Howard, two outstanding practitioners, prepared the chapters on the structure of the sales tax.
corporation attempts to isolate its brick and mortar nexus by creating a new related entity based outside of Connecticut for its remote selling? Does the existence of brick and mortar nexus by a related entity mean that the remote vendor, not having nexus itself with Connecticut, nonetheless has to collect the State’s use tax?

Dealing with the problem of entity isolation is critical to Connecticut’s fisc. Many of the largest retailers in the country use some type of corporate structure to isolate their brick and mortar nexus. One of the first manifestations of this approach involved the mail order industry when corporations like Saks Fifth Avenue and Bloomingdales created new entities to handle their catalog and mail order sales.\(^{50}\) More recently, corporations have created new dot.com entities for doing business over the Internet.

Any legal analysis of whether a dot.com entity can be made to collect the Connecticut sales or use tax must start with Quill v. North Dakota.\(^{51}\) That case endorsed two safe harbors. The first is based on the Supreme Court’s holding in National Geographic v. California Board of Equalization.\(^{52}\) That case held that a vendor has nexus with a state if it has a physical presence in that state which is not de minimis.

The second safe harbor is based on National Bellas Hess, Inc. v. Department of Revenue.\(^{53}\) That case held that a vendor does not have nexus if it does not have a physical presence in the state and its only connection with customers in the taxing state is by common carrier or the United States mail.

According to Quill, these safe harbors are “a means for limiting state burdens on interstate commerce.”\(^{54}\) Like other bright line tests, “this test appears artificial at its edges: Whether or not a state may compel a vendor to collect a sales or use tax may turn on the presence in the taxing state of a small sales force, plant, or office.”\(^{55}\)

\(^{50}\) See e.g., Bloomingdale’s By Mail, 567 A.2d 775; SFA Folio Collections, Inc. v. Bannon, 585 A.2d 666 (Conn. 1991), cert. denied, 501 U.S. 1223 (1991); SFA Folio Collections, Inc. v. Tracy, 652 N.E. 2d 693 (Ohio 1995).
\(^{52}\) National Geographic Society v. California Board of Equalization, 430 U.S. 551 (1977).
\(^{53}\) 386 U.S. 753 (1967).
\(^{54}\) 504 U.S. at 313.
\(^{55}\) Id. at 315.
The Quill Court was influenced by the existence of more than 6,000 local sales and use tax jurisdictions in the country. The Court was concerned about the imposition on interstate commerce that would result from a remote vendor having to master the sales and use tax laws of all of these jurisdictions. The Court protected what it viewed as the legitimate interests of vendors that relied on Bellas Hess. The Court was also concerned about the retroactive application of a state victory in Quill.

Is entity isolation protected by Quill? Such a remote vendor is doing more than merely selling to customers in Connecticut through a common carrier or the U.S. mails. Accordingly, the safe harbor would not automatically apply to immunize the vendor from collecting the Connecticut use tax.

Although the safe-harbor might not literally apply, and certainly the vendor could not argue that it had any reliance interests to be protected because there is no Supreme Court decision on point, would the Court nonetheless be solicitous of the burden that would be imposed on interstate commerce if the vendor were forced to collect the use tax? But how much of a burden exists when the remote vendor is part of a corporate family that has already mastered the sales and use tax laws of the market state? After all, it is one thing for a vendor sitting in the basement of her home in Utah, who has carved out a niche for a specialty product that she is selling over the Internet, to have to master the sales and use tax laws all over the country, it is quite a different imposition for a vendor that is part of a corporate family that has already acquired the necessary expertise.

Put differently, the brick and mortar store has already mastered the intricacies of the Connecticut sales tax. It is already collecting the sales tax from customers at its stores. If the brick and mortar entity started a new Internet division operated under the same corporate umbrella, there would be no doubt under existing law that sales or use tax would have to be collected. But if the Internet division were incorporated, there would be no new imposition on interstate commerce. The new

---

56 Id. at 313 n. 6.
57 See Michael J. McIntyre, Taxing Electronic Commerce Fairly and Efficiently, 52 Tax Law Rev. 625 (1997), who first proposed the argument discussed in the text. One difference involves the collection of local sales and use taxes. Depending on the sourcing rules, the local sales and use taxes might be easier for a brick and mortar to collect than for a dot.com to collect.
entity would have the same access to the collective experience and expertise of the brick and mortar corporation in collecting the Connecticut sales and use tax. 58

Some states have recently adopted statutes that require a remote vendor to collect a state’s use tax if it is selling goods into a state that are similar to goods sold by a brick and mortar related entity. Connecticut should analyze these statutes and adopt the best features of each.

None of these recent statutes has yet been challenged. There have been, however, a few state cases that raise the issue of entity isolation in the context of a sales tax. Although taxpayers have won most of these, 59 including a Connecticut case, 60 only one involved the interpretation of a statute, similar to what I am proposing. The state supreme court’s analysis in that Ohio case has been described as “baffling.” 61 Although the court refers to constitutional issues, the case is ultimately one of statutory interpretation.

With a tightly drawn statute and a carefully crafted argument, I think the U. S. Supreme Court would be likely to uphold the obligation to collect the Connecticut sales/use tax. Besides the logic of the argument, as elaborated above, I think the Court will be sympathetic to a state for at least three reasons.

58 The U.S. Supreme Court has indicated in other contexts that the line between a division and a corporation should not have constitutional significance. For example, in Electric Bond & Share Co. v. SEC, 303 U.S. 419 (1938), the Court declared that: The findings of the District Court ... leave no room for doubt that these defendants are engaged in transactions in interstate commerce. That they conduct such transactions through the instrumentality of subsidiaries cannot avail to remove them from the reach of the federal power. It is the substance of what they do, and not the form in which they clothe their transactions, which must afford the test. The constitutional authority confided to Congress could not be maintained if it were deemed to depend upon the mere modal arrangements of those seeking to escape its exercise. Id. See McIntyre, supra note 76, at 643. The issue of combined reporting is another context in which the Court has treated a related entity the same as a division. See John A. Swain, Cybertaxation and the Commerce Clause: Entity Isolation or Affiliate Nexus?, 75 S. Cal. L. Rev. 419 (2002).
59 See, e.g., Bloomingdale’s By Mail, 567 A.2d 775;
60 SFA Folio Collections, Inc. v. Bannon, 585 A.2d 666 (Conn. 1991), cert. denied, 501 U.S. 1223 (1991). In SFA Folio, the State sought to make the mail order subsidiary of Saks Fifth Avenue collect the Connecticut use tax on its sales into the State. There was no statute of the sort proposed in the text, which is one of the reasons the case was lost. “Clearly, there is no statute within the Connecticut sales and use tax chapter ... that allows the commissioner to treat separate corporations as part of one enterprise for the purpose of imposing sales and use tax liability, and the commissioner does not make such a claim.” 582 A.2d at 672. Further, the State did not argue the case based on the approach suggested in the text. Finally, the court’s holding that SFA Folio had no due process connections with Connecticut has been overruled by Quill.
61 McIntyre, supra note 76, at 649.
First, Quill was a highly unprincipled decision. The Quill Court had a political agenda. The Court wanted to protect the reliance interest of the mail order industry that had structured itself around the holding of Bellas Hess. To avoid having to collect a use tax, many remote vendors structured themselves so that they did not have a physical presence in the state and limited their activities in a state to common carriers and the U.S. mail. The current use of entity isolation goes well beyond the fact pattern upheld in Bellas Hess and in Quill.

Second, the Quill Court wanted to remove any doubts about the constitutionality of Congressional intervention. Whenever Congress had previously considered enacting bills that would require remote vendors to collect the use tax if certain conditions were met, the argument was raised that earlier Supreme Court decisions, especially Bellas Hess, were grounded on considerations of due process. The orthodox view is that Congress can expand due process protections but cannot contract them. Consequently, if Bellas Hess and the physical presence safe harbor were viewed as implementing federal due process safeguards, there would be doubt about whether Congress could require a use tax to be collected where the Court had ruled otherwise.

The Court skillfully finessed this dilemma by bifurcating, for the first time, the concept of nexus. Quill held that there were actually two concepts of nexus, one located in the Due Process Clause, and one located in the Commerce Clause. This novel approach, without support in the case law, allowed the Court to pursue its agenda. By holding that Quill had Due Process contacts with North Dakota, the Court cleared the way for federal legislation. By holding that Quill did not satisfy Commerce Clause nexus, the reliance interests of remote vendors would be protected.

Justice White chided the majority for its unprecedented approach. The Court was willing to engage in such unprincipled behavior because, as parts of the opinion make clear, it viewed Congress as being the appropriate body to deal with this complicated issue. In more than one place in the opinion, the Court invited

---

63 504 U.S. at 325.
Congress to act.

Thirteen years have passed since Quill was decided and while Congress is still debating the issue, no action has been taken. Moreover, the revenue threat to the states is so much more severe because of the growth of the Internet. My guess is that should the Court grant cert in a dot.com situation, its frustration with Congress will make it more favorably disposed toward the states.

Third, the world has changed in another fundamental way: the existence of the Streamlined Sales Tax Project (SSTP). One of the brightest rays of hope for state sales tax reform, the SSTP was instituted by state governments in 1999 with the assistance of the Multistate Tax Commission, the Federation of Tax Administrators, the National Conference of State Legislatures, and local governments. The SSTP has surprised skeptics by making substantial progress toward modernizing, unifying, and simplifying sales and use tax collection and administration. The accomplishments of the SSTP will help assuage the Court’s concerns in Quill about the imposition imposed on interstate commerce from the then messy world of state and local sales taxes. If the SSTP’s successes continue, it becomes more likely that the Court will uphold the type of statute suggested above.

IV. Tax Expenditures

A. Introduction

Legislators have made a policy decision to use the Connecticut tax system for more than just the raising of revenue. The State’s tax laws typically contain provisions intended to subsidize favored economic activities. These provisions, which represent a conscious legislative choice to favor certain transactions or activities, accomplish their goals by granting a tax reduction to selected taxpayers. Because these subsidy measures are spending programs implemented through the tax system, they are commonly known both in Connecticut and throughout the country as “tax expenditures.” According to the most recent study by the State, for fiscal year 2005

---

64 For a discussion of the SSTP, see Pomp and Oldman, supra note ???, at
tax expenditures are estimated to cost $4.4 billion. As the following chart indicates, tax expenditures are the largest component of state spending.

![Connecticut Appropriations, FY '05](image)

A tax expenditure can be viewed as if the taxpayer had actually paid the full amount of tax owed in the absence of the special provision and simultaneously had received a grant equal to the savings provided by the special provision. Tax expenditures are just one of numerous ways in which the Connecticut Legislature provides for governmental assistance. In FY 05, for example, the State spent $4 billion more than the explicit spending budget would suggest.

---

65 Office of Fiscal Analysis, Connecticut General Assembly, Connecticut Tax Expenditure Report, Aug. 30, 2004, p. 11. To be included as a tax expenditure in this report, a provision must meet the following criteria: have an impact on a statewide tax; confer preferential treatment; reduce tax revenue; not be an appropriation; not be included in the definition of the tax base; not be subject to an alternative tax; and can be amended or repealed by a change in state law. Id. p. 3.

66 Table prepared by Ellen Scalletar of Connecticut Voices for Children.
A tax expenditure is a neutral term. Tax expenditures are not necessarily good or bad. They need to be evaluated like any other spending program and subjected to the normal budgetary criteria: how much money is being spent; how is this money being distributed; is the expenditure achieving its intended goal; and is the expenditure the best means of achieving that goal. Tax expenditures should compete for dollars like any other spending program and thus should be subjected to, and survive, a cost-benefit analysis. Unfortunately, the Legislature has been indifferent to applying this analysis.

B. A Tax Expenditure Budget

The federal government and many states have long recognized that tax expenditures are policy decisions that spend money just like explicit spending programs, and should be examined periodically using traditional budget and funding criteria. To further this process, the U.S. Treasury Department started publishing a tax expenditure budget in 1968. In 1974, the U.S. Congressional Budget Office began publishing its own annual tax expenditure report, and in the same year the Office of Management and Budget began including a tax expenditure analysis with the President’s annual budget request to Congress. The states soon followed and many states, including Connecticut, prepares some form of tax expenditure budget. The Connecticut Tax Expenditure Report states “[a] tax expenditure is similar to a direct expenditure in that it can be used to accomplish public policy goals.” 67

The tax expenditure budget explicitly recognizes that the State’s budget and the extent of its spending programs cannot be evaluated without taking into account the policy choices that are represented by tax expenditures. Each tax expenditure represents a legislative decision to spend money, often unlimited in amount, on a particular taxpayer or group of taxpayers. Unless attention is paid to tax expenditures, the Legislature does not have either its tax policy or its budget policy under full control. This is especially true in Connecticut where the amount spent through tax expenditures exceeds the amount in any other budgetary category. Unfortunately, the State’s tax expenditure budget, which absorbs much time and effort to generate, is not integrated into the budgetary process.

67 Id. p. 3.
C. Lack of Accountability and Review

The Legislature has been negligent in not scrutinizing tax expenditures the way it analyzes explicit spending programs. Indeed, Legislators have ignored their own laws calling for such scrutiny. Connecticut has a statute that requires that the tax expenditure budget be reviewed and analyzed. It has another statute calling for a detailed analysis of corporate tax credits. Unfortunately, legislators have ignored both statutes. Accordingly, because of the lack of legislative oversight, once a tax expenditure has been added to the tax code, it will almost always escape the periodic scrutiny and analysis that is typical of explicit spending programs. Tax expenditures thus represent the worst features of a state-spending program, one that is buried from scrutiny. Legislators have spent billions of dollars with no accountability whatsoever.

D. Lack of Transparency and Accountability in Tax Expenditures

Because the Legislature has chosen essentially to ignore tax expenditures, the number of taxpayers claiming a tax expenditure and the cost of such expenditures have grown. Over the period 1987 to 2002, the number of credits has increased, as

---

68 Conn. Gen. Stat. Sec. 12-7b(e), which requires that the joint standing committee of the General Assembly having cognizance of matters relating to finance, revenue and bonding shall meet to receive and analyze the tax expenditure report. There is no written evidence that such an analysis has ever occurred.

69 Conn. Gen. Stat. Sec. 12-217z establishes a Corporation Business Tax Credit Review Committee comprised of the chairpersons and ranking members of the joint standing committee of the General Assembly having cognizance of matters relating to finance, revenue and bonding, or their designees; one member appointed by each of the following: The Governor, the president pro tempore of the Senate, the speaker of the House of Representatives, the majority leader of the Senate, the majority leader of the House of Representatives, the minority leader of the House of Representatives and the minority leader of the Senate; and the Commissioners of Revenue Services and Economic and Community Development, or their designees. The committee is required to study and evaluate all the existing credits against the corporation business tax. The study is supposed to consider whether: a credit provided a benefit to the state in terms of measurable economic development, new investments in the state, new jobs or retention of existing jobs, or measurable benefits for the workforce in the state; there is sufficient justification to continue a credit as it currently exists or is it obsolete; a credit could be more efficiently administered as part of a broad-based credit; and whether a credit adds unnecessary complexity in the application, administration and approval process for the credit. The committee is required to analyze the history, rationale and estimated revenue loss as a result of each tax credit and to recommend revisions necessary to change the tax by eliminating or changing any redundant, obsolete or unnecessary tax credit or any credit that is not providing a measurable benefit sufficient to justify any revenue loss to the state. The committee was suppose to report its findings and recommendations to the joint standing committee of the General Assembly having cognizance of matters relating to finance, revenue and bonding no later than January 30, 2002, and every five years thereafter. Apparently, the Committee has never met.
have the number of returns claiming these credits and the total amount claimed in
credits. To take just one example, in 1987 there were just nine tax credits to offset
the Corporation Business Tax and 289 returns claimed one or more of these credits,
reducing tax liability by a total of $2.71 millions. By 2002 (the most recent year for
which data are available), there were 26 tax credits, with 16,374 returns claiming
credits, reducing tax liability by a total of $134 million.\(^70\)

Tax expenditures undermine the State’s spending cap and debt limits.\(^71\) For
example, if the $169 million in corporate tax credits in FY 02 were implemented as
explicit spending programs, such as direct cash grants, this sum would have counted
against the state-spending cap. Further, if such economic development aid were
provided through bonding, it would have counted against the State’s debt limit.
Using tax credits for economic development avoided both constraints. Tax
expenditures were apparently conscious legislative decisions to engage in spending
programs that avoided the cap and debt limits. Programs implemented through the
tax system thus had an advantage in competing for funds over spending programs,
which would have run up against the spending and debt limits.

The use of tax expenditures, rather than grants and loans, reduces markedly the
transparency and accountability of State government. Not only are the cap and debt
limits avoided, but also neither the public, nor legislators, know which corporations
claimed what credits and how much in credits they claimed. Currently, state
corporation income tax returns, even for publicly-traded corporations, are not
public documents. Also, unlike with grants and loans provided through the
Department of Economic Community and Development (DECD), there is rarely
any agreement between a corporation claiming tax credits and the state regarding
what the corporation is expected to do to receive the financial benefit (e.g., create a
certain number of new jobs). Indeed, aside from a law that legislators have
ignored,\(^72\) there is no process to monitor if Connecticut receives anything at all in
return for its spending.

Tax expenditures further undermine the budget because with a few exceptions, they

\(^{70}\) Shelley and Ellen, did I get this from you? If so, what is the cite? Do you have more up to date info?
\(^{71}\) For a description of the State’s spending cap and debt limit, see Shelley Geballe, A Citizen’s Guide to the
\(^{72}\) See supra note ???
are not capped. As a result, unlike spending programs, the potential for revenue loss is virtually unlimited in any given year. The most significant constraint is that tax credits may not reduce a corporation’s tax liability by more than 70%. Tax expenditures represent a policy choice by the Legislature to spend unlimited amounts of money, with no oversight or evaluation. In short, tax expenditures represent rapidly growing *entitlements*. They provide eligible corporations a virtual “blank check” in perpetuity, with *no* oversight.

At a minimum, the names of corporations receiving credits above a certain amount should be made public. This modest, simple step would allow the more costly tax expenditures to be evaluated. Because legislators have shown no interest in following their own law calling for a review of corporate tax credits, disclosure of the beneficiaries would allow researchers and other interested members of the public to step in and determine what the State receives in return for the subsidies that go to particular corporations. If the tax expenditure were implemented in the form of a spending program, the identity of the beneficiary would be known; there is no reason why that identity should be secret just because the money is spent in the form of a credit. DECD monitors its grants and loans and tax expenditures should not be allowed to avoid this same vigilance. Other states, such as Maine and Minnesota, have taken major steps in monitoring their grant programs as well. OFA does a wonderful job in preparing a tax expenditure budget; it would be a small additional step to disclose by name of corporation the major beneficiaries.

The issue of disclosing the beneficiaries of tax expenditures is a subset of a more

---

73 Two exceptions are the employer-assisted housing credit, capped at $1 million per year, Conn. Gen. Stat. Sec. 12-217p and the credit for computer donations to schools, also capped at $1 million per year, id. Sec. 10-228b.


75 Maine discloses company-specific information for all deals over $10,000 and includes the number of jobs created or retained, changes in employment levels, total amount of assistance, and details about type and purpose of each form of assistance. Minnesota discloses company-specific information for all deals over $25,000 and includes number of jobs, amount of subsidy, hourly wage of each job created, statement of goals identified in the agreement, date by which each job and wage goals will be met, and amount of assistance. Connecticut discloses company-specific information for all deals over $250,000 and includes number of jobs created, projected jobs created, number of jobs at initial application, and amount of assistance. Other states that disclose economic subsidies include Illinois, Louisiana, Nebraska, North Carolina, Ohio, Texas, and West Virginia. For more complete discussion, see http://www.goodjobsfirst.org/pdf/disclosure.pdf.
general argument, presented in Part Six below, that the public is entitled to know the amount of income taxes paid by a corporation.

Tax expenditures, like many of the other topics discussed above, raises the more general issue of state taxes and economic development, discussed in the next Part.

V. State Taxes and Economic Development*

A. Overview

The issue of the effect of state taxes on economic development permeates all discussions on Connecticut tax policy. Ironically, there is probably no other subject where the prevailing political wisdom is so at odds with the empirical research.

For many years, the orthodox learning has been that state taxes had insignificant impact on the location of economic activity (other than income from capital). In the last decade or so, there has been some attempt to challenge this wisdom. For example, some researchers have claimed that they have found correlations between certain tax factors and certain indicia of economic activity.

A recent review of these studies by Professor Lynch, however, concludes that their results were often inconsistent and idiosyncratic and that the correlations do not appear large. "[D]o tax cuts and incentives create jobs in a cost-effective manner? Conversely, do state and local public services undermine growth? A review of the available data strongly suggests that the answer to both of those questions is no. And while state and local tax cuts may in theory stimulate economic activity, in practice they are unlikely to do so. That means state and local governments may be wasting billions of dollars annually on tax cut policies that are failing, while under funding programs that can promote long-term growth and job creation."

Many reasons exist why legislators should be skeptical about arguments that changes in the tax system that are opposed by business will be bad for economic development.

First, innumerable factors are important to a business in its decision about where to locate. Depending on the type of business at issue, the locational decision can be influenced by plant or site availability, access to financing, access to and cost of transportation, quality and cost of labor, proximity to markets, the cost of utilities, proximity to supplies, proximity to other company facilities, the

---

77 The red tape involved in site assembly may be a much greater investment barrier than the price of land. See R. Vaughan, State Taxation and Economic Development (1979), p. 25.

78 Transportation costs affect both the revenue a firm receives from its sales and the prices it pays for its inputs. Availability of transportation linkages, such as the ease with which trucks can make deliveries and collections, or the proximity of a railroad spur, shipping pier, or major airport, can also be critical for some activities. Cities like New York, which have traditionally housed a large number of small firms whose products are fairly transportation-intensive, suffer from inadequate access to rail transportation and inconvenient access to truck routes. See Vaughan, supra note 26, at 24.

79 Because training labor is expensive, businesses are attracted to areas that have a ready supply of skilled labor. Labor that is priced low relative to its skill was a major factor in the development of manufacturing in the South. See Vaughan, supra note 26, at 24. Skilled labor also appears critical to attracting technology-oriented firms. See note 34 infra.

80 The cost of labor may be a major consideration in competitive labor-intensive industries, for example, apparel, leather, furniture, and consumer electronics. Another labor consideration is whether the workforce is likely to be unionized. See R. Schmenner, Making Business Location Decisions (1982), p. 37. A company with seasonal needs for labor has to be located in an area with a large labor pool. See Vaughan, supra note 26, at 24.

81 A site near established markets may be essential for industries such as printing, plastics fabrication, paper conversion, and can manufacturing, which involve commodities that have a low value-to-weight ratio and thus have transportation costs that are a high percentage of the selling price of the goods. See Schmenner, supra note 29, at 37.

82 One of the factors cited by Bankers Trust for transferring part of its operations from New York to New Jersey was the lower cost of utilities, an important consideration presumably because of the large amount of electricity needed to run the company’s computers. See New York Times, April 29, 1983, p. B3. Energy costs are commonly mentioned as one of the reasons why the banking and insurance industries are relocating part of their operations outside of New York City. See New York Times, March 2, 1982, p. D23; December 23, 1981, p. D14. State and local taxes, of course, contribute to the cost of energy. The price and availability of office space is another factor contributing to the movement of firms from New York City to less dense regions, both within and without the state.

83 For example, paper mills typically locate near a supply of trees and water; fruit and vegetable processors are usually located near farms; and petrochemical complexes must be close to pipelines. See Schmenner, supra note 29, at 37.

84 Some manufacturing plants operate as satellites to a base or main plant and cannot be located too far from the main plant without stretching the lines of support too taut. Schmenner, supra note 29, at 37. Savin Corporation decided to build a plant in Union, N.Y. because four of its feeder plants were already in the area. According to the corporation’s senior vice president, “the choice wasn’t made because of tax considerations.” Wall Street Journal, July 1, 1980. Nonetheless, the State’s Commerce Commissioner chose to describe Savin’s decision as “a splendid example” of the drawing power of tax incentives. Id. As the Savin example suggests, state officials responsible for economic development have an institutional interest in exaggerating the impact of tax incentives. When Church and Dwight built a new plant in Ohio,
regulatory environment, the quality of a state’s schools, colleges, and universities, the cost of housing, the level and quality of public services, and the range of other amenities that enter into the general quality of life offered.

Second, taxes are one of the many costs of doing business and the magnitude of these other costs may easily swamp the amount of state taxes involved. For example, an analysis by New York of those corporations which apportioned their income for purposes of the state franchise tax—a group that paid approximately 70 percent of the corporate tax revenues—indicated that their labor costs in New York were 53 times as large as their state corporate tax payments. A two percent wage differential was equivalent in its effect on profits to a 106 percent corporate tax

---

85 High-tech companies, which have been wooed by many states, are especially sensitive to the existence of prominent universities having graduate-level technical programs that produce a pool of potential employees. A well-known but dated example involves Microelectronics and Computer Technology Co., a joint venture of 12 major companies, including Control Data, Digital Equipment, Honeywell, RCA, and Sperry, which was courted by 57 cities. According to the president of Microelectronics, in selecting Austin, Tex. for its site the corporation emphasized “the output of technical people in the area,” particularly electrical engineers and computer scientists with advanced degrees -- and “not who’s holding a gold watch to get you to come.” Wall Street Journal, May 12, 1983. The existence of high quality graduate programs no doubt explains the presence of high-tech firms along Route 128 in Massachusetts and in the Silicon Valley in California. But see infra.

Sweeping changes in educational policies were pursued throughout the South in order to attract industries dependent on the educational depth of the work force. Many of these changes were financed by increased taxes. New York Times, March 20, 1982, p. 26. The Alabama Governor's Task Force on Economic Recovery expressed a similar concern: “Alabama's traditional combination of low taxes and minimum services no longer constitutes a sound basis for progress . . . . Today the premium is on the elements which support technology -- the educational system, engineering resources, communications research.” New York Times, June 14, 1983, p. A19.

86 Before the dot.com bubble burst, the high cost of housing in the Silicon Valley was making it increasingly difficult for companies to attract employees and caused some corporations to move to lower-cost areas. Wall Street Journal, May 11, 1983, p. 37. The cost of housing played a role in the selection of Austin, Tex. by Microelectronics and Computer Technology Co., supra note 34. “The biggest economic factor was the cost of private housing. Taxes didn’t play a significant role in our decision . . . . The governor of Texas put together a statewide task force of bankers, industrialists, educators and political figures . . . and they did some clever things to reduce the hassles of relocating, such as getting bank commitments for mortgage money below FHA rates, and starting a job placement center for spouses.” USA Today, August 24, 1983, p. A8.

87 Improvements in the level and quality of public services, such as a state’s infrastructure, will benefit many firms, both large and small. By comparison, tax incentives tend to accrue to a small percentage of large firms.

88 According to one of the leading researchers on locational decision-making, corporations visit a potential site in order to gather information about the community -- its attractiveness as a place to live and raise a family, its housing, schools, medical facilities, cultural and recreational activities, and its civic pride. Schmenner, supra note 29, at 20.
differential. For a labor-intensive corporation, a few pennies difference in the hourly wages paid to employees might reduce its costs by more than any conceivable tax savings that would result from locating in one state rather than another.\footnote{Many studies have concluded that regional differences in labor costs, construction costs, and energy costs are generally too large to be offset by differences in tax levels. For one of the pioneering studies, see Cornia, Testa, and Stocker, State-Local Fiscal Incentives and Economic Development, Urban and Regional Development Series No. 4, Academy for Contemporary Problems (1978).}

Third, state and local tax payments are deductible for purposes of the federal corporate income tax. The effect of this deduction, the so-called federal offset, is to reduce both the absolute burden of state and local taxes and differences in burdens among the states. For example, consider a corporation subject to a 35 percent federal corporate marginal tax rate. Assume that this corporation is deciding whether to move from State A to State B. Taxes would be $200 in State A but would only be $100 in State B—a $100 difference. After taking into account the federal offset, however, the out-of-pocket cost of state taxes is $130 in State A and $65 in State B. The net difference in taxes between A and B is reduced to $65 ($130-$65), from $100 ($200-$100).\footnote{To the extent that other costs of a business are also deductible, the relative differentials between such costs and taxes would be unchanged.}

In 2000, state and local taxes paid by businesses reduced their total receipts by 1.1% and amounted to only 1.2% of their costs of doing business. That burden was further reduced by the federal deductibility of state and local taxes. After federal deductibility, all state and local taxes paid by businesses reduced their revenues by 0.7% and accounted for only 0.8% of their costs. Moreover, each dollar of taxes collected from business lowers profits by less than $1 because firms, to some unknowable extent, can shift their taxes to customers, employees, suppliers, or shareholders.\footnote{Robert G. Lynch, Weaknesses in the Common Arguments for State and Local Tax Cuts and Incentives, 32 State Tax Notes 597, 598 (2004).}

Fourth, differences in state and local taxes may reflect differences in the level and quality of state and local public goods and services, which also affect business locational decisions. Low taxes are not necessarily attractive to businesses if they mean that the firm will have to supply, at its own expense, what is supplied through the public sector in other states or other jurisdictions. Furthermore, if low taxes
mean inferior schools, a state may lack the educated and literate labor force that is essential to certain types of businesses. Of course, not all public goods and services are equally important to businesses.

Fifth, to the extent that tax rate differentials are capitalized, their impact will be reduced. For example, low property taxes in one jurisdiction might mean that land sells for a higher price than it would sell for in another jurisdiction having higher property taxes. In other words, land located in a high-property tax jurisdiction may sell for less than an equivalent parcel of land in a low-tax jurisdiction, assuming that differences in taxation are not reflected in differences in public services, which might also be capitalized.

Sixth, most relocating companies plan to stay at their new site years longer than any group of elected officials is likely to be in office. Consequently, current tax levels, special concessions, or special features of the tax law may not be a reliable basis upon which to make a multi-million dollar investment. What one group of legislators might grant today by way of concession another might eliminate tomorrow, especially if financial conditions change significantly. Fiscal stability and predictability may be more important than special concessions.

Seventh, a state tax incentive that is granted by way of incorporating a similar federal provision may have no impact on a firm's decision-making if the future of the federal provision itself is in jeopardy. For example, states have been urged to adopt the recent federal provisions on bonus depreciation in order to provide a tax incentive to businesses. It is highly unlikely that any business would make a major investment decision on the basis of whether a state had adopted bonus depreciation.

---

94 See supra note 24.
95 For a general discussion, see Report by the Staff of the Legislative Commission on the Modernization and Simplification of Tax Administration and the Tax Law, The Article 9-A Franchise Tax: Should New York Adopt ACRS? (December 31, 1984). The issue of whether a state should adopt the new federal bonus rules on depreciation also illustrates a significant difference in perspective between federal and state tax law. When the Congress enacts special tax provisions designed to encourage investment, it is
Eighth, state tax incentives may contain their own seeds of destruction. If incentives are effective at all, a state will gain only a short-lived advantage over other states because the latter can be expected to adopt similar ones.\textsuperscript{96} A tax incentive that is adopted by all states is equivalent to no incentive at all, except that tax revenue is needlessly lost. In reality, however, states are afraid of letting any other state obtain an advantage, and thus tax incentives are often adopted without evaluating the results that occurred elsewhere.

Ninth, some executives charged with the locational decision may be uninformed about the existence of tax incentives. For example, one researcher found that most firms were unaware of whether tax incentives even existed when making their locational decisions. In the case of those firms that were aware, only a small portion claimed that they would have located in another state in the absence of the incentives. Further, most firms making new investments did not even consider locating in any state other than their final choice.\textsuperscript{97} The major accounting firms,}\textsuperscript{96}

\begin{footnotesize}
\footnotesize
\begin{itemize}
\item For example, shortly after New York adopted its double-weighted receipts factor Massachusetts and Connecticut adopted similar provisions. See Report by the Staff of the Legislative Commission on the Modernization and Simplification of Tax Administration and the Tax Law, The Article 9-A Franchise Tax: The Double-Weighted Receipts Factor (May 1985).
\item Some economists argue that business accounting and organizational structures can reduce the effectiveness of a tax incentive. Tax incentives operate at the overall company level by reducing the company's final tax. But the problem that generated the need for a tax incentive is often focused at the plant level, where the plant manager is faced with the decision to purchase equipment that would otherwise be unprofitable without the tax incentive. Consider, for example, the investment tax credit (ITC). Unless the tax savings at the overall level are allocated within the company to the particular plant, that plant manager might be saddled in the company's books with a high pre-ITC cost for the equipment. See Surrey, Warren, McDaniel & Ault, Federal Income Taxation (1972), Vol. 1, p. 271 at n. 21. Further, the plant manager or other persons in charge of purchasing equipment may be unaware of the credit. A staff member of Minnesota's Taxation Committee expressed a similar sentiment: "We've learned that accountants are better at discovering tax breaks than managers." See D. Frey, Economic Development Tax Incentives: A Staff Perspective, Paper Presented at the National Conference of State Legislatures, July 22, 1984.
\end{itemize}
\end{footnotesize}
however, now have groups that advise their clients about existing incentives.

Tenth, there are relatively few footloose firms that can be affected by tax incentives. Finally, a recent case in the 6th circuit court of appeals holding Ohio’s investment tax credit to be unconstitutional casts doubt on many of the tax incentives used by state and local governments. 98

Professor Enrich has summarized the debate over taxes and economic development as follows:

“[R]elative to other costs of doing business, state taxes are simply too small to have a major influence on business decision-making. Other factors with far greater impacts on costs, accessibility of raw materials and markets, and regulatory stringency, are far stronger determinants of location decisions and of economic growth. The literature on economic development incentives is filled with examples of business acknowledging that their decisions were not guided by the available state fiscal incentives. Often business decision makers were unaware of the incentives until after their decision; in other cases, the incentives were candidly acknowledged as what one executive called ‘a little extra cream on top.’ At best, incentive packages only become relevant in breaking a tie between sites that do not differ significantly on more important dimensions.” 99

If all the evidence suggests that rate cuts and tax incentives are an ineffective tool for development, why have they proliferated? “In a political atmosphere dominated by concerns about economic vitality and jobs, elected officials face intense pressure to engage in the incentive competition. In such an atmosphere, each state strives to match other states’ efforts and to make itself more attractive to businesses than its neighbors and competitors. Failing to do so is perceived as the equivalent of unilateral disarmament in the face of a first-strike attack.” 100

“[E]lected officials are often as interested in the symbolic content of their actions as in their concrete effects. By taking visible steps to encourage economic growth,

99 Enrich, supra note 24, at 391-92.
100 Id. at 393.
they can take credit for subsequent economic successes, whatever their actual causes, and avoid blame for any losses of jobs to other states that otherwise would have been attributed to them if they failed to act. From a political perspective, doing something is almost always better than doing nothing, particularly in regard to an issue about which voters care deeply. That other states are actively engaged in the competition strengthens the political arguments for joining in, both by providing cover, with which officials can justify their own actions, and by fueling the perception that a failure to act would be either negligence or folly.”  

“Even if the likelihood of a positive impact is understood to be slim, the potential benefits of a visible success, even when discounted for its low probability, may far outweigh the political costs of a measure whose burdens, in the form of reduced government revenues, are indirect and widely dispersed. Moreover, those constituents who will be directly and positively affected by a favorable location decision (or injured by a negative one) will typically be far more vocal on the issue than those state citizens who bear the diffuse costs, and far more likely to base their ultimate assessments of decision makers on their performance in this sphere.”

“The businesses that stand to benefit from state incentives have learned to fuel the interstate competition. As incentives have become more and more common, businesses have come to expect governmental sweeteners as routine fringe benefits of their siting decisions. Businesses have become increasingly adept at playing the states off against one another to stimulate more attractive offers. A former New York state tax commissioner, for example, describes businesses’ ‘conducting highly publicized “negotiations” with another state or buying an option on office space in another state’ solely to create the impression that they needed to be wooed. And, because business leaders and their lobbyists typically have ready access to elected officials, business advocates’ self-serving assertions about the importance of state tax policy to the business climate and to business location decisions carry substantial weight in the political process.”

“Given the powerful political impetus to participate in the incentive competition, tax breaks offer state officials a particularly convenient mechanism for the delivery

---

101 Id. at 394.
102 Id.
103 Id. at 394-95.
of incentives. Because tax breaks involve a reduction of public revenues, rather than an expenditure of public funds, they do not directly compete with other programs demanding scarce governmental resources. They are typically adopted through a process independent of the appropriation machinery, and they ordinarily do not require annual re-authorization, as direct budgetary outlays do.” 104

The above represents the longstanding view that state taxes have an insignificant effect on economic development. Is there any reason to abandon this view in light of recent studies? Professor Lynch, who reviewed these recent studies, acknowledges that although state tax cuts and incentives might theoretically create jobs in a cost-effective manner, in practice they are unlikely to do so. He criticizes some of the well-known studies that have concluded otherwise on the grounds that: they failed to take into account the interrelationship between taxes and public services and assumed that taxes can be cut without a reduction in services; the studies suggest only small effects of taxes on economic activity and the results are often inconsistent with each other, not reproducible, and unreliable; the negative effects of state and local taxes are exaggerated; contrary to the assumptions of the econometric studies, state and local taxes may be irrelevant to business investment decisions; and most of the studies measure their explanatory variable tax burdens inaccurately. After reviewing the recent studies, Professor Lynch concluded that: “The only thing that can definitely be concluded from the body of research on tax cuts is that the effects of tax cuts are small at best, and zero or negative if one takes into account the need to cut public services when taxes are cut. At minimum, policymakers should be wary about making economic policy based on the inconsistent results of econometric studies.” 105

Professor Lynch also determined that the recent econometric research suggests that state and local tax cuts and incentives are a cost-ineffective way of creating jobs. If the amount of forgone tax were spent by the public sector, more jobs would be created than by implementing the tax cuts and incentives. He describes the recent econometric studies as “nearly unanimous in concluding that state and local tax incentives fail to attract a significant number of new businesses, create numerous jobs, or substantially enhance state economic performance.” 106

104 Id. at 395.
106 Id. at 768.
To the contrary, recent studies suggest that increases in taxation that financed increased spending on education and infrastructure actually encouraged economic growth. Some public services, such as roads and highways, stimulated economic activity by making it cheaper for firms to transport goods. Other services, such as education and health, increased the productivity of labor. Consequently, tax reductions may hurt growth and employment by reducing public services.

That public spending might stimulate the economy more than tax cuts is not surprising. When taxes are increased to fund public services, the additional spending occurs locally. But a cut in taxes will not necessarily result in increased local spending. Some of the tax cut might be saved and not spent, but if spent, might not be spent locally. Indeed, the net effect of a tax cut is likely to be a loss of employment. Any jobs that might result from cutting taxes are likely to be offset by the jobs lost because of reduced public services.

Tax cuts and incentives can also undermine other factors that contribute to a good business climate. Business climate is a slippery concept. Attempts to measure a state’s business climate often suffer from the problems encountered in measuring a state’s tax burden: most business climate studies are not industry-specific and are thus too general to be very useful. Disparate industries are likely to have very different impressions of a state’s business climate and a general study that ranks various aspects of doing business in a state cannot reflect the priorities of every sector of the economy. In discussing the psychological effects of investment incentives on a state’s business climate, Professor Bird notes that “unfortunately, about all one can do about such matters is to note their existence and our inability to say anything definite about them.”

However defined, tax incentives and tax cuts, by reducing revenue, can actually undermine a state’s business climate. “Businesses need to know that they can rely on high-quality, well-administered public services to facilitate the conduct of their enterprises. Roads, bridges, and highways must be maintained in good repair; ports and airports must be large enough to handle transportation needs; sewage systems must be adequate to meet the needs of existing firms and be expandable to service

107 See Richard D. Pomp, supra note 3, at 403 n.63.
prospective businesses; snow removal and flood control must be reliable and timely; fire protection and police services must be ready when needed; the justice system must be professional, impartial, and quick to resolve contract disputes; and the schools and colleges must help to generate a skilled and well-trained workforce. A relatively crime-free state with high-quality public services, including a good infrastructure and a high educated workforce, will have an excellent business climate."\textsuperscript{109}

The data indicate that most incentives provide money to projects that would have taken place anyway. In many cases, the money forgone by the cuts and incentives could have been better spent to enhance the "business climate" by investing in public service improvements.\textsuperscript{110}

As discussed in Part One, Connecticut is not a particularly high business tax state. When arrayed by "business share of all taxes," Connecticut ranks dramatically lower than the rest of the country, and lower than its four contiguous neighbors.

It has been commonplace to make these types of comparisons in debates over state tax policy. Personally, however, I do not find them very useful. Too often these studies have been used without any candid discussion of their inherent weaknesses. This lack of discussion is unfortunate because the utility of interstate tax comparisons for state policymakers is problematic, and serious questions can be raised concerning their use and abuse.\textsuperscript{111}

B. \textbf{Uses and Misuses of Interstate Tax Comparisons}\textsuperscript{112}

\textsuperscript{109} Lynch, supra note 40, at 601.  
\textsuperscript{110} Lynch, supra note 40, at 603.  
\textsuperscript{111} Professor Zubrow issued a similar warning more than 40 years ago: "The measurement of comparative State and local tax burdens constitutes one of the more formidable if not wholly intractable tasks in the field of public finance. This is usually recognized by students of taxation despite the fact that special tax committees, industrial development agencies, representatives of business and sundry other special interest groups are continually 'proving' that the tax burdens in their respective States or communities are either higher or lower than those prevailing elsewhere." Zubrow, Some Difficulties with the Measurement of Comparative Tax Burdens, Proceedings of the 54th Annual Conference of the National Tax Association (1961), p. 151. The temptation to continue to misuse such studies is apparently irresistible.  
1. Are Taxes Too High or Too Low?

One of the most common uses made of interstate comparisons is to determine whether taxes paid by Connecticut citizens and businesses are ‘too high.’ Although simple to state, the ‘too high’ question is exceedingly difficult to answer. In the abstract, most businesses would have little difficulty agreeing that taxes are ‘too high.’ Who would not like a tax reduction? On a more concrete level, however, the relevant inquiry is whether the amount of taxes paid represents fair value for the level of governmental goods, services, and transfer payments received by Connecticut residents. More specifically, how does the level of taxation compare with the quantity and quality of the goods, services, and transfer payments that such taxes finance? How do these goods and services compare with those that are desired by the electorate? If taxes were lowered, what would be the impact, if any, on the quality of life in Connecticut?

These are critical questions in determining whether taxes are too high, but not ones that are explicitly addressed by interstate tax comparisons. By their nature, such comparisons deal only with the revenue-raising side of the budget and not with the spending side. Without examining interstate differences in public goods and services, however, comparisons limited only to taxes provide an incomplete picture.

First, differences in taxes might reflect differences in the scope or quality of governmental goods, services, and transfer payments. State and local governments differ from each other in terms of their size, location, demographics (e.g., population density, the number of families below the poverty level, the number of elderly), the degree of urbanization, commercial development, tax bases, and social philosophy. Not surprisingly, businesses in Connecticut may prefer a higher level of goods, services, or transfer payments than do residents of jurisdiction Y. A study can determine that taxes are higher in Connecticut than in Y, but by itself, no inference could be drawn that taxes were ‘too high’ in Connecticut. After all, ‘taxes are what we pay for civilized society’ and jurisdictions differ in their views about what constitutes a civilized or just society.

Second, differences among states in levels of taxation may not necessarily represent

---

113 See id.
differences in the scope or quality of government goods and services, but rather of nomenclature. For example, businesses in a Connecticut jurisdiction may ‘pay’ for garbage collection, water, or sewerage through their property taxes, whereas businesses in another state might pay for a similar level of services through user charges paid to either the public or the private sector. Although Connecticut appears to have the higher taxes, such a conclusion would be misleading.

Third, differences in taxation might represent differences among the states in the cost of government. Businesses in Connecticut might pay more in taxes than businesses in State Y for the same level of goods and services because Connecticut must pay more to provide those services than State Y. Costs can vary among states because of differences in climate, topography, demographics, the age and condition of the infrastructure, the degree of urbanization, or the amount of bureaucratic waste and inefficiency. To take just one illustration, the cost of maintaining a highway is likely to be greater in Connecticut, a state that is subject to extremes in weather conditions than in a state having a temperate and more stable climate.

In the abstract, the ‘too high’ question provides little useful information for Connecticut policymakers. For the ‘too high’ question to be useful, the taxpayers of interest be specifically identified. Are taxes too high for individuals or corporations? If the former, what types of individuals are of concern? Commuters? Retired persons? Chief executive officers? Middle management? Blue-collar workers? Young professionals? People living at the poverty level? Taxpayers with capital gains, interest, or dividends? Married couples with two income earners?

Which corporations are of concern? Multistate corporations or intrastate corporations? Capital intensive or labor intensive? Those that are part of a family of related corporations? Corporations selling primarily within or without the State? Those that lease rather than own their property? As various studies have made abundantly clear, a state tax structure can treat taxpayers with the same economic income very differently so that the ‘too high’ question cannot be answered without clearly defining the taxpayer. Put differently, the taxpayers of interest will vary, depending on why policymakers are asking the question in the first place, of whether taxes are too high.
Even once the relevant individuals or corporations are defined, studies of comparative tax burdens cannot answer the question of whether taxes are too high relative to the quantity and quality of publicly provided goods, services, and transfer payments. Taxes represent but one-half of that question. Because the other half—comparing the level and quality of government expenditures—is fraught with methodological difficulties, the temptation is to focus only on the tax side of the question. Nevertheless, a systematic analysis of public expenditures is required before the ‘too high’ question can be properly evaluated.

Instead of using interstate comparisons to determine whether taxes are ‘too high,’ sometimes they are used to determine whether taxes are ‘too low.’ Typically, the ‘too low’ question is phrased in terms of whether an underutilized source of revenue exists. To be sure, in some cases the underutilization of a tax base represents a conscious policy decision, such as the lack of a broad-based income tax in New Hampshire, Tennessee, or Florida, or the absence of a corporate income tax in Nevada, or the favorable rules on the taxation of intangible income in Delaware. In other cases, however, policymakers may be unaware that they are relying less heavily upon a particular tax base than are their neighboring states. In any event, the ‘too low’ question raises the same range of issues as does the ‘too high’ question.

2. Are Taxes Discouraging Economic Development?

A second use of tax comparisons is to determine the effect of a state’s tax system on attracting and maintaining businesses and their employees—an issue that is related to the ‘too high’ (or ‘too low’) question. This issue has been addressed above.

3. Are Taxes Out-of-Line with Other States?

A third use made of interstate comparisons is to determine whether a state is out-of-line with other states because its taxes are too high (or too low). As a matter of logic, Connecticut can be out-of-line either because its taxes are too high or because the taxes in other states are too low. In many cases, however, the out-of-line question is another way of asking whether a state’s taxes are too high and expresses concern over the negative impact that the tax system might be having on a state’s economy. In other cases, the out-of-line question is another way of identifying a
potentially underutilized tax base.

Occasionally, the out-of-line argument is used as evidence of waste or inefficiency in government. For example, if Connecticut has higher taxes than State Y, but Connecticut taxpayers receive less in government goods and services than taxpayers in Y, the difference might be attributable to waste and inefficiency. Before this conclusion can be reached, however, differences in the cost and quality of government goods and services and the reliance on user charges need to be evaluated.

4. Are Taxes Fairly Distributed?

A fourth, though less frequent, use of interstate tax comparisons is to evaluate the fairness of the distribution of a state’s tax burden. This inquiry has at least two aspects: the distribution of the tax burden between businesses and individuals and the distribution of tax burdens among individuals or businesses. Theoretically, issues of fairness involve value judgments that should be independent of those reached by other states. Realistically, however, some constraints are imposed on policymakers. For example, many persons view a progressive tax as a fair tax. A conflict may arise, however, between the progressivity of a state tax system and the need to attract businesses and employees. At some point, a state tax system may be so progressive that it encourages middle- and high-income persons to live elsewhere, a consideration that might be especially relevant for states having metropolitan areas located within commuting distance from other states. Similarly, a state is not unconstrained in the proportion of its taxes that it can raise from businesses. Ultimately, however, the economic effects of how a state distributes its tax burden cannot be determined without taking into account who benefits from the provision of public goods and services.

C. Preferred Approach to Interstate Tax Comparisons

Connecticut Legislators are often being told that making a change in the corporate income is the key to economic growth. Without it, corporations will abandon the state; with it, Connecticut can compete with the rest of the country. While a legislator should be very skeptical about finding the Holy Grail in such a convenient manner, the temptation for legislators to do something to help the
economy is strong. So how should Connecticut policymakers evaluate the effect that a proposed change might have on business?

My preferred approach is to measure the effects of a tax change on a corporation’s after-tax rate-of-return. After all, that is one of the key ways that businesses use to evaluate their own investment and locational alternatives. Using after-tax rates-of-return has a number of advantages over the use of more aggregate measures. (One disadvantage of this approach is that it ignores the value of state and local services to the business, and more generally, to the state as a whole. A few researchers, however, addressed this weakness.)

First, the use of after-tax rates-of-return allows tax differentials to be completely isolated from other factors that may influence a firm’s profitability. This approach allows a state or a firm to determine how significant other cost advantages have to be to overcome a tax disadvantage (or vice versa). Because the more aggregate studies cannot isolate tax differentials, they present a less accurate picture.

To illustrate the weaknesses in some of these other more aggregate studies, consider those that use total tax collections divided by total business costs as their measure of tax burden. One problem with this approach is that costs and profits vary extensively by state and by industry. A high ratio of aggregate tax-to-business costs may not mean that a state is taxing heavily relative to other states; it may simply mean that non-tax costs are low. A more fundamental defect in this approach, however, is that taxes and business costs are not always independent of each other. If government-provided goods and services reduce costs that a corporation would otherwise incur, a state with a high tax-to-cost ratio may actually be a better place to do business than a state with a low tax-to-cost ratio.

Another approach that can be misleading is compare tax burdens by dividing business taxes by total tax receipts. The resulting ratio indicates only the proportion of state taxes paid by businesses and not the overall level of taxation. A state with a high ratio may actually impose a lower tax on business than a state with a low ratio.

Finally, any aggregate type of measure, whether taxes-to-business costs or business taxes divided by total taxes, cannot possibly reflect the range of special tax provisions that exemplify state tax structures. As one group of researchers stated, "... it makes little sense to talk of State A being a higher taxing State than State B except in terms of particular firms and then only in relation to specific marginal investments." Using after-tax rates-of-return eliminates these defects.

A second major advantage of using after-tax rates-of-return is that it precisely captures the Federal offset. For a firm subject to a 35 percent Federal marginal rate, a $10,000 local property tax results in a net out-of-pocket cost of only $6,500 ($10,000 - 35 percent x $10,000). Conversely, a state investment tax credit of $10,000 increases the firm's after-tax profits not by the full amount of the credit, but by only $6,500. This interaction between the Federal corporate tax and state and local taxes is particularly important when considering policy changes. Unless this interaction is considered, the benefits to the firm cannot be accurately weighed against any revenue forgone.

Indeed, the Federal offset highlights an inherent inefficiency in the use of state tax incentives. By lowering a corporation's state taxes, a tax incentive has the effect of increasing the corporation's Federal taxes. For a corporation subject to a 35 percent Federal marginal tax bracket, every $100 of Connecticut tax savings increases its Federal taxes by $35. In other words, Connecticut forgoes $100 in tax revenue but the corporation receives only $65 ($100-$35) in net benefit, with the Federal government receiving $35 of increased revenue. Put differently, to reduce a firm's taxes by $100, Connecticut must forgo $154 in taxes, with the Federal government benefiting by $54. This "reverse revenue sharing," which is inherent in using state tax incentives, is fully captured by the use of after-tax rates-of-return. 116

Third, the use of after-tax rates-of-return helps determine whether tax provisions may affect different firms in different ways. Different firms earning identical

---


116 A reduction in the rate of the franchise tax would also have the effect described in the text. A state program that was structured to provide a tax-free benefit to a corporation would not have such an effect, if the program did not reduce a cost that a business would have otherwise incurred.
before-tax profits may pay different taxes in the same jurisdiction. Tax liabilities may vary with asset composition (personal vs. real property), the location of sales (in-state or out-of-state), or the size of the firm. As an example, the recently adopted bonus depreciation provides significant advantages to firms with a large proportion of their assets in depreciable property. "Decoupling," that is, not incorporating bonus depreciation into state tax law, thus affects some firms more than others. Similarly, single weighting the apportionment formula will affect firms very differently depending on whether they export from Connecticut or import into Connecticut. In formulating state policy, it is important to know whether the tax system favors or disfavors firms with particular characteristics or firms in specific industries. Unlike the more aggregate measures of corporate tax burden, the use of after-tax rates-of-return is designed specifically to capture these differences.

Fourth, after-tax rates-of-return capture both the level and patterns of tax liabilities over time. A firm contemplating a new investment is concerned not only with the taxes it will pay in the first year of its investment but also with its tax liabilities over time. A one-year measure of tax liability is misleading because taxes vary from year to year. A corporate income tax, for example, will not be paid during loss years (typically occurring during a start-up period), whereas property and sales taxes will. After-tax rates-of-return readily accounts for the level, pattern, and duration of the firm's tax liabilities.

Fifth, the effects of changes in the tax law on the profitability of firms can be evaluated using after-tax rates-of-return. Changes in parameters such as depreciation rates, apportionment formulae, tax credits, or tax rates can be simulated and the impact on profits—often surprisingly small—can be measured.

Sixth, a corporation considering a new investment in one state is concerned with the effect of the investment on its tax liabilities in other states. Because of the various ways in which the states divide the income of a corporation for income tax purposes, the taxes paid in Connecticut can be affected by a corporation's expansion into State B. A calculation of after-tax rates-of-return will capture this interaction, whereas a one-year snapshot of the taxes paid to State B will not.

117 For a general discussion, see Report by the Staff of the New York Tax Study Commission, 'The Article 9-A Franchise Tax: Should New York Adopt ACRS?' (December 31, 1984).
The final advantage is that an after-tax rate-of-return analysis requires a state to model the types of corporations that are of interest. For example, a sensible approach to economic development would be to determine what Connecticut’s strengths and comparative advantages are over other states. What kinds of businesses and activities make sense for the future of the State? How can Connecticut build on its advantages? After all, not every type of economic activity makes sense for a state.

Once Connecticut policymakers determine the types of activities or industries it is trying to attract, the next logical step would be to determine what are the existing obstacles or hurdles? What will the CEO of a corporation in a targeted industry that Connecticut wishes to attract consider to be the impediments to moving or expanding in the State? While I am skeptical that the corporate income tax would rank high on that list, let alone some feature like the lack of single-factor sales apportionment, the firm can nonetheless be modeled and its after-tax rates-of-return can be determined. Various changes in the corporate income tax can then be simulated and their effects on after-tax rate-of-return evaluated. Certainly this approach provides more useful and focused information than relying on the types of statistical aggregates discussed above.

As another example, consider the adoption of the single-factor apportionment formula for manufacturers. In debating the shift to a single sales factor, the Legislature did not first ask the question about what types of corporations Connecticut is looking to attract, and then concluded that the obstacle to their coming to Connecticut was the apportionment formula. But even if they had, the next question would be whether the change in the apportionment formula would have the desired effect. And that question should be answered in terms of the effect the shift to single-factor apportionment will have on after-tax rates-of-return, not based on self-serving anecdotes by business, as is so often the case.

VI. Public Access to State Corporate Income Tax Returns

A. Introduction

---

Part Four above argued that the names of corporate beneficiaries of tax expenditures should be public information. Such disclosure would enhance the transparency of the Connecticut tax structure. In addition, it would encourage greater accountability. This Part makes the more general argument that the amount of corporate income taxes paid by each corporation should be made public.

During the 1980’s, Citizens for Tax Justice (CTJ), a Washington-based think tank, was able to utilize data from annual reports to shareholders and to the Securities and Exchange Commission (SEC) to document that some of the largest, most profitable corporations in the country were paying little or nothing in federal income taxes. The public outcry that resulted from the reporting of this information was one of the keys to the sweeping changes included in the Tax Reform Act of 1986.

CTJ’s work had a profound effect on educating the public about the need for corporate tax reform. Unfortunately, its work cannot be replicated in Connecticut. To be sure, we know that in a recent year, when ranked by sales, 30 of the largest 50 corporations in the state paid less in corporate income tax than the persons who cleaned their offices at night. But Connecticut citizens and legislators do not know the identity of these corporations. The annual reports of publicly-traded corporations contain information on the aggregate amount of state and local income taxes paid, but this information is not broken down state-by-state.

Working with this aggregate data, CTJ just released a study showing that 252 corporations in the Fortune 500 escaped state income tax on 2/3 of their profits. More shocking, 71 of these corporations paid no state income tax in at least one year from 2001 through 2003. Twenty-five of these corporations enjoyed multiple no-tax years. AT&T, Merrill Lynch, and ITT Industries—corporations with a presence in Connecticut—paid no state income tax at all over the three-year period. Sears, Southwest Airlines, Pitney Bowes, and Eli Lilly paid no tax in two out of the three years. The 252 corporations avoided a total of $41.7 billion in state corporate income taxes over the three years.\(^{119}\)

Unfortunately, because corporations do not report to the SEC their corporate income taxes on a state-by-state basis, there is no way of knowing how much these corporations paid—or did not pay—in Connecticut. Yet none of the fundamental

---

questions about the Connecticut corporate income tax can be answered without knowing, by name of corporation, the amount of tax that it paid. The discussion of tax expenditures in Part Four showed that over $4 billion is spent on beneficiaries whose identity is unknown, thus negating any sophisticated cost-benefit analysis of whether Connecticut is getting its money’s worth. Certainly a change in the law that was limited to identifying the amount of tax expenditures received by name of corporation would be a starting point in increasing accountability and transparency in government. But that would be only a starting point. The lack of a more general disclosure makes it impossible to evaluate the extent to which the corporate tax burden is allocated fairly or rationally.

Other states have done a better job. Wisconsin has had a disclosure law since 1923. Any resident of Wisconsin can find out by the payment of a nominal fee how much in corporate income taxes is paid by every corporation doing business in that state.

In 1991, both Arkansas and West Virginia adopted statutes providing for the disclosure of information on the dollar amount of certain specific credits taken by corporate and individual taxpayers. The Arkansas law is similar to the Freedom of Information Act and allows interested parties to request from the Arkansas Director of Taxation, by name of taxpayer, the amount of benefits received pursuant to specified tax incentives.

The West Virginia statute requires the State’s Tax Commissioner to publish an annual report indicating the name and address of every taxpayer, whether a corporation or individual, receiving any one of a list of specified credits, and the amount, by broad dollar category, of the credit received.

A comprehensive law was enacted in 1993 in Massachusetts as the result of the efforts of a state-level tax reform organization, the Tax Equity Alliance for Massachusetts (TEAM). Originally put forward as a state ballot question, the law was written as part of an agreement among TEAM, the business community, and legislative leaders. This statute initially required all publicly-traded corporations doing business in Massachusetts that already publish in SEC reports their federal income tax liability, to disclose six key items of information related to their Massachusetts taxable income and tax liability. The law was later gutted to eliminate the disclosure of the names of the corporations, so-called “anonymous disclosure.”

120 Richard D. Pomp, Corporate Tax Policy and the Right to Know, Enhancing Legislative and Public
B. Disclosure at the Federal Level

The Connecticut Legislature has previously considered—and rejected—changing the law to require the public disclosure by name of corporation of the amount paid in State corporate income taxes. Critics of this proposal described it as radical and innovative. In reality, extensive financial information, including tax information, is already in the public domain because of SEC regulations and generally accepted accounting principles. What is not fully appreciated, however, is that even prior to the enactment of the Securities Act of 1933 and the Securities Exchange Act of 1934, corporate tax returns or key items of tax information were frequently matters of public record.

Long before these Acts, disclosure was the rule rather than the exception—even for individuals. A review of the history of public access to federal tax returns reveals that the issue of corporate tax disclosure was almost always intertwined with questions related to the privacy of individual tax returns. The privacy extended to federal corporate returns generally piggybacked onto the treatment of individual returns. The privacy issue was basically fought—and lost—over the issue of whether individual returns should be public information. No one on either side of the debate went to great lengths to distinguish the different issues involved in corporate disclosure from those of access to individual returns. Having chosen to pitch their battle over access to individual returns, supporters of disclosure gave up an opportunity to achieve corporate disclosure directly through the provisions of the Internal Revenue Code.

The few times when Congress did focus on the differences between corporations and individuals, it tended to opt for more disclosure in the case of corporations. For example, under federal law, a 1% shareholder or more inspect the tax return of his or her corporation (although the shareholder cannot disclose any information obtained from the inspection).

In recent years, the need for public access to federal corporate income tax returns has been mooted. The SEC has essentially preempted the issue by mandating the disclosure by publicly-traded corporations of extensive financial data including numerous components of taxes paid.

Access, 6 State Tax Notes 603 (1994).
C. The Rationale for State Level Disclosure

1. Firm-Specific Disclosure is Necessary for Informed Tax Policy

Legislators and citizens have an obvious interest in Connecticut’s corporate income tax, if for no other reason that large sums of money are involved both in the amount of taxes imposed and the amount forgiven through tax expenditures.

The issue of how a state taxes, or exempts from tax, corporate activity raises fundamental value judgments about how the costs of government should be distributed. Both large-scale corporate tax avoidance and inefficient tax expenditures mean that a state must rely more heavily on other taxes—with different incidence patterns—or cut spending.

In addition to the question of how taxes are distributed between corporations and individuals, another significant issue is how the corporate tax is distributed among corporations and among industries within states. Connecticut’s corporate income tax is replete with provisions that discriminate between small and large corporations, in-state and out-of-state corporations, capital-intensive and labor-intensive corporations, and corporations that sell out-of-state and those that sell within the State.

As discussed above, tax expenditures benefit greatly certain unidentifiable corporations.\(^{121}\) Whatever the general case for disclosure, certainly the beneficiaries of tax expenditures should be disclosed, just as they would be if they received grants or subsidies from the State. To evaluate whether tax expenditures serve their ostensible purposes, researchers must know, at the very least, which corporations received what types of incentives and in what amounts. Only then can it be determined whether the benefits to Connecticut of these incentives justify the forgone revenue, and whether such incentives need to be enhanced, reduced, or redirected.

Firm-specific data facilitate consideration of a full range of issues surrounding corporate tax policies. Disclosure facilitates informed and critical evaluation of the distribution of tax burdens and of corporate requests for tax relief—requests that may be underscored by express or implied threats to abandon Connecticut for a more favorable tax climate. Disclosure allows the public to evaluate more

\(^{121}\) See Part Three above.
effectively corporate claims that they are straining under an excessive tax burden. And, disclosure would discourage corporations from misleading legislators and the media by taking public positions inconsistent with the facts.

Without firm-specific data, it is not possible to do the type of analysis, known as microsimulation, which provides the most accurate picture of the impact of tax changes. Only with microsimulation is it possible to consider the interrelationship of different provisions of the tax law.

Public understanding of seemingly complex issues has been essential to the development and implementation of the many significant economic reforms instituted at the federal and state levels. Government officials are unlikely to be able to enact economic reform legislation, even if based on sound theoretical reasoning and extensive empirical evidence, if they are unable to explain the need for such laws to the ordinary citizens; nor, in our democratic society, should they be able to do so. Specific case studies are essential to explaining complex economic issues to the public, as CTJ’s experience in the 1980’s demonstrated.

3. Sunlight is the Best Disinfectant: Disclosure Would Promote Openness and Accountability

Disclosure is just another reminder that as Justice Brandeis observed, “sunlight is the best of disinfectants.” Not surprisingly, the principal architects of the early securities acts were disciples of Justice Brandeis. Good government requires openness; the free flow of information is a remedy for poor policies and political ills. “Information is the currency of the ‘marketplace of ideas,’ the prerequisite for political self-determination, and a security against usurpation by secret cabals.”

Openness and accountability make it less likely that tax laws will be made behind closed doors, where special interests are more likely to prevail over the public’s interest.

To evaluate whether the tax system with its myriad special provisions is working as the Legislature intended, the public must know, at the least, how much each corporation is paying in corporate income taxes. Only then can the public and legislators evaluate the tax. Disclosure can restore public confidence by either showing that the current system is working well or by providing the information necessary for effective reform.

---

Disclosure is based on rather traditional values—the public as well as elected officials should be informed about the workings of our economic and legal systems and that to the maximum extent possible, public policy should be made in an open and informed manner. Sunlight in the form of disclosure will help restore confidence in both the business community and the tax system.

4. Connecticut Disclosure will Complement SEC-Mandated Disclosure

Compared with the extensive information already in the public domain because of SEC requirements, state disclosure is modest. Primarily because of the SEC, the public has been given a window into the financial affairs, including the income tax data of publicly-traded corporations. State disclosure would open that window a crack more.

D. Arguments Against Disclosure

1. Firm-Specific Data can be Disclosed Anonymously

Opponents of disclosure argue that it is unnecessary to publish the names of corporations. Statistical aggregates can be used to evaluate the workings of the corporate tax. However, unless the name of a taxpayer is published along with its corporate tax information, it would be nearly impossible to obtain the hoped for benefits of disclosure. Corporations whose tax liabilities appear unconscionably low cannot be identified from statistical aggregates. Tax policy judgments cannot be made in the abstract but need an identifiable context in which to operate. Microsimulations, discussed above, cannot be performed on aggregates.

The disclosure of firm-specific data without corporate names would make it impossible to match the disclosed tax information with other publicly available data on employment, investment, and other relevant indicia. And if there were not some way to track the same corporation from year-to-year, even limited longitudinal analyses would be impossible.

Statistical data without identifying the corporations involved inevitably limits its use by researchers. Statistical information can be presented in various ways. For example, income taxes paid by a corporation can be compared with its receipts, property, number of employees, amount of assets, type of business, and so forth.
The value of the data is obviously constrained by the way it is presented. What might be a valuable presentation for some policymakers and researchers would be irrelevant for others. By contrast, if the data are presented with the name of the corresponding corporations, researchers can correlate the tax information with other publicly available data that they wish to utilize. Researchers can pursue whatever issues are most relevant—then, or at any time in the future. Without knowing the name of the corporations, researchers would not be able to use the information disclosed in conjunction with the information in Form 10-k’s, annual reports, and other databases.

Disclosure eliminates one of the subtle, but serious defects with the use of aggregate data. All too often, what is of interest to researchers are the “outliers.” Statistical aggregates can hide much of value in evaluating a state tax system. If, for example, some of the largest corporations in Connecticut pay only a nominal income tax, such information is highly relevant form a policy perspective but lost when buried in aggregates.

2. Disclosure will Violate a Corporation’s Right to Privacy

The extent of SEC-required disclosure by registered corporations makes it obvious that such corporations have long ago surrendered any claim that their financial data should be protected under some right of privacy. If the disclosure of their federal income tax liabilities and other financial information does not raise a constitutional issue, then neither should the disclosure of their state tax information.

Revealing the taxes paid by small, closely-held corporations might be viewed as violating legitimate expectations of privacy by its shareholders. Accordingly, such corporations could be exempted from any disclosure requirements.

3. Disclosure will Reveal Proprietary Information

While opponents of disclosure assert that revealing the amount of a corporation’s taxes or tax expenditures would reveal proprietary information, no one has been able to present a viable example of this. If there were any substance to this argument, it would have been made a long time ago about the copious information that federal laws force corporations to reveal. SEC and other federal laws already require many corporations to disclose tax and financial information, and such disclosure has not jeopardized the economic interests of the corporations.
Further, for information to be valuable, one needs to know today what a competitor is going to do tomorrow. By the time a corporation requests the normal extensions and files its return, whatever tax information would be disclosed would be stale. Yesterday’s information obtained tomorrow is worthless.

4. Disclosure will Discourage the Filing of Accurate Returns

In the case of individuals, it is sometimes argued that confidentiality of tax returns encourages persons to make full and truthful declarations, without fear that those statements would be revealed or used against them for other purposes. In the case of corporations, the contrary argument would seem more plausible. If corporations were publicly accountable for the information furnished on their Connecticut income tax returns, their incentive to report truthfully might be even greater. Disclosure could increase the likelihood that employees, competitors, or other businesspersons would notice glaring omissions or anomalies and bring them to the attention of the authorities.

5. Disclosure will Mislead the Public

Opponents of disclosure contend that the general public is unable to understand the significance and implications of corporate tax information. Only tax experts, it is held, can understand the multifarious and complex factors that interact to generate a corporation’s tax liability. The public would be confused, or unreasonably angered, by learning of nominal corporate tax liabilities paid by identifiable corporations. The public’s passions will be inflamed out of ignorance and misunderstanding.

This “ignorant and unduly agitated public” argument ultimately challenges the premises underlying a democratic society. A well-functioning democracy requires an informed public. If corporations feel that the disclosed information is likely to be misinterpreted, they can educate the public and Legislators by providing more information and a fuller explanation.

This argument captures nicely what the beneficiaries of the current defects in the tax system know all too well. The defects continue because they are described only through the use of mind numbing statistical abstracts. It is hard to bet outraged about a numerical aggregate. Real flesh and bone is required to capture the public’s attention. Corporations that have been paying less in corporate tax than those who
sweep their floors at night should fear the public’s reaction if their identities were to be known. But the public has every right to learn the identity of legislative largesse—and would know that information if the largesse took the form of an explicit spending program.

6. Disclosure Will Undercut Connecticut’s Business Climate

Opponents of disclosure argue that it would create or exacerbate an anti-business climate in the State. Disclosure would antagonize the business community.

This argument proves too much. Any legislation that the corporate community opposes can be characterized as poisoning the business climate. Such arguments are usually put forth, in one form or another, through the incantation of economic growth. This issue has been thoroughly discussed in Part Four above.

VII. Conclusion

Many of the pressing issues that face Connecticut Legislators—transportation, crime, education, health care—either have unknowable or very costly solutions. In contrast, the defects in the tax system have knowable solutions that will raise money rather than costing money. Implementing combined reporting, adopting a throwback rule, rethinking the single-factor apportionment formula, undertaking a rigorous and comprehensive review of tax expenditures, aggressively collecting sales taxes owed on Internet and mail order sales, and providing more public disclosure about corporate income taxes is a way of taxing smarter, more efficiently, and achieving greater accountability and transparency in the tax system. Like a dike, the State’s tax structure requires constant vigilance, maintenance, and repair. Luckily, we know how to make the repairs and have the tools to do so. The only question is whether we have the will to do so.