



The Case for Reforming, Not Eliminating, Connecticut's Business Entity Tax Shelley Geballe, JD, MPH

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If help for small businesses is the goal, reform and not elimination of Connecticut's Business Entity Tax is warranted. On January 23, 2008, Secretary of the State Susan Bysiewicz and a bipartisan group of legislators called for total elimination of the business entity tax. Secretary Bysiewicz explained, "This tax is an obstacle to small business owners who are responsible for 80% of new jobs in our state and help our economy grow."¹

On January 29, 2008, the Senate Democrats announced their "*Emergency Relief Plan for Connecticut Families*." Included in the *Plan* was a proposal to impose a *one year moratorium* on the business entity tax for *small* businesses only (determined by revenue and value of assets). The *Plan* explained that this "would help the truly small businesses deal with the burden of high energy and other costs."²

Shortly thereafter, the House Republicans again endorsed the idea of total repeal of the business entity tax, an idea they stated they had proposed first in 2003.³

This issue brief explains *what* the business entity tax is, *what* types of businesses pay this \$250 annual tax rather than the corporation business tax (which is based on the company's net income or capital base), and suggests that if the goal is to aid *small* businesses during this economic downturn, then reform of the tax -- rather than outright repeal -- is warranted.

The rationale for corporation business taxes. For decades, Connecticut corporations have paid the corporation business tax "for the privilege of carrying on business in a corporate capacity in Connecticut."⁴ This "privilege" includes the insulation of the personal assets of the owners of the business from any claim for damages arising from a contract or tort action. The tax due is the higher of 7.5% of

Connecticut net income (or apportioned income for multi-state corporations) or 3.1 mils per dollar of the corporation's capital base. Each corporation must pay at least \$250/year in tax. In 2004, 44,160 Connecticut corporations paid a total of \$490.7 million in corporation business taxes (and \$388.35 million after tax credits). 29,509 of these corporations (67%) paid only the \$250 minimum tax.

CT's Business Entity Tax is imposed on certain corporations and partnerships that are not subject to Connecticut's corporation business tax. The Connecticut business entity tax is the annual \$250 tax⁵ imposed since 2002⁶ on every⁷ domestic⁸ S corporation (S-corp), limited liability company (LLC)⁹, limited partnership (LP), and limited liability partnerships (LLP), as well as foreign S-corps, LLCs, LPs, and LLPs that are transacting business in Connecticut and required to register with the Secretary of the State. In 2006, 118,775 business entities paid a total of \$32.2 million in business entity taxes.

The business entity tax is *not* imposed on domestic or foreign C corporations or single member LLCs that elect to be taxed for federal income tax purposes as C corporations. Rather, these businesses pay Connecticut's corporation business tax.¹⁰

CT's Business Entity Tax is equal to the corporation business tax's minimum tax. Some businesses now paying the \$250 entity tax previously paid *more than* \$250 in corporation business taxes. Notably, many businesses that now pay the \$250 business entity tax once paid Connecticut's corporation business tax. That is, they paid the corporation business tax based on their net income or capital base. Beginning in 1996, Connecticut phased-out the corporation business tax on S corporations. Income was allowed to "pass-

through” to the shareholders/partners with no corporate income tax imposed. This change reduced business taxes for all S corporations except those that had been paying the \$250 minimum corporation business tax.

Not all business entities paying Connecticut’s Business Entity Tax are small “mom and pop” businesses. In 2003, 18 of Connecticut’s 100 largest companies (nearly one-fifth of our largest companies) paid the \$250 business entity tax, rather than the corporate business tax.¹¹ Purdue Pharma, L.P.,¹² a privately-held pharmaceutical firm based in Stamford that produces (among other drugs) the pain killer OxyContin, was ranked Connecticut’s 35th largest company in 2006, based on sales of \$1.4 billion.¹³ As a limited partnership, it would pay the \$250 business entity tax, not the corporation business tax on its net income or capital base.

Close to three-quarters of the production companies claiming “film production” tax credits are LLCs (36 of the 49). Though they each pay the \$250/year business entity tax, collectively their claims for transferable (i.e., saleable) tax credits now total more than \$51 million. Already, the In Bloom LLC has sold \$2 million of its tax credits to Kohl’s Department Stores, Inc.¹⁴

Most of the recent growth in Connecticut businesses has been in pass-through entities (S corporations, LLCs, LPs, and LLPs). Given the more favorable tax treatment afforded pass-through business entities, it should not be surprising that the number of Connecticut pass-through business entities grew by about 30% between 2001 and 2006, while the number of C corporations declined by about 10%.¹⁵ The impact of this shift in corporate legal form is continued erosion of the corporation business tax base and its revenues. Repeal of the \$250 business entity tax on *all* pass-through entities would accelerate the loss of revenue from the business sector, further shifting the tax burden to families.

Connecticut’s \$250 Business Entity Tax is not anti-competitive. About half of all states impose an entity-level tax on LLPs and LLCs, including New York, New Jersey, New Hampshire, Rhode Island,

and Maine.¹⁶ The tax in many of these states exceeds Connecticut’s tax of \$250 per entity. For example, some neighboring states (New York, New Jersey) impose a tax on each *member* or *partner* of the entity; for a business with multiple members/partners, the total tax would exceed a single tax on the entity itself.¹⁷ Other states in the region (New Jersey, New Hampshire) impose a tax based on the net income of the entity.¹⁸ Rhode Island, like Connecticut, imposes an entity tax, but it is twice ours at \$500/year. Requiring a Connecticut business entity to pay \$20.83/month for the privilege of operating a business in Connecticut – or simply sheltering personal assets from liability -- is not, on its face, excessive.

If Connecticut wants to target help to small businesses, it would be fairer to create graduated tax rates than a total exemption. Entities with less than \$50,000/year in gross business income or with less than \$100,000 in assets, for example, could pay a smaller tax than \$250/year for the “privilege” of operating a business in Connecticut, while very profitable firms could be required to pay more.¹⁹ This would assure that *all* business entities contribute *something* to the costs of maintaining the infrastructure that supports their businesses or investments.

Reform of Connecticut’s business tax code is needed to assure a more level playing field among *all* Connecticut businesses. Changes in apportionment formulas (that allow certain large, multi-state firms to shift profits out of state) and the steady enactment of new tax credits, exemptions and deductions have narrowed Connecticut’s business tax base and created distortions in our market. Greater equity among businesses would be achieved by repeal of these many preferential tax expenditures, extension of the business tax to *all* businesses (regardless of legal form), and adoption of a progressive rate structure that imposes higher taxes on larger, more profitable firms than on smaller and start-up companies. By so broadening the base of the tax, the business tax rate could likely be reduced, making Connecticut more competitive for *all* businesses.

¹ *Bysiewicz: Abolish the Business Entity Tax Now!* (January 23, 2008), available at www.sots.ct.gov.

² *Senate Democrats Announce Emergency Relief Plan For Connecticut Families* (January 29, 2007), available at: www.senatedems.ct.gov.

³ *House Republicans' Targeted Tax Cuts Hedge Against Economic Downturn* (January 30, 2008), available at: www.housegop.ct.gov.

⁴ CT Department of Revenue Services, Informational Publication 2007(26).

⁵ In 2003, the business entity tax was increased to \$300, but then reduced again in 2004 and years thereafter to \$250.

⁶ PA 02-1 (May Special Session) created the business entity tax.

⁷ Conn. Gen. Stat. §12-284b, as amended by PA 06-159, §14, clarifies that *every* domestic business entity is subject to the business entity tax, not just those entities that are required to file an annual report with the Secretary of State under Conn. Gen. Stat. §33-953, 34-106, 34-13e, or 34-420.

⁸ “Domestic,” when used to describe a business entity, means an entity formed under the laws of Connecticut, while “foreign” means a business entity that is not a domestic business entity. CT Department of Revenue Services, SN 2006(12).

⁹ PA 92-267 created this new form of business entity, the Limited Liability Company. PA 97-70 authorized the single member LLC.

¹⁰ CT Department of Revenue Services, Policy Statement 2007(4).

¹¹ CT Legislative Program Review and Investigations Committee, *Connecticut's Tax System* (2006), p. 202. This study reports that another 18 of the 100 largest companies in Connecticut paid the \$250 minimum corporation business tax. That is, more than one-third of the state's 100 largest companies paid just \$250 each for the privilege of carrying on a business in the state.

¹² See www.perduepharma.com for more details about this company.

¹³ See the Connecticut's Magazine's, *The Connecticut 100* (January 25, 2007). Available at: www.zwire.com/site/news.cfm?newsid=17747943&BRD=2329&PAG=461&dept_id=600736&rfi=6.

¹⁴ CT Commission on Culture and Tourism's *Digital Media and Film Tax Credit Report* to the Secretary of the Office of Policy and Management (February 6, 2008).

¹⁵ CT Legislative Program Review and Investigations Committee, *Connecticut's Tax System* (2006), p. 202.

¹⁶ B. Ely, S. Grisson, and M. Houser, *State Tax Treatment of Limited Liability Companies and Limited Liability Partnerships*. 2007 SIT 142-2 (State Tax Notes, Tax Analysts, 2007).

¹⁷ New York imposes a tax of \$100 per year on each *member* or *partner* in an LLP or LLC, with a cap on the tax paid by the entity of \$25,000/year. New Jersey imposes a tax of \$150 per year on each member/partner in an LLP or LLC with three or more members/owners (and no annual fee for entities with fewer members/partners).

¹⁸ In New Jersey, LLCs and LLPs also pay 6.37% of New Jersey net income allocated to all nonresident, non-corporate members/partners and 9% of New Jersey net income for all nonresident corporate members/partners. New Hampshire imposes a 5% tax on dividends and interest exceeding \$2,400, an 8.5% tax on business profits (only for LLCs and LLPs with

more than \$50,000 in gross business income), and a 0.75% tax on the “business enterprise value tax base” of the LLC/LLP (with a dollar-for-dollar credit against the business profits tax for the amount of business enterprise tax paid).

¹⁹ The tax due could be based on such factors as net income, assets and/or number of employees, requiring disclosure to DRS of such information (which is not now required).