CORPORATE TAXA

WHAT IT COULD MEAN FOR

Connecticut businesses are pummeled from all sides by legislative changes impacting tax and financial reporting. And beyond legislative impacts, the process of corporate taxation is squeezing businesses in other ways. "In a *Compliance Week* analysis of 400 companies that reported material weaknesses in their most recent annual reports, one-third attributed problems to taxes," says Mike Burke, director of tax operations, Tri-State area, for Jefferson Wells. "Tax related restatements [thus far in 2006] are ahead of the pace observed in 2005. Confounding the process, corporate tax accounting has been swept up in the perfect storm of [the Sarbanes-Oxley Act of 2002], a regulatory crackdown on abusive tax shelters, and a skilled workforce shortage," he says.

The 2006 crop of new laws, credits and reforms reflect two over-riding themes: job creation and compliance. *Connecticut Business Magazine* spoke with a statewide panel of experts who shared some of the highlights.

BY DEBORAH NASON

State Legislative Changes

Employment is very much on the minds of Connecticut legislators, who introduced new tax credits aimed at hiring displaced workers and creating new jobs. Carol Swinkin, CPA, with North Haven-based Seward and Monde, discusses several new legislative changes in the state that will impact businesses, going forward.

Displaced Workers Tax Credit: "This relates to people who worked in Connecticut and lost their jobs due to layoffs or restructuring," she explains. "If you hire these people at 75 percent of their salary or more, you can get a tax credit for each displaced worker, after the employee completes 12 full months. They're really trying to beef up jobs in the state."

New Jobs Creation Tax Credit: "This is for companies that are new to Connecticut, which are creating at least 50 new permanent jobs (of at least 35 hours per week). The credit can be up to 25 percent of the income tax withheld from the new employees.

Flow-Through of Tax Credits: "Now, 'pass-thru' entities (trusts, 'S' corps, partnerships, LLCs) can receive tax credits if they are involved in a qualified employment expansion project," says Swinkin. "To qualify, the project must create at least 400 permanent full-time jobs, new to Connecticut, over a maximum of five full years. Formerly, most of these credits were only good for certain types of corporations."

Film Production Credit: "This is an interesting credit," says Swinkin. "You can actually sell it in the open market. The credit applies to up to 30 percent of certain production expenses and costs in excess of $50,000 incurred in Connecticut for any type of entertainment content—TV, commercials, video." She explains the reasoning behind this credit: "Although these production companies don't pay taxes in the state, Connecticut is trying to get them to spend money here."

Increased focus on compliance: "There's been a new audit division created by the Department of Revenue Services," she says. Its goal: to integrate its own data with that of the Department of Labor, and other state departments. "They're really pushing to look at non-filing and non-reporting in the state. They're finding a lot of instances where, for example, taxes were withheld for employees, but not remitted. Now with its new computer system, the state can data mine and match up individual returns with company [remittances]."

Federal Legislative Changes

The Tax Increase Prevention and Reconciliation Act (TIPRA), enacted in May of 2006, offers a wide range of changes that affect both businesses and individuals. A May 2006 report from Deloitte Tax LLP lists some of the immediate provisions affecting businesses:

- "Increase corporate estimated tax payments due July through September for corporations with assets in excess of $1 billion in certain years."
- "Delay due date until October 1st for a percentage of corporate estimated taxes that are otherwise due on September 15 in certain years."

On compliance, Dave Acampora, tax managing partner for Deloitte Tax's Connecticut practice, describes several new federal provisions that encourage increased transparency by requiring a wider use of IRS software and the introduction of new disclosure rules.

E-filing: While electronic filing of taxes has been prevalent for a while, more and more companies are being required to file their returns electronically. "The threshold is going to expand in 2007 to 'C' and 'S' corporations with $10 million or more in assets, and at least 250 income tax returns." Returns may include filings covering payroll taxes, 1099s, W-2s, etc. Shouldn't companies be happy to do this? "Not initially," he says. "It requires a different process. And what's a little disconcerting—you don't know until you press the button, if you have a good product. Part of e-filing is the possibility of rejection due to technical or other errors. You have to now provide for some rejection time; and many forms need to be incorporated into tax return preparation software." And beyond converting in-house forms, says Acampora, the IRS is also allowing fewer and fewer .pdf attachments. "The idea is to get all the information into the body of the IRS software."

Disclosure rules: "The SEC adopted new rules requiring a single compensation figure to be reported of the CEO, CFO and the next three highest paid executives or directors. This impacts any public company and affects year-end reporting for fiscal years ending on or after December 15, 2006." He summarizes the repercussions: "More disclosure, more embarrassment."

Federal excise tax refunds: Acampora also describes an interesting tax refund opportunity that has a wide appeal. "Federal excise tax is applied to almost all long-distance phone calls," he explains. "But in August of 2006, the IRS told companies to stop collecting this tax on its behalf. There is a refund opportunity [generally within the three year statute of limitations, but sometimes longer] to request refunds. The IRS is asking companies to compute the credit due to them and apply it to their tax returns." While federal excise taxes seem small, these three percent assessments add up. A company with $10,000 in monthly long-distance charges pays $300 per month in federal excise taxes. Multiply this by the 36 month look-back period, and you could have a hefty refund coming to nearly $11,000. "I think every company should take advantage of this," says Acampora.

Pension Protection Act

The Pension Protection Act is another significant piece of legislation enacted in 2006. Deloitte Tax summarizes the act's impact, explaining, "...[it] will simplify and transform rules governing the funding of defined benefit plans, accelerate funding obligations of employers, prospectively clarify the rules for cash balance plans, make permanent the revisions enacted in 2001 that were set to expire in 2010, strengthen diversification rights and investment education provisions for plan participants, and encourage automatic enrollment in defined contribution 401(k) plans."

Mike Redemske, CPA, a professor of tax accounting at the University of Connecticut, discusses the act's compliance and tax implications.

"This act deals with companies that have pension plans that are not fully funded," he says. Those companies will have seven years to bring themselves up to snuff." Why would pension plans not be fully funded? "Possibly because their [pension] investments didn't perform as well as expected—for example, they were using a strategy based on the 1990s [economic environment]," he explains.

In addition, Redemske says that the new law, which will become effective in 2007, puts the responsibility on the employer to provide financial education to employees. According to a 2006 report by the National Association of Insurance and Financial Advisors, "Retirement plan sponsors can arrange to have investment advice delivered to participants without worrying about being exposed to fiduciary liability in connection with that advice." The report adds, "The law is very clear about who can provide advice to retirement plan participants and what circumstances must be present in order for a plan sponsor to have met its fiduciary responsibility in connection with that advice."

With respect to tax considerations, the Pension Protection Act permanently enabled the ability of employers to offer Roth IRAs. What's in this for employers? "It's a benefit entirely to the employees," says Redemske. "It affects how your 401(k) monies are taxed to [them]." He explains: "Let's say you have a regular IRA where you have $5,000 a year taken from your income, and allocated to several mutual funds. When you are ready to withdraw the funds—maybe they've grown to $20,000—you would have to pay tax on the full amount you withdrew." But with a Roth IRA, he says, you would be taxed at the time the original $5,000 is taken from your income, and you would pay no taxes when you withdrew your money in the future.

FIN 48

Government entities are not the only ones calling the shots when it comes to compliance and financial reporting. The Norwalk-based Financial Accounting Standards Board (FASB), as authorized by the SEC, is also having a say with its Financial Interpretation Number 48, or FIN 48 for short.

AT A GLANCE

2006 Connecticut legislative changes: "2006 Legislative Changes Affecting Corporate Business Tax" – www.ct.gov/drs/lib/drs/publications/pubssn/2006/sn06-8.pdf

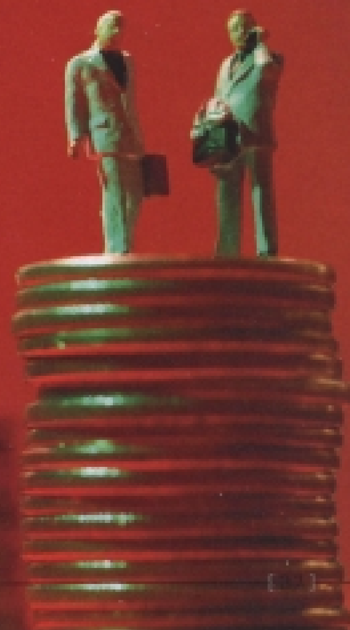
TIPRA: In May of 2006, the Tax Increase Prevention and Reconciliation Act of 2005 (TIPRA) was enacted. Here is a summary report from Jefferson Wells: Key Provisions of the Tax Increase Prevention and Reconciliation Act of 2005 – www.jeffersonwells.com/Knowledge/Tax/TIPRA.pdf

Federal excise tax refunds: Federal Telecommunications Excise Tax – www.deloitte.com/dtt/cda/doc/content/us_tax_federal_telecom_excise_tax.pdf

Pension Protection Act of 2006: This summary report was prepared by CCH – http://tax.cchgroup.com/Legislation/2006-Pension.pdf

FIN 48: "Summary of Interpretation No. 48" – www.fasb.org/st/summary/finsum48.shtml

Sarbanes-Oxley for smaller companies: Are You Ready for Section 404? – www.jeffersonwells.com/Knowledge/Internal/ready_for_404.pdf



"There's been some lack of clarity over the proper way to reflect owed taxes in financial statements," explains Mark Caplan, a partner with KPMG LLP in Hartford. "In July of 2006, the FASB recognized that there was diversity in practice of recording tax positions [credit, deduction or other decisions]. In some situations, the tax law isn't clear, such as the repair of major fixed assets—are these capitalized or expensed? What about investment in R&D? Leasing arrangements? Same questions apply." Indeed, U.S. businesses claim billions of dollars in tax positions that may or may not hold up.

The FASB has come up with a process when making these interpretations and decisions. "This applies to companies which issue financial statements under Generally Accepted Accounting Principles [GAAP]," says Caplan. The rules will be effective for the first fiscal year beginning after December 15, 2006.

FIN 48 has two steps:

1. "When evaluating when it is appropriate to record a tax position, the company must take a 'more likely than not' approach," he says. "That is, it is greater than 50 percent likely that you will sustain the position based on its technical merits." Adds Caplan, "Don't think: 'I'll never be audited'. Assume: 'I will be audited', and with full disclosure of information. Therefore, if you think you would have less than a 50 percent likelihood of prevailing, don't do it."

2. There is an increased disclosure requirement, he says. "In footnotes, you must indicate that there are a [cumulative] amount of [tax positions] that have not been recognized—but may be. "FASB is not telling you what you should or should not be taking on your tax returns, but what you should put on your financial statements—how to account to your shareholders about your taxes," says Caplan.

SOX Spreads

The concern with compliance continues with the Sarbanes-Oxley Act of 2002. Another wave of SOX compliance requirements begins in mid-2007, as the act expands its reach to smaller companies [referred to in this context as "non-accelerated filers"], says Jefferson Wells' Burke.

He says the affected businesses are "all publicly-traded companies with $75 million or less of public float where available (or market capitalization, otherwise) as of December 31, 2005, that have filed at least one annual report with the SEC."

Burke adds, "Section 404 [of the Sarbanes-Oxley Act] requires management to assess internal controls over financial reporting and issue reports on the effectiveness of these controls. This is required for all fiscal years ending on or after December 15, 2007. Furthermore, the company's external auditor must issue an opinion on management's assessment of internal controls over financial reporting and attest to the effectiveness of internal controls. This will be required for all fiscal years ending on or after December 15, 2008."

Looking Forward: 2007

Mike Burke of Jefferson Wells points out to a number of tax-related legislative programs that could be approved soon.

Within the Treasury Department 2007 project agenda are several items of interest to corporate tax departments, he says, including:

- Temporary regulations to facilitate electronic filing
- Guidelines for estimating stock basis in tax-free reorganizations
- Guidance on mergers involving foreign corporations
- Guidance on the exemption of certain investment income of foreign governments
- Proposed regulations regarding unrealized receivables and inventory items of a partnership

There are some possible tax credit extensions waiting in the wings, says Burke. "Everyone should have their eyes peeled for these credits—it is money that could be in their pockets." These include:

Welfare-to-Work: "The welfare-to-work credit is available to employers for wages paid to long-term family assistance recipients who began working before January 1, 2006 (barring further Congressional action). The amount of the credit is 35 percent of the qualified first-year wages plus 50 percent of the qualified second-year wages for the tax year. The credit applies only to the first $10,000 of wages in each year with respect to any individual. Thus, the maximum total credit per qualified employee is $8,500 for the two years."

Work Opportunity: "A credit is available for wages paid by employers who hire individuals from certain target groups."

Research and Development: "This is a credit for increased research expenditures."

Connecticut State Business Tax Climate

In its recently released 2007 State Business Tax Climate Index, the Tax Foundation created a master index from 113 variables to rate the tax climate for business in each state. Connecticut was ranked near the bottom, at 37. The State Business Tax Climate Index is derived from a combination of five indices. Connecticut's rank on each of these was: corporate tax: 28, individual income tax: 19, sales tax: 33, unemployment tax: 16, and property tax: 49.

The 10 best states were:

1. Wyoming
2. South Dakota
3. Alaska
4. Nevada
5. Florida
6. Texas
7. New Hampshire
8. Montana
9. Delaware
10. Oregon

The 10 worst states were:

41. Minnesota
42. Maine
43. Iowa
44. Nebraska
45. California
46. Vermont
47. New York
48. New Jersey
49. Ohio
50. Rhode Island

In its accompanying report, the Tax Foundation explains: "State lawmakers are always tempted to lure business with lucrative tax incentives and subsidies. Lawmakers create these deals under the banner of job creation and economic development, but the truth is that if a state needs to offer such packages, it is most likely covering for a woeful business climate plagued by bad tax policy. A far more effective approach is to systematically improve the business tax climate for the long-term."

Deborah Nason is a freelance business journalist whose work has appeared in national and statewide publications such as the *Christian Science Monitor*, *Investment News*, and *Virginia Business Magazine*. She relocated to Connecticut after serving as a contributing editor and lead writer for five years for the *Blue Ridge Business Journal* in Roanoke, Va. She has a master's degree in management and human resource development.