Testimony to

Senate Select Committee on Budget and Tax Reform

"Weighing the fairness of the Corporate Franchise Tax and the effectiveness of its tax expenditures"

Presented by

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My name is Ken Pokalsky and I am Senior Director of Government Affairs for The Business Council of NYS, Inc.

I appreciate the opportunity to testify today, on behalf of The Business Council and our 3,000 members across New York State. Our membership is diverse by location, sector and size.

In the limited time available to us this afternoon, I will try to touch on the several issues and questions raised in your hearing notice, and give you a sense of The Business Council's main concerns and priority recommendations regarding state business tax policy.

In addition to the testimony we are submitting testimony today, we will be providing the Select Committee with additional business tax reform recommendations in the near future.

$3.13 billion in Corporate Franchise Tax expenditures in 2005 for economic development purposes

In the hearing notice, you cite "$3.13 billion in Corporate Franchise Tax expenditures in 2005 for economic development purposes." That number appears to be derived from the Department of Tax & Finance's most recent tax expenditure report, and deserves a closer look.

The bulk of that $3.1 billion ($2.919 billion) is due to New York's exclusion of interest, dividends and capital gains from subsidiary capital – including foreign subsidiaries - from the federal taxable income (FTI) of Article 9-A taxpayers.

This exclusion dates back to 1944, and was adopted in recognition of New York as a "corporate headquarters state." Its express purpose was to encourage corporations that functioned as a "holding company" to remain in the state. As of 2007, New York still had more Fortune 500 company headquarters than any other state (57).

Importantly, while this exclusion reduces the NYS tax liability of a holding company, it does not affect (or reflect) the tax liability of any of its operating companies with NYS tax liability.

Since 1944, most states have provided exclusions for some or all of dividend income from subsidiaries. In this respect, New York's exclusion is comparable to provisions of other states. While we do not have breakout data from the Department of Tax & Finance, we expect that the dividend exclusion accounts for the bulk of this $2.9 billion figure for New York.

Since this type of dividend exclusion is found in most state's tax statutes, any proposal to limit its availability to New York businesses would most definitely impact our competitiveness.

It should be noted that this exclusion is partially offset by the state's adoption of mandatory combined reporting for Article 9-A taxpayers. Adopted in 2007, this impact is not reflected in the "tax expenditure" data available to us today.

Setting aside this core component of the state's corporate franchise tax, 2005 CFT economic development tax expenditures – about $350 million - were fairly limited compared to the *$105 billion* state budget for the comparable state fiscal year.

Between 2004 and 2007, New York's private sector grew by 3.6 percent while the U.S. average was 5.6 percent. Since the state entered a recession in March 2008, it has lost over 124,100 private sector jobs.

We share your concern about New York's disappointing level of economic growth in recent years, and the need for New York to become more competitive.

We also agree that we need to assure that our economic development investments are strategically targeted, and assure that those investments provide adequate economic returns to the state.

However, we urge the Legislature to realize that New York's competitiveness issues are not confined to corporate income tax levels or credits. The state high cost structure – energy, real property taxes, health care coverage mandates and others – are heavily influenced by state legislative actions, and have been exacerbated by this year's budget. For the vast majority of businesses operating in New York, these high state-imposed and state-influenced costs are not and cannot be offset by tax credits and development incentives.

By far, the most effective, inclusive economic development incentive is a more competitive business cost structure. This would entail lower marginal tax rates across the board, lower real property taxes (achieved by reduced state mandates, reduced spending, local government consolidations, and compensation reforms), lower energy prices (achieved by lower state-imposed costs and assessments), and lower health care costs (achieved by fewer coverage mandates and lower health service assessments).

Are the tax benefits associated with the Corporate Franchise Tax doing what they promised to do: creating jobs, promoting economic development and providing the state with an adequate return on investment?

Obviously, there has been considerable attention given to the cost and impact of the Empire Zones program. On the one hand, we believe this program has been instrumental in bringing major capital investment to the state. However, because the program offered relatively significant incentives, the Empire Zones program suffered from "mission creep," resulting in questionable results in some instances. (We provide further comments on the Empire Zones program below.) Importantly, many of the concerns regarding the initial program have been addressed by legislative actionost of the initial "loopholes" identified in the program have been closed, and this year's budget further limited access to, and value of, Empire Zone tax credits.

In most other cases, we believe that specific CFT tax credits are performing as intended.

For example, the investment tax credit (and its NYS variants, including the QETC and the film production credit) is directly dependent on the level of investments made in the state. If anything, the effectiveness of the state's ITC is eroded by our alternative minimum tax. To assure the full effectiveness of the ITC, we should consider further reduction, or elimination of the AMT, or alternative approaches that assures more timely benefits from ITC-eligible investments (e.g., allowing for refundability of ITCs after several years of carry-forward.)

Are there certain tax benefits provided for larger corporations that small businesses cannot take advantage of or have difficulty receiving? How can a better balance between small and large businesses be achieved?

In general, we do not see this as a significant problem.

If we confine this question to the CFT, the major distinction would be for credits/exclusions/incentives that small businesses, because of their size and structure, would be less likely to be able to take advantage of (e.g., exclusion of income from subsidiary capital.) However, small businesses would also be less likely to be subject to mandatory combined reporting with entities with limited economic relationship to the business taxpayer.

On the other hand, the state's most significant economic development credit program, Empire Zones, is generally accessible to large and small business; in fact, the vast majority of businesses in the zones program are small business.

Likewise, other tax credit/economic development incentive programs have been created for the exclusive use of small to mid sized business, such as the qualified emerging technology credit.

A major distinction in tax treatment was created in the recently enacted budget. In adopting new, higher marginal personal income tax rates, small business taxpayers who pay income taxes under the PIT as partnerships, LLCs or subchapter S corporations could face a marginal tax rate more than 30 percent higher than were they subchapter C corporations taxed under Article 9-A.

What is the best way to use tax benefits to revitalize upstate urban areas?

Among other things, we believe that a straightforward brownfield program is essential to urban redevelopment efforts. The state should consider additional reforms to its brownfield program to provide a more expedited, more certain administrative process and more definitive post-remediation liability protections. New York adopted a brownfield program with a long, elaborate administrative process and stringent remedial requirements and uncertain access to use-based cleanup approaches common in most other states' brownfield program. These hurdles were offset by very generous remediation and redevelopment tax credits. Last year, the state limited the availability and value of tax credits, while leaving the negative (and anti-competitive) aspects in place.

The program should be amended to:

- Provide more streamlined public input requirements, give applicants more certainty in the ability to apply for and use appropriate use-based standards, and provide more complete post-remediation liability protections to non-responsible parties.
- Establish a "bright line" definition of brownfields to include sites with contamination over a promulgated "standard."
- Reduce the administrative time required for approving projects and establish a streamlined brownfield cleanup oversight program for lesser contaminated sites that chose to not seek eligibility for remediation or redevelopment tax credits.
- Extend cleanup program and tax credit eligibility for (Class 2) state superfund sites, RCRA corrective action sites, and petroleum spill sites, when the application is filed by a "volunteer" as defined in law (non-responsible party), and the volunteer agrees to remediation beyond that required of the responsible party for the site.

What provisions in the Empire Zone program should be preserved, scrapped or replaced to better achieve its missions of job creation and economic development?

Until we achieve broad cost-competitiveness reforms, we strongly believe that the state needs a program like Empire Zones to provide incentives for businesses to locate and grow in New York.

In considering future alternatives to Empire Zones, we believe the state should consider multiple programs with distinct purposes. These include a program (modeled on Empire Zones) to incentives large investment projects; incentives targeting municipal redevelopment efforts; and incentives to address the unique needs of emerging technology sectors (expanding the existing QETC should be considered.)

In considering modifications of the Empire Zones program for large investments, while we are working on a comprehensive reform proposal, we could share some initial suggestions.

We believe the program – or its successor program – should continue to provide real property tax benefits, which are necessary to offset the state's most non-competitive business tax. Going forward, we would support a program that provides a refundable RPT credit to all qualifying companies, but that applies the credit to the increased valuation of the property based on the taxpayer's investments and improvements. This would be a powerful incentive for investments by both new and incumbent business.

We support the continuation of an enhanced Empire Zone investment tax credit. The state should consider making the credit refundable for all eligible taxpayers, and consider increased credits for priority investments such as locations in distressed areas.

We also have several ideas for modifying the Empire Zones job/wage credit (currently $3,000 for "targeted" worker, "$1,500 for non-targeted, for up to 5 years.) We would support a revised credit that based the value of the credit on the level of wages/benefits provided to new workers. As an alternative, the state should consider a program modeled on New Jersey's "business employment incentive program," which provides cash grants of between 50 an 80 percent of PIT withholdings for new employers, for significant new employment in targeted industries.

What tax benefits should be added to or enhanced in the Corporate Franchise Tax to give New York an edge in attracting business investment?

As discussed above, further reductions in, or elimination of, the alternative minimum tax would provide a more significant, more immediate incentive for new capital investments in New York. While businesses new to New York receive refundable tax credits under the Empire Zones program, existing businesses qualifying for the ITC see the benefit reduced – and pushed into the future – by the AMT.

As an alternative, the state should allow taxpayers with unused and expiring investment tax credits to in effect "cash in" those credits for new, refundable credits based on new in-state capital investments.

As discussed below, we should significantly reduce the capital base CFT cap – an alternative tax calculation that penalizes businesses with no or low profits, and provides a disincentive to maintaining physical and investment capital in the state.

Is the Corporate Franchise Tax's four-way structure, which computes tax liability under four alternative bases, too complex or unfair for certain businesses?

The most anti-competitive aspects of the alternative base approach are the AMT (discussed above), and the recently increased $10 million cap on liability for non-manufacturing taxpayers paying their CFT based on in-state capital (a cap that was increased from $1 million in the FY 2009 budget.) This is a substantially increased tax burden on businesses with significant physical or financial capital in the state, but with little or no profits in a given tax year. Last year's legislative action had a particularly adverse impact of the state's financial services sector, at a time when they were already facing significant fiscal stress.

Are businesses paying a reasonable share of the overall New York State tax burden? How would changing the balance between business taxes and other parts of the tax structure effect the stability of the state's revenue system and impact economic development?

The more important question is whether the state's tax burden is <u>too high</u>, and whether it is <u>impacting economic development,</u> rather than asking about the relative share of the tax burden.

The answer, in both cases, is an unequivocal yes.

New York's state and local tax burdens per capita and per $1000 of personal income are both tops in the U.S., at 60% and 37%, respectively, above national averages. We believe this figures show the adverse impact the state's spending levels, and tax burdens, have on economic growth.

The impact is even more dramatic when you consider other state-imposed and state-influenced costs. Our 2007 "Benchmark" study (see attached) showed that New Yorkers – including business – paid a $35 billion premium for things such as taxes, health care, energy, employee benefits than they would have had we matched the national average in these key, government-related costs of living and doing business. That is more than $1,800 a year per capita, or more than $5,015 for every private-sector job.

Does business pay a "reasonable share" of these high tax burdens? We know that business pays a considerable share of all state, local and combined taxes in New York. According to a 2003 study completed by our Public Policy Institute, business pays about 25 percent of all state-imposed taxes, about 40 percent of local-imposed taxes (primarily real property and sales taxes), for a combined share of 34 percent (see attached.)

We do not see how increasing these business tax burdens could have anything but a negative impact on the state's economic development effort.

Likewise, considering that corporate franchise tax revenues, based on net income, is more volatile than other major NYS taxes, increasing the state's reliance on the CFT would reduce, rather than increase, stability in state tax revenues (for example, CRT revenues fell by 10.0 percent in Fiscal 2009, more than double the projected fall in PIT revenues, while state sales/use tax revenues increased by 1.3 percent.)

Considering the specific questions asked by the Committee, and the limited time available to us today, these comments do not address all of the tax reform issues on which we are currently working, and we will be providing the Committee with additional input in the near future.

Again, I appreciate this opportunity to share these suggestions and concerns with you, and I look forward to working with the Select Committee in developing and adopting tax reforms and incentive programs that will restore New York State's economic competitiveness.

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