Staff report to the New York State Senate Select Committee on Budget and Tax Reform

on

Evaluating the equitability of New York State's business and banking tax structures and their effectiveness to foster economic growth statewide

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Chair: Senator Liz Krueger

Senator Neil Breslin

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Based on testimony from public hearings in Rochester on April 30 and New York City on May 21

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Executive Summary

As economists increasingly forecast the U.S. recession to end as early as August, it remains to be seen whether New York State will rise in tandem with the nation out of the economic downturn or follow state tradition and experience a slower recovery.

An adverse business climate – wrought with high labor and energy costs and heavy taxes – has long been blamed for New York's failure to keep pace with the nation in terms of economic development. On the tax front, New York's property, personal income and unemployment taxes rank among the highest in the nation and draw the most ire from the state's business community. But, ironically, New York's main business tax – the Corporate Franchise Tax (CFT) – is not considered to be high on the list of problems for businesses.

The CFT, which is established under Article 9-A of the Tax Law, does not appear to raise many red flags at first glance. Even though New York ranked 49th in the Tax Foundation's 2009 Business Tax Climate Index, the corporate tax index component of the survey ranked 22nd. At $2.76 billion, CFT's net collections accounted for 4.7 percent of total General Fund collections in fiscal year 2008.

Far from being a tax that impedes the state's economic recovery, the CFT will likely play an important role in shaping the state's post-recession economy. It can influence everything from how entrepreneurs organize their businesses (e.g. S corporation vs. C corporation), where assets are allocated and how much companies invest in those assets. The CFT can also play a pivotal role in creating and retaining private sector jobs statewide by leveraging over $2 billion in annual tax expenditures, most notably through the Empire Zones program and Investment Tax Credit.

However, the end result of these behaviors influenced by the CFT is an increasingly unequal business environment in New York. From varying individual and corporate income tax rates to the formula corporations must use when determining their in-state taxable activities to the complexity involved in applying for tax incentives, the CFT in recent years has strayed farther from market neutrality. Winners and losers abound.

Wanting to create a more level playing field for businesses statewide as they move to recover from the recession, the Senate Select Committee on Budget and Tax Reform held two public hearings in spring 2009 to evaluate the equitability of the state's business and banking tax structures and their effectiveness to foster economic growth statewide. On April 30th and May 21st, the six-member, bi-partisan committee chaired by Senator Liz Krueger held public hearings on these issues in Rochester and New York City, respectively.

In all, the Select Committee received testimony from 18 experts. Key findings based on their testimony are detailed in this report. They include:

- **Structure**: Unequal treatment under the CFT begins at businesses' inception, when entrepreneurs decide on the structure of their entity (e.g. S corporation vs. C corporation). The inequities persist as companies determine the percentage of their taxable in-state activities through the recently-adopted single sales apportionment factor.
- **Expenditures**: The cumulative impact of all of New York's taxes makes various tax incentives offered under the CFT essential to ensuring in-state businesses' competitiveness. But since New York became the first state to introduce an investment tax credit 40 years ago, its effectiveness has been diminished through restrictions put on credits' usage and the complexity associated with receiving them. This trend has continued in other CFT tax expenditures, most notably in the Empire Zones program.
- **Conformity**: Over the past several years, the rift between the business and banking tax laws for New York State and New York City has widened, creating mounting

administrative burdens for, and inequities among city companies. The discrepancies between the two tax systems worsened in 2007, when the state closed four major big business tax loopholes and the city did not conform to those changes.

- **Conclusion**: Given the fragile states of New York's financial and economic conditions, it is imperative for the state to curb its influence in business formation and close remaining tax loopholes. The Select Committee wants to further explore ways to establish more tax neutral treatments for varying business structures. It also wants to investigate further ways to equalize the tax advantages provided almost exclusively to multi-state corporations and manufacturers through the single sales factor. One equalization method experts suggested was a throwout rule. In the coming months, the Select Committee also plans to continue its investigation into prospective alternatives for the Empire Zones program. In June, the New York City Mayor's Office delivered to the Senate city tax conformity legislation, which Select Committee Chairwoman Krueger sponsored (S.50047). However, the senator is concerned about the single sales factor's negative impact on city tax revenues.

Introduction

By mid-May, the nation's economic outlook was brightening. Despite mounting job losses and continued sluggishness in the housing and retail sectors, a consensus was growing among economists that the national recession that began in December 2007 was losing momentum. Some economists pegged the recession's end for August 2009.[1] On May 5th, Federal Reserve Chairman Ben Bernake said he expects "economic activity to bottom out, then turn up later this year."[2]

However, three weeks after Bernake delivered his hopeful forecast to Congress' Joint Economic Committee in Washington D.C., New York State Governor David Paterson issued a grimmer economic view. The governor said he expects revenues over the next 11 months to fall far further from the $2.5 billion decline he forecasted in April, resulting in a $6 billion deficit for New York's 2010 fiscal year.[3]

The differing outlooks suggest the state will continue to grapple with the recession even as it subsides on the national scale. Although, Bernake added that U.S. economic activity will remain sluggish and "only gradually gain momentum." But this divergence in economic forecasts is not uncommon in New York, where state recessions tend to last longer than national recessions. For example, the state recession that began in December 2000 and lasted 31 months, but the nation's recession that started in March 2001 and lasted eight months.[4]

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[1] The Wall Street Journal, "Economists Foresee Protracted Recovery." May 14, 2009

[2] The New York Times, " Bernake sees hopeful signs, but no quick recovery." May 5, 2009.

[3] Newsday, "Ny gov. predicts $6B budget deficit next year." May 26, 2009

[4] New York State Department of Labor, "Comparison of U.S. and New York State Recessions." www.labor.state.ny.us/workforceindustrydata/icei.shtm

New York's slowness to emerge from steep economic downturns is often blamed on the state's overreliance on the financial services industry. Not helping the recovery is a burdensome business climate: a combination of high health care and energy costs that impede economic development. And, of course, taxes.

"The Tax Capital of the World" is the Wall Street Journal editorial board's name for New York. "Second to worst" is how the Tax Foundation sums up the state's business tax climate. Yet as the business community decries the state's tax policies, the tax that applies exclusively to general businesses – the Corporate Franchise Tax (CFT) – is not drawing the most of their criticism. That dubious distinction instead goes to New York's property taxes (49 percent higher than the national average[5]), personal income taxes (fourth highest in the nation, as of April 2009[6]) and unemployment insurance taxes (sixth highest in the nation[7]).

Although New York's main business tax is not viewed as one of the biggest obstacles to New York's recovery, it will without question play an important role in shaping the state's post-recession economy. While the market principles of demand and supply will influence the types of businesses that operate in the state, the CFT can influence how many of them are structured.

The CFT can influence decisions on whether businesses form as an entity with profits that pass through owners' personal income tax returns or as corporations that pay a corporate income tax. The CFT can also influence where a company's assets are allocated and how much it invests in those assets. It also plays a pivotal role in creating and retaining private sector jobs

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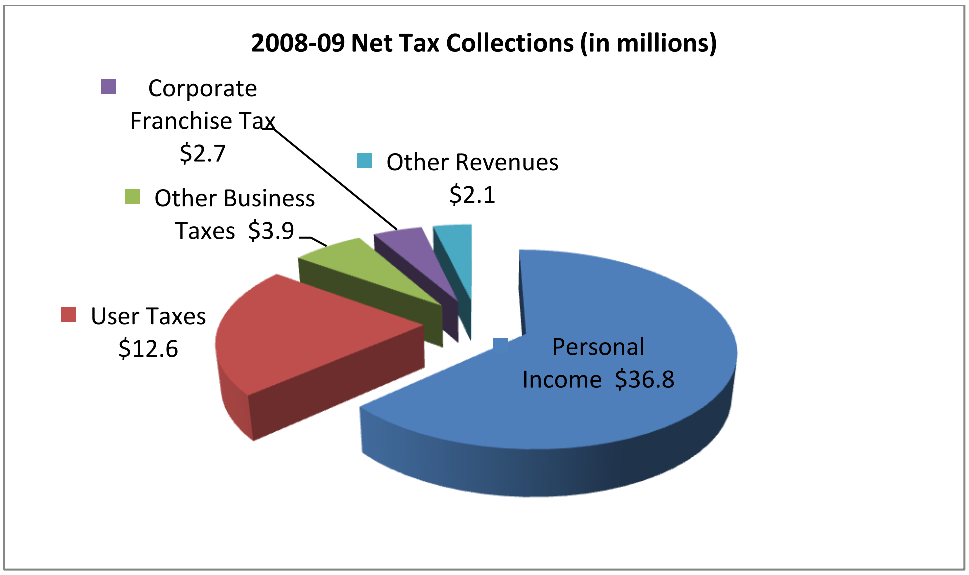
[5] New York State Office of the New York State Comptroller, "local Government Issues in Focus: Property Tax in New York State." www.osc.state.ny.us/localgov/pubs/research/propertytaxes.pdf

[6] Small Business & Entrepreneurship Council, "Business Tax Index 2009." www.sbecouncil.org/uploads/BusinessTaxIndex2009Final.pdf

[7] The Tax Foundation, "Unemployment Insurance Tax Index, 2009" April 2009. www.taxfoundation.org/taxdata/show/24381.html

statewide by leveraging over $2 billion in annual tax expenditures, most notably through the Empire Zones program.

Business taxes are the third greatest source of tax revenues for the state, following the personal income tax and sales, excise and user taxes. In fiscal year 2008, business taxes accounted for 12.3 percent of the $58.51 billion the state collected in taxes.[8] At $2.76 billion, the CFT accounted for 4.7 percent of total General Fund collections that year.[9]



The CFT, which is established under Article 9-A of the Tax Law, does not appear to raise many red flags at first glance. Even though New York ranked 49th in the Tax Foundation's 2009 Business Tax Climate Index, the corporate tax index component of the survey ranked 22nd. Meanwhile, property, unemployment insurance, sales and individual income taxes all ranked in the mid to high 40s, with a ranking of 50 being the worst. The Tax Foundation's annual business climate report gauges and compares five tax components in all 50 states.

[8] Business taxes include the CFT, Corporation Tax, Bank Tax, Petroleum Tax, Insurance Tax and Direct Writings Tax.

[9] New York State Department of Taxation and Finance, "Monthly Tax Collections." March 2009.

The CFT has emerged as one of the least problematic taxes for businesses; therefore placing on it the onus of offsetting the adverse impacts of what the business community has dubbed New York's "killer taxes." It is probably no accident that the Real Property Tax Credit has become the costliest segment of the Qualified Empire Zone Enterprise program under the CFT. Its cost has swelled from $82.5 million in 2005 to an estimated $150 million this year.[10]

When looking at various aspects of the CFT's structure and its tax expenditures, experts frequently speak of them having "unintended consequences" and "gone wrong" or being "theoretically … not the right answer." What they see is the Legislature's attempt to frame tax policy in a way that is conducive to economic development. But it is here where those "unintended consequences" start to sprout, because of the tendency to gear tax policy toward select industries at a cost to others.

"[T]argeted corporate tax breaks are not costless. Every dime of foregone tax collections from corporate tax breaks (or from any tax break at that matter) has to be made up by higher taxes on someone else, and those higher taxes impose costs on taxpayers in the same way that the foregone corporate tax revenues would have," Matthew Gardner, the executive director of the Institute on Taxation, said.

In a narrow view, Gardner's warning about tax expenditures leading to higher tax rates has not panned out in recent years. CFT tax expenditures rose 73.2 percent from $1.31 billion in 2003 to $2.28 billion in 2005, the most recent year for which data is available.[11] Rather than

[10] New York State Department of Taxation and Finance, "Annual Report on New York State Tax Expenditures." 2009-2010.

[11] New York State Department of Taxation and Finance, "Annual Report on New York State Tax Expenditures." 2007-2008 and 2009-2010.

increasing in the wake of this expenditure growth, the CFT's earned net income tax rate decreased. In 2007, the state lowered the earned net income rate from 7.5 percent to 7.1 percent.

The CFT rate reduction took effect near the peak of the economy's boom. CFT General Fund tax collections peaked in fiscal year 2006 at $3.68 billion. A year later, when the reduction took effect, collections declined 6.3 percent to $3.45 billion.[12] After the recession reached New York in 2008, CFT collections were down to $2.76 billion, a 25 percent plunge from 2006's record high.[13] Although the 2009-2010 enacted budget anticipated collections to rebound to $2.92 billion this fiscal year, it is unclear whether the state will hit that target in lieu of the governor's mid-May forecast of a $6 billion deficit. [14]

However, it would be hard to claim that the growth in foregone tax revenues has not increased the financial burden on businesses, even though the CFT tax rate recently declined. As Patrick Fleenor, the Tax Foundation's chief economist, said, "A major problem with existing tax policy is that some industries face very high effective tax rates while others pay trivial amounts of tax and some even receive a subsidy through the tax system."[15]

Fleenor's alternative, put simply, is "A lower rate and a clean base" (i.e. no more tax credits). But Peter Faber, chairman of The Partnership for New York City's Tax Committee, dismissed theoretical arguments that "taxes should be done in the abstract" and "there should be no incentives." He called such claims "unrealistic" and said "the tax system offers us a way to

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[12] New York State 2009-2010 Executive Budget, "Economic and Revenue Outlook," ph. 279

[13] Monthly Tax Collections

[14] Exec Bud March 09 Taxation, Enacted budget report

[15] Testimony from Patrick Fleenor, chief economist for The Tax Foundation. New York City public hearing, May 21, 2009.

bring about economic change without having a government agency dispense money to people who are requesting it." [16]

Given how small changes in the tax law can lead to bigger problems, business leaders statewide warned against limiting any review of New York's business taxes to the CFT.

"The error, in our view, is to view the Corporate Franchise Tax in a vacuum," said Christopher Wiest, the vice president of public policy and advocacy for the Rochester Business Alliance.[17]

Brian Sampson, the executive director of Unshackle Upstate, echoed Wiest's statement, saying, "Viewed in isolation, as a matter of tax policy, individual taxes don't appear to be offensive or potentially destructive. However, such a myopic vision is a disservice. Rather, we need to look at the entire tax structure."[18]

Also citing the need for tax rules "to be considered in their entirety" was The Clearing House Association. Noting how perennial "piecemeal" changes to the tax rules have created "significant and troubling uncertainty for business taxpayers," the banking trade organization said "any changes should be in the form of coordinated rules based upon a consistent set of policies that work together in a manner that is fair, administrable and predictable." [19]

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[16] Testimony from Peter Faber, chairman for The Partnership for New York City's Tax Committee. New York City public hearing, May 21, 2009.

[17] Testimony from Christopher Wiest, vice president of Public Policy and Advocacy for the Rochester Business Alliance. Rochester public hearing, April 30, 2009.

[18] Testimony from Brian Sampson, Executive Director for Unshackle Upstate, Rochester public hearing, April 30, 2009.

[19] Testimony from The Clearing House Association. New York City public hearing, May 21, 2009.

Mindful of the dangers of taking a "myopic" view, the Senate Select Committee on Budget and Tax Reform this spring turned its attention to the CFT with a public hearing in Rochester on April 30th.[20] The six-member, bi-partisan Select Committee chaired by Senator Liz Krueger held a second hearing on the CFT in New York City on May 21st.[21] Due to the financial services sector's importance to the city's business environment, the Select Committee broadened its review to include the Bank Tax, which is established under Article 32 of the Tax Law.[22]

Given that by May the state had lost almost 191,000 private sector jobs on a seasonally-adjusted basis since it entered a recession 14 months earlier, the Select Committee kept an emphasis on the economic development potential of the CFT and Bank Tax during the hearings. At the same time, the Select Committee also inquired about the inequities built into these tax systems.

In all, the Select Committee heard oral testimony from 16 experts and it received written testimony from two other experts. Highlights from their testimony included:

Structure: Unequal treatment under the CFT begins at businesses' inception, when entrepreneurs decide on the structure of their entity (e.g. S corporation vs. C corporation). The inequities

[20] For the Rochester public hearing, the Select Committee heard oral testimony from Judy Seil of the Monroe County Industrial Development Agency, Christopher Koetzle of the Support Services Alliance, Randy Wolken of the Manufacturers Association of Central New York, Ken Pokalsky of the Business Council of New York State, Christopher Wiest of the Rochester Business Alliance and Brian Sampson of Unshackle Upstate.

[21] For the New York City public hearing, the Select Committee heard oral testimony from Matthew Gardner of the Institute on Taxation and Economic Policy, Michael Smith of the New York Bankers Association, James Parrot of the Fiscal Policy Institute, Patrick Fleenor of the Tax Foundation, Nathan Newman of the Progressive States Network, Brian Model of Stonehenge Capital Co., Nancy Lancia of the Securities Industry and Financial Markets Association, Peter Faber of The Partnership for New York City, Angela Miele of the Motion Picture Association of America and Thomas Riley of the New York State Society of Certified Public Accountants.

[22] For the Rochester and New York City public hearings, the Select Committee also received Written Testimony from Jon Greenbaum of Metro Justice of Rochester, Joe Huddleston of the Multistate Tax Commission and The Clearing House Association.

persist as companies determine the percentage of their taxable in-state activities through the recently-adopted single sales apportionment factor. Experts' recommended solutions to these inconsistent tax treatments included:

- Establishing a PIT "carve out" for S corporations and other small businesses to mitigate the impacts of this year's PIT surcharges, which could make those entities pay a marginal tax rate more than 30 percent higher than what they would pay as C corporations. The Support Services Alliance and Unshackle Upstate called for the "carve out." The Tax Foundation stressed the need for "tax policy that is neutral with respect to firm structure."
- Expanding the single sales factor to entities subject to New York's Bank Tax and New York City's tax code, as recommended by the Multistate Tax Commission, The Partnership for New York City and the Securities Industry and Financial Markets Association. Progressive taxation organizations, such as the Fiscal Policy Institute, Metro Justice of Rochester and the Institute on Taxation, argued against the single sales factor in general, calling it a "potential job destroyer."
- Adopting so-called "throwback" or "throwout" rules to ensure corporations subject to the CFT do not avoid paying taxes on profits from states that levy no corporate income tax. These measures could close a loophole opened by the single sales factor.

Expenditures: The cumulative impact of all of New York's taxes makes various tax incentives offered under the CFT essential to ensuring in-state businesses' competitiveness. But since New York became the first state to introduce an Investment Tax Credit (ITC) 40 years ago, its effectiveness has been diminished through restrictions put on credits' usage and the complexity associated with receiving them. This trend has continued in other CFT tax expenditures, most notably in the Empire Zones program. Experts' recommended solutions to these issues included:

- Eliminating or reducing the CFT's alternative minimum tax, which erodes the value of the ITC, as proposed by the Business Council of New York State. The Business Council also suggested the establishment of refundable credits after several years of carry forward. But the Institute on Taxation opposed the ITC carry-forward feature, saying it encouraged future tax avoidance and discouraged future investment. The Fiscal Policy Institute said tying the ITC to job creation could make carry-forward credits less problematic.
- Making the procurement of tax incentives simpler, particularly for small businesses. The Support Services Alliance and New York State Society of Certified Public said many small businesses pass on credits geared toward them because of the costly application process and annual reporting requirements.
- Looking to Michigan, Pennsylvania, New Jersey and Ohio to find model tax incentive programs for whatever replaces the Empire Zones program, which sunsets in 2010. The Manufacturers Association of Central New York, Business Council, The Partnership and Unshackle Upstate especially liked programs from these states for their ability to target niche industries.

Conformity: Over the past several years, the rift between New York State's and New York City's business and banking tax laws has widened, creating mounting administrative burdens and inequities for city companies. The discrepancies between the two tax systems worsened in 2007, when the state closed four major business tax loopholes and the city did not conform to those changes. Experts' recommended solutions included:

- Aligning the city's business and banking tax codes with the 2007 loophole closers and several other provisions. The Securities Industry Association advocated for conformity provisions including the single sales factor, customer sourcing for select finance sector receipts and a net operating loss carryforward for banks. The New York Bankers Association also supported a bank carryforward. But the Bankers Association opposes making the city, like the state, establish a customer-based nexus for credit card companies and require combined reporting for real estate investment trusts and regulated investment companies.

Conclusion: Given the fragile states of New York's financial and economic conditions, it is imperative for the state to curb its influence in business formation and close remaining tax loopholes. The Select Committee wants to further explore ways to establish more tax neutral treatments for varying business structures. It also wants to investigate further ways to equalize the tax advantages provided almost exclusively to multi-state corporations and manufacturers through the single sales factor. One equalization method experts suggested was a throwout rule. In the coming months, the Select Committee also plans to continue its investigation into prospective alternatives for the Empire Zones program. In June, the New York City Mayor's Office delivered to the Senate city tax conformity legislation, which Select Committee Chairwoman Krueger sponsored (S.50047). However, the senator is concerned about the single sales factor's negative impact on city tax revenues.

Structure

I. Business Organization

Entrepreneurs face a tough choice when they look to operate in New York. They need to choose a business structure. Their options include sole-proprietorships, partnerships, limited liability companies, S corporations and C corporations.

The state does not tell entrepreneurs what they should choose, but its tax policy subtly influences their decision. While shopping for a business entity in New York, entrepreneurs often find themselves reaching for a structure that does not suit their needs, though it is still alluring. It boils down to a question of organizing either as an entity whose owners or managers pay their firm's taxes through their own PIT returns or as a corporation that pays an entity-level corporate income tax.

S Corporations fall into the former category, though they are still required to pay a fixed dollar minimum tax under the CFT.[23] Under the CFT, C corporations pay the highest tax calculated under four alternative bases. They include an entire net income tax, an alternative minimum tax, a business capital tax and a fixed dollar minimum tax. In 2005, 88 percent of C corporations' liability was paid under the entire net income base.[24]

Complicating the decision for an entity's structure, from a strict taxation standpoint, are New York's unequal individual and corporate income tax rates. After the Cuomo administration in 1987 initiated a campaign to lower New York's PIT rates, income tax rates largely leaned in favor of S corporations and unincorporated business. However, the three-year PIT surcharges

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[23] The fixed dollar minimum tax is based on gross receipts. It ranges from $25 for S corporations with a gross income of up to $100,000 and $4,500 for those entities with a gross income of over $25 million.

[24] Executive Budget Revenue Outlook, pg.287.

applied to the top rate of 6.85 percent beginning in 2003 and again in 2009 reversed that dynamic. In the early 1990s, while PIT rates were declining, CFT rates actually rose and peaked at 10.35 percent.

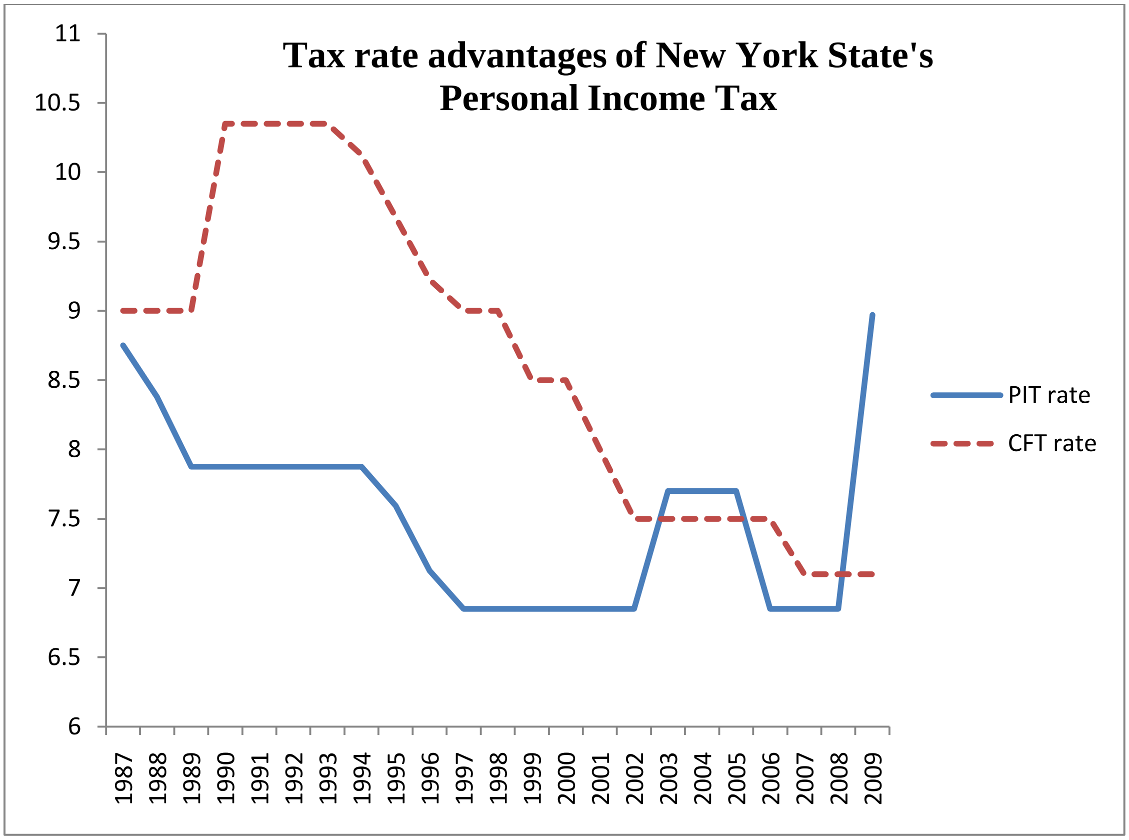
Reflecting these favorable tax rate trends, New York's ranks of S Corporations increased by 78 percent to 344,312 between 1990 and 2004, the most recent year for which data is available. During that period, C corporations increased by 8 percent to 257,538.[25]

"You shouldn't have to choose entities based on tax treatment. If a partnership makes sense for me to do business – business wise – I shouldn't have to become a corporation or LLC or some other kind of entity for tax reasons. In my mind, tax benefits should be the same [for S Corporations and C Corporations]. Inconsistencies like that give other businesses an unfair competitive advantage if they're formed differently," said Thomas Riley, the former president of the New York State Society of Certified Accountants.

Ken Pokalsky, senior director of government affairs at the Business Council, warned that because of this year's PIT surcharge, S corporations could face a marginal tax rate more than 30 percent higher than what they would pay as C corporations. In lieu of this heightened tax burden, business organizations such as the Support Services Alliance and Unshackle Upstate called for a "carve out" for S corporations and other small businesses.

"Taxes often distort this critical choice of firm structure," said Fleenor at the Tax Foundation. "New York, for example, has not integrated its individual and corporate tax systems. This increases taxes on the corporate form and encourages some firms, which would have organized as traditional corporations, to organize as non-corporate form."

[25] Ibid., 286



Despite the business community's opposition to different tax treatments based on the structure of a company, it does largely support preferential tax treatment based on the type of company. In 2005, the state lowered small businesses' CFT rate to 6.5 percent, and two years later that rate became applicable to qualifying manufacturers and emerging technology companies. Meanwhile the regular CFT rate was set at 7.1 percent. Taking into account New York's high labor and energy costs, Sampson said "Manufacturers are at a distinct disadvantage in the state of New York, and perhaps they should be treated differently." Randy Wolken, president of the Manufacturers Association of Central New York, called for the elimination of the CFT for manufacturers. He said that move would create "a more viable and attractive place to maintain a successful business."

II. Single Sales Factor

The reduction of the CFT rate for manufacturers was not the only action the Legislature took in 2007 to enhance the industry's tax competitiveness. That year – a year ahead of schedule – the state completed the phase-in of a single sales factor apportionment factor. Lawmakers passed that provision in 2005 and initially gave it a three-year phase in. The provision changed the way corporations calculate their in-state portion of their taxable activities, taking it from a three-factor formula of payroll, property and receipts to a single receipts factor.

The apportionment change amounted to a tax cut for manufacturers and other corporations that produce goods in New York – where many of their assets and employees are located – but that sell their products outside of the state. Essentially, a manufacturer with production operations in New York but no customers in the state would vastly reduce its taxable activities base.

The ability of the single sales factor to minimize a corporation's tax burden by taking assets and employees out of the equation makes it especially appealing to multistate corporations and financial services firms in New York City. But while non-bank financial services firms such as dealers and brokers subject to the CFT are able to benefit from the single sales factor, banking corporations remain bound to the three-factor apportionment under the Bank Tax. The Bank Tax is established under Article 32 of the Tax Law.

"This difference in apportionment formula can cause taxpayers competing in similar markets to have very different amounts of income apportioned to the state. It also adds additional complexity to the proper determination of tax among members of a related corporate group, some of which are subject to tax under Article 9-A and other under Article 32," said Joe Huddleston, the executive director of the Multistate Tax Commission.

Huddleston suggested resolving these differences by adopting a uniform system of taxing all financial institutions. He noted there would be difficulty in designing such a system, starting with formulating a uniform definition of "financial institution." The Multistate Tax Commission in 1994 formulated a recommended definition for "financial institution," which is part of its Recommended Formula for the Apportionment and Allocation of Net Income of Financial Intuitions. Huddleston's organization is drafting an updated version of this definition.[26] The Partnership also offered its assistance in developing a uniform "financial institution" definition.

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[26] The Multistate Tax Commission in 1994 defined a "financial institution" as:

(1) Any corporation or other business entity registered under state law as a bank holding company or registered under the Federal Bank Holding Company Act of 1956, as amended, or registered as a savings and loan holding company under the Federal National Housing Act, as amended;

(2) A national bank organized and existing as a national bank association pursuant to the provisions of the National Bank Act, 12 U.S.C. §§21 et seq.;

(3) A savings association or federal savings bank as defined in the Federal Deposit Insurance Act, 12 U.S.C.§ 1813(b)(1);

(4) Any bank or thrift institution incorporated or organized under the laws of any state;

(5) Any corporation organized under the provisions of 12 U.S.C. §§611 to 631.

(6) Any agency or branch of a foreign depository as defined in 12 U.S.C. §3101;

(7) A state credit union the loan assets of which exceed $50,000,000 as of the first day of its taxable year;

(8) A production credit association organized under the Federal Farm Credit Act of 1933, all of whose stock held by the Federal Production Credit Corporation has been retired;

(9) Any corporation whose voting stock is more than fifty percent (50%) owned, directly or indirectly, by any person or business entity described in subsections (1) through (8) above other than an insurance company taxable under [insert applicable state statute] or a company taxable under [insert applicable state statute];

(10) A corporation or other business entity that derives more than fifty percent (50%) of its total gross income for financial accounting purposes from finance leases. For purposes of this subsection, a "finance lease" shall mean any lease transaction which is the functional equivalent of an extension of credit and that transfers substantially all of the benefits and risks incident to the ownership of property. The phrase shall include any "direct financing lease" or "leverage lease" that meets the criteria of Financial Accounting Standards Board Statement No. 13, "Accounting for Leases" or any other lease that is accounted for as a financing by a lessor under generally accepted accounting principles.

For this classification to apply,

(a) the average of the gross income in the current tax year and immediately preceding two tax years must satisfy the more than fifty percent (50%) requirement; and

(b) gross income from incidental or occasional transactions shall be disregarded;

or

(11) Any other person or business entity, other than [an insurance company taxable under ___________], [a real estate broker taxable under ___________], [a securities dealer taxable under ___________] or [a __________ company taxable under ___________],which derives more than fifty percent (50%) of its gross income from activities that a person described in subsections (2) through (8) and (10) above is authorized to transact. For the purpose of this subsection, the computation of gross income shall not include income from non-recurring,

Uniformity concerns also arise when looking at New York City's tax code, which retains a three-factor formula. Representatives from New York's financial industry stressed that the single sales factor could play an important role in enhancing the city's ability to attract new business. Nancy Lancia, the managing director of state government affairs for the Securities Industry Association, said "amending the New York City tax code by bringing it into conformity with the New York State tax code would encourage firms to locate property and employees in New York City – a move directly in alignment with supporting New York City as a leading global financial center."[27]

Even though New York City has retained its position as the "financial capital of the world" through the recession, its hold on the status has gradually slipped. The recession has undoubtedly taken its toll on the city's financial services industry. By last March, securities industry employment declined 11.8 percent, or 22,600 jobs, from its August 2007 peak of 191,800 jobs. Many of those lost jobs were high-paying positions that largely contributed to the hole in this year's budget in the form of lower top tier PIT collections. As of 2007, New York accounted for 23.2 percent of the nation's securities industry jobs. But New York has largely missed out on the industry's growth over the past two decades. Between the 1987 stock market crash and last March, New York's securities industry has added 15,800 new jobs, but that is only 4.6 percent of the 339,000 industry jobs created in the other 49 states.[28]

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extraordinary items.
(12) The [State Tax Administrator] is authorized to exclude any person from the application of subsection (11) upon such person proving, by clear and convincing evidence, that the income-producing activity of such person is not in substantial.

[27] Testimony from Nancy Lancia, managing director of state government affairs for the Securities Industry and Financial Markets Association. New York City public hearing, May 21, 2009.

[28] The Securities Industry and Financial Markets Association, "The Street, the City and the State." May 2009.

To compete for those securities industry and other jobs, a growing number of states have adopted the single sales factor. About 23 states have adopted the rule, including Connecticut, Massachusetts and California, where it takes effect in 2011. This heightened competition is a driving force behind the argument for establishing uniform apportionment for the state and city, even though those actions are revenue losers for them. At the end of its three-year phase-in, the single sales factor provision included in the 2005-2006 budget was projected to cost the state $130 million.[29]

"The apportionment of income, for New York City purposes, should be based on where the customer is located. This eliminates the adverse effects of having property and employees in New York City. Now, theoretically, you can argue this may not be the right answer, but many of the states that are competing with us for business have this rule: the single sales factor," said Faber.

Jon Greenbaum, the executive director of Metro Justice of Rochester, summed up the theoretical argument against the single sales factor, saying, "Ultimately, each corporation's profits should be taxed in their entirety, but many corporations pay no tax at all on a portion of their profits. This problem has emerged, in part, due to recent state efforts to manipulate the apportionment rules that distribute such profits."

Gardner at the Institute on Taxation also argued against the single sales factor, calling it a "potential job destroyer." It "actually encouraged some New York employers to leave the state and effectively put up a sign at the state border saying 'Don't open a warehouse here.'" He acknowledged that the provision did result in a tax cut for New York manufacturers. "It is also a tax hike on most other companies," particularly companies that have little or no state

[29] New York State 2005-2006 Enacted Budget Report.

employment and that sell proportionately more of their products in New York. And corporations that do business only in the state "can derive no benefit from the single sales factor."

"So. Initial scorecard for the single sales factor: multistate manufacturers: one; mom-and-pop companies: zero," Gardner said.

III. Nowhere Income

The adoption of the single sales factor increased New York's exposure to what is called "nowhere income." Nowhere income is untaxed profits that arise when a corporation does business in a state that lacks a corporate franchise tax or when its activity in the state is not sufficient enough to be subject to that tax. Four states – Nevada, South Dakota, Texas and Washington – have no corporate income tax.

"The possibility of 'nowhere income' opens up the potential for tax-adverse companies to organize their businesses to maximize nowhere income and minimize the state taxes they owe," said James Parrot, the chief economist for the Fiscal Policy Institute.[30]

To address the problems posed by nowhere income, progressive taxation advocates called for provisions that would capture New York corporations' untaxed income. These provisions include the so-call "throwback" or "throwout" rules.

The throwback rule requires income made in states or to the federal government that are not taxed be "thrown back" to the corporation's home state. Under the throwout rule, that untaxed income is "thrown out" and do not get applied to a corporation's sales-based

[30] Testimony from James Parrot, chief economist for the Fiscal Policy Institute. New York City public hearing, May 21, 2009.

apportionment calculation. About half of the states have a throwback or throwout rule, but New York is not one of them.[31]

[31] Ibid.

Expenditures

I. Investment Tax Credits

In 1962, the federal government rolled out an Investment Tax Credit (ITC) program "to encourage modernization and expansion of the nation's productive facilities and thereby improve the economic potential of the country, with a resultant increase in job opportunities and betterment of our competitive position in the world economy." The ITC program granted businesses a credit against their income tax liability equal to a percentage of investments in machinery, equipment and furniture.[32]

Seven years after the launch of that federal program, New York became the first state to adopt its own ITC, and several other states later followed its lead. But by 1986, the Reagan administration largely left the task of incentivizing private sector capital investments to states by eliminating the federal ITC program and replacing it with lower corporate income tax rates.[33] Since 1969, at least 21 other states have rolled out broad ITC programs, and even more have adopted industry- and regionally-specific credits.[34]

Since the federal government repealed its ITC program, states' tax incentive programs have become increasingly more unwieldy, though not without yielding substantial economic gains. One clear example of states' elevated role in incentivizing capital investment is seen in New York's Empire Zones program, which took effect in 1986. Given the proliferation of ITCs nationwide, the San Francisco branch of the Federal Reserve Bank in 2008 issued a report

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[32] The Jerome Levy Institute of Bard College Public Policy Brief. "Investment Tax Credit Reconsidered: Business Tax Incentives and Investments," by Thomas Karier. June 1994.

[33] Ibid.

[34] San Francisco branch of the Federal Reserve Bank, "State Investment Tax Credit: A Zero-Sum Game?" by Robert Chirinko and Daniel Wilson. July 2008.

examining whether the tax incentives are effectively bringing investments or attracting businesses into states and how much of that increase was lured away from competitor states.

After studying 48 contiguous states and 20 years of data, the Fed concluded states' ITC programs "substantially increase" capital formation within their boundaries by reducing the price of capital. But when competing states likewise employ tax-induced reductions to lower the price of capital, their capital formation is "significantly decreased." And while manufacturers tend to locate on the sides of state borders with the lower price of capital, "the difference is economically small." Based on these findings, the Fed concluded that "state capital tax policy appears to be a zero-sum game among states in that an equi-proportionate increase in own-state and competitive-state user costs tends to have no effect on own-state capital formation."[35]

Zero-sum game or not, it is one New York must play, business experts said. And it is an expensive game, often with uncertain payoffs. In 2005, the most recent year for which data is available, CFT tax expenditures totaled $2.28 billion, almost double the $1.31 billion in foregone tax revenues from two years earlier. During the same period, ITC credits used by businesses subject to the CFT rose to $97.5 million from $86.2 million.[36] Keeping the state in this game are the political and economic pressures that keep effective tax rates high and competitor states courting New York businesses with tax incentive packages.

Faber summarized the former dilemma, saying, "To compensate for this we have to make our tax system far more simple and attractive. We have to use incentives to mitigate the harsh effective tax rates. It's very nice to say, as other witnesses have done, that ideally we ought to

[35] San Francisco Fed

[36] New York State Department of Taxation and Finance, "Annual Report on New York State Tax Expenditures." 2007-2008 and 2009-2010.

have a broad base, low tax rates and everyone treated the same way. But the trouble is we're stuck with the 17 percent [effective tax rate in New York City], and I don't expect it to come down dramatically."

Fleenor described the latter situation, saying: "I understand the politics of special tax breaks. Businesses come to you complaining that other state legislatures are handing out targeted tax preferences like candy, so where's their candy. You size up the competition and weigh in with your best effort to match them. Those are hard requests to turn away. But by going down the tax-candy road you are not giving your industries what they need to stay healthy."

For example, politics have become an increasingly powerful force in states' attempts to attract film production business. Since Louisiana became the first state to offer a film production in 2002, 39 other states have rolled out similar initiatives. New York's Empire State Film Production Credit took effect in 2004 and is scheduled to sunset in 2013.

Although the Legislature approved $350 million for the program in the 2009-2010 budget, a lack of film production credits cost the state an entire pilot season. According to Angela Miele, vice president for state tax policy at the Motion Picture Association of America, no "pilot" or test television programs are expected to come to New York this year, compared to up to 20 in 2008.[37]

"With 80 percent of the state engaged in these initiatives, the likelihood of a motion picture being filmed somewhere without an incentive is slim. States know that they need to have incentives if they want to compete for this business," said Miele.

[37] Testimony from Angela Miele, vice president for state tax policy for the Motion Picture Association of America. New York City public hearing May 21, 2009.

Notwithstanding any significant reduction in these internal and external pressures on Albany, lawmakers are likely to continue offering tax incentives to spur job creation. That puts increasing pressure on New York – especially during a recession – to ensure economic development investments are strategically targeted and providing the state with an adequate return on investment. This emphasis has become significantly crucial to the Empire Zones program, which cost the state $453 million in 2005, less than a quarter of that year's total CFT expenditures.[38]

On May 11th, Senate Majority Leader Malcolm Smith moved to address the efficiency and accountability problems plaguing New York's tax incentive programs. He proposed legislation to create a Beyond Empire Zones Task Force charged with drafting the blueprint for whatever replaces the program, which is set to expire in June 2010. The task force would consist of 29 business and community leaders, and by December they would make recommendations on how to replace the Empire Zones.

Despite saying Empire Zones have been "instrumental in bringing major capital investment to the state," Pokalsky at the Business Council added that the program has "suffered from 'mission creep' resulting in questionable results in some instances." However, other CFT credits, such as the ITC and variant tax credits for everything from film producers to financial firms, "are performing as intended."

"If anything," Pokalsky said, "the effectiveness of the ITC is eroded by our alternative minimum tax." He recommended either reducing or eliminating the alternative minimum tax. Another option is assuring more timely benefits for ITC-eligible investments by providing refundable credits after several years of carry forward.

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[38] 2009-2010 Tax Expenditure Report

However, progressive taxation advocates said the ITC is not performing as intended. While Gardner acknowledged “the ITC requires companies to actually invest in order to claim it, there’s no way to know whether this investment would have occurred anyway absent the credit.” He argued against the maximum carry-forward feature of ITCs, saying it has “implications for future tax avoidance” by allowing corporations to pull from billions of dollars in unused credits and reduce future corporate income tax payments. By 2005, New York businesses had $1.4 billion in carry-forward ITCs.[39]

“This means that large companies could stop reinvesting in New York altogether and would still be able to reduce their tax liability to the legal minimum or close to it for another decade,” said Parrot at the Fiscal Policy Institute.

To address the carry-forward issue, Parrot suggested linking the ITC to job growth. One scenario he recommended was reducing the credit in its first year and increasing its value under the Employment Incentive Credit as jobs are created or retained in subsequent years. “The enhanced Employment Incentive Credit would replace the ability to carry forward ITC credits independent of employment levels,” he said.

II. Complexity

As Faber noted, the state’s vast array of tax incentives are essential to leveling the playing field between in-state corporations and their out-of-state competitors subject to more lenient tax policies. But large corporations are much more likely to participate on that level field than small businesses.

“We appreciate your interest in leveling the playing field between small and large businesses. [But] many small businesses do not have the resources, expertise or professional

[39] Ibid.

assistance to take advantage of some of the state's special tax credit programs," said Christopher Koetzle, the vice president of membership services for the Support Services Alliance.

According to the New York State Society of Certified Public Accountants, it could cost an employer with 40 full-time and 20 part-time workers an estimated $5,100 to apply for Empire Zone certification and to conduct other accounting work necessary for receiving credits under the program. That cost is based on Syracuse CPA rates and up to 34 hours of accounting work. A CPA would have to spend an additional 25 hours annually – to the tune of $3,750 – documenting employment levels, credit received and other annual reports.

"For a small business, applying to be in an Empire Zone can be very burdensome. A lot of them will pass on it because I'll charge them more than the credit's going to be … I know we need compliance, but we need simplicity so the small business man can take advantage of credits," said Riley at the New York State Society of Certified Public Accountants.

Below is a chart detailing the estimated amount of time it would take a CPA to conduct various Empire Zone accounting tasks for an employer with 40 full-time and 20-part time workers. Cost estimates, provided by the CPA Society, are based on Syracuse CPA rates:

Task	**Description**	**Estimated Hours**	**Estimated Cost**
Certification application	After verifying that the business is located in an Empire Zone, the business must complete an application for certification (form EZ-1).	6 to 8	$1,200
Empire Zone coordinator application meeting	During the application process, it is beneficial to have at least one meeting with the zone coordinator to discuss the company and the plans the company has for the future in order to meet the requirements to become a certified Empire Zone enterprise.	4 to 6	$900
Preliminary payroll calculations	In order to take the credits, a calculation must be done to determine the number of employees the company had during its "base period" and "test year" as defined in the instructions for each tax credit form. It often takes the company several weeks to accumulate their payroll records for these years.	15 to 20	$3,000

Annual employment test calculations	Each year that credits are being taken, the company must first pass the employment test to determine if they are eligible for the credits for that year. In order to determine if the company passes the employment test, they must calculate the number of full time employees for each quarter of the year for which credits are being claimed.	6 to 8	$1,200
Annual Empire Zone Credit Form	For each year the credits are being taken, a form has to be filled out for each credit. This form contains the information from the calculations described above, along with other information required to be included.	12	$1,800
Business Annual Report	The company must also complete a Business Annual Report every year to summarize its business activity, capital investments, employment changes, Empire Zone benefits taken, etc.	3 to 5	$750
Amend tax returns to include a retention credit	Companies issued a retention certificate after their initial Empire Zone review must attach the certificate to their 2008 tax returns in order to receive the benefit of any tax credits claimed. Many corporations and shareholders will have to amend their 2008 tax returns for 2008 tax agency bulletin was not issued until April 15, 2009.	3 to 5	$750 per return

To ease New York's tax burden, many small business representatives said they prefer lower income tax rates to more tax expenditures. Wiest at the Rochester Business Alliance advocated eliminating the CFT, though he added that "At a minimum, the state should consider further Corporate Franchise Tax reductions, specifically for small businesses, manufacturers and other upstate businesses.

III. Model Tax Incentive Programs

Simplicity. Predictable. Consistency. These are traits businesses look for in economic development tax incentive programs. They are not finding them in New York, and especially not in Empire Zones. Over the past eight years, Empire Zone rules have changed almost annually "to combat criticisms and loopholes," the Citizens Budget Commission noted in a 2008 report on the program. "None of the reforms has succeeded in cleaning it up."[40]

After the program launched in 1986, Empire Zone standards remained stable for seven years. But after 1993 lawmakers began loosening eligibility criteria. Initially consisting of 10 economically impoverished zones in 1986, the program has swelled to include 85 zones statewide and 8,700 businesses. The biggest change to the program came in 2001, when its wage tax credit was expanded and property tax and income tax credits were added to it. The 2001 changes also required businesses to create only one job to be eligible for tax credits and loosely defined "new business," allowing businesses to claim tax credits for "new" jobs simply by reincorporating (i.e. "shirt-changing" jobs).[41]

In the 2009-2010 budget, the Legislature closed the shirt-changer loophole by authorizing the decertification of firms that change their name to maximize Empire Zone benefits and fail to meet economic benefit standards. Also put on the decertification list were firms that fail to provide less than $1 in investments and wages for every $1 in state tax incentives. The changes are expected to provide the state with $90 million in savings.

Highlighting the expected fallout from the recent changes to Empire Zones, Monroe County Planning and Development Director Judy Seil said, "Many companies within Monroe County certified in an Empire Zone could [lose] their certification under this new provision. Once a company loses its Empire Zone benefits, they are liable to close up shop and flee New York State entirely for a region with an improved business climate." As of 2007, Monroe

[40] Citizens Budget Commission, "CBC Report: It's Time to End Empire Zones." December 2008.

[41] Citizens Budget Commission.

County's Empire Zones program consisted of 112 certified businesses, which had created 6,136 jobs and invested $154 million in the county.[42]

Given that Empire Zones' "problems are so extensive and longstanding, its past reform attempts so ineffective and its impact so dubious that it should be abolished," the Citizens Budget Commission concluded. The organization could get its wish with the June 2010 sunset of the program. But, as Wiest said, "We don't think that elimination of these programs is going to be helpful."

Pokalsky added: "Until we achieve these broad cost competitive reforms we talked about earlier, we believe programs like Empires Zones are going to be essential to promote new capital investment in the state … Maybe we should ditch the name Empire Zone and talk about the components of effective tax policy and incentive policy."

The task of proposing those future Empire Zone alternatives could largely fall on the proposed Beyond Empire Zones Task Force. But several business leaders at the Select Committee's public hearings pointed to other state economic development programs that could serve as models for New York's revised or replacement Empire Zones program.

Pennsylvania's Keystone Opportunity Zones (KOZ) and its related programs received praise from both Pokalsky and Sampson for its simplicity focus on niche markets. Faber mentioned The Partnership's proposed Growth and Relocation Incentive Program (GRIP), which is modeled after New Jersey's Business Employment Incentive Program. Under GRIP, businesses statewide could receive rebate payments only after jobs are created, and the level of the benefit is related to the wages of those new positions.

[42] Testimony from Judy Seil, director of Monroe County Planning and Development Department. Rochester public hearing, April 30, 2009.

Wolken at the Manufacturers Association said “There are a series of states that do it better. Those states include Pennsylvania, Ohio and Michigan. “[I]t's not bad to take a playbook from them.”

Below is a chart compiled by the Select Committee staff detailing four states' prospective models for the Empire Zones programs.

Program	Purpose	Characteristics	Key Requirements	Administration Structure	Results
Keystone Opportunity Zone Program (KOZ) Pennsylvania Established in 1998	Eliminates a host of state and local taxes in under-utilized, abandoned and unused areas. KOZ-covered state taxes: Corporate Net Income Taxes, Capital Stock & Foreign Franchise Tax, Personal Income Tax, Sales & Use Tax, Bank Shares and Trust Company Shares Tax, Alternative Bank and Trust Company Shares Tax, Mutual Thrift Institutions Tax, Insurance Premiums Tax KOZ-covered local taxes: Earned Income/Net Profits Tax, Business Gross Receipts, Business Occupancy, Business Privilege and Mercantile Taxes, Local Real Property Tax, Sales and Use Tax.	Statewide, there are 12 KOZ regional zones, with each one being no more than 5,000 acres. Each regional KOZ consists of up to 20 sub-zones. Sub-zones can be up to 10 acres in rural areas and 20 acres in urban areas. Each zone has a 12-year life cycle. Industry-specific zones – called Keystone Opportunity Investment Zones – are also available to businesses in advanced manufacturing, environmental industries, life sciences and informational technologies.	Businesses moving into a KOZ must either increase their full-time employment ranks by 20 percent during their first full year of operation in the zone or make a capital investment of at least 10 percent of gross revenues from the immediately preceding fiscal year. Benefits are not automatic and are subject to an annual renewal process. Businesses must be current on their present taxes and code requirements of local communities.	The Pennsylvania Department of Community and Economic Development organizes the program's framework, including the certification and operations of KOZs. Local jurisdictions designate coordinators to serve as contacts for zone facilitation.	Between 1999 and 2002, KOZ helped create 13,614 new jobs and retain 7,962 existing jobs. It prompted $1.5 billion in existing or planned capital investments. Thirty-five percent of that development occurred on former Brownfield or old industrial sites.
Renaissance Zone Program Michigan Established in 1996	Excludes business from having to pay select state and local taxes to encourage job creation and capital investments. Exempt taxes include: state business tax, state personal income tax, state 6-mill education tax, local personal property tax, local real property tax, local income tax, utility user tax (Detroit only).	Each Renaissance Zone can consist of 10 different geographically-defined sub-zones. Michigan has 21 zones, which include 155 geographic areas. Michigan also has industry-specific Renaissance Zones for businesses in agricultural processing, renewable energy, forest products processing and tool and die industries	Businesses cannot be delinquent on state income taxes and single business taxes. They cannot be substantially delinquent on property taxes and city income taxes. Business must file an annual Michigan Business Tax form and, if appropriate, state and local income tax returns. Zone designations expire after 15 years. Tax benefits are phased out in 25 percent increments during the designation's last three years.	Local governments with Renaissance Zone designations designate new sub-zones and the duration of portions of each zone. The Michigan Strategic Fund approves new sub-zones and time extensions.	Between 1997 and 2008, Michigan announced 550 Renaissance Zone projects, which created 9,562 jobs and over $2.8 billion in private investment.

Business Employment Incentive Program (BEIP) *New Jersey* *Established in 1996*	Reduces the total amount of state income taxes withheld on newly created jobs related to business expansion relocation projects. It can be used for fixed assets, working capital for operating needs and the refinancing of bank debt.	Sixty-seven percent of the BEIP awards issued in fiscal year 2008 went to small businesses that employed less than 100 jobs each. Sixty-one percent of 2008's grants went to projects expected to create less than 100 new jobs. The lion's share of 2008's grants went to the manufacturing (26 percent), life sciences/high-tech/pharmaceutical (41 percent) and financial services (22 percent).	Business must create at least 25 jobs in a two-year period, but biotech companies are required to create at least 10 jobs. Business must prove a BEIP grant is a "material" factor in conducting the expansion or relocation project in New Jersey, and that it is financially viable. Applicants are given greater consideration if they demonstrate they can pay new workers at an average rate 1.5 times above the minimum wage. BEIP grants can last up to 10 years. Businesses receiving them must maintain their projects in New Jersey for at least 1.5 times the number of years of the grant.	The New Jersey Economic Development Authority makes direct payments in the form of grants to businesses relocating into or expanding in the state.	Between 1996 and 2008, New Jersey has executed 392 BEIP agreements valued at $1.2 billion. The grants helped create an estimated 74,700 new jobs and $11.9 billion in public and private investments.
Job Creation Tax Credit *Ohio* *Established in 1993*	Provides a refundable, performance-based tax credit against corporate income taxes based on state income taxes withheld from new, full-time employees.	Projects include headquarters operations, manufacturing, science and technology, research and development, distribution, and certain service-oriented projects. Retail and low-wage projects are not eligible. In 2004, 19 tax credit projects were approved, with 48 percent of them going to durable goods manufacturers. Service-based companies received 8.6 percent of the awards and 7.4 percent went to finance, insurance and real estate firms.	Businesses have three years to fulfill their job creation targets. If businesses surpass those targets, their credit is increased respectively. Businesses do not receive their tax credit certificate until they file an annual progress report. Businesses must create at least 25 new, full-time jobs, with their average hourly base wage rate being at least 150 percent above the federal minimum wage. In special cases where businesses created 10 or more jobs, their average hourly base wage rate must be at least 400 percent of the federal minimum wage. The business must maintain operations at the project site for at least twice the term of the tax credit.	The Ohio Tax Credit Authority, a five member board of taxation and economic development experts, reviews and approves applications for tax credit assistance. It also sets applicants' benefit levels. The Ohio Tax Credit Authority oversees the program, monitoring and reporting on the progress of tax credit projects.	Between 1993 and 2004, the Ohio Tax Credit Authority approved 1,470 economic development projects. By 2004, 807 of them were active, with commitments to make $13.8 billion in fixed-asset investments and create 94,674 new, full-time jobs. In 2004, Ohio issued over $41.3 million in tax credits, which were only issued to businesses that had hit their new job creation, existing job retention and capital investment targets.

Conformity

On Feb. 5th, 2007, New York City Mayor Michael Bloomberg made his annual trip up to Albany to testify before at a joint legislative hearing of the Senate Finance Committee and the Assembly Ways and Means Committee (a.k.a. the Joint Fiscal Committee). He came to the Capitol to comment on proposals in former Governor Eliot Spitzer's 2007-2008 Executive Budget. At the time, Bloomberg's focus was on opposing Spitzer's plans to eliminate $660 million in state revenue-sharing funds with the city and supporting the governor's proposal to pump additional operating aid into city schools over four years.

The economic crisis that would erupt in the New York City's financial district less than two years later had only begun to cause tremors in the city by the time of the mayor's visit to Albany. The subprime mortgage industry's meltdown began in late 2006 as more subprime borrowers defaulted on their loans, driving lenders out of business or into bankruptcy. But at the same time, the U.S. economy was growing. When the mayor delivered his testimony, the city's unemployment rate was 4.9 percent– the rate's lowest level for the month since 1988. By last May, it had risen to 8.7 percent, the highest rate for that month since 1993.

It was in this environment where Spitzer moved to clamp down on big business tax avoidance practices with a series of tax loophole closing provisions. Four such provisions, which promised the state $450 million in savings, made it into in the $150 billion budget the Legislature passed in March 2007. They included:

- **Combine reporting**: Requires corporations to file a combined tax return that includes income from their subsidiaries and corporate affiliates.

- **REIT Loophole closer**: Required corporations to file tax returns including subsidiary real estate investment trust (REIT) and regulated investment companies (RIC).
- **Grandfathered corporations**: restricts the ability of corporations to receive grandfathered CFT tax filing status.
- **Tax shelter reporting**: Equipped the New York State Department of Taxation and Finance with permanent statutory tools to counter the spread of tax shelters.

However, Bloomberg did not follow Spitzer in his loophole closing campaign, further widening the rift between the business and banking tax laws for the city and state. At the February hearing, the mayor questioned the detrimental nature of the loopholes, though he did not specifically name the four measures cited above. He told the Joint Fiscal Committee, "I don't know whether these loopholes are things that should exist or should not exist. The state Legislature passed the budget each year and put these loopholes in deliberately. I think you have to go back and see why you put them in and whether the economic reason to put them in made sense and makes sense today. And if they don't make sense today, I'm all in favor of changing them; and if they do make sense, leave them in."[43]

While it "made sense" for New York City to not close the equivalent loopholes in its business tax laws the state sealed in 2007, that was no longer the case by the time the recession reached full tilt last autumn. The city then in earnest mounted a campaign to conform its General Corporation Tax and Bank Tax to the state's CFT and Bank Tax.

[43] Transcript of the Joint Legislative Hearing of the Senate Finance Committee and the Assembly Ways and Means Committee on Local Government/General Government, Feb. 5, 2007.

"[Conformity] eliminates some of the administrative burdens created by having two different systems of accounting for receipts and encourages the Senate to introduce and pass such legislation this session," said Lancia at the Securities Industry Association.

Along with calling for relief from the administrative burdens posed by the unaligned business tax laws, the Securities Industry Association also called for New York City's adoption of a single sales factor and a separate receipts factor allows brokers and dealers to source receipts to customers' mailing address instead of where services are delivered. The Legislature included the customer sourcing provision in the 2000-2001 budget.

Another tax system discrepancy opposed by the Securities Industry Association is New York City's lack of a Bank Tax operating net loss carryforward that allows banking companies to use one year's net operating losses to offset future profits. The carryforward option is also available to businesses subject to the city's General Corporation Tax. More than half the states have this provision, and New York added it to the state's Bank Tax in 2001.[44]

"This disparate treatment also sends the message to taxpayers that the City of New York will participate in sharing in the profits when taxpayers are successful; however, [it] will not share the pain when taxpayers or the economy weaken," Lancia said.

New York Bankers Association President Michael Smith said he supported a New York City Bank Tax net operating loss carryforward. But he opposed the city's adoption of the state Bank Tax provision that says credit card companies establish taxable presence or "nexus" by having customers – not a physical location – in the city. The Legislature included a credit card

[44] Testimony from Michael Smith, president of the New York Bankers Association. New York City public hearing, May 21, 2009.

nexus provision in the state's 2008-2009 budget. Smith also voiced opposition to requiring city REITs and RICs to file combined tax returns with their parent company.[45]

"[C]onforming, as it is proposed in the drafts, would be a tax increase on banks. This particular initiative should be in an overall look at the Bank Tax. We would consider that piecemealing," Smith said.

Out of all of the state's recent loophole closing actions, which the city is considering to adopt as well, Gardner at the Institute on Taxation called the requirement for combined reporting the most significant. A New York City combined reporting provision would require combined filing if there are substantial inter-corporate transactions between a parent company and its subsidiaries. As of April 2009, 23 states required combined reporting and another four were considering adopting them.[46]

"Combined reporting is intuitively fair because it ensures that a company's tax liability should not change just because it's organizational structure changes," Gardner said. "It also creates a level playing field between smaller and larger companies."

The conformity bill would also change New York City's Unincorporated Business Tax (UBT), which the state lacks. The city currently provides a 100 percent credit to offset UBT liability of up to $1,800. The conformity bill proposes to create a credit that would essentially eliminate the tax on unincorporated businesses with incomes below $100,000. UBT taxes would be reduced for unincorporated businesses with incomes under $150,000. The tax relief provision would eliminate the tax liability of approximately 11,000 sole-proprietorship and partnerships of

[45] Ibid.

[46] Center on Budget Policy and Priorities, "A Majority of States Have Now Adopted A Key Corporate Tax Reform – Combined Reporting." April 2009. www.cbpp.org/files/4-5-07sfp.pdf

New York City's 32,000 unincorporated businesses. An additional 6,000 sole-proprietorship and partnerships would realize reduced taxes under the legislation. This provision will cost the city roughly $25 million annually.

Under the conformity bill, New York City's single sales factor would be phased in over 10 years. The long phase-in ensures the city will be able to generate new tax revenues over the short-term, though the legislation will ultimately be revenue negative. In 2010, the city projects conformity to yield $167 million in new tax revenues, but by 2019 conformity will result in $185 million in lost revenues due primarily to the phase-in of the single sales factor.

Ultimately, conformity will assist New York City in meeting its mandate to keep a balanced budget at a time when tax revenues are shrinking drastically. But, at least in the short-term, conformity will raise taxes on city businesses already struggling through the recession.

It's far from an ideal situation, but Nathan Newman, the interim executive director of the Progressive States Network, said "reasonable revenue increases are the best approach to addressing the current economic and fiscal crises [and are] far better than budget cuts." He warned that cuts to education, health care, transportation and other government services pose a greater threat to states' economic recovery than higher taxes.[47]

"If states use the revenue collect effectively, they can translate higher taxes into stronger economic performance. But that is not a product of higher taxes per se, but of wise spending decisions that may or may not be made with those revenues," Newman said.

Citing a recent Center on Budget Policy and Priorities report, Newman noted how 16 states have raised new revenue through tax measures in response to the recession, and another 17

[47] Testimony from Nathan Newman, interim executive director of the Progressive States Network. New York City public hearing, May 21, 2009.

states are contemplating such actions. As the recession began to emerge in 2007 and 2008, another 10 states took similar revenue-raising actions.[48]

In arguing against the assertion that revenue-raising actions stifle economic performance during recessions, Newman noted how "supposedly low-tax states" have suffered far higher job losses than New York. Between March 2008 and last March, New York lost 160,000 jobs, or 1.8 percent of total jobs. During the same period, employment dropped 5.4 percent in both low-tax Florida and Nevada and 7 percent in Arizona.

"Aside from Texas, New York has the least percentage of job loss of any large state economy in the nation," Newman said.

The below chart, provided by the Progressive States Network, shows the percentage of employment loss across the states between March 2008 and March 2009.

[48] Center on Budget and Policy Priorities, "Tax Measures Help Balance State Budgets: A Common and Reasonable response to Shortfalls." May 18, 2009. www.cbpp.org/cms/index.cfm?fa=view&id=2815

Conclusions

I. On Structure

"Single sales factor, economically, has a double-edges sword. Which edge of the sword dominates we are not clear … But you should absolutely be concerned about the equity impact on the single sales factor on the New York State corporations," said Gardner at the Institute on Taxation.

For better or worse, New York began wielding this sword two years ago. While the single sales factor essentially afforded many manufacturers and multi-state corporations with a tax cut, it also cuts into the state's tax revenues. The Select Committee wants to explore ways to equalize the tax advantages provided almost exclusively to multi-state corporations and manufacturers through the single sales factor. One equalization method experts suggested was a throwout rule.

Another tax structure equity concern the Select Committee wants to further investigate involves the unequal income tax rates for C corporations, S corporations and other entities.

II. On Expenditures

"If you wanted to create jobs, it will be simple. Eliminate farm machinery. Everyone will be working. Because we're going to be back to a pre-existing condition, said Fleenor at the Tax Foundation. "That's not what we want. We want productivity."

But the question is how does a state get it?

For organizations such as the Tax Foundation, the Rochester Business Alliance and Manufacturers Association, the "guided philosophy" the state should follow revolves around broad and low tax rates. While lawmakers should not lose sight of this philosophy, the current political environment across the country pushes many states into pursuing pro-active tax policies in regard to economic development.

In the coming months, the Select Committee plans to further explore other states' tax incentive programs and how components of them can be incorporated into whatever replaces the Empire Zones program after it expires in 2010. Also paramount to this investigation will be finding ways to ensure small businesses can easily apply and receive tax incentives from the successor program without compromising its accountability standards.

III. On Conformity

"But if there are loopholes that are no longer appropriate, I couldn't agree more with the governor," Bloomberg told the Joint Fiscal Committee in February 2007, referring to Spitzer's decision to close major tax loopholes in the state's business tax laws.[49]

In 2007, the city deemed Spitzer's loopholes appropriate, and it decided not to conform to the state's tax laws and close them. But two years later, the loopholes seem to be increasingly inappropriate with New York City tax revenues projected to decline $5 billion from 2008 to 2010, and over 91,000 city private sector workers losing their jobs over the past year.

However, the discrepancies between the state and city business tax laws stretch far beyond the 2007 loophole closing provisions. Recognizing that it is also inappropriate to burden city businesses with dual tax accounting practices for the city and state and the unlevel playing field they create, Bloomberg's office in the spring delivered to Albany legislation that would align these two tax systems.

To help achieve this end, Senator Krueger sponsored the city's tax conformity bill (S.50047). The legislation proposes to bring to the city a single sales factor, combined reporting, a net operating loss carryforward and several other already-enacted state business taxing

[49] Joint Legislative Hearing.

methods. However, the senator is concerned about the single sales factor's negative impact on city tax revenues.

About the Select Committee on Budget and Tax Reform

On Feb. 5, 2009, the New York State Senate adopted Senate Resolution No. 315, which created the Select Committee on Budget and Tax Reform. Since then, the six-member, bi-partisan committee chaired by Senator Liz Krueger has sought to look at New York State's entire tax structure. It aims to determine what aspects of it are working smoothly and where there are inequities and complications that must be rectified.

The Select Committee embarked on this mission initially by holding a public hearing on March 12, 2009 to explore progressive changes to the state's personal income tax (PIT) system From this hearing in Albany, the Select Committee noted how PIT rate reductions in the 1990s and earlier part of this decade resulted in a greater tax burden shift to property taxes. Given this trend — coupled with the elimination of the Middle Class STAR Rebate Check Program in the 2009-2010 budget — Senator Krueger introduced legislation (S.4239) proposing to establish a middle-class circuit breaker tax credit that would be phased in over four years. The bill would provide tax relief to households with an adjusted gross income of less than $250,000 annually, broadening the reach of the state's existing circuit breaker program.

Given the state's economic and fiscal crises, the Select Committee then turned its attention to New York's business and banking taxes. It held public hearings on April 30, 2009 in Rochester and May 21, 2009 in New York City to evaluate the equitability of the state's business and banking tax structures and their effectiveness to foster economic growth statewide. After hearing about the varying tax treatments imposed on businesses by the state and New York City, Senator Krueger sponsored legislation (S.50047) that would align the two tax structures.

The Select Committee’s members also include Senators Neil Breslin, Kenneth LaValle, Kevin Parker, Bill Perkins and Michael Ranzenhofer. Select Committee staff includes Executive Director Michael Lefebvre, Principal Analyst Richard Mereday and Administrator James Schlett.