

A Burden on ALL of New York State: The Need to Reform Corporate Taxes

The combined, corporate New York State/New York City income tax rate – at 15.3%, the highest in the country -- impedes New York State residents from fully realizing the comparative advantage of some of their state's most attractive economic resources: the natural ports in the New York Harbor estuary, the business and communications infrastructure of a world-class city, and the human capital of some of the nation's leading universities. The onerous tax rate forces companies to locate businesses elsewhere in the country outside the five boroughs of New York City, where tax rates are lower, depriving all New York State residents of the benefits they would otherwise derive from having one of the world's foremost economic engines within their state's borders. This costs all New Yorkers tens of thousands of jobs, hundreds of millions of dollars in lost economic activity, and millions of dollars in tax receipts.

While the New York State marginal tax rate on business income is comparable to that of neighboring states, New York's leaders must recognize that the New York's competition isn't New Jersey or Connecticut; it's New Delhi and Kowloon. Even domestically, New York's tax rate compares unfavorably with states that experienced strong growth in recent economic expansions: the Carolinas, Florida, Georgia, Utah, Nevada and Virginia.

A Corporate Landscape Littered with Incentives for the Old Economy

New York State's system of taxing business entities inhibits capital formation, is unduly burdensome on business taxpayers, inordinately complex, and requires extraordinary record preparation and record-keeping that no other state or governmental agency requires. Its complexity creates barriers to entry for the uninitiated from out-of-state, who must usually seek professional "in-state" tax advice, as well as for start-ups and entrepreneurial businesses, whose costs to comply with New York's byzantine tax system -- *even when they are generating operating losses* -- is outrageous and unnecessary.

New York's corporate tax system is a relic of the mid-20th Century, when "conglomerates" dominated the corporate landscape and New York's leaders were trying to lure corporate headquarters to the office towers of Manhattan. New York's leaders of that age adopted a tax scheme that would attract the Fortune 500 companies of the age, or, more specifically, their holding companies to New York State, along with the large, well-paid, corporate staffs they had in the 1950's and 1960's.

In this scheme, income from "subsidiary capital" was taxed only to the extent the subsidiary actually did business in New York State. Income from "investment capital", amounts companies invested in non-consolidated subsidiaries and other stock holdings – was similarly mostly exempt.

But the "headquarters" tax scheme had perverse disincentives for locating value-creating operating companies, like manufacturing and research, in New York State. Under the scheme, most New York companies were better off locating their operating companies outside New York State in a separate subsidiary. If the "headquarters" company operated its businesses as divisions, their income was taxed by New York State. But if the operating divisions were separately incorporated and were operated

entirely outside New York State, their income and capital would be entirely exempt from New York State taxes! When dividends were paid to the corporate parent, those dividends were also exempt from tax, as these were income from subsidiary capital. For the Fortune 500, New York was attractive because foreign dividends were exempt from New York State tax. [Indeed, even “deemed” dividends, like Subpart F income, Section 78 dividend gross-ups and Section 956 income from investing foreign E&P in the United States was exempt from New York tax.]

By the 1970’s, though, the conglomerate had mostly fallen out of corporate fashion. New York’s egregiously high personal income tax rates led to an exodus of corporate decision makers, who chose to earn their executive salaries in the suburban office parks of lower-taxed, neighboring states. When the wave of corporate “down-sizing” and “right-sizing” seized the Fortune 500 in the late 1980’s – flattening corporate lines of reporting and moving hordes of “headquarters staff” types closer to their operational subsidiaries -- the entire scheme of a New York’s “headquarters company” tax system lay moribund, kept alive only by the lobbying efforts of a handful of powerful old corporate dinosaurs who still benefitted from it. But even these old holdovers were only protecting decades-old investments; even they wouldn’t consider making a new business investment in New York State.

Today, New York’s corporate tax system continues as a relic, as far removed from today’s business trends as the Edsel and the Hoola-Hoop. While there have been some notable improvements in recent years, such as moving to single-factor (sales) apportionment, small taxpayers are still burdened by compliance costs and, in the five boroughs of New York City, the burden of having to comply with two discrete tax systems, two separate audit regimes, and two separate appeals processes. This burden on small and medium businesses is exacerbated because new businesses and nonresident companies hoping to enter the New York market must usually engage expert tax counselors at rates varying anywhere from \$300 to \$800 per hour to explain what, in the end, are only modest revenue differences for the city and the state, but that greatly exacerbate the cost of tax compliance.

Other New York Oddities:

- New Yorkers who elect to be taxed under Subchapter S to be exempt from tax at the corporate level under the federal and New York State law, must still bear corporate-level tax status in New York City. Some large privately held companies that conduct business as “S Corps” have audited financial statements that are entirely devoid of income tax expense, except for an odd-looking tax provision for the burden of New York City tax (which usually has to be explained to people who don’t live here.)
- New York City imposes an “unincorporated business tax” on partnerships, sole proprietorships, and other entities that are (as the name implies) “unincorporated”. The purpose is to tax those entities owned by individuals that are not residents of the city (and thus not taxable on the business profits they earn in New York City.) The UBT has a cumbersome and unduly complicated credit mechanism intended to avoid double-taxation of the same income on New York City residents. But the system could be scrapped entirely simply by imposing a withholding tax on New York City unincorporated businesses, as several other jurisdictions do.

- New York State and New York City each impose different bases for apportioning income on unincorporated entities, so that companies that conduct business in New York City must track two different sets of apportionment data.
- Business entities that have been audited by New York State are required to report the findings of the audit to New York City. New York City can then conduct its own audit, if it so desires. Taxpayers must challenge any issues on two separate appeals tracks – *even if the issue in dispute in the two taxing jurisdictions is identical.*
- New York City’s personal income tax is administered and audited by officials from the New York State Department of Taxation and Finance. New York City’s business taxes are administered by New York City, even though New York State’s tax is virtually identical (save for some minor differences that usually have an immaterial tax effect.) Were New York City’s audit staff to join New York State’s audit staff, the total amount of tax audits of different business taxpayers in New York State would increase significantly

New York’s business tax system should be scrapped as a tax regime that is inordinately complex and unduly burdensome; a system for which the cost for proper compliance is simply too high. It should be replaced by a simplified system that largely “piggybacks” the federal tax regime, but that encourages entrepreneurship, in-state capital formation and business innovation.

New Yorkers should use the tax system to transform the upstate economy from a rust-belt relic of the 1950’s economy to the nation’s foremost center for new business formation. We should turbo-charge the downstate economy to maintain New York City as the world’s foremost financial services center and to encourage innovation in industries in a diverse array of businesses where the city and surrounding areas maintain comparative advantage: biotechnology, medical services, internet technology, design, shipping, fashion, publishing, entertainment, film production, and tourism.

In a world economy where billions in capital can be moved with the click of a mouse and where businesses are free to locate virtually anywhere they choose, New Yorkers need to be attractive and innovative. We need to present a face to the world’s investment community that welcomes business development and job creation. Our business tax system does practically the opposite. It needs to change before the world and the march of time passes New York by.