Governor Spitzer's Corporate Income Tax Proposals: Overdue Reforms, or Raising Taxes?

What:	Presentation by Michael Mazerov, Center on Budget and Policy Priorities Discussion to follow
When:	Friday, March 16, 2007, 12:30 to 2:30 pm
Where:	LOB Room 711-A Buffet deli lunch available
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Governor Spitzer included in his first executive budget a number of proposals that affect corporate taxes in New York, including:

- Closing a number of very specific tax loopholes and tax shelters that currently allow some businesses to pay less in taxes than competitors with the same net income, and
- Adopting combined reporting, a systemic reform that will make it much harder for tax planners to invent new ways of shifting income among subsidiaries as a way to avoid paying state taxes.

About $449 million in the General Fund is at stake. As of now (March 14, 2007) the Assembly has agreed to the governor's corporate tax reform proposals but the Senate has rejected them. The Senate budget also includes several other big dollar proposals (increasing school aid for suburban districts, restoring Medicaid cuts and expanding the property tax rebate program). By the last week in March, the Senate and Assembly must hammer out a budget agreement that reconciles these competing priorities.

The policy is as interesting as the politics, and even more complex. Corporate taxes in New York (and across the country) have fallen dramatically over the last 30 years, as a percentage of personal income and also as a percentage of total tax receipts**;** personal income tax payers and sales tax payers have had to pick up the slack. State practices vary widely—both with respect to the way multi-state corporations must report their income and the way that a firm's income is apportioned among the states for tax purposes. New Yorkers should take a look at theory and practice around the country before making a final decision.

Michael Mazerov is a Senior Fellow at the Center on Budget and Policy Priorities (CBPP) and an expert on state and local taxation of business. Prior to joining CBPP in 1998, he served for almost nine years as Director of Policy Research for the Multistate Tax Commission, an interstate compact organization that addresses state taxation of interstate commerce. Earlier in his career, he conducted research on state and local budget and tax policy issues for the American Federation of State, County and Municipal Employees.

Corporate Taxes in New York and Other States

Combined reporting limits the ability of corporations to avoid taxes by shifting revenues and expenses among subsidiaries.

Sixteen states have required combined reporting for over 20 years. More recently Vermont and Texas adopted this approach, and last week the West Virginia legislature gave final passage to a bill requiring combined reporting. In addition to Governor Spitzer's current proposal, the governors of four other states (Iowa, Massachusetts, Michigan and Pennsylvania) are proposing combined reporting to their legislatures this year.

In New York, under current tax law, the individual corporations that make up a corporate family such as Wal-Mart or ExxonMobil can choose to be taxed as separate entities. However the Commissioner of Taxation and Finance Commissioner is authorized to require a corporate family to file a combined return if (because of inter-company transactions or some agreement, understanding, arrangement or transaction) she determines that doing so is necessary "in order to properly reflect (that business's) tax liability."

This authority, together with a substantial increase in the last 20 years of what is politely referred to as "aggressive tax planning," has resulted in a significant increase in audit revenues. In the last four years, for example, audit revenues have amounted to between 16 percent and 27 percent of regular corporate franchise tax collections. For the current fiscal year, audit revenues are projected to be fully 40 percent of regular corporate franchise tax collections.

Governor Spitzer's combined reporting proposal would change the law to require corporate families with substantial inter-subsidiary transactions to file combined returns in the first instance. This would greatly reduce the continuing search for new income shifting arrangements that characterizes the current system.

Moving in this direction will also serve to level the playing field among competing businesses. Not all multi-state corporations engage in the aggressive use of transfer payments and income shifting among subsidiaries, and virtually no small businesses have the ability to use such tax reduction techniques.

States' policies about apportioning corporate income can cause businesses to strategically change their corporate structures.

Each of the states with a corporate income tax has chosen "formula apportionment" as the method of determining the share of a firm's nationwide profits that it will tax. The alternate method, specific matching of in-state sales and in-state expenses, is subject to manipulation and poses a prohibitive auditing burden. Most states, including New York, have traditionally used three factors (property, payroll and sales) in apportioning corporate income.

New York is now in the final year of a transition to a new system under which it will apportion corporate income solely on the basis of the share of a firm's sales in New York State. This "Single Sales Factor" (SSF) approach was adopted by the Legislature in 2005, at the urging of a number of multi-state corporations who stood to benefit significantly from the change.

SSF apportionment creates special revenue risks for states without combined reporting. These risks arise because, by federal law, none of the income of a multi-state corporation can be taxed by a state unless that corporation has "nexus" or physical presence (that is, property or employees) in that state—even if it makes millions of dollars of sales to residents and/or businesses in the state.

This nexus rule means that SSF apportionment might encourage some multi-state corporations to put nexus-creating property or payroll into subsidiaries that have little, if any, sales in New York. They could then make sales into New York from an entity with no property or payroll in New York. Without combined reporting, income from those sales wouldn't be taxable at all.

Given New York's transition to 100 percent sales-only apportionment in 2008, combined reporting is essential to prevent such tax avoidance.