Reforming the New York Tax Code

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Executive Summary

New York State is at a crossroads. Our tax structure is scheduled to change in a way that will render state revenues inadequate for the budget years ahead. Hundreds of thousands of households struggle to pay property tax bills that represent an inordinate share of their incomes. And, in the aftermath of the Great Recession, far too many New Yorkers are still looking for jobs as good as the ones they used to have.

What can be done? What strategies can we pursue that will increase revenues to preserve the services that support New Yorkers' quality of life and make it possible for families to move up the socioeconomic ladder—and that will, at the same time, make the tax system fairer?

Tax fairness and tax affordability are both intertwined with the concept that taxes should be based on the "ability to pay" principle. Under a tax system based on the "ability to pay," there is an effort to use a mix of taxes and tax credits that shields subsistence income from taxation, and recognizes that a family needs all of its first $30,000 or so of income to pay for life's necessities but that none of a family's thirtieth $30,000 of income is needed for survival.

Economists define a tax or a tax system as progressive if the share of household income that goes to paying that tax (or those taxes) increases as the household's income increases. Under a regressive tax or a regressive tax system, the opposite is true: as a household's income increases, the share of that income used to pay the tax or taxes involved goes down.

If New York State's current income tax surcharge expires at the end of the year as scheduled, and is not replaced by a fairer system that raises almost as much money, the state will face a multi-billion dollar revenue loss. And, New York will be left with a compressed five-rate structure with the top rate of 6.85 percent applying to taxable incomes over $40,000. Thus, a moderate income family would be subject to the same marginal rate as the family with a $10 million income.

Providing tax relief targeted to heavily-burdened moderate and middle income households while having the wealthiest pay modestly more will also help stimulate the state's economy. Those New Yorkers who are struggling to make ends meet will take any reduced taxes and pump that spending right back into the economy. The pressure on middle and lower income families is evidenced by the fact that more than 675,000 households with incomes under $100,000 a year and who have lived in their current homes for at least 5 years, pay more than 10 percent of their income in property taxes on their primary residences. At the same time, slightly higher taxes on those taxpayers with incomes at the very top are not likely to lower their spending.

At present, state and local taxes in New York are regressive overall, meaning lower and middle income families pay a higher share of their income in state and local taxes than those further up the income ladder. Sales and property taxes are highly regressive, enough so that they offset the slight progressivity of the state income tax. A middle income family pays 11.6 percent of its income in state and local taxes while those lucky enough to be in the top 1 percent pay 8.4 percent, and that's with the current income tax surcharge.

New York has made many positive changes in its tax code over the years. These have included eliminating the marriage penalty and instituting a state Earned Income Tax Credit to provide relief to low income working families, but it has also cut the top personal income tax rate by more than fifty percent. Forty years ago, New York State's income tax had 14 brackets, ranging from 2 percent to 15 percent. Since then, the rate structure has been collapsed and the top tax rates have been dramatically reduced. If, instead, we had indexed personal exemptions and tax brackets for inflation rather than eliminating brackets from the bottom and the top of the rate schedule, 90 percent to 95 percent of New Yorkers would be paying less than they now pay, and state revenues would be some $8 billion higher.

But more recent developments have tended to make the overall system less fair while crippling its ability to raise needed revenue. Several corporate tax changes in recent years, together with an expansion of various business tax expenditures in the name of economic development, have significantly lowered the amount of state business income tax collections in relation to the size of the state economy. If business income taxes were the same 0.8 share of total New York State Gross Domestic Product as 25 years ago, the state's business tax collections would be $3 billion a year greater.

Over the decade from the mid-1990s to the mid-2000s, a series of changes to New York's personal and corporate income taxes reduced state tax collections by several billion dollars. Reduced resources at the state level limited the amount of local aid the state could provide to school districts and other local governments. These changes have, in turn, put greater pressure on local property and sales tax bases, directly contributing to the extraordinarily high number of low- and middle-income New York households for whom local property taxes consume 10 percent or more of household income..

Both the Institute on Taxation and Economic Policy's analysis of the distribution of the state-local tax burden by income ranges and the NYS Department of Taxation and Finance's effective tax rate calculations underscore the need for greater graduation of the income tax rates at the very top end of the income distribution.

If New York were to establish a one percent increase from 6.85 to 7.85 percent beginning at $665,000, the Division of the Budget's estimate of the current one percent threshold, with another one percent at $1 million, and additional one half of one percent increments at $5 million and $10 million, the state could generate between $4.4 billion and $5.1 billion per year.

Top 1% Progressive Income Tax Proposal

Income range	2009 to 2011 Temporary Surcharges	Proposed 1% Plan	Change
Potential 2012 Tax Year Revenue*	**Between $4.7 and $5.5 Billion**	**Between $4.4 and $5.1 Billion**	
200k single and 300k married to 500k	7.85%	6.85%	**-1.00%**
500k to 665k	8.97%	6.85%	**-2.12%**
665k to 1 million	8.97%	7.85%	**-1.12%**
1 million to 5 million	8.97%	8.85%	**-0.12%**
5 million to 10 million	8.97%	9.35%	**+0.38%**
10 million to 100 million	8.97%	9.85%	**+0.88%**
100 million and above	8.97%	9.99%	**+1.02%**

*The distribution of the projected revenue by state fiscal year depends on when the rate structure is enacted.

New York could also raise needed revenue by reforming its corporate taxes. Updating LLC filing fees with a progressive fee structure for higher income LLCs would generate $75 million annually. Equalizing the treatment of in-state and out-of-state hedge fund managers operating in New York would generate $50 million. And enhancing the state's enforcement of taxes due on real estate partnership profits (section 1231 gains) would generate several hundred million dollars initially and $100 million annually.

Corporate tax cuts that take the form of reductions in tax rates have a very uncertain effect and are unlikely to offset the adverse economic effect of cutting government spending. Fundamentally, businesses hire or invest in response to increased demand, whether from consumers or other businesses. In the current economic environment, there is a strong consensus among economists that inadequate demand is restraining hiring and business investment. Large corporations have substantial cash reserves already—adding a tax cut to the mix in the absence of a pickup in demand is unlikely to tip the balance in favor of hiring. The lack of demand and orders is the main factor keeping small businesses from hiring. Targeted state job tax credits that provide tax reductions to businesses that add workers have not been proven to be cost effective job generators.

The revenue from the personal and corporate income tax reforms identified in this report could and should be used in ways that would both avoid job-killing budget cuts and make job creating investments. More specifically, this revenue could be used to:

- Address the state's projected budget gap in ways that would stem the tide of public sector job losses that are putting a real drag on the economic recovery;
- Create jobs by restoring the state's commitment to
    - Adequate funding of elementary, secondary and higher education,
    - Accessible and affordable health care and
    - A transportation infrastructure that properly supports New York's high-productivity economy;
- Establish an emergency jobs program to help with immediate needs such as the rebuilding of homes, businesses and public facilities that were destroyed or which sustained significant damage as a result of tropical storms Irene and Lee; and
- Establish a middle class circuit breaker that targets meaningful relief to those families that are most in danger of being forced out of their homes.

Reforming the New York Tax Code

Each state decides for itself what taxes it is going to collect to fund the public services that it provides.

Each state also decides for itself:

- What kinds of local governments it is going to have,
- What services its various local governments are going to be required to provide,
- What other services those local governments will be allowed to provide,
- What taxes its different local governments are authorized to collect,
- What limits, if any, it will place on the rates that local governments can set for the various taxes that they are authorized to collect, and
- How much aid the state government will provide to its various local governments to assist them in meeting their assigned service responsibilities.

The cumulative result of those decisions over time is that each state has a tax system that is composed of some taxes that are imposed at the state level and some that are imposed at the local level. In addition, most states have some taxes that economists characterize as progressive and some that they characterize as regressive; and some progressive taxes are more progressive than other progressive taxes while some regressive taxes are more regressive than other regressive taxes.

- A tax is characterized as progressive if the share of household income that goes to paying that tax increases as the household's income increases. Most income taxes are progressive because they both (a) shield subsistence income from taxation through the use of deductions, exemptions and targeted credits, and (b) have graduated rates. But some incomes taxes are more progressive than others.

- A tax is characterized as regressive tax if the share of household income that goes to paying that tax decreases as the household's income increases. Most excise taxes and general sales tax are regressive for the simple reason that as a household's income increases, the portion of its income that it spends to meet life's necessities decreases. Residential property taxes on primary residences are particularly regressive at the low end of the income distribution and they also, on average, take a greater share of a middle income families' incomes than of the incomes of very high income families. But there is less of a consistent relationship between income and property taxes than there is between income and other taxes. This is particularly true during periods of high and long-term unemployment, when some families have greatly reduced incomes and higher property tax bills.

- A proportional tax is one under which all households, regardless of their income level, pay about the same portion of their income. Many people are attracted to the simplicity and seeming fairness of the idea of a "flat tax" under which everyone would have the same income tax rate with no provisions that allow some households to pay a lot less than other households with even lower incomes. The real problem is that most advocates of a "flat tax" want to have it replace the progressive income tax rather than the more regressive taxes, which would make the tax system as a whole more regressive.

While it is interesting to understand if an individual tax is regressive, proportional, or progressive, the much more important question is whether a tax system as a whole is regressive, proportional, or progressive. In other words, is the mix of progressive and regressive taxes such that the system's progressive taxes are relied on enough, and are progressive enough, to balance out the negative impact of the system's regressive taxes? The subsequent sections of this paper will examine how New York State's most progressive tax, the Personal Income Tax (PIT), has changed over the last 40 years, how it is scheduled to change in 2012, how it fits together with the other parts of New York's tax system, and, why and how the New York State Personal Income Tax should be made more progressive at the high end of the income distribution. The final section of this paper examines some changes that are necessary for New York's corporate taxes to work effectively and to create an even playing field for New York employers.

The Personal Income Tax

Over the last 40 years, numerous changes have been made in the New York State Personal Income Tax. Some of these changes have made this tax more progressive while other changes have created a virtual flat tax for the top end of the income distribution.

Important progressive changes have worked to shield subsistence income from taxation by increasing New York's Standard Deduction and by establishing and then expanding tax credits targeted to low income working families. But the PIT has become less progressive through the compression of the bracket and rate structure from one with 14 brackets ranging from 2 percent to 15 percent to one with five brackets ranging from 4 percent to 6.85 percent; the elimination of the personal exemption for taxpayers; and, the freezing for decades of the value of the state's dependent exemption. In the early to mid-1970s, New York State had an on-again off-again 2.5 percent surcharge resulting in an effective top rate for several years of 15.375 percent. Since then, the state's permanent top rate has been reduced by more than 50 percent to the current top rate of 6.85 percent. See Figure 1.

New York State has had two temporarily higher tax rates in place since 2009; but those rates are scheduled to expire at the end of the 2011 calendar year. The first of those two temporary brackets increased the tax rate by one percent from 6.85 to 7.85 percent for single taxpayers with taxable income over $200,000 and for married taxpayers filing joint returns with taxable incomes over $300,000. The second temporary bracket applies to taxpayers with taxable incomes above $500,000 regardless of filing status and involves a rate increase of 2.12 percent from 6.85 to 8.97 percent.[1]

If these two temporary rates are allowed to expire, there will be significant impacts for both state revenue adequacy and tax fairness.

[1] The seemingly odd top rate of 8.97 percent has been New Jersey's permanent top rate since 2004. New Jersey had a temporary top rate of 10.75 percent for the 2010 calendar year tax year.

From a revenue perspective, the expiration of the temporary top rates will reduce state revenue by an estimated $5 billion per calendar year tax year. The state's projected budget gap for 2012-2013, for example, would not exist if the temporary rates were not being allowed to expire. In terms of the fairness and logic of the PIT, the expiration of the temporary top rates will mean that New York State's top income tax rate will revert to 6.85 percent and that rate will apply to the portions of taxable income in excess of $20,000 for single taxpayers and in excess of $40,000 for married taxpayers.

Taxable income is not total income[2] but, even so, these relatively low top bracket thresholds create a situation in which an additional dollar of income earned by someone with a very modest amount of taxable income is taxed at the same rate as an additional dollar of income earned by someone with hundreds of thousands of dollars (or more) of taxable income. These are what are referred to as "marginal" tax rates.

New York's tax code also has a provision under which taxpayers with incomes above $100,000 gradually pay back the benefits of having had their first $20,000 (for single taxpayers) or their first $40,000 (for married couples filing joint returns) of taxable income taxed at rates lower than 6.85 percent. The result is that taxpayers with incomes above $150,000 have a nominal tax rate of 6.85 percent on all of their taxable income. This is not, however, these taxpayers' overall average tax rate relative to their taxable income, since many taxpayers, even at very high income levels, benefit from the state's various tax credits.

The New York State Department of Taxation and Finance (T&F) publicly reports effective tax rates by income ranges that it calculates by comparing taxpayers' "tax after credits" to their New York Adjusted Gross Income (NYAGI). As Figure 2 indicates, the T&F-calculated effective tax rates gradually increase over the bulk of the income ranges but they flatten out for the $500,000 to $1 million income range and the three higher income ranges. In fact, the average effective tax rate for the highest income range ($10 million and above) is actually lower (6.166 percent) than the effective rate (6.192 percent) reported for the second highest income range ($5 million to $10 million), and only minutely higher than the effective rate (6.083 percent) for the $500,000 to $1 million range.[3]

The NYS Personal Income Tax as Part of a State-Local Tax System

To examine the progressivity of New York's overall state-local tax system, we turn to the Institute on Taxation and Economic Policy's November 2009 report, "Who Pays? A

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[2] Taxable income for New York State PIT purposes is New York Adjusted Gross Income minus deductions (either standard or itemized) and dependent exemptions. The application of the relevant tax rates to taxable income results in a taxpayer's "tax due before credits" which after the subtraction of credits is the bottom-line amount due which is also referred to as the taxpayer's "tax liability."

[3] These reported effective tax rates overstate taxes as a percent of all income since "New York Adjusted Gross Income" is less than "Federal Adjusted Gross Income" which in turn is less than "Total Income" for federal income tax purposes. And "Total Income" does not include interest income from investments in state and local bonds.

Distributional Analysis of the Tax Systems in All 50 States."[4] In this report, ITEP estimated state and local taxes as a share of total family income for non-elderly households by income ranges for each of the 50 states. For New York State, ITEP's effective personal income tax rates would be lower than the New York State Tax Department's estimates because of ITEP's use of a more comprehensive definition of income except for the fact that the ITEP estimates are for state and local taxes not just state taxes. For interstate comparisons, it is very important to look at state and local revenues on a combined basis since there is a great deal of variation among the states in terms of the division of responsibility—between the state governments themselves and their local governments—for the financing of various public services.

The conclusion of the 2009 ITEP analysis is that, on average, the top one percent of non-elderly households in New York State in 2007 paid 6.7 percent of their total income in state and local income taxes. This is, in effect, a weighted average of (a) the New York City and Yonkers resident households in this income range who paid more than 6.7 percent of their total income in personal income taxes in 2007 because of those two cities' local income taxes, and (b) households in this income range who lived in other parts of New York State and who paid less than 6.7 percent of their total income in personal income taxes in 2007. See Figure 3.

The ITEP analysis is also very important since it looks at the distributional impact of all state and local taxes, not just income taxes. For New York State, the ITEP analysis shows that the overall tax system is not even proportional, let alone progressive. As Figure 4 shows, when the personal income tax is excluded from the analysis, New York's mix of state and local taxes is classically regressive, taking 13.1 percent, on average, of the income of the 20 percent of non-elderly households with the least income but only 2.7 percent, on average, of the income of the one percent of non-elderly households with the most income.

Figure 4 also shows that New York's income tax is progressive but not progressive enough at the top end of the income distribution to move the overall tax system to proportionality. For the lowest income 20 percent of non-elderly households, the income tax is estimated to be, on average, a negative 3.5 percent. That means that enough of the people in this quintile are working families with children to qualify for enough in refundable Earned Income Tax Credits (EITCs) to equal 3.5 percent of the income of all the households in this category including those who do not qualify for refundable EITCs. The impact of this negative 3.5 percent income tax figure is to reduce the overall tax burden for this quintile to 9.6 percent of income. This may be more than such low income families should be paying in state and local taxes but only the top one percent of households, those with incomes above $633,000, paid less of their income, on average (9.4 percent), in state and local taxes. See Figure 5. And, as Figure 6 shows, the top one percent of households benefited significantly from the federal deductibility of state and local income and property taxes which reduced their overall effective state and local tax rate from 9.4 percent to 7.2 percent.[5]

[4] The Institute on Taxation and Economic Policy (ITEP) maintains and regularly updates a 50-state microsimulation model that it uses to estimate the relationship between the major categories of state and local taxes and the total income of households. http://www.itepnet.org/whopays/.

[5] As an aside, it is worth noting that the households in the next highest income category, those with incomes between $209,000 and $633,000, benefitted much less from this federal offset even though their federally-deductible state and local income and property taxes represented, on average, a substantially larger portion of their income than those taxes represented for the top one percent. This anomaly is attributable to the workings of the federal

Why and How the New York State Personal Income Tax Should be Made More Progressive at the High End of the Income Distributions

Both the Institute on Taxation and Economic Policy's analysis of the distribution of the state-local tax burden by income ranges and the NYS Department of Taxation and Finance's effective tax rate calculations underscore the need for greater graduation of the income tax rates at the very top end of the income distribution.

If New York were to establish a one percent increase from 6.85 to 7.85 percent beginning at $665,000, the Division of the Budget's estimate of the current one percent threshold, with another one percent at $1 million, and additional one half of one percent increments at $5 million and $10 million, the state could generate between $4.4 billion and $5.1 billion per year. [6] See Figure 7.

This revenue could be used in ways that would both avoid job-killing budget cuts and make job creating investments. More specifically, this revenue could be used to:

- Address the state's projected budget gap in ways that would stem the tide of public sector job losses that are putting a real drag on the economic recovery;
- Create jobs by restoring the state's commitment to
  - Adequate funding of elementary, secondary and higher education,
  - Accessible and affordable health care and
  - A transportation infrastructure that properly supports New York's high-productivity economy;
- Establish an emergency jobs program to help with immediate needs such as the rebuilding of homes, businesses and public facilities that were destroyed or which sustained significant damage as a result of tropical storms Irene and Lee; and
- Establish a middle class circuit breaker that targets meaningful relief to those families that are most in danger of being forced out of their homes. See Figures 8 and 9.

Alternative Minimum Tax (AMT) which now hits the upper middle class much harder than it hits really high income households. New York's civic, business and labor leaders should work with their counterparts from other states to end the treatment of state and local taxes paid as an item of tax preference in the calculation of the federal AMT.

[6] The low estimate of $4.4 billion is based on the assumption of an economic stutter-step that would cause incomes in 2012 to regress to 2008 levels. The higher estimate of $5.1 billion is based on a revenue outlook consistent with the May 15, 2011, estimate ($4.1 billion) for the Assembly Majority's proposal for a true millionaires' tax (A.7802). If the $665,000 bracket in this proposal were dropped, it is estimated that the revenue raised would be between $4.15 billion and $4.85 billion. Another possible modification would involve adding a 9.99 percent rate for incomes of $100 million or more. An estimate of the likely revenue yield of this proposal is not currently available.

Corporate Tax Reform

There are several reasons to undertake corporate tax reform, but it is unlikely that corporate tax reform or changes will boost New York's economy and job creation in the short run. Since, like most states, New York has to balance its budget every year, new tax cuts or tax credits—which amount to the same thing since tax credits reduce tax collections—would have to be offset by spending reductions elsewhere in the state budget. There have already been $20 billion in state spending cuts over the past three years in such areas as local school aid, public higher education, social services, mass transit aid, and revenue sharing aid to localities, and the state is facing a budget gap of close to $3.5 billion for the remainder of the current year and in the coming year.

The most compelling reason to reform corporate taxes is to close loopholes, end costly and ineffective tax breaks, and fix shortcomings that unnecessarily reduce tax collections and thereby limit the resources New York State has to maintain and invest in infrastructure needed to foster long term economic growth.

Corporate tax cuts that take the form of reductions in tax rates have a very uncertain effect and are unlikely to offset the adverse economic effect of cutting government spending. Fundamentally, businesses hire or invest in response to increased demand, whether from consumers or other businesses. In the current economic environment, there is a strong consensus among economists that inadequate demand is restraining hiring and business investment. Large corporations have substantial cash reserves already—adding a tax cut to the mix in the absence of a pickup in demand is unlikely to tip the balance in favor of hiring. The lack of demand and orders is the main factor keeping small businesses from hiring.

Targeted state job tax credits that provide tax reductions to businesses that add workers have not been proven to be cost effective job generators. Several states have job tax credits, but as noted state fiscal experts Iris Lav and Robert Tannenwald conclude: "there is no evidence that these states' economies are doing better than other states' economies."[7] A perennial problem is determining whether or not the job tax credit, which often amounts to a few thousand dollars, actually induces a firm to hire additional workers, or just rewards them for doing something they would otherwise do. In an economic recovery period like the one we're in, most of the tax credits paid out may go to businesses that were hiring anyway. Although New York's unemployment is extremely high and long-lasting and layoffs continue among many businesses, enough companies are adding workers so that there is a modest level of net private sector job growth. The usual churning in the economy means that gross job gains are much greater than net job gains; thus, many more jobs would trigger a tax credit than indicated by the net job gain. A recent analysis by widely respected labor market and economic development expert Timothy Bartik of the Upjohn Institute concluded that for every job induced by job tax credit, four other jobs receiving the credit would have been created anyway.[8]

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[7] Iris J. Lav and Robert Tannenwald, "The Zero-Sum Game: States Cannot Stimulate Their Economies by Cutting Taxes," Center on Budget and Policy Priorities, March 2, 2010.

[8] Timothy J. Bartik and John H. Bishop, "The Job Creation Tax Credit, Dismal projections for employment call for a quick, efficient and effective response," Economic Policy Institute, October 20, 2009. The Bartik-Bishop report pertains to a federal job tax credit proposal where federal revenue gains and safety net savings go further in offsetting the cost. Appendix G discusses why state job tax credits are different and not effective.

New York State already spends over $5 billion a year in various business tax breaks

Given New York's economic and budget challenges, all budget options and tax provisions need to be carefully considered. However, "everything on the table" is usually taken to mean including in budget discussions the possibility of both tax increases and budget cuts. But, a third set of budget-closing options is rarely discussed: the approximately $5.3 billion that goes each year to New York State business tax expenditures.

New York State business tax expenditures include a wide array of special tax breaks, credits, exemptions and other provisions given to individual corporations or to a class of businesses or business owners to reduce business tax liability to New York State in the name of economic development. In all, there are 39 different business tax breaks.[9]

Business tax expenditures are "off budget" but, nonetheless, they are a form of spending and they cost New York State money. The term, after all, is tax "expenditures." The State could choose to directly fund the activities for which businesses claim tax benefits, and if the State did that, these expenditures would be much more transparent and accountable rather than be, in effect, "hidden spending." In effect, tax expenditures are "back door" spending. Collecting the foregone taxes represented by business tax expenditures would increase revenues to the state treasury. Not collecting them increases the size of the hole that must be filled by other taxpayers or by cuts in services. At a time when every spending item in the state budget is under scrutiny, business tax subsidies paid through the "back door" warrant an equally close review

Closing a loophole opened with recent New York corporate tax change: single sales factor

Despite a dubious economic development record, the Single Sales Factor (SSF) method for the apportionment of multi-state corporate income was adopted by New York State in 2005. Its three-year phase-in was accelerated by a year in 2007. Summing up his extensive review of the research on the Single Sales Factor method, Michael Mazerov of the Center on Budget and Policy Priorities concludes: "states adopting a single sales factor apportionment formula are likely to find it a relatively ineffectual incentive for job creation and investment."[10]

The SSF approach increases the portion of a multi-state corporation's profit that will go untaxed because of a 1959 federal law (P.L. 86-272) that prohibits a state from taxing any portion of the income of a corporation that has sales but no property or payroll in that state. This untaxed profit is known as "nowhere income." Until P.L. 86-272 is repealed or substantially reformed, New York should adopt either a "throwback" or a "throwout" rule.[11]

Under a "throwback" rule, sales made in states where a firm's income is not taxable (because of P.L. 86-272) are "thrown back," for apportionment purposes, to the state from which the sales were made. A "throwout" rule is a variation that excludes nowhere sales from entering into the

[9] For a further discussion of New York business tax breaks, see Fiscal Policy Institute, "The Growing Budget Burden of New York's Business Tax Expenditures," December 7, 2010.
[10] Michael Mazerov, *The "Single Sales Factor" Formula for State Corporate Taxes. A Boon to Economic Development or a Costly Giveaway?* Washington, D.C.: Center on Budget and Policy Priorities, 2001, revised September, 2005.
[11] Recognizing the problem of "nowhere income," legal experts seeking to establish a uniform and fair system of state-level corporate taxation have long recommended that states adopt a "throwback" or "throwout" rule. Institute on Taxation and Economic Policy, *"Nowhere Income" and the Throwback Rule,* Policy Brief # 38, 2008.

apportionment calculation at all. About half the states, including New York, have *not* adopted a "throwback" or a "throwout" rule. This is one of the reasons that the corporate income tax share of state revenues has declined in many states.

The decline in corporate income taxes relative to the size of New York's economy

From 1984 to 1994, total corporate income tax collections (from the two corporation income taxes [Articles 9 and 9A], the insurance corporation tax, and the bank tax), represented 0.8 percent of New York State's Gross Domestic Product (GDP). Because of the continued existence of various tax loopholes, the ill-conceived expansion of business tax subsidies, and the adoption of changes such as Single Sales Factor, corporate income taxes were only 0.5 percent of state GDP in 2009 and 2010. See Figure 10.

If the corporate tax share of state GDP were increased through loophole closing and by curbing unwise business tax expenditures and restored to the 0.8 percent that existed 25 years ago, the state would have over $3 billion more in revenues each year to invest in infrastructure and human capital and build a more sustainable and productive economy.

Needed reforms in the taxation of LLCs and other unincorporated businesses

One of the ways in which New York's tax structure has not kept pace with economic and other changes is in the area of unincorporated businesses. Typically, people tend to think that the universe of unincorporated businesses is dominated by small businesses, the self-employed, sole proprietorships, and fledgling partnerships. Numerically, that might be the case. But in New York State there are a very large number of very large unincorporated businesses with substantial receipts and business income. In New York City, which does tax the business income of unincorporated businesses through its Unincorporated Business Tax (UBT), Limited Liability Companies (LLCs) and Limited Liability Partnerships (LLPs) paid $800 million in taxes in 2005, nearly three fourths of the total unincorporated business tax liability, and an amount equal to 40 percent of the total collected under the City's General Corporation Tax.[12]

Within the finance sector, the role played by private equity and hedge funds has increased dramatically in recent years. These entities typically are organized as LLCs or LLPs, and to some extent, the strong growth in the City UBT liability in recent years stemmed from LLCs and LLPs in the finance sector. Eleven of the world's largest private equity firms are headquartered in the city. Thirteen of the world's top 50 performing hedge funds are based in New York City.[13]

Large LLCs and other business partnerships benefit from state public services and from state laws that grant them special legal advantages not available to other forms of businesses.[14] The State should seek to tax appropriately these large business entities. New York City's 7,600 LLCs

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[12] The amount of UBT taxes paid by LLPs and LLCs exceeded the total bank tax collections for that year. See, City of New York, Department of Finance, Office of Tax Policy, *Statistical Profiles of New York City Business Income Taxes, Tax Year 2005*.
[13] Fiscal Policy Institute, *Re-thinking the New York City Business Tax Treatment of Private Equity Fund and Hedge Fund "Carried Interest*, April 15, 2008.
[14] Michael Mazerov, *Reforming the Tax Treatment of S-Corporations and Limited Liability Companies Can Help State Finance Public Services*, Center on Budget and Policy Priorities, April 8, 2009.

and LLPs had combined taxable income in New York City in 2005 of $20 billion, which works out to an average of $2.6 million in business income per entity. These are not small businesses. Yet, the State has gone in the other direction in terms of appropriately taxing these large businesses. Obviously, since New York City already imposes a four percent business income tax on unincorporated businesses, there are limits to how much the State could tax such entities. But the current state fee structure is extremely nominal.

The State should consider action in three areas involving unincorporated businesses.

- Update LLC filing fees

  In 2003, the maximum Limited Liability Company (LLC) filing fee was increased from $10,000 to $25,000. Initially authorized for two years and then extended for two more, the higher maximum was in effect for tax years 2003-2006. The fee structure was still on the member basis at this point. Filing fee collections, which are paid as part of New York State's Personal Income Tax, increased from $26.5 million in 2002 to an average of about $72 million for 2003-2006.

  In 2008, however, the member basis was replaced with a fixed fee structure and the maximum lowered to $4,500, even for entities with New York source gross income of $25 million or more. (The same fee structure applies to the fixed dollar *minimum* tax for S and C corporations.)

  In 2009, filing fees were established for non-LLC general partnerships on the same fee structure as for LLCs. The revenue projection for this change was estimated by the State Tax and Finance Department at $50 million.

  The State should consider restoring the $25,000 maximum filing fee and have it apply to both LLCs and general partnerships over some very high business receipts or income threshold. An alternative would be to add one or more additional brackets at the top end of the graduated fee structure. Given the number and size of such entities in New York, such a change might generate $75 million in additional revenue.

- Tax nonresident hedge fund management fees

  In his 2010 Executive Budget proposal, Governor Paterson proposed to "expand the nonresident personal income tax to include income received from hedge fund management fees." As the governor's proposal explained, "Currently, only a small portion of such income is taxed as compensation, with the remainder deemed tax-free capital gains. This proposal would result in equal treatment of this income for residents and nonresidents."[15] This proposal would generate $50 million in additional revenue.

- Eliminate the carried interest exemption under New York City's Unincorporated Business Tax

[15] Governor David Paterson, *2009-10 New York State Executive Budget*, p. 127.

While not a state revenue item, it would be important in helping New York City to close its projected Fiscal Year 2013 budget for the State Legislature to eliminate the carried interest exemption loophole in the City's Unincorporated Business Tax. This would put the taxation of private equity and hedge funds on the same footing as that of thousands of smaller businesses. The City taxes the fees received by managing partners in private equity and hedge funds but exempts "carried interest" from taxation. Carried interest refers to the profit share received by managing partners, usually 20 percent of the profits generated by the pooled investment of the limited partners.[16] The New York City Independent Budget Office estimated that eliminating the carried interest exemption for the Unincorporated Business Tax would yield $200 million a year for New York City.[17]

Underpayment of taxes related to real estate partnerships

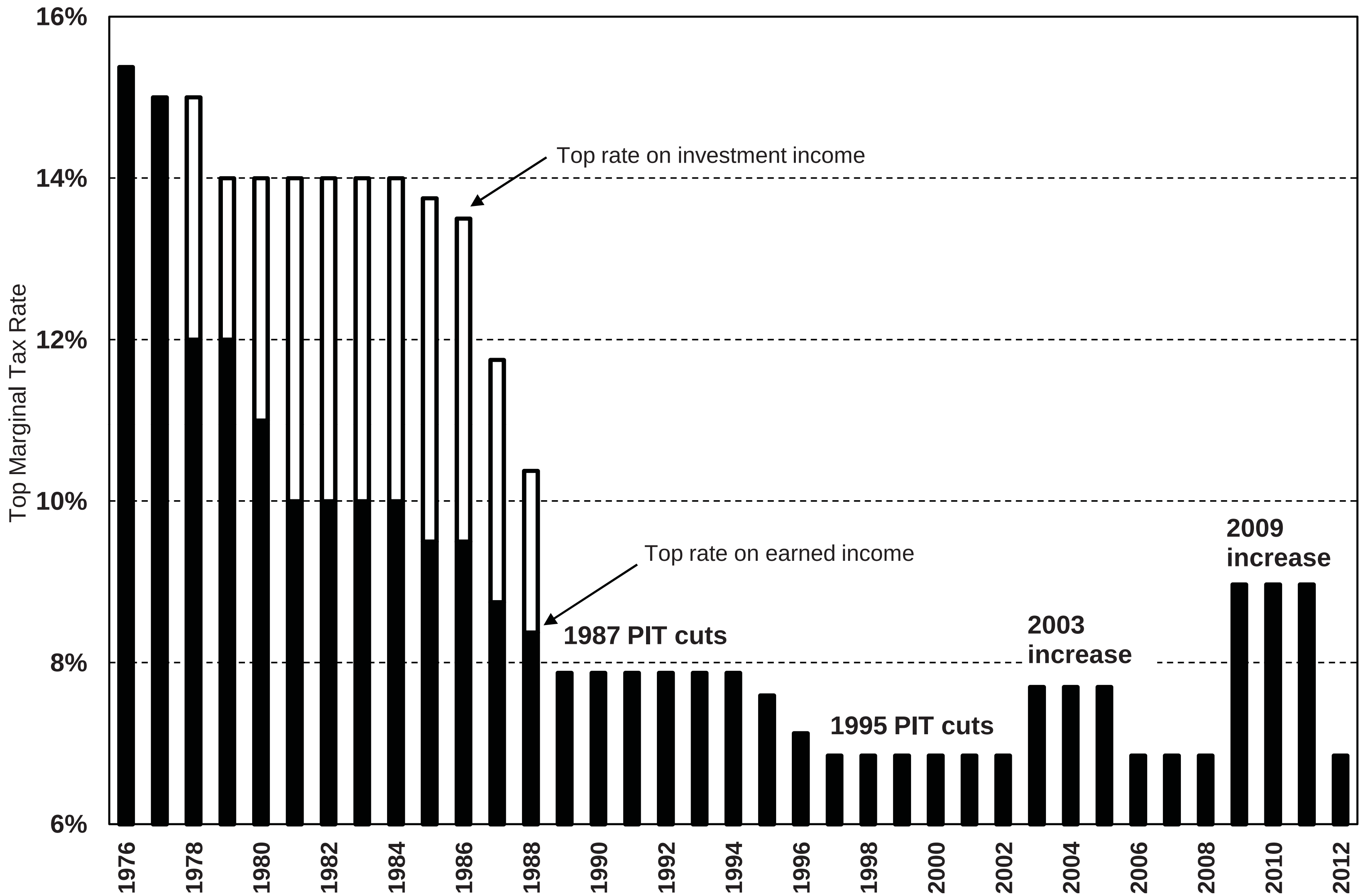
New York needs to more closely monitor tax returns of investors in real estate partnerships in order to ensure compliance with tax law provisions. Studies by the Internal Revenue Service indicate that non-compliance has grown and that effective enforcement could yield significant revenues to the federal and state governments. In an examination of 2005 tax returns, the IRS estimated that real estate investors underpaid $5 billion in taxes to the federal government and $385 million to New York State. Underreporting or misreporting of capital gains from real estate investments is the main cause of tax underpayments.[18] Reuters columnist David Cay Johnston, who reported the 2005 IRS data when he wrote for the New York Times, recently wrote that the annual underpayment of New York State taxes in connection with real estate partnerships ranged from $200 annually to as high as $700 million. Johnston also pointed out that New York City could be losing out on $40 million annually.[19]

Given that this practice has been occurring for some time, it is possible that the state could recover as much as $1 billion from prior year audits, and that annually recurring revenues would be $100 million or higher.

The Fiscal Policy Institute (www.fiscalpolicy.org) is an independent, nonpartisan, nonprofit research and education organization committed to improving policies and practices to better the economic and social conditions of all New Yorkers. Founded in 1991, FPI works to create a strong economy in which prosperity is broadly shared.

[16] Fiscal Policy Institute, *Re-thinking the New York City Business Tax Treatment of Private Equity Fund and Hedge Fund "Carried Interest*, April 15, 2008.
[17] New York City Independent Budget Office, "Budget Options for New York City," April 2011, p. 46.
[18] David Cay Johnston, "Ex-I.R.S. Agent Says Tax Evasion by Real Estate Partners Is Huge," *The New York Times*, December 7, 2007.
[19] David Cay Johnston, "Ignoring Tax Cheats," *Reuters*, September 27, 2011.

1. After cutting its top personal income tax rate by more than 50%, from 15.375% to 6.85%, New York raised it back to 8.97% for 2009, 2010 and 2011.



2. New York State Personal Income Tax: Average effective tax rates for full-year residents with taxable returns

New York Adjusted Gross Income (NYAGI) Range			Tax after credits as a percent of NYAGI
Less than		5,000	0.999%
5,000	-	9,999	1.550%
10,000	-	14,999	1.410%
15,000	-	19,999	1.750%
20,000	-	24,999	2.245%
25,000	-	29,999	2.599%
30,000	-	34,999	2.894%
35,000	-	39,999	3.157%
40,000	-	44,999	3.365%
45,000	-	49,999	3.530%
50,000	-	54,999	3.653%
55,000	-	59,999	3.821%
60,000	-	64,999	3.928%
65,000	-	74,999	4.051%
75,000	-	99,999	4.318%
100,000	-	149,999	4.960%
150,000	-	199,999	5.508%
200,000	-	499,999	5.820%
500,000	-	999,999	6.083%
1,000,000	-	4,999,999	6.122%
5,000,000	-	9,999,999	6.192%
10,000,000	and over		6.166%

Source: New York State Department of Taxation and Finance, Analysis of 2008 Personal Income Tax Returns, Table 20, page 34.

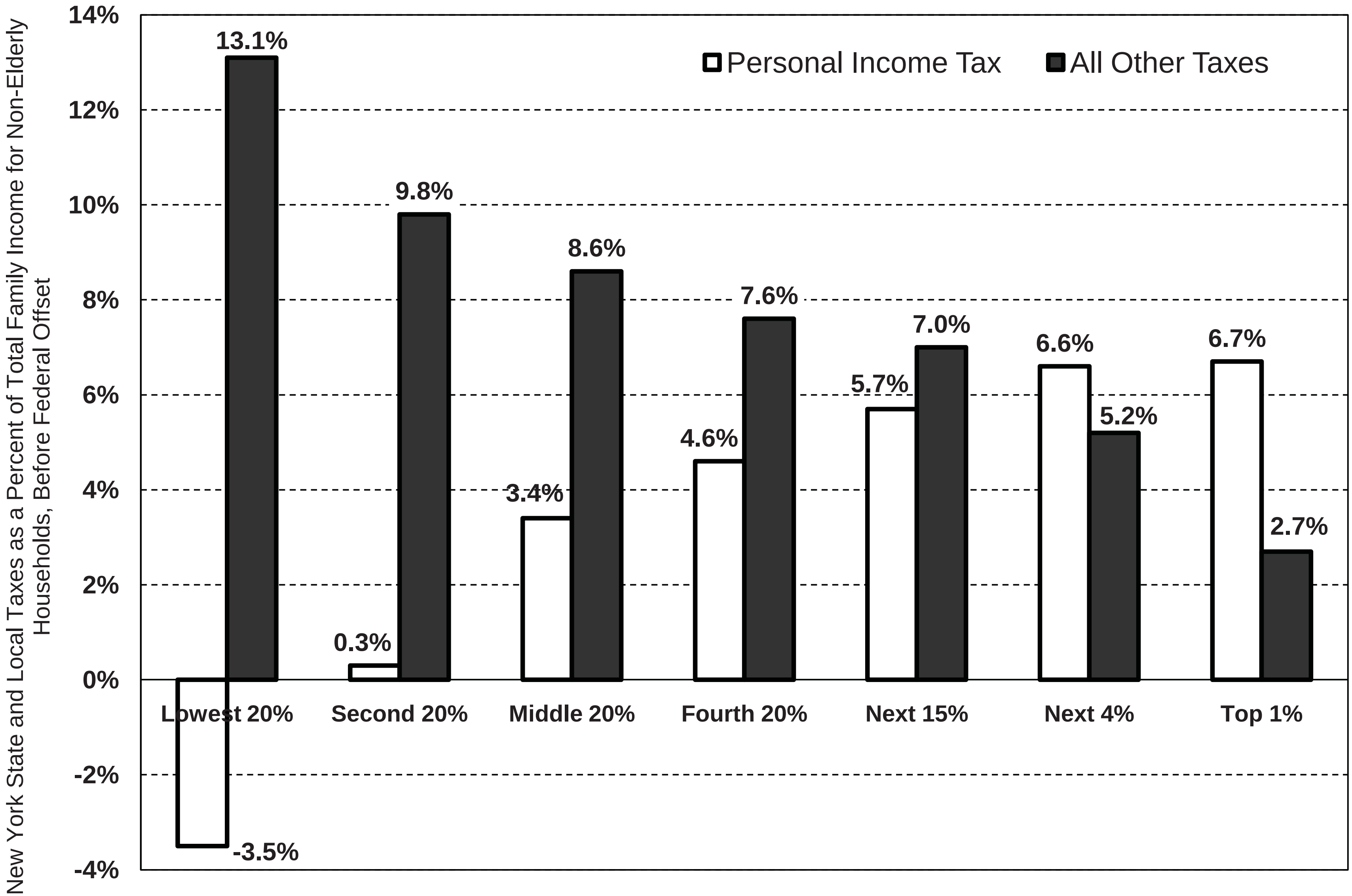
3. New York State & Local Taxes in 2007

Shares of family income for non-elderly taxpayers

Income group	Lowest 20%	Second 20%	Middle 20%	Fourth 20%	Top 20%		
					Next 15%	Next 4%	TOP 1%
Income range	**Less than $16,000**	**$16,000 - $33,000**	**$33,000 - $56,000**	**$56,000 - $95,000**	**$95,000 - $209,000**	**$209,000 - $633,000**	**$633,000 or more**
Average income in group	**$9,600**	**$24,400**	**$43,800**	**$73,100**	**$133,000**	**$338,100**	**$3,065,800**
Sales & excise taxes	**7.3%**	**6.0%**	**4.7%**	**3.7%**	**2.8%**	**1.7%**	**0.9%**
General sales - iIndividuals	3.6%	3.3%	2.8%	2.3%	1.8%	1.1%	0.6%
Other sales & excise - ind.	1.5%	0.9%	0.6%	0.4%	0.3%	0.1%	0.0%
Sales & excise on business	2.2%	1.8%	1.4%	1.0%	0.7%	0.4%	0.2%
Property taxes	**5.8%**	**3.8%**	**3.9%**	**3.8%**	**4.1%**	**3.3%**	**1.5%**
Property taxes on families	5.3%	3.3%	3.4%	3.4%	3.6%	2.6%	0.6%
Other property taxes	0.5%	0.5%	0.5%	0.5%	0.5%	0.8%	0.9%
Income taxes	**-3.5%**	**0.3%**	**3.4%**	**4.7%**	**5.8%**	**6.8%**	**7.0%**
Personal Income Tax	-3.5%	0.3%	3.4%	4.6%	5.7%	6.6%	6.7%
Corporate Income Tax	0.0%	0.0%	0.0%	0.1%	0.1%	0.2%	0.4%
TOTAL TAXES	**9.6%**	**10.1%**	**12.0%**	**12.2%**	**12.7%**	**11.8%**	**9.4%**
Federal Deduction Offset	-0.0%	-0.1%	-0.5%	-1.1%	-1.9%	-1.1%	-2.2%
TOTAL AFTER OFFSET	**9.6%**	**10.0%**	**11.6%**	**11.0%**	**10.7%**	**10.8%**	**7.2%**

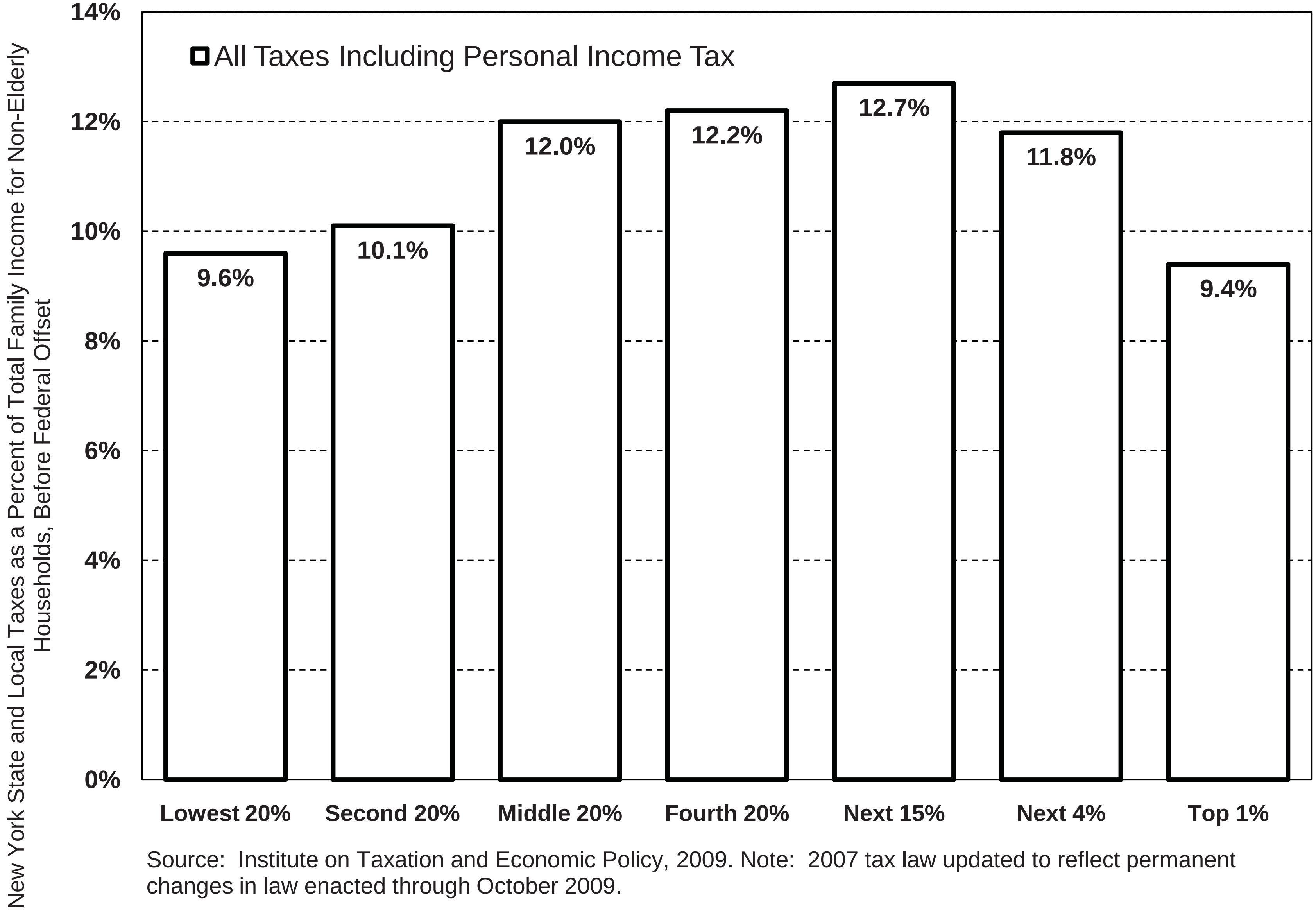
Note: Table shows 2007 tax law updated to reflect permanent changes in law enacted through October 2009.

4. New York's income tax is progressive, but not progressive enough to balance out the regressivity of the rest of the state-local tax system.



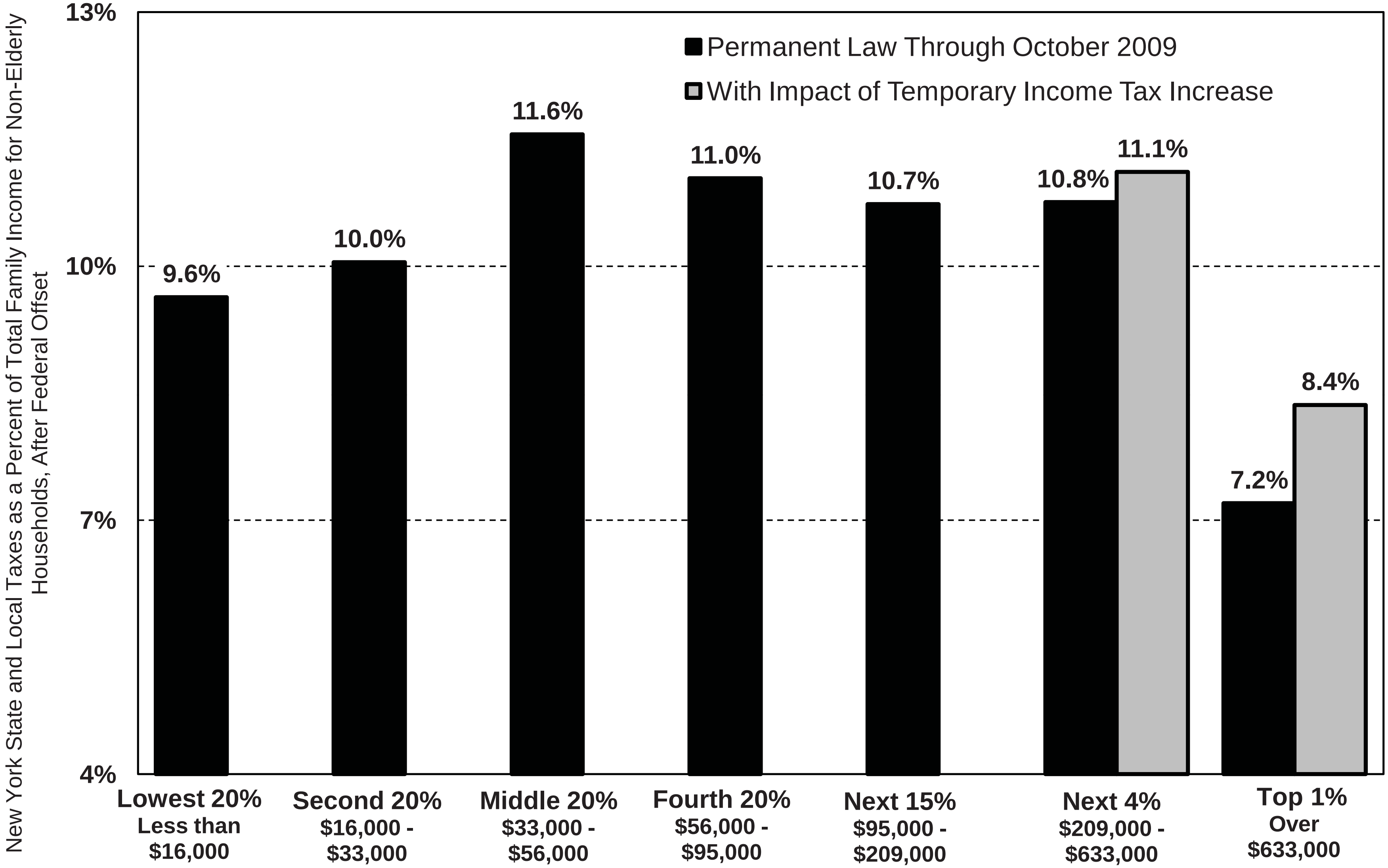
Source: Institute on Taxation and Economic Policy, 2009. Note: 2007 tax law updated to reflect permanent changes in law enacted through October 2009.

5. Even before taking federal deductibility into consideration, the top 1% of NYS taxpayers paid less of their income in state and local taxes than all others, including the lowest income quintile of families.



Source: Institute on Taxation and Economic Policy, 2009. Note: 2007 tax law updated to reflect permanent changes in law enacted through October 2009.

6. Overall, the wealthiest 1% of households pay a much smaller share of their income in state and local taxes than do all other New Yorkers, even with the temporary income tax increase.



Source: Institute on Taxation and Economic Policy, 2009.
Note: 2007 tax law updated to reflect permanent changes in law enacted through October 2009.

7. Top 1% Progressive Income Tax Proposal

Income range	2009 to 2011 temporary surcharges	Proposed 1% plan	Change
	$4.7 to $5.5 billion*	$4.4 to $5.1 billion*	
$200,000 single and $300,000 married to $500,0000	7.85%	6.85%	**-1.00%**
$500,000 to $665,000	8.97%	6.85%	**-2.12%**
$665,000 to $1 million	8.97%	7.85%	**-1.12%**
$1 million to $5 million	8.97%	8.85%	**-0.12%**
$5 million to $10 million	8.97%	9.35%	**+0.38%**
$10 million to $100 million	8.97%	9.85%	**+0.88%**
$100 million and above	8.97%	9.99%	**+1.02%**

Source: Fiscal Policy Institute analysis.
Note: * Projected 2012 tax year revenue. The distribution of the projected revenue by state fiscal year depends on when the rate structure is enacted.

8. More than 675,000 New York households pay 10 percent or more of their income in property taxes. A quarter million pay 20 percent or more.

Household income range	Estimated share of households whose property taxes paid in 2009 were:				Total number of households in income range
	Less than 10% of income	10% to 19.99% of income	20% or more of income*	10% or more of income	
$25,000 or less	150,496	101,851	170,472	272,323	422,819
Above $25,000 but not above $50,000	404,899	149,117	71,124	220,241	625,140
Above $50,000 but not above $100,000**	859,739	N/A	N/A	184,423	1,044,162
TOTAL: All $100,000 or less	1,415,134	354,043	241,596	676,987	2,092,121

Source: Fiscal Policy Institute analysis of microdata from the U.S. Census Bureau's 2009 American Community Survey. Estimates shown are for homeowning households that meet the 5-year residency requirement in the Galef/Little and Krueger/Engelbright Circuit Breaker bills.

Notes: * This column, for the $25,000 or less income category, includes 15,945 households with zero or negative income that paid property taxes in 2009.
** The subtotal of all households in this income range paying 10% or more of income in property taxes in 2009 includes (a) 103,075 jouseholds that paid between 10% and 19.99% of income in property taxes; and (b) 81,348 househlds that paid $10,000 or more in property taxes and who, because of top coding, can not be apportioned between the "10% to 19.99% of income" property tax category and the "20% or more of income" property tax category.

9. Nearly half of New York households with incomes of $50,000 or less pay 10 percent or more of their income in property taxes.

	Estimated share of households whose property taxes paid in 2009 were:			
Household income range	**Less than 10% of income**	**10% to 19.99% of income**	**20% or more of income***	**10% or more of income**
$25,000 or less	36%	24%	40%	64%
Above $25,000 but not above $50,000	65%	24%	11%	35%
Above $50,000 but not above $100,000**	82%	N/A	N/A	18%
TOTAL: All $100,000 or less	68%	N/A	N/A	32%

Source: Fiscal Policy Institute analysis of microdata from the U.S. Census Bureau's 2009 American Community Survey. Estimates shown are for homeowning households that meet the 5-year residency requirement in the Galef/Little and Krueger/Engelbright Circuit Breaker bills.

Notes: * This column, for the $25,000 or less income category, includes 15,945 households with zero or negative income that paid property taxes in 2009.
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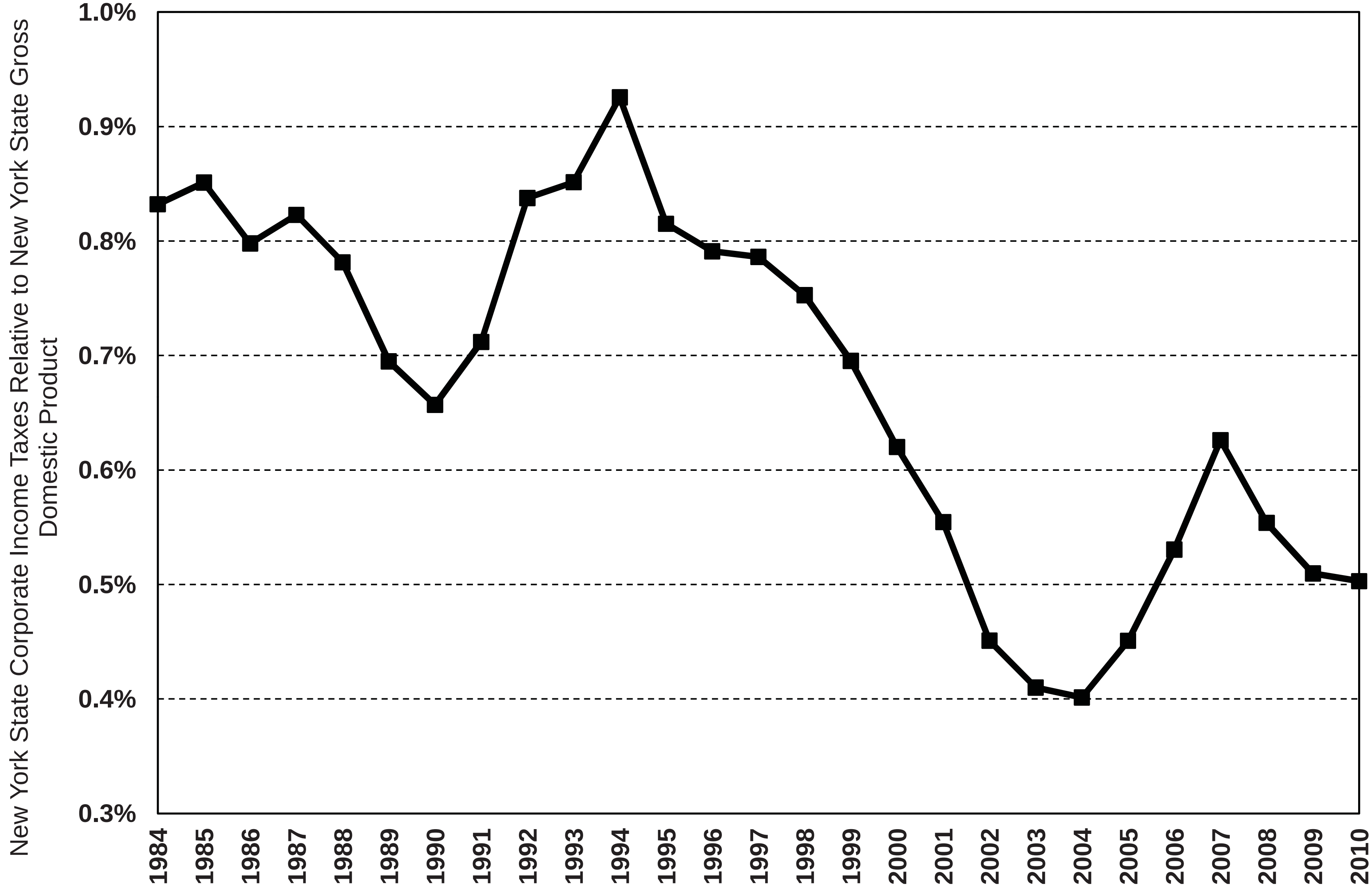
10. New York's corporate income tax revenues have fallen substantially relative to the size of the economy.



Source: New York State Department of Taxation and Finance; U.S. Bureau of Economic Analysis (NYS GDP data).

FPI

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