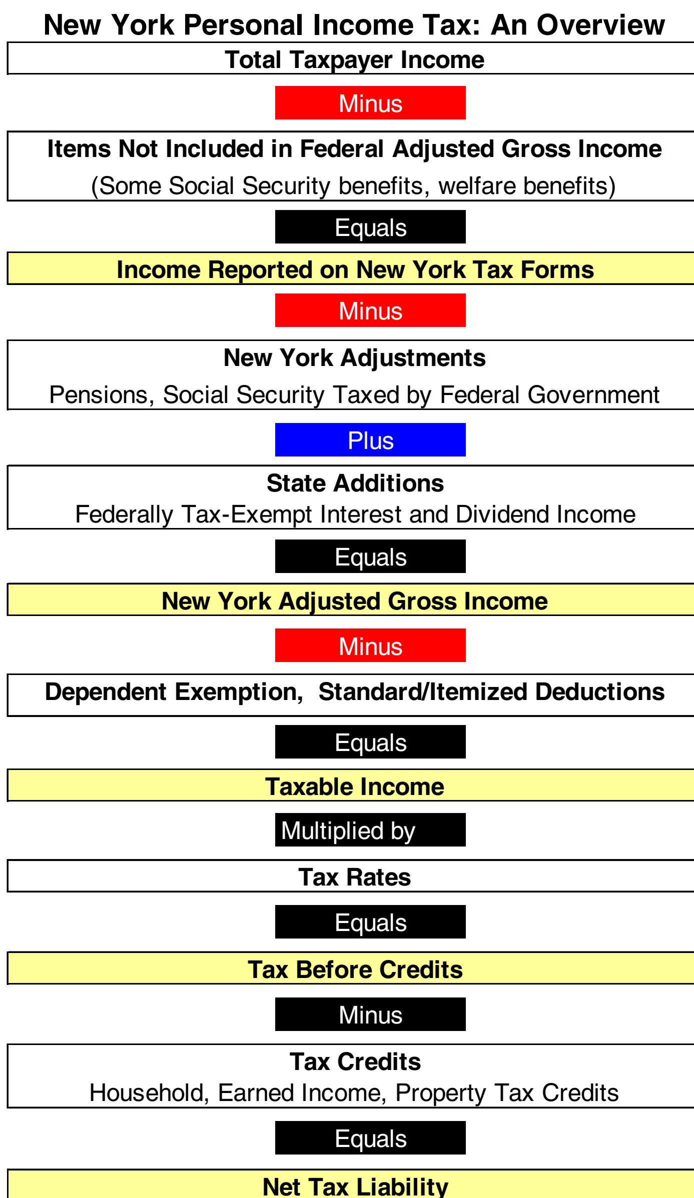
CHAPTER FOUR

THE NEW YORK PERSONAL INCOME TAX

The personal income tax is the only major progressive tax levied by state and local governments. The New York income tax helps to offset the regressivity of the sales, excise and property taxes that form a majority of New York revenues. But the tax has become sharply less progressive in the past quarter century, and a variety of poorly targeted tax loopholes threaten to reduce the state's ability to fund education and other services. As a result, the state's income tax is no longer sufficient to offset the unfairness of other New York taxes. This chapter looks at options for reforming the New York state income tax.



How it Works

Like most states, New York's personal income tax is based on federal rules. The starting point for determining New York taxable income is federal adjusted gross income (FAGI). Federal AGI includes most income sources, but excludes most Social Security benefits, welfare benefits, education IRAs and medical savings accounts. New York's use of federal AGI as a starting point means that these federal tax breaks are automatically passed through to the New York tax as well.

In addition to these federal exclusions, New York allows its own "adjustments" to federal AGI. New York AGI differs from federal AGI in two important ways:

- All federally taxable Social Security benefits are exempt in New York.
- All public pension benefits are exempt, and up to $20,000 of private pension benefits are exempt for New Yorkers over 59 years old.

The state also allows adjustments for federal bond interest and contributions to a College Choice Tuition Savings Program. The chart on the next page compares the cost of these New York adjustments in 2004.

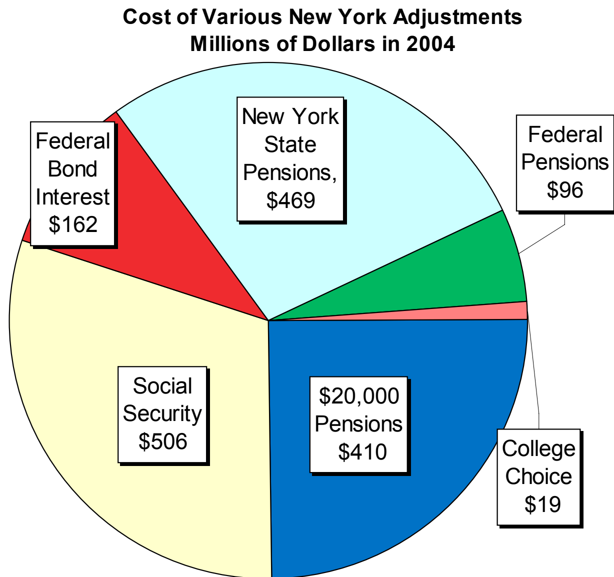
Like the federal government, New York also allows taxpayers to choose between taking a standard deduction, which shelters up to $14,600 from income for married couples, and itemized deductions, which allow wealthier taxpayers to write off mortgage interest costs, extraordinary medical expenses, real property taxes, and other costs of living. The state also follows federal rules in disallowing part of these itemized deductions for the very wealthiest taxpayers, on the theory that these wealthy New Yorkers have a greater ability to pay than other itemizers.

New York itemized deductions are different from federal itemized deductions, however, in two ways. First, state and local income taxes can be deducted on federal forms, but are not deductible on New York forms. (Most other states take the same approach, diverging from the federal treatment of state and local income taxes.) Second, New York adds a second high-income disallowance for itemized deductions.

New York's tax rate structure is graduated, applying higher marginal rates to higher incomes. The tax has five permanent rates, ranging from 4 percent to 6.85 percent. In 2002, the top rate of 6.85 percent applied to married New Yorkers with taxable income

over $40,000 ($20,000 for single taxpayers). For taxpayers with adjusted gross incomes over $100,000, the benefit of the lower tax rates is gradually phased out, so that taxpayers earning over $150,000 pay at a flat 6.85 percent rate on all their taxable income. In addition, temporary 2003 legislation creates two higher income tax brackets (7.5 percent and 7.7 percent) that will expire at the end of 2005. The 7.7 percent top rate applies only to New Yorkers earning over $500,000.

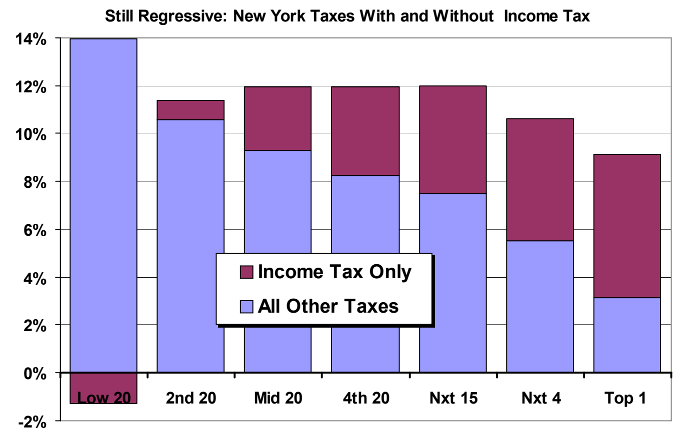
A Progressive Income Tax



The New York state income tax is progressive. In 2003, low-income taxpayers, on average, received 1.3 percent of their income in refunds. The middle 20 percent of taxpayers paid 2.6 percent of their income in income taxes, and the wealthiest one percent of New Yorkers paid 6.0 percent of their income in New York state personal income taxes.

When the deductibility of state income taxes on federal income tax returns is taken into account, however, the New York income tax is much less progressive—and much less burdensome on the wealthiest taxpayers. In 2003, the effective income tax rate on the wealthiest 1 percent of New Yorker falls from 6.0 to 4.3 percent when federal deductibility is taken into account.

Moreover, the progressive influence of the income tax is not sufficient to offset the regressivity of New York sales and property taxes, as the following chart shows. Only a more progressive income tax—or a dramatically lower reliance on regressive sales and property tax could allow New York to achieve even a proportional, "flat" tax system overall.



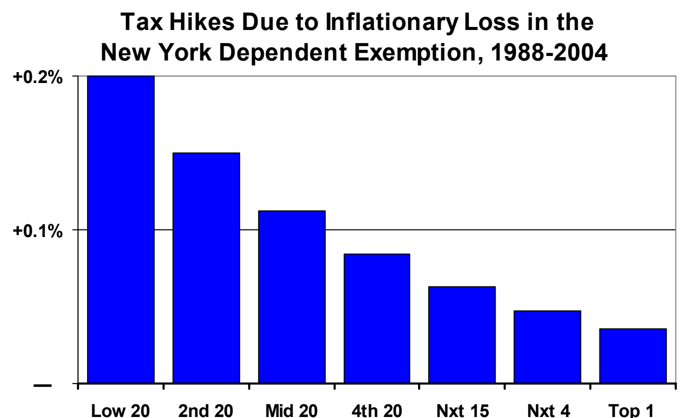
Factors Limiting Progressivity

While the New York income tax is progressive, several features of the tax structure make it less progressive than it could be. Most notably:

- The state's personal income tax brackets are not indexed for inflation, which means that each of the higher income tax rates apply to proportionally more New Yorkers each year.
- The top marginal income tax rates have been cut dramatically over the past quarter century—indirectly shifting more of the income tax to low- and middle-income New Yorkers.
- The complete exemption of Social Security benefits only wealthier retirees.
- The state exempts up to $20,000 of private pension benefits for taxpayers 59 and older, discriminating against elderly wage-earners.

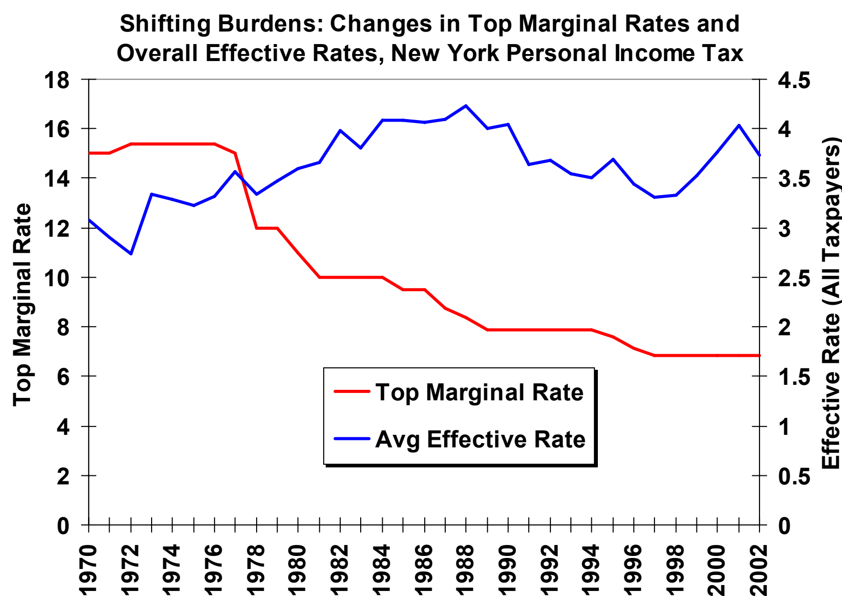
Indexing for Inflation

New York's graduated tax rate structure is designed to ease the impact of higher income tax rates on low- and middle-income New Yorkers who have less "ability to



pay," by allowing them to pay at lower rates. However, the lower tax rates have become less effective over time in sheltering the income of lower-income New Yorkers because the tax brackets are not indexed for inflation. For example, the 4 percent bottom rate applies to the first $16,000 of taxable income. This amount was last modified in 1997. Between 1997 and 2004, inflation reduced the real value of the bottom bracket to just $13,600—so each year, more and more low-income taxpayers are paying at rates above the bottom rate. Since the other tax brackets have remained unchanged during this period, inflation has also reduced the value of these intermediate tax brackets over this time. By not updating the tax brackets to take account of this inflationary impact, New York lawmakers have essentially passed a regressive tax hike on low- and middle-income New Yorkers since 1997.

The state's dependent exemption has been similarly devalued. The exemption was increased to its current level ($1,000 per child) in 1988. If the exemption had been indexed for inflation since then, it would be worth almost $1,600 today—meaning that New York lawmakers have essentially enacted a $600 cut in the exemption granted to families with children.



Declining Rates

Even as effective tax rates have crept upwards, New York lawmakers have enacted a series of cuts in the top marginal rates paid by the wealthiest New Yorkers, falling from over 15 percent in 1973 to 6.85 percent in 2003. One indicator of the impact this inflationary hike has had is the gradual growth in the effective tax rates on New Yorkers. As the chart on this page shows, the average effective tax rate on New Yorkers has crept upwards even as the top marginal rate has been cut dramatically.

This "tax shift" from lower-income to wealthier New Yorkers has been exacerbated by cuts in the income tax rate that is applied to unearned income. Between 1978 and 1988, New York imposed a higher tax rate on unearned income (including capital gains and dividends) than on earned income. For example, in 1978, the top rates were 12 percent on earned income and 14 percent on unearned income. In 1989, the tax rate on unearned income was lowered to equal the top rate on regular income. Since unearned income is disproportionately realized by wealthier New Yorkers, this change has made the income tax less progressive.

Social Security Exclusion

Under federal tax rules, Social Security benefits are exempt for income taxpayers whose "provisional income" is below $32,000 for married couples ($25,000 for other taxpayers). Taxpayers with income exceeding these thresholds pay some tax on Social Security benefits.[15] This limited federal tax on Social Security applies to less than 20 percent of elderly New Yorkers. However, New York departs from the federal definition of AGI by allowing taxpayers to subtract any and all Social Security income that is taxable for federal purposes. Both the federal exemption and the New York exemption tend to benefit wealthier elderly taxpayers. The New York-specific exemption, however, is especially regressive—and quite costly.

Pension & Annuity Exclusion

New York exempts certain types of pension and annuity income for taxpayers over the age of 59. This exemption applies to the first $20,000 of eligible pensions and annuities. This tax break is forecast to cost $410 million in 2004.

This exemption creates two glaring problems of tax equity: first, it provides a special exemption to elderly taxpayers at all income levels. The pension

[15] Provisional income includes most sources, but excludes half of Social Security benefits. For taxpayers with income above these thresholds, but below $44,000 ($34,000 for single filers), 50% of Social Security benefits contributing to income above these thresholds are subject to tax. At very high income levels (above $44,000 for married couples), 85% of benefits are subject to tax.

benefits of the wealthiest executive receive the same favored treatment as do the benefits of the lowest-paid worker. A second inequity in this approach to elderly tax relief is that it provides special treatment for non-working taxpayers, with no comparable exemption for the earned income of otherwise identical seniors. Over-65 workers whose earnings are based on salaries rather than pensions are completely excluded from this generous tax break. Since elderly New Yorkers who work tend to be poor, this tax preference for unearned income—with no similar tax break for earned income—is hard to justify.

Limiting the pension tax break to low- and middle-income retirees—or replacing the pension tax break with a more general elderly exemption that applies to both earned income and unearned income—are two approaches to tax reform that would improve the perceived fairness of the New York income tax.

Low-Income Tax Relief Mechanisms

New York's income tax allows a variety of credits designed to make the income tax more progressive. This section outlines the major tax credits currently available and suggests possible reforms.

Since 1978, New York has allowed a **Household Credit** designed to provide targeted tax relief to low-income families. Single taxpayers earning less than $5,000 a year receive a $60 credit, and larger families receive an extra $15 for each additional family member. The value of the credit decreases gradually for families earning between $5,000 and $32,000 ($28,000 for singles), and is unavailable for taxpayers earning over $32,000. The relatively low income thresholds keep the cost of this credit low. But this credit is available to fewer and fewer taxpayers each year, since none of the credit's features are indexed for inflation.

The New York **Earned Income Tax Credit** (EITC) is among the most generous in the nation. Low-income working taxpayers can claim a refundable tax credit equal to 30 percent of the federal credit. Because EITC eligibility is determined at the federal level, New York policymakers can ease the administrative burden on state residents by "piggybacking" eligibility for this credit on federal rules. However, one factor that limits both the simplicity and the fairness of the New York EITC is the interaction between the EITC and the household credit. In particular, the state EITC is reduced on a dollar-for-dollar basis by the household credit claimed. Eliminating this interaction would make it easier for New Yorkers to claim the credit and would allow the EITC to fulfill its tax fairness potential.

New York is among more than a dozen states that now allow **dependent care credits** designed to reduce the cost of caregiving for working parents. Like the EITC, New York's dependent care credit is based on federal rules. The New York credit is actually more generous than the federal credit at low income levels, allowing certain taxpayers to claim between 101 percent and 110 percent of the federal credit.

However, the New York credit shares one flaw of the federal credit: its poor targeting. New Yorkers earning over $65,000 can claim a credit for 20 percent of their dependent care expenses—even though dependent care expenses do not significantly reduce wealthier taxpayers' ability to pay. A few states have restricted eligibility to taxpayers with income below a certain amount. By following this example, New York lawmakers could better target relief to low-income parents and preserve the fairness of the income tax.

Local Income Taxes

New York is one of about a dozen states that allow certain local governments to levy their own income taxes on top of the state tax. States allowing local-option income taxes usually do it in one of two ways: by granting authority to specific cities or by granting authority to any taxing district at a given level of government (either cities, school districts or counties) in a state. Examples of the latter approach include Maryland, where each county levies a "piggyback" tax that applies to the same tax base as the state tax, and Iowa. New York, by contrast, has given taxing authority only to New York City and Yonkers.

For New York City, state law establishes a separate bracket and rate structure, while for Yonkers the state authorizes the city to impose a tax of up to 19.25% of the amount due the state. For the last several years, Yonkers has set its income tax rate at 5% of the amount due the state. The New York City tax for 2005 (which includes two temporary high-end brackets) has six rates ranging from 2.907 percent (for married couples with taxable income under $21,600) to 4.45 percent (for income over $500,000). The Yonkers income tax and large portions of the New York City income tax are subject to reauthorization by the State Legislature for tax years beginning in and after 2006.

One option for New York policymakers seeking to preserve the fiscal autonomy of counties and municipalities is to allow counties outside of New York City the general authority to levy a local-option income tax. These county taxes could, like the New York City tax, be administered and collected by state tax admini-

strators on state tax forms, requiring no new paperwork. An optional statewide local income tax would help achieve tax diversity and adequacy in New York. Given the recent experience of counties such as Erie and Oneida, in which strapped lawmakers have recently sought to balance budgets by increasing the combined state and local sales tax rate as high as 9.75 percent, diversification of the local tax base to include income taxes may be sorely needed.

From 1966 to 1999, New York City also levied a "commuter tax" on New York residents living outside the city (and on residents of other states) that worked in the city. The commuter tax was a flat tax, levied at a 0.45 percent rate for salaries and wages and 0.65 percent for self-employment income. The rationale for the commuter tax, as in other large metropolitan areas nationwide levying such a tax, was that nonresidents working in the city consume city services—and should help pay for the cost of providing these services. The costs imposed by nonresident commuters can be substantial: one recent estimate is that providing services to commuters accounts for between 2.2 and 3.8 percent of the city's entire budget.[16] In 1999, the state legislature repealed the commuter tax without the assent of New York's mayor or its city council.

The "commuter tax" repeal reduces New York tax collections by close to $450 million annually—and creates an incentive for City workers to live in bedroom communities outside the city. Re-enacting the tax would help ensure that the burden of funding New York City government is more equally distributed among those who benefit from city services.

Exporting State (and Local) Income Taxes

An important—and frequently overlooked—feature of personal income taxes is that part of their cost is ultimately paid by federal taxpayers in other states. New York taxpayers who itemize their federal income tax returns are allowed to deduct their state income taxes on their federal forms. In other words, when New York taxpayers pay their state income taxes, they get part of it back through federal tax cuts.

About 17 percent of the state income taxes paid by New Yorkers are offset by federal tax cuts. For high-income taxpayers, close to 33 percent of their state income taxes are offset in this way.

This write-off tends to benefit higher-income taxpayers (the ones most likely to itemize) and reduces the progressivity of the New York individual income tax. However, it also benefits the New York economy. The deductibility of state individual income taxes means that some of the state income tax revenues that are used to fund state services actually impose no cost at all on the New York economy.

The deductibility of state income taxes is an especially important consideration when evaluating the impact of potential income tax changes. New York lawmakers seeking to raise income taxes can decide what fraction of a tax hike should be paid by New Yorkers and what portion of the tab should be picked up by the federal government, simply by targeting the tax hike to a particular segment of the population.

State tax increases that target low-income taxpayers (such as reducing the threshold for filing taxes) tend to be paid entirely by state residents, since low-income New Yorkers are unlikely to itemize their federal tax returns. But state tax hikes targeted to wealthier taxpayers will be partially exported to the federal government, because these taxpayers are more likely to itemize their federal tax returns and tend to pay higher marginal federal income tax rates. The more progressive the income tax hike, the greater the percentage of the state tax increase that will be paid in the form of a federal tax subsidy, rather than from the pockets of New Yorkers.

Conclusion

New York's personal income tax plays an important role in reducing the overall unfairness of the state tax structure. But tax cuts in the last two decades have made the income tax much less progressive—and are now insufficient to offset the regressivity of New York state and local sales and property taxes. Reforms that restore the former importance of the income tax, while broadening the income tax base, will likely be an important ingredient in the state's effort to adequately fund education.

[16]Chernick, Howard and Tkacheva, Olesya. "The Commuter Tax and the Fiscal Cost of Commuters in New York City." (2001)