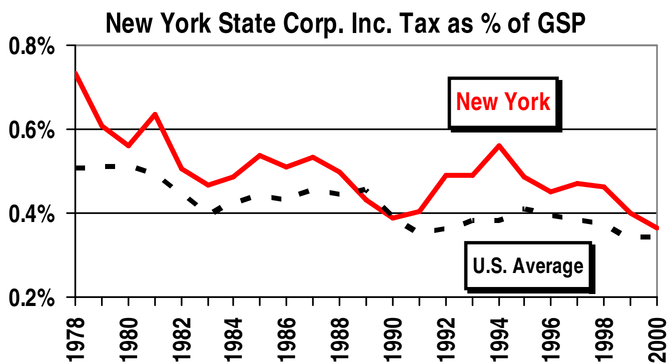
CHAPTER FIVE

THE NEW YORK CORPORATE INCOME TAX

The corporate income tax is an important tool for state tax progressivity. The corporate tax helps offset the regressivity of the property and sales taxes which make up the bulk of state and local tax revenues. However, in recent years New York state corporate income tax revenues have declined both as a share of total New York revenues and as a share of the state's economy. This decline is troublesome for several reasons: first, it appears to have been at least partially due to corporate tax avoidance strategies rather than the conscious design of New York policymakers. Second, some of the decline is due to tax loopholes granted by New York lawmakers—and there is little evidence that these tax breaks are having a positive impact on the state's economic climate. Third, it means that an increasing proportion of the tax load is borne by individual New York taxpayers. However, New York lawmakers can help revitalize the corporate income tax by eliminating these loopholes and tax avoidance strategies—and can add greater accountability to the tax policy process by allowing more public disclosure of corporate tax breaks.

A Declining Tax Source

The New York corporate income tax is in decline, both as a share of the state's economy and as a share of total taxes. In the past quarter century, New York state corporate income taxes have fallen by more than half, from 0.73 percent of Gross State Product (GSP) to 0.34 percent of GSP. This mirrors a national trend in corporate taxes, as the following chart shows —but the New York state corporate tax has fallen faster than the national average.



The corporate income tax also represents a smaller piece of the New York tax pie. In 1982, the corporate income tax generated 7.5 percent of all New York tax revenue. In 2002, the corporate tax represented only 5.7 percent of all New York tax revenue.

Advantages of the Corporate Income Tax

Unique among the major taxes levied by state governments, the corporate income tax is a progressive tax that is largely exported to residents of other states. Both of these traits—its progressivity and its exportability—are due to the fact that corporate income taxes are generally passed through to owners of corporate stock.

Since stock ownership is concentrated among the very wealthiest taxpayers, the corporate income tax is one of the most progressive taxes a state can levy.

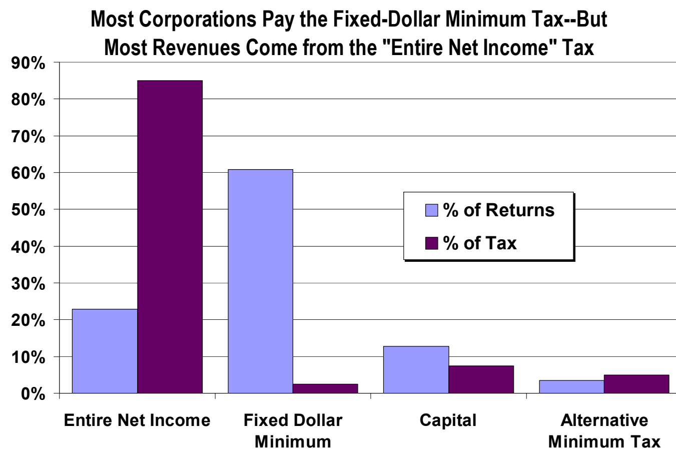
Because most corporations with New York operations have shareholders throughout the nation, the corporate income tax is distributed to other states depending on where a company's shareholders live. The corporate income tax is an important part of the New York tax system because it is the only option available for taxing non-New Yorkers who own stock in companies doing business in New York. These shareholders benefit indirectly from the public services provided to New York corporations—and the corporate income tax is an essential means of ensuring that these out-of-state shareholders share in the cost of providing public services.

How The Corporate Income Tax Works

Like most states levying a corporate income tax, New York ties its corporate tax base closely to federal income definitions, using federal tax rules as a starting point in determining state taxable income. New York then applies a set of rules that subtract from (and add to) a company's federal taxable income to get New York taxable income.

These rules fall into two broad categories: federally required "housekeeping" rules that limit the amount of a corporation's income each state is allowed to tax, and special targeted state tax breaks that are provided because New York lawmakers want to encourage economic development or other social outcomes. State taxable income is multiplied by a set of tax rates to yield tax before credits. The state allows tax credits for research and other activities which are subtracted to yield net tax liability.

The New York corporate income tax actually involves four separate taxes (businesses are required to calculate liability under each tax and pay the largest). The principal New York corporate tax is a 7.5 percent tax on a slightly modified version of the federal corporate income tax base called the "entire net income" (ENI) base. This tax base accounted for 85 percent of the Article 9-A corporate income taxes paid in fiscal year 2000, but only 23 percent of returns filed.



Corporations doing business in New York are required to calculate their tax under the ENI base and three other bases, and pay whichever method yields the most tax:

- A fixed-dollar minimum tax, ranging from $250 to $500 for the largest corporations;
- A "net worth"-based tax;
- An alternative minimum tax, which applies a lower 2 percent rate to a broader measure of profits.

The most important of these four taxes is the ENI tax, which was enacted in 1917 as a three percent tax. The tax rate was gradually increased in subsequent decades, reaching a high of 12 percent in the mid-1970s. Since 1997, the corporate tax rate has been cut dramatically, falling from 9 percent to 7.5 percent.

In theory, the New York corporate income tax is based on corporate profits. Yet the tax base includes many loopholes that allow corporations to pay far less than they would if they were being taxed on actual profits. This means that the effective tax rate on companies doing business in New York (that is, tax collections as a percentage of total corporate profits) is typically much lower than the nominal 7.5 percent rate.

How States Tax Multi-State Corporations

Many corporations do business in more than one state. Such multi-state corporations typically pay income taxes in more than one state as well. New York faces two important limits as it seeks to tax its share of these companies' profits:

- First, if a corporation does not conduct at least a minimal amount of business in New York, the state is not allowed to tax the corporation at all. Corporations that have sufficient contact in the state to be taxable are said to have *nexus* with New York.
- Second, each state with which a corporation has nexus must devise rules for dividing the company's profits into an "in-state" portion and an "out-of-state" portion—and the state can only tax the in-state portion. *Apportionment* is the process by which states achieve this.

These limits exist for a good reason: if every state taxed all of the income of all corporations, businesses could find their profits taxed multiple times. And in fact, when state corporate income taxes were first adopted, there were no agreed-upon rules for dividing corporate profits between states. As a result, some businesses found that nationally, more than 100 percent of their profits were subject to state taxes. In the 1950s, legal reformers worked to set up a fair, uniform way of allocating income between states that would result in multi-state businesses' profits being taxed exactly once. The result was the Uniform Division of Income for Tax Purposes Act (UDITPA).

How Apportionment Works

The UDITPA model legislation prescribed relying equally on three different factors in determining the share of a corporation's profits that can be taxed by a state. These factors are:

1) The percentage of a corporation's nationwide **property** that is located in a state.

2) The percentage of a corporation's nationwide **sales** made to residents of a state.

3) The percentage of a corporation's nationwide **payroll** paid to residents of a state.

The main rationale for using these three factors to determine taxable income is that companies benefit from public services in a variety of ways, including owning property in a state, making sales within a state, and having an in-state employee base. The three-factor formula ensures that corporate tax liability reflects each of these benefits.

If every state adopted this standard, as UDITPA was designed to encourage, states could ensure that all corporate income would be taxed exactly once. And most states did initially adopt the UDITPA three-factor approach, assigning each factor an equal weight in determining taxable income. But in the past twenty years, many states (including New York) have chosen to reduce the importance of the property and payroll factors, and increase the importance of the sales factor. New York is one of more than a dozen states that now "double-weight" the sales factor by making a corporation's in-state sales twice as important as each of the other factors. At the extreme, four states rely entirely on the sales factor (and therefore do not use the property or payroll factors at all) in determining a corporation's taxable income. This approach is known as the "single sales factor" or SSF. In recent months, lawmakers have seriously considered adopting SSF for New York manufacturers.

Pitfalls of the Single Sales Factor

SSF is typically enacted for two reasons. First, it is argued that SSF makes a state a more attractive place for businesses to expand their property and payroll: if the property and payroll factors are ignored in calculating a state's corporate tax, then a business can hire employees or build a plant in a state without incurring any additional corporate profits tax. Second, SSF is sometimes enacted in response to threats from companies that already have substantial in-state employment and property. For example, Massachusetts adopted SSF in response to threats from the Raytheon corporation that it would reduce its employment in the state unless it was adopted.

But these arguments overlook several disadvantages of heavily weighting the sales factor. First, while some companies will benefit from SSF, **other companies will actually pay more taxes under SSF**. Manufacturing companies that have more of their property and payroll in New York (and sell more of their products to customers in other states) would benefit from SSF, but companies with little in-state employment and property that sell proportionately more of their products in New York would be hurt by SSF. Whether SSF would cut a New York firm's corporate taxes overall—or hike these taxes—depends on the importance of manufacturing in a state's economy.

Second, when SSF is enacted in response to the threats of in-state corporations to relocate in other states, there is **no guarantee that these corporations will not "take the money and run."** For example, after the passage of SSF, Raytheon cut thousands of Massachusetts jobs.

Third, SSF **creates harmful tax avoidance incentives for some businesses**. A company that sells products in an SSF state, but does so only by shipping products into the state (and therefore has no nexus) will not have to pay any income tax to the state. But if such a company makes even a small investment of employees or property in the state, it will immediately have much of its income apportioned to the state because the sales factor counts so heavily. Thus, SSF gives these companies a clear incentive not to invest in the state. Even worse, SSF gives companies with in-state employees an incentive to move all of their employees out of state to eliminate their nexus with the state—thus zeroing out their tax.

Fourth, by discriminating against some companies and in favor of others, SSF **makes corporate income taxes less fair**—and can result in profitable companies paying no state income tax. For example, under the Illinois SSF rules, a corporation that has all of its employees and property in Illinois, but makes all of its sales to customers in other states, will pay no Illinois tax, no matter how profitable it is. This unfairness reduces public confidence in the tax system.

Corporate Tax Loopholes

Corporate tax revenue has declined in many states because of special tax breaks enacted by lawmakers. In addition, many profitable businesses have learned to manipulate tax laws to take advantage of loopholes that lawmakers had no intention of creating. New York has taken steps to close some of these loopholes—but others remain.

Among the most pernicious and frequently exploited of these unintended loopholes is the **"Delaware holding company"** loophole. Corporations operating in multiple states pay New York income taxes only on the share of their profits that are generated in New York. Corporations doing business in New York can therefore reduce their New York income tax by minimizing the amount of New York profit they report. One way they accomplish this is by creating passive investment corporations, or PICs, in states (notably Delaware and Nevada) that do not levy corporate income taxes or do not tax certain types of corporate profits.

Companies then shift their New York profits, on paper, to their subsidiary PICs in, say, Delaware—and reduce the amount of profit that is taxable in New

York. New York is one of 26 states that currently have a statutory mechanism designed to curb the use of the PIC loophole—but is also one of only five states that have taken a narrow approach to closing this loophole. In particular, a May 2003 law disallows certain "related-party" transactions. Four other states take the same approach as New York, explicitly forbidding corporations to deduct payments to PICs from their income. However, there is growing evidence that New York's PIC legislation may be a temporary solution at best: legislation enacted by Delaware lawmakers in 2004 makes it easier for businesses to circumvent the anti-PIC rules used by New York and other states.

New York's anti-PIC strategy amounts to closing one loophole at a time—and Delaware's response to this legislation illustrates that this approach is only effective until corporations are able to find new paths to tax shifting. A more common—and more effective —approach to solving the PIC problem taken by 16 other states is requiring *combined reporting* of income so that the profits from PICs and other subsidiaries are added together for tax purposes. By comparison to the anti-PIC legislation enacted by New York in 2003, combined reporting is a comprehensive solution that eliminates the incentive for multi-state corporations to shift income from higher-tax to lower-tax jurisdictions. Anti-PIC legislation simply closes down one particular avenue for income-shifting while leaving the tax avoidance incentives intact.

Another example of damaging tax avoidance currently used in New York occurs in the division of corporate profits into the categories of **business income** and **nonbusiness income**. The former is income from transactions in the regular course of the business's trade, and the latter refers to all other income. Generally, for tax purposes, business income is apportioned among the states affected according to a set of apportionment rules. But in more than half the states—including New York—the statutory definition of business income is worded in a way that excludes certain irregular transactions. Businesses in these states can reduce their tax liability by not counting these transactions as part of business income. Many states have closed this loophole by defining business income as all the income that is allowed by recent U.S. Supreme Court standards.[17] New York is among the states that have not taken this step—but could easily shore up the tax base by making a minor wording change in its tax statutes.

One special limitation on the ability of states to tax multi-state corporations is that any given state can only tax companies that have a "physical presence" in the state. Companies that do business in a state without actually having a physical presence there can avoid paying state income tax on income earned in that state. This results in "nowhere income"—income that is not taxed by any state. There is, however, a simple solution to this problem that has been enacted by more than half of the states with corporate income taxes: a "**throwback rule**," which simply provides that any income of a multi-state corporation that is not taxed in another state will be "thrown back" into the sate in which the sales are made to be taxed there. By enacting a throwback rule, New York can help ensure that all income is taxed exactly once at the state level.

The decline of the federal corporate income tax base is well-documented—and New York has taken some steps to avoid it. Federal "stimulus" legislation enacted in 2002, and expanded in 2003, increased the amount of **accelerated depreciation** corporations can write off. In states (such as New York) that base their definitions of taxable corporate profits on federal rules, this federal tax cut means that unless steps are taken to "decouple" from the federal income definitions, state taxes will go down as well. However, legislation passed in 2003 decouples the New York corporate income tax from federal rules, except for some investments in areas of Manhattan. New York's effort to protect itself from this federally-induced revenue loss follows on the heels of similar responses in dozens of other states—and sets an important precedent as the state seeks to insulate itself from future federally-imposed tax cuts.

New York Investment Tax Credits

Most of the loopholes described so far are primarily the result of clever accounting by corporations. But lawmakers have also intentionally enacted some tax breaks that further reduce the yield and fairness of the New York corporate income tax.

The New York Investment Tax Credit (ITC) was created in 1969 to encourage companies to invest more in New York State. Under the ITC, when a firm makes a qualifying investment, a certain percentage of the investment is allowed as a dollar-for-dollar reduction in the firm's tax liability. As initially enacted, the credit offered a 1 percent rebate on any amount invested in plant and equipment in New York state.

[17] Michael Mazerov, "Closing Three Common Corporate Income Tax Loopholes Could Raise Additional Revenue for Many States," Center on Budget and Policy Priorities, Washington, DC, Apr. 9, 2002.

The credit has since been expanded, and now allows a five percent credit for investments of less than $350 million and a four percent credit for investments over $350 million. The ITC is non-refundable (that is, credits cannot be used to reduce taxes below zero), but unused credits can be carried forward to reduce future taxes for up to 15 years.

The theory behind the ITC is that companies will invest more in plant and equipment if they are rewarded with tax breaks. However, this theory is flawed for two reasons. First, firms tend to make investments when doing so makes good business sense—not because of tax credits. These companies will accept investment tax credits when they are offered, of course—but they're basically being rewarded for what they would have done anyway.

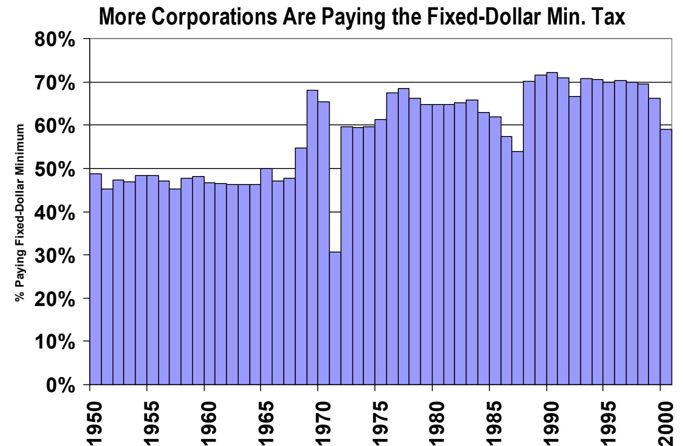
Second, in the rare cases where business investments are prompted by tax breaks, the investments that result are likely to be bad for the national economy. Tax-driven investments channel resources into areas where they are less productive than they could be—and reduce the efficiency of the economy.

The ITC is also very expensive and targets its benefits to a few of the biggest corporations. In 1985, five companies got over 44 percent of the benefits from the ITC. As a result, at least one of these companies ended up paying only the $250 minimum tax.

The ITC also has implications for future tax avoidance. Unused tax credits can be carried over to reduce taxes in future years. In any given year, corporations doing business in New York have more than a billion dollars in unused credit carryforwards.

Strengthening New York's Minimum Tax

New York is one of about a dozen states that have responded to the growth of corporate tax avoidance by adopting an alternative minimum tax (AMT)—an alternative tax base designed to act as a backstop to prevent corporate tax avoidance in the regular profits-based tax. Unusually, New York actually has two minimum taxes: a fixed-dollar minimum tax and an AMT calculated as a percentage of taxable income. Enacted in 1987, the fixed-dollar minimum tax is $325 for businesses with annual payrolls under $1 million, $425 for firms with payrolls between $1 million and $6.25 million, and $1,500 for firms with payrolls over $6.25 million. The minimum tax has become increasingly important over the years, as the chart at right shows. In 2001, over 60 percent of corporations filing New York returns paid only the minimum tax. This trend is worrisome because it suggests that tax loopholes have become increasingly important and because recent cuts in the state's AMT mean that this important backstop is less effective as a revenue source than it formerly was.



What makes the AMT effective is that it applies a lower rate to a broader, more loophole-free measure of corporate income. But New York lawmakers have gradually eroded this broader income definition by allowing some of the same deductions from AMT income that are allowed from regular income.

Lawmakers have also cut the AMT tax rate dramatically. Between 1998 and 2000, the AMT rate was reduced from 3 percent to 2 percent.

As tax loopholes continue to erode the state's corporate tax base, strengthening the AMT by increasing the rate and broadening the AMT base will be an important step to help ensure the future vitality of the corporate income tax in New York.

No-Tax New York Corporations?

The growing use of tax loopholes at the federal level and the decline of the federal AMT has meant that individual Fortune 500 corporations have been able to use federal tax breaks to reduce their corporate tax substantially despite being hugely profitable.

A September 2004 ITEP analysis of 275 of the largest and most profitable corporations in America found that 82 of these corporations—almost a third of the total—managed to pay zero or less in federal corporate income taxes in at least one year between 2001 and 2003.[18] In other words, almost all of these companies actually received net tax rebates from the federal government during this period. Because New

[18]*Corporate Income Taxes in the Bush Years*, Robert S. McIntyre and T.D. Coo Nguyen, Citizens for Tax Justice and Institute on Taxation and Economic Policy, September 2004.

York taxable corporate profits are based on federal taxable profits, it is likely that these federal loopholes also reduce the taxes paid by New York corporations.

The CTJ/ITEP analysis was made possible by the fact that publicly held corporations must disclose information about their federal corporate income tax payments to shareholders and the Securities and Exchange Commission (SEC). As a result, we know that some of the top employers in New York have been able to take advantage of loopholes in the federal corporate income tax. For example, the CTJ/ITEP study found that twelve profitable New York-based Fortune 500 companies managed to pay less than zero in federal income taxes in at least one year between 2001 and 2003, and that four of these companies actually paid an effective corporate income tax rate of less than zero overall during the three-year period.

Profitable New York-Based Fortune 500 Companies Paying Less than Half the 35% Federal Tax Rate

	Effective Tax Rate:			
Company	2003	2002	2001	3-year average
ITT Industries	–23.4%	–27.7%	–14.5%	**–22.3%**
Time Warner	–3.3%	2.2%	–52.7%	**–7.3%**
KeySpan	–12.5%	–3.0%	15.8%	**–1.6%**
JPMorgan Chase	14.6%	–55.6%	17.5%	**–1.1%**
Verizon	1.8%	–12.1%	28.6%	**0.5%**
Cendant	6.2%	–4.7%	–0.1%	**1.5%**
Lehman Brothers	–2.1%	9.9%	2.1%	**1.9%**
IBM	1.5%	4.7%	0.3%	**1.9%**
Bank of New York	3.5%	10.3%	–1.6%	**3.6%**
Dover	1.0%	1.4%	12.8%	**4.7%**
L-3 Communications	7.4%	5.3%	2.4%	**5.6%**
Pfizer	–2.8%	27.9%	3.7%	**8.2%**
Consolidated Edison	–14.0%	7.2%	33.6%	**10.8%**
Pepsi Bottling	15.1%	3.3%	20.7%	**12.2%**
Colgate-Palmolive	18.5%	11.8%	5.1%	**12.3%**
Merrill Lynch	14.2%	17.1%	8.9%	**12.9%**
American Express	17.3%	21.9%	–10.2%	**13.8%**
Foot Locker	27.0%	9.4%	4.5%	**14.9%**
Viacom	18.6%	12.1%	16.5%	**16.0%**
Metlife	20.3%	38.5%	–2.3%	**16.2%**
Energy East	2.0%	14.3%	32.9%	**17.3%**

If these large, profitable corporations were this successful in reducing their tax liability through completely legal tax loopholes on the federal level, it seems plausible that the same corporations may be using these loopholes to reduce their state corporate income taxes as well. Unfortunately, neither the SEC nor most state governments (including New York) require corporations to release detailed information on the tax loopholes they have claimed.

New York's Department of Taxation and Finance publishes an annual "tax expenditure report" identifying the aggregate cost of some of the tax breaks enjoyed by corporations in New York. But the report tells us nothing about the taxpaying behavior of individual corporations—or about the impact these loopholes are having on the effective tax rate paid by profitable corporations doing business in New York.

As a result, it's not currently possible to determine whether the loopholes described here have spawned an epidemic of state tax avoidance. However, more open disclosure of state corporate tax information could help clarify this issue. As Good Jobs First has documented, nine states now require corporations to disclose some information about the state or local tax breaks they receive. Most recently, in the fall of 2001 North Carolina legislators amended the state's tax-subsidy law to require extensive company-specific reporting of tax credits. These disclosure requirements apply to state tax credits for training, research and development, and machinery and equipment credits. The North Carolina law also requires disclosure, when a company claims development zone credits, of how many of the new jobs created as a result of the tax credit went to residents of the development zone. This sort of disclosure requirement could help New York lawmakers determine the effect of these tax breaks on individual companies' taxpaying behavior.

Conclusion

The New York corporate income tax is an important source of tax progressivity. In the absence of a healthy corporate income tax, state lawmakers must increase their reliance on other tax sources—including individual income and property taxes. Yet New York lawmakers have taken no actions to prevent this tax shift from corporate taxpayers to individual taxpayers.

At a time when New York policy makers are facing difficult decisions about the appropriate combination of revenue-raising measures to adequately fund education and other important services, shoring up the corporate income tax base by eliminating unintentional loopholes is an obvious (and relatively painless) choice that will be instrumental in ensuring the future vitality of the corporate income tax—and of the state education system.