Business Taxation in New York City

New York City and New York State recently have made serious efforts to improve their economies by lowering business taxes. Some tax rates have been reduced, many incentives have been added and strengthened, and some taxes have been abolished. However, much remains to be done. Businesses in New York City still face a complicated system of state and city tax laws which impose higher operating costs for firms located here and reinforce the city's reputation as being inhospitable to business.

This article briefly reviews the present tax system and notes some general ideas for restructuring it. The article also points out two areas in particular need of change—the heavier taxation of small firms relative to that of large firms and the limited tax relief given to firms with competitors in lower tax jurisdictions.

The complexity of business taxation

New York City's and New York State's complicated tax systems consist of franchise-type taxes assessed according to the net income, total revenues, or some measure of the value of the firm; other taxes assessed on the value of goods and services used by businesses; and tax incentives in the form of credits, deductions, and exemptions which lower taxes for firms that qualify. While a company or a single division of a company is subject to only one franchise-type tax, it may be subject to other business taxes and be eligible for any number of the tax-incentive programs.

Franchise-type taxes. Both the city and the state impose separate franchise taxes on banking corporations, public utilities, and "9A" corporations—a broad category which covers most corporations and is named after the statute that created the tax at the state level. A similar type of tax is imposed on the adjusted net income of unincorporated businesses. (The state's unincorporated business tax is being phased out.) Insurance companies are subject to state franchise taxes. The separate treatment at both the state and the city levels of each of these five categories only hints at the complexity of business taxes. Many of these franchise-type taxes, for instance, provide a number of alternative methods of computing tax liability.[1]

Compounding the complexity of the tax systems is the diversity in the rates of taxation (Table 1). For New York State, income tax rates are 12 percent for banking corporations, 9 percent for insurance companies, 10 percent for 9A corporations, and 4.5 percent for unincorporated businesses.[2] Insurance companies are also subject to an additional tax on the amount of their net premiums. The rates are 1 percent on net premiums for accident, health, and life insurance poli-

[1] For example, the state's tax on 9A corporations specifies four alternative methods for computing tax liability. The one yielding the highest amount must be used. Two methods involve a tax on net income applied either to the "entire net income" allocated to New York State or to allocated income-plus-salary payments (designed to prevent closely held corporations from avoiding this tax by paying out profits as salary). A third method uses a different tax rate which is applied to the firm's business and investment capital allocated to New York State. The last method is simply a minimum tax of $250. Almost 90 percent of the revenue from this tax is derived from the income or income-plus-salary basis with an additional 8 percent coming from corporations paying the minimum tax. Corporations are also subject to a tax based on the capital of subsidiaries.

[2] Public utilities are taxed on their gross income; however, these taxes are not considered here.

Table 1

Rates for Selected Taxes on Business*

Type of tax	Tax base	New York State Recent peak	New York State Current or scheduled	New York City Recent peak	New York City Current or scheduled
Financial corporations:					
Savings banks and savings and loan associations	Allocated net income†	15.6%‡	12%	12.134%	12.134%
Other banks	Allocated net income†			13.823%	13.823%
Insurance companies	Allocated net income†	9%§	9%§	#	‖
Other "9A" corporations	Allocated net income†	12%‡¶	10%	10.05%	9%
Unincorporated businesses	Allocated net income†	5.5%	0 (1981)	4%	4%
Property tax	Assessed value			8.795%	8.75%
Commercial rent tax	Rent per premises			7.5%**	6%** (1981)
Sales and use taxes	Purchase price	4%	4%	4%	4%
Stock transfer tax	Per share			$ .0625‡**	0 (1981)
Occupancy taxes:					
Commercial rents	Per premises			$12.00/year**	$12.00/year**
Vending machines	Per vending machine			$ 2.00/year**	$ 2.00/year**
Hotel	Per room			$ 1.00/day **	$ 1.00/day **

* All major taxes, except on public utilities and payroll, are included.

† Allocated net income is the amount of a firm's total net income subject to New York taxes.

‡ Includes tax surcharges.

§ Insurance companies also pay a tax on net premiums. The maximum tax liability for insurance companies cannot exceed 2.6 percent (previously 2.65 percent) of net premiums.

New York City used to impose a premium tax on all insurance policies written locally. The rates in 1974 were 0.6 percent for New York City insurance companies and 0.4 percent for non-New York city companies.

‖ The city imposes a premium tax on fire insurance policies written by non-New York City companies. The amount paid can be credited against state taxes.

¶ Omnibus (bus) corporations also paid an additional tax of 5.75 percent.

** Maximum rate.

Sources: Commerce Clearing House, Inc., and New York State Department of Commerce.

cies and 1.2 percent on net premium for other types of insurance.

At the city level, tax rates on the net allocated income basis also differ between industries. Commercial banks pay 13.823 percent, while savings banks and savings and loan associations pay 12.134 percent. Most other corporations pay 9 percent, and unincorporated businesses pay 4 percent.

Three features of the franchise-type taxes are noteworthy. First, because of this plethora of tax laws, different subsidiaries of the same company may be required to pay taxes computed at different rates. Second, some of these taxes result, in effect, in double taxation. The unincorporated business tax assesses for a second time practically all the salaries paid to partners and proprietors who also pay personal income taxes on this same income. Similarly, part of the salaries paid by corporations to officers and to holders of more than 5 percent of the company's stock is taxed twice under the income-plus-salary method, which many small, closely held firms must use to compute their tax liability.[3] Third, while most of the tax rates for these franchise-type taxes are still much higher than before New York City's fiscal crisis in the mid-1970's, many tax rates have recently been lowered. For example, New York State's 30 percent surcharge on financial corporations, as well as other surcharges imposed at the height of the fiscal crisis, has been allowed to lapse. In addition, the tax base for insurance companies was shifted from exclusive reliance on

[3] Over 90 percent of the firms having to compute their taxes on the income-plus-salary basis paid less than $3,000 in corporation taxes to the state in 1975-76 New York State Department of Taxation and Finance, *Statistical Supplement to the Annual Report of the Department of Taxation and Finance and New York State Tax Commission, 1977-78*, Table 3.

Table 2
Description of Tax Incentives

Incentive	Requirements	How realized	Level
New York State			
Investment tax credit	Investment in production facilities	Credit against corporation or unincorporated business taxes	4% of the value of the investment
Employment incentive tax credit	Received investment tax credit plus increase in employment of 1% from level in year before investment made	Credit against corporation or unincorporated business taxes	2% in each of three years after taking the investment tax credit
Job incentive credit	Certification by job incentive board as an "eligible business facility" (must sell product beyond local market, have five or more employees, and have a training program)	Percentage reduction in franchise-type taxes otherwise owed	The credit can be claimed for up to ten years and is the average of two ratios: qualified new investment in the "eligible business facility" to the firm's total land, plant, and equipment within the state; and salaries and wages for the jobs created or retained to the firm's total salaries and wages within the state
One-year write-offs	Investment in tangible business property for research and development, industrial waste treatment, and air pollution control facilities	Deduction from taxable income	Can deduct the whole cost in one year
Change in allocation of income rules	Out-of-state sales, payroll, or property	Reduces proportion of income allocated to New York State for tax purposes	Sales factor given double weight in allocation formula*
Sales and use tax exemptions	Fuel, machinery, and equipment purchased for production; and materials, machinery, and equipment purchased for research and development, waste treatment, and pollution abatement facilities	Exempt, or tax paid is allowed as credit against income tax.	Eliminates tax
New York City			
Double deduction for depreciation	Investment in depreciable assets used for production	Deduction from taxable income	Up to twice Federal depreciation allowances
One-year write-offs	Same as for state	Same as for state	Same as for state
Property tax exemptions	New construction or reconstruction of industrial and commercial facilities, granted by Industrial and Commercial Incentive Board	Increase in value exempt from property tax	First year 95% for all but new construction of commercial (initial exemption for it is 50%) Following years Decreases 5% per year until eliminated
Moving cost credit	Move into New York City from out-of-state with ten or more commercial or industrial job opportunities	Credit against corporation or unincorporated business taxes	Up to $300 per new commercial job and $500 per new industrial job
Property tax stabilization	Move into New York City from out-of-state with 100 or more industrial or commercial jobs and rent space, eligibility determined by the Industrial and Commercial Incentive Board	Credit against corporation or unincorporated business taxes	Equal to any increase in property taxes passed through under the lease for a period of up to ten years
Sales and use tax exemptions	Machinery and equipment purchased for production; and materials, machinery, and equipment purchased for research and development, waste treatment, and pollution abatement facilities.	Exempt, or tax paid is allowed as credit against income tax	Eliminates tax

* For more detailed explanation of recent changes in New York State's allocation rules, see text.
Sources: Commerce Clearing House, Inc., and New York State Department of Commerce.

net premiums received to a less onerous combination of premiums and income, with the maximum tax liability lowered from 2.65 percent to 2.6 percent of net premiums. (For a discussion of the taxation of insurance companies, see the accompanying article on pages 9-19.)

Other business taxes. New York City and New York State also impose several other taxes on the goods and services used by businesses.[4] State and city sales taxes—each assessed at 4 percent—tax many of the goods and services used by businesses. (Both levels of government also impose a "use" tax on purchases made outside their jurisdictions but used within them.) Although purchases of goods that become part of the final product are exempt from the sales and use taxes, other items such as computers, materials used in the construction of new buildings, and machinery and equipment used by service industries are all taxed.

New York City has a number of additional levies. Rental payments on property used for business purposes are taxed under both the commercial rent tax (the maximum rate is now 6.75 percent, down from 7.5 percent in 1977) and the general occupancy tax (the maximum flat charge is $12 per rented premises per year.) There are other occupancy taxes as well. Vending machines and hotel rooms are taxed, respectively, at maximum rates of $2 per machine per year and $1 per room per day. The stock transfer tax is being reduced in stages and is scheduled to be phased out in 1981. Real property, *i.e.,* land and buildings, are taxed at a rate of 8.75 percent on assessed value.

Tax incentives. New York City and New York State offer a myriad of tax incentives. The proliferation of these programs and the strengthening of existing ones have been part of the city's and state's response to the deterioration of their economies. Although fiscally incapable of making substantial cuts in basic tax rates, both levels of government have used their tax-incentive programs to foster the development of the private sector. These programs are well intentioned, and they do reduce taxes for those firms that meet the eligibility requirements. Unfortunately, they also contribute to the overall complexity of the tax system by creating a host of exemptions, deductions, and credits. (The major features of the tax incentives are summarized in Table 2.)

New investments may qualify for one of three different tax breaks. The state's investment tax credit provides a credit against taxes equal to 4 percent of the value of any investment in production facilities. If the same firm increases its employment 1 percent subsequent to this investment, then it also qualifies for an employment incentive tax credit which is set at one half the investment tax credit and may be taken in *each* of the following three years. The city does not offer any type of investment tax credit but does allow firms to take depreciation deductions at up to twice the Federal rate. An alternative credit (the job incentive credit) is available at the state level for firms investing in either production or nonproduction facilities such as office buildings. In contrast to the investment tax credit, in which the amount of the credit varies with the investment outlay, the amount of the job incentive credit varies with the firm's profits since it is set as a percentage of the taxes otherwise owed. As a third option for investments in facilities for research and development, industrial waste treatment, or air pollution control, firms can depreciate the entire amount of these expenditures in one year.

New investments may also qualify for relief from sales and use taxes and from property taxes. Most purchases of machinery and equipment are exempt from sales and use taxation, as are all purchases made to operate the facilities eligible for the one-year write-offs.[5]

In New York City, investments in new construction or reconstruction of buildings are eligible for exemption for up to nineteen years from property taxation. Large firms moving into the city from outside the state and renting their space can be insulated from increases in property taxes passed through under their leases, even if the increases result from building improvements. Moreover, some firms moving in are also eligible for tax credits to offset their moving costs.

Many businesses will benefit from two recent changes in the state's rules for determining the proportion of their net income subject to taxation by the state. This proportion is related to the amount of "business" the firm does within the state by using an allocation formula that takes into account how much of a firm's sales, payroll, and property are within the state. One of the recent changes doubles the weight given to the sales factor. This lowers taxes for a firm whose percentage of sales inside the state is smaller than its percentages of in-state payroll and property. The other change now allows firms which do not have a "regular place of business" outside the state to allocate their income. The savings from these modifications can be substantial (see chart).

[4] Omitted from the text are payroll taxes for unemployment insurance and workmen's compensation The rates for these taxes vary among firms within the state as well as between states.

[5] New York City does not actually exempt the purchase of manufacturing machinery and equipment from sales and use taxes but accomplishes the same objective by allowing firms to claim these taxes as credits against their franchise taxes The reason for choosing this less direct method is that these taxes cannot be altered because the legislature has made their revenues allocable to the Municipal Assistance Corporation to pay its debt obligations and operating expenses.

Illustration of the Reduction in Income Subject to New York State Tax Due to Revised Allocation Rules*

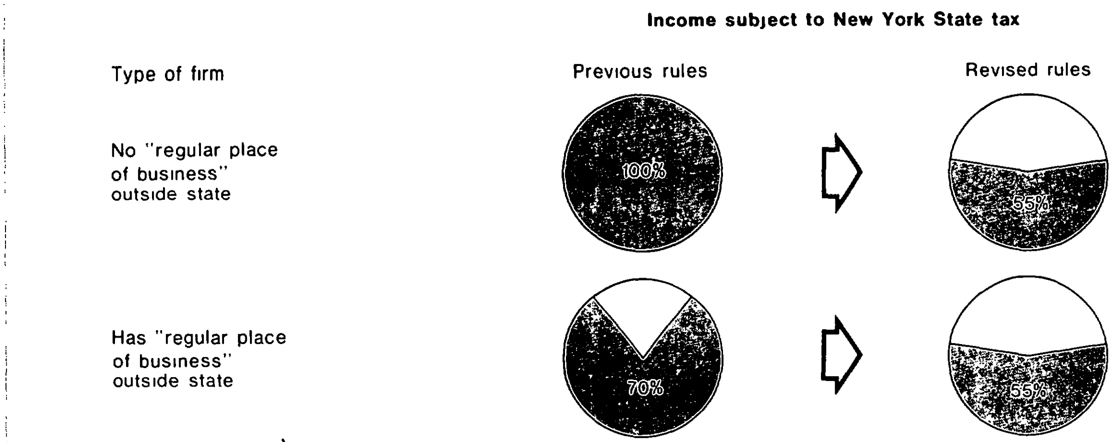

*Illustration based on firm with 10 percent of sales, and essentially all property and payroll within the state For discussion of allocation rules see text Revised formula allows firm to allocate income even without a "regular place of business" out of state and gives double weight to the sales factor. For example, the 55 percent is (2(10%) + 100% + 100%) /4

Forging the tax system into an efficient tool to promote the recovery of the local economy is a difficult task. Nevertheless, even a simple overview can uncover areas in particular need of change. At least two stand out: the taxation of small firms relative to that of larger firms and the taxation of firms that sell some or all of their product outside the state.

Small firms

Small firms are particularly hard hit under the present tax system. Although both the city and state tax firms of all sizes at a uniform rate, the effective tax rate declines with firm size because state and local taxes are deductible from Federal taxable income. Those firms paying at the highest marginal bracket on their Federal corporation tax return end up with a net city and state tax of about half the sum of the statutory rates, whereas small firms pay a net tax of more than three fourths the statutory rates.[6] In addition, because many small businesses are unincorporated or closely held, much of their income is double taxed.[7]

Not only are small firms taxed at a higher effective rate than larger firms, but they are excluded from taking advantage of a number of tax incentives. For example, eligibility for New York City's moving credit is restricted to firms employing at least ten workers and the property tax stabilization program requires a firm to have at least one hundred employees.

The imposition of a higher tax burden on small firms seems inappropriate. While the exact number of jobs provided by small firms is unknown, nearly 90 percent of the city's business establishments have fewer than twenty employees and account for a significant fraction of output in the city A further reason to encourage small firms is the city's traditional role as an incubator for small, innovative firms The long-run economic development of the city may depend on its

[6] The effective rate of state and local taxation depends not just on their statutory rates but also on the Federal tax rate For example, most corporations are taxed at 9 percent by New York City and 10 percent by New York State However, taking into account the interactions resulting from the deduction allowances by the state for local taxes and by the Federal Government for both state and local taxes, the total tax burden is only 55 774 percent for firms subject to the maximum Federal rate of 46 percent and 32 023 percent for firms subject to the minimum Federal rate of 17 percent which applies to corporations with profits of less than $25,000 Thus, the state and city taxes create an additional tax liability of 9 774 percentage points for the large firms and 15 023 percentage points for the small firms

[7] The unincorporated business tax contains a tax credit designed to help firms with very small profits Because this credit decreases as profits increase, there is a range in which the effective tax bite on each additional dollar of profit is twice the statutory rate

ability to attract and hold firms from their earliest stages of development.

Export-based firms

In addition to burdening small firms, the city's tax system, in particular, provides insufficient tax relief to many of the firms selling some or all of their product outside the state. As a result, many of the jobs provided by these so-called "export-based" firms have moved elsewhere. Originally, these firms were considered the best ones to tax since it was presumed that they could shift part of the tax burden to their out-of-state customers in the form of higher prices. However, advances in communications and transportation have made it easier for many of the businesses in New York City to be located elsewhere. While the loss of jobs is not wholly attributable to taxes, for many firms the relative level of taxation plays an important role in their location decisions. Consequently, only when the city offers relative cost advantages can it impose higher taxes than other localities without losing its role as a major center of manufacturing activity or even of legal, business, and financial services.

In this environment, New York City needs to change its treatment of export-based firms. Under the city's rules for determining the amount of a firm's income which is subject to local tax, only those firms with a "regular place of business" outside the city can allocate their income. This prerequisite of an out-of-city office is detrimental to the city's economy since it encourages firms to set up satellite offices which, once established, provide an alternative location from which a firm can easily expand. Furthermore, even firms eligible to allocate their net income may not receive sufficient tax relief to compete with firms located elsewhere because the city weighs payroll and property equally with sales in its allocation formula.

Options for improving business taxation

In the near term, a complete revamping of New York City's and New York State's tax systems is not possible. Budgetary requirements and the enormity of the task preclude changes that would significantly lower the tax receipts of either level of government. Nevertheless, small adjustments are feasible.

As a first step in tax reform, the effectiveness of the current incentives in attracting or preserving jobs needs to be assessed. How many firms have relocated in the city because of these special tax relief programs? How many firms would have expanded in the city anyway? How many firms already located in the city with no plans to leave are able to take advantage of these programs?

Answering these questions is not easy. Even a tax incentive that is initially well constructed may later run into difficulties. New York City's program of property tax exemptions for construction and reconstruction of commercial and industrial properties illustrates this problem. While the extent to which it spurs construction is unknown, the bulk of the tax relief has gone for new office buildings of large national corporations already located in the city. More importantly, this tax incentive may now be unnecessary for Manhattan in view of the revival of construction activity.

A hard-headed reexamination of the tax incentives would probably lead to the elimination of many of those presently offered. All but the ones visibly contributing to the recovery of New York's economy should be phased out, and no new tax incentives should be added unless their net benefit is clear. A thorough overhaul would yield two benefits. First, the complexity of the system would be reduced, and the costs of confusion produced by the present system would be diminished. Second, the revenue saved could be devoted to other forms of tax relief such as lowering some tax rates. Here also, care must be taken in selecting which taxes to reduce.[8]

Some taxes are being eliminated. Both the state's unincorporated business tax and the city's stock transfer tax are now being phased out. The elimination of more taxes in order to simplify further the tax system is generally very costly in terms of revenue loss (see Table 3 for the revenue raised by each of the major taxes). However, the city's occupancy taxes on commercial rents and vending machines—they raise a total of only $1.5 million—can easily be removed. As a byproduct of such a move, both the city and the business community would realize savings on administrative and paperwork costs. Eliminating the occupancy tax on commercial rents may be even more significant due to the symbolism of eliminating the duplicate taxation of commercial rents, leaving only the commercial rent tax. Since perception of the city's attitude may be an important factor in firms' location decisions, a tax cut that simplifies the tax system should yield the additional benefit of counteracting the city's past image as a place inhospitable to business.

The bias against small firms should be examined.

[8] A major portion of the revenues devoted by the city to tax relief has gone recently to reduce the commercial rent tax. However, the beneficial effects from cutting this tax may not have been as large as expected. Although its reduction may help to placate those business people who find its existence particularly onerous, the actual cost savings to firms signing new leases may be marginal. In the short run at least, the benefits most likely accrue to landlords who can increase their rental charges in correspondence with the fall in the tax rate. The competitive position of New York City as a location for business may thus be unchanged. Of course, in the long run, such an increase in the return to landlords may help prompt an increase in the supply of rental space.

Table 3

Revenue From Business and Other Major Taxes

Type of tax	New York State revenue: Millions of dollars	New York State revenue: Percent	New York City revenue: Millions of dollars	New York City revenue: Percent
Corporation ("9A") tax	1,005	8 7	479.4*	7.6
Financial corporation tax	169	1.5	150 0*	2.4
Unincorporated business tax	50	0 4	70 6*†	1.1
Utilities tax	480	4 2	109 1	1.7
Insurance taxes	201	1 7		
Commercial rent tax			200 7	3.2
Occupancy taxes				
Commercial rent and vending machines			1 5	‡
Hotel			10 8	0.2
Stock transfer tax			198.1	3.1
General property tax			3,186 9	50 3
Personal income tax	4,894	42 4	710 8*	11 2
General sales and use taxes	2,590	22 4	971 0	15 3
Other	2,166	18 7	248 1	3 9
Total	11,555	100 0	6,337.0	100 0

* Net of refunds. † Unlike the state, New York City does not exempt professionals from this tax. ‡ Less than 0.1 percent.

Sources: New York City Office of Management and Budget, *Executive Budget—Fiscal Year 1979, Supporting Schedules*, pages 3R-4R, and New York State Division of the Budget, Fiscal Year 1979

The tax rate for these firms could be lowered and size requirements for tax incentives could be removed. Furthermore, the double-taxation feature in the franchise-type taxes that small businesses generally pay should be eliminated. The city's unincorporated business tax and the city and state taxes on 9A corporations could be revised so that tax liability on salaries is limited to the higher amount of that computed under these taxes or of that computed under the personal income tax. A major benefit of such a change, particularly in the case of the unincorporated business tax, would be to reduce significantly the incentive for the partners and proprietors of these companies to live outside the city. Since the city's unincorporated business tax is 4 percent and the maximum personal income tax on residents is 4 3 percent, the owners of these businesses would pay essentially the same amount of tax regardless of where they reside.

Export-based firms also need to be studied to determine which ones, with further tax relief, would be able to operate profitably in New York City. At a minimum, the city should move toward the state's new income allocation rules, allowing firms to allocate net income whether or not they have a "regular place of business" outside the city and to give double weight to the sales factor.

The outlook

New York needs to overhaul its tax system. In the short run, fiscal constraints limit the extent of change possible. Yet, despite these constraints, some minor taxes can be eliminated and tax incentives strengthened. Greater tax relief needs to be directed to small firms and those competing for market share outside New York. In the long run, New York City and New York State need to simplify their tax systems as well as to lower taxes. While the recent tax cuts have undoubtedly aided business, further tax changes can play an important role in spurring the economic recovery of New York City.

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