Testimony of Matthew Gardner
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Thank you for the opportunity to submit testimony on corporate tax reform options for New York. My name is Matthew Gardner, Executive Director of the Institute on Taxation and Economic Policy (ITEP). Founded in 1980, ITEP is a nonprofit tax policy research group focusing on federal and state tax policy issues, with an emphasis on tax fairness and adequacy.

The stated purpose of this hearing is to evaluate the impact of New York's business taxes on equity and economic growth. These are laudable concerns: the most basic questions to ask about any corporate break are whether they are allocated fairly, and whether there's any reason to think they will help create jobs in New York, so I welcome the chance to discuss existing and proposed tax breaks in this context.

My testimony will focus first on what we know about the magnitude of corporate tax avoidance under current law. I'll then briefly discuss the benefits—and the limits—of the important "combined reporting" reforms recently enacted by New York, and will also discuss several especially problematic tax breaks in the state's current corporate tax law. Finally, I'll discuss the important question of whether corporate taxes should be considered to have a measurable impact on economic development.

The Problem: "Zero-Tax Corporations"

The U.S. corporate income tax is in decline. Even before the recent economic downturn, at both the federal and state levels, governments were collecting far less in corporate income taxes, as a share of the economy, than they did just a quarter century ago. New York's corporate tax collections have, in general, mirrored the nationwide downturn in corporate tax collections.

This decline is troublesome for two reasons. First, it appears to be at least partially the result of tax avoidance strategies by corporations rather than the conscious design of federal and state policymakers. Second, a decline of the corporate taxes paid by the biggest, most profitable companies inevitably means that taxes paid by smaller businesses and taxes paid directly by individuals must make up a bigger share of the tax pie.

There is growing evidence that the corporate income tax is nearing collapse from the sheer weight of these loopholes. A February 2005 ITEP analysis of 252 of the largest and most profitable corporations in America found that 71 of these corporations – more than a quarter of the total – managed to pay zero state corporate income taxes in at least one year between 2001 and 2003.[1] Twelve of these 71 companies were headquartered in New York State, and three of these managed to pay either zero or less than zero for the entire three-year period we surveyed—despite being profitable in each of these years.

If the 252 corporations included in ITEP's study had paid the 6.8 percent average state corporate tax rate on the almost $1 trillion in U.S. profits that they reported to their shareholders, they would have paid $67.1 billion in state corporate income taxes over the 2001-03 period. Instead, they paid only $25.4 billion. Thus, these 252 companies avoided a total of $41.7 billion in state corporate income taxes over the three years.

An Important First Step: Combined Reporting

One of the main reasons for the staggering decline in state corporate taxes is the willingness of multi-state corporations to go to great lengths to artificially shift the apparent location of their taxable activities from its subsidiaries in higher-tax jurisdictions to subsidiaries in lower-tax jurisdictions. A growing number of states, including New York, have (correctly, in our view) identified and implemented the single tax reform mechanism that is most effective in combating this form of income shifting: combined reporting of the profits of multi-state corporations.

As you know, combined reporting requires a multi-state corporation to determine its apportionable income by adding together the profits of all its domestic subsidiaries – without regard to their location – into one total. Since the income of a company's subsidiaries in the various states is added together in one sum, there is no tax advantage to income shifting between these subsidiaries under a combined reporting regime.

Combined reporting is intuitively fair because it ensures that a company's tax liability should not change just because its organizational structure changes. It also creates a level playing field between smaller and larger companies. Small companies doing business only in New York are at a competitive disadvantage because they can't use separate accounting to reduce their tax. This is simply because they have no business units in other states to which to shift their income. Large, multi-state corporations will find it easier to avoid tax using separate accounting because they do have business units in multiple states.

New York, as already noted, has recently enacted combined reporting. This is a laudable step and should play an important role in preserving the state's tax base going forward. But combined reporting, as enacted by New York, does not completely remove the incentive for companies to play games with their books by artificially shifting profits around.

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[1] *State Corporate Income Taxes, 2001 - 2003*, Robert S. McIntyre and T.D. Coo Nguyen, Citizens for Tax Justice and Institute on Taxation and Economic Policy, February 2005

When combined reporting rules only apply to a company's domestic operations, but don't factor in a company's overseas income, it's known as a "water's edge" rule: combined reporting stops at the edge of the Atlantic and Pacific Oceans. But as combined reporting states like Illinois have discovered to their chagrin, under a "water's edge" rule multi-state companies can become multi-national companies—at least on paper—and create subsidiaries overseas that play essentially the same tax-avoidance role that would be played by subsidiaries in other states in the absence of combined reporting. As The Wall Street Journal documented in late 2007, the Wal-Mart corporation managed to cut its Illinois income taxes by millions of dollars a year by opening a small office in Florence, Italy, despite having no Italian stores.[2] Several states, including Massachusetts, Minnesota and West Virginia, have expanded their water's edge rules to include subsidiaries located in known foreign tax havens. This is a sensible step that New York should consider.

The Single Sales Factor: A Potential Job Destroyer

If presented with a proposed corporate tax change that contained no job-creation guarantees whatsoever, actually encouraged some New York employers to leave the state and effectively put up a sign at the state border saying "don't open a warehouse here," members of this panel would presumably reject such a change. Yet several years ago, the New York Legislature passed, and the Governor signed into law, a major corporate tax change that can be accurately described in exactly this way: the "single sales factor" apportionment rule.

Like other states, New York follows two guidelines in applying its corporate tax to the profits of multi-state corporations. First, companies must have some minimal level of contact, or nexus, with the state. Second, the state must devise a rule for determining what fractions of a multi-state company's activities can be considered "in state" and "out of state."

Historically, most states have followed the recommendations of the Uniform Division of Income for Tax Purposes Act (UDITPA) and used the existence of three factors—the location of a company's payroll, property, and its sales—to determine the "in-state" portion of a company's activities. This is a sensible approach because the presence of any of these factors is a reasonable approximation of the activities of a company in a given state. But since 2006, New York (like a growing number of other states) has chosen to ignore the payroll and property factors in determining a company's in-state activity, and instead determines a company's taxability only by measuring the share of its national sales that take place in the state.

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[2] Jesse Drucker, *Why Wal-mart Set Up Shop in Italy*, The Wall Street Journal, November 14, 2007.

The resulting "single sales factor" provides tax cuts to one class of multi-state corporations: companies that produce goods in New York, most or all of which are sold to consumers in other states or around the world. This is why the advocates of the single sales factor approach view it as an economic development incentive.

But it's not obvious that this view is correct. While the single sales factor does unambiguously reduce the taxes paid by this one class of companies, it *increases* the taxes paid by other classes of corporations. In particular, companies with little in-state employment and property that sell proportionately more of their products in New York are paying higher taxes now than they would be if the single sales factor hadn't been enacted.

And of course, companies that do business entirely within the state of New York can derive no benefit from the "single sales factor" at all. This is a tax break for some multi-state corporations, at the expense of purely in-state businesses and of other multi-state corporations.

Perhaps most worrisome, the single sales factor actually creates an incentive for multi-state companies that already have New York facilities to eliminate those facilities, and also create a clear disincentive for out-of-state companies that might have been considering creating facilities in New York. This is because of the arcane, but important, rules governing whether multi-state companies can be taxed at all by a state. The principal federal law governing corporate taxability, Public Law 86-272, says that a company that sells products in New York, but does so only by shipping products into the state, has no nexus and therefore won't have to pay any income tax to the state. So if the Acme Company has no facilities in New York, but sells a substantial share of its products to New York residents, then under the single sales factor it won't be taxable in New York. But the minute it hires a New York employee or opens a New York warehouse, it becomes subject to the New York corporate income tax. And if Acme currently has nexus because it has a single warehouse in the state, it can move the warehouse to Connecticut, continue selling into the state and eliminate all New York corporate taxes in that way. This is, to put it mildly, probably not the sort of economic development incentive New York lawmakers had in mind when they enacted the single sales factor.

Finally, it's worth reiterating that at a time when the emphasis for lawmakers is (correctly) on "jobs, jobs, jobs," the tax cuts delivered because of the single sales factor have no job creation "strings" attached to them at all. New York corporations can claim this tax break even if the companies that lobbied loudest for it—and that benefit most when it's enacted—are systematically reducing their in-state employment, as Massachusetts found to its chagrin after adopting the single sales factor in the 1990s.

If this committee wishes to evaluate the efficacy of existing economic development incentives, the single sales factor would be an excellent place to start.

Other Loophole-Closing Options

■**Decoupling from "CODI".** The federal economic recovery legislation passed earlier this year includes one provision, the "cancellation of debt income" provision or CODI, that has been estimated by the Center on Budget and Policy Priorities to cost the state of New York $200 million in fiscal year 2010 alone. The provision allows companies that have borrowed money, and who then buy back their debt at a discount in 2009 or 2010, to wait until 2014 before reporting the forgiven debt as taxable income. (Normally, forgiven debt must be reported as taxable income in the same year it was received.) Further, once 2014 arrives, these companies can spread this income out over the five-year period between 2014 and 2018. Since the New York corporate tax is based on federal rules, lawmakers must choose whether to conform with this legislation—in which case the aforementioned $200 million state tax cut will occur in the current fiscal year—or to decouple, in which case lawmakers won't be granting this new corporate tax cut at this time.

The companies that can benefit from this so-called "stimulus" provision are those that have sufficient cash on hand to buy back their debt, which means they're less financially strapped than many other businesses, so they hardly seem a prime candidate for tax breaks at this time. Moreover, the case for passing through this federal tax cut to New York is especially weak, since the tax break isn't at all designed to encourage job creation in New York State, and isn't obviously linked to job creation goals anywhere in the US.

■**Repealing Net Operating Loss Carrybacks.** Every state with a corporate income tax recognizes that business profits vary sharply from one year to the next, and allow companies to effectively measure their profitability—and, therefore, their taxability—over a multi-year period. This is done by allowing companies to use their net operating losses (NOL's) in one tax year to offset their profits in other years. More than half of the states now allow losses to be carried forward, but do not allow losses to be carried back at all.[3] New York is one of a minority of states that allow losses to be carried backwards—that is, to retroactively offset taxes paid during previous profitable years. During economic slowdowns, allowing NOL carrybacks has the effect of magnifying the drop in corporate profits tax collections. Given the severity of the ongoing recession, this is an especially opportune time for New York to repeal its carryback, while preserving the right of corporations to carry their losses forward. The fact that there's no obvious linkage between the NOL carryback and job creation is another reason to look skeptically upon this tax break.

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[3]Mazerov, Michael, *Minority of States Still Granting Net Operating Loss Carryback Deductions Should Eliminate Them Now,* Center on Budget and Policy Priorities, May 2009

■ **Reforming the Investment Tax Credit.** New York's 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.

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 economy. Tax-driven investments channel resources into areas where they are less productive than they could be—and reduce the overall efficiency of a state's economy.

This is a different sort of problem from the other tax provisions described here, and demonstrates the fundamental difficulty of knowing whether corporate tax incentives can ever be truly effective. Alone among the tax breaks discussed, the ITC requires companies to actually invest in order to claim it. But there's no way to know whether this investment would have occurred anyway absent the credit.

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 carry-forwards. This represents a huge reduction in future corporate income tax payments for New York State.

Taxes and Economic Development

This hearing is meant to focus on, among other things, how best to use corporate tax breaks in the name of economic development. But one can reasonably ask whether corporate tax breaks are ever very effective in achieving economic development goals. Virtually every state legislature that has entertained options for closing corporate tax loopholes—or has expressed reservations about granting new ones—has heard apocalyptic predictions of the dire economic consequences that would result from these changes. There are several brief points I would like to make on this topic.

First, targeted corporate tax breaks are not costless. Every dime of foregone tax collections from corporate tax breaks (or from any tax break, for that matter) has to be made up by higher taxes on someone else, and those higher taxes impose costs on taxpayers in the same way that the foregone corporate tax revenues would have. The more generously lawmakers provide targeted incentives to specific companies or industries, the higher the tax rate has to be on everyone else in order to raise sufficient revenues. Put in the language of the 1986 Tax Reform Act, the lesson is simple: the broader the tax base, the lower the tax rate can be. And the narrower the tax base, the higher the tax rate must be. The collective impact of even the best-intentioned tax subsidies is a tax increase on everyone who's not lucky enough to get these subsidies.

Second, these anti-tax arguments are generally based on anecdotal arguments or threats by corporations, rather than hard empirical evidence.

Third, serious economic analyses of the relationship between tax incentives and economic development generally find little or no relationship between tax levels and economic outcomes. Studies that do purport to show such a relationship typically make simplifying assumptions that do not apply in the real world. For example, such studies will frequently estimate the negative impact of tax increases on a state's economy, but will not estimate the positive economic impact of increased state spending. In today's political climate, lawmakers raise taxes because it's the only way available to fund services that improve the quality of life for individuals and businesses. Any analysis that does not attempt to quantify this positive effect is basically assuming that lawmakers take the gains from tax increases and throw them down a hole in the ground.

Fourth, this basic finding of the economic literature really should come as no surprise. State and local taxes are a very small part of the costs that most businesses face. As Robert G. Lynch, the Chairman of the Department of Economics at Washington College found in his landmark study, *Rethinking Growth Strategies: How State and Local Taxes and Services Affect Economic Development*, "…after federal deductibility, all state and local taxes paid by businesses … accounted for only 0.8 percent of their costs."[4] State corporate income taxes, in turn, constitute only a fraction of the state and local taxes businesses pay.

As a result, the other costs that businesses incur are far more important in determining a state's business climate. Lynch's research leads him to include in this set of costs:

> "...the cost and quality of labor, the proximity to markets for output . . . access to quality transportation networks and infrastructure (e.g., roads, highways, airports, railroad systems, and sewer systems), quality-of-life factors (e.g., good schools, quality institutes of higher education, health services, recreational facilities, low crime, affordable housing, and good weather), and utility costs."[5]

Many of these costs can, in turn, be mitigated by state appropriations and other public policies, but only if states have the resources they require.

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[4] Lynch, Robert G., *Rethinking Growth Strategies: How State and Local Taxes and Services Affect Economic Development*, Economic Policy Institute, March 2004, p. 4.
[5] *Ibid*., p. 6.

To its credit, the business community generally understands this—by and large, business leaders in New York know that an effective public sector can improve their bottom lines and that it is in the business community's long-term interest to have a corporate tax that is applied evenly and fairly. And that's really my final point—the overwhelming majority of corporations doing business in New York are good corporate citizens. As a result, relatively few businesses would be affected by loophole-closing reforms.

In the end, as New York City Mayor and long-time business leader Michael Bloomberg once put it, "Any company that makes a decision as to where they are going to be based on the tax rate is a company that won't be around very long. If you're down to that incremental margin you don't have a business."

Conclusion

New York has taken important steps to solidify its corporate tax base in a way that discourages income-shifting tax avoidance activities, and members of the legislature should be applauded for this achievement. The questions being asked by the committee today are healthy ones: can we justify existing tax breaks in terms of our economic development goals? Can we justify enacting new ones? I've argued that several of the most prominent tax breaks currently provided in the state's corporate tax laws simply aren't designed to achieve economic growth, and may actually deter it. I've also argued that these tax breaks are hard to defend from an equity perspective in that they pit some New York businesses against others. Closing these loopholes would result in a more level playing field for all New York businesses, and could result in lower tax rates as well.

Thank you for the opportunity to provide the Committee with this testimony.