REPORT # 531

TAX SECTION

New York State Bar Association

Recommendations Regarding
New York State's Response to Federal Tax Reform

Table of Contents

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Attached letter dated 6/19/86 enclosing report regarding New York State's Response to Federal Reform sent to the following:

The Honorable Mario M. Cuomo
CC: Mr. Brad Johnson

The Honorable Roderick G. W. Chu
New York State Commissioner of Taxation & Finance

The Honorable Warren M. Anderson
Majority Leader
New York State Senate

The Honorable Daniel B. Walsh
Majority Leader
New York State Assembly

The Honorable John J. Marchi
Chairman
Senate Finance Committee

The Honorable Stanley Fink
Speaker
New York State Assembly

The Honorable Arthur J. Kremer
Chairman
Way & Means Committee

Frank Mauro, Esq.
Secretary
Ways & Means Committee

Mr. R. Wayne Diesel
Director of the Budget
New York State Division of the Budget

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New York State Bar Association

June 19, 1986

The Honorable Mario M. Cuomo
Executive Chamber
State Capitol
Albany, NY 12224

Dear Governor Cuomo:

Pending Federal tax reform proposals, which now seem highly likely to be enacted, will profoundly affect New York State individual and corporate income taxes. Prompt adjustment of New York income tax laws is necessary to avoid distortion and preserve New York State's competitive position in relation to other states.

I enclose a report prepared by a Special Committee of the New York State Bar Association Tax Section, chaired by Gordon Henderson, that describes the distortion that will result from the enactment of current Federal tax proposals and recommends possible state action.

I hope the report proves useful to you.

Sincerely,

Richard k. Cohen
Chairman

Enclosure
cc: Mr. Brad Johnson (w/enclosure)

REPORT # 531

TAX SECTION

New York State Bar Association

June 17, 1986

RECOMMENDATIONS REGARDING NEW YORK STATE'S RESPONSE TO FEDERAL TAX REFORM

Because the tax bases for the New York personal income tax and corporate franchise tax largely conform to the Federal income tax base, adoption by the Federal government of the pending tax reform proposals will have a profound effect on New York State's individual and corporate income taxes. New York will need to adjust its income tax laws immediately upon adoption of the Federal reforms if it is not to suffer a serious erosion of its competitive position in relation to other States. The purpose of this report is to recommend an approach for the State to take in choosing what adjustments to make.

We would like to emphasize the importance of prompt action by the State. Should a final Federal bill be sent to the President in late summer or early fall, a special session of the New York Legislature this fall would seem in order. Delay until the regular budget

1. They reduce the aggregate Federal tax burden on individuals -- by 6.4% in the Senate proposa1,[1] 9% in the House proposal, and 7% in the President's proposal. Because they are intended to be revenue neutral, they add the dollar amount of this individual tax reduction to the tax burden on corporations. Since the aggregate tax paid by corporations is less than that paid by individuals, this results in an increase in the aggregate corporate tax burden that is greater than the 6.4% to 9% reduction in the individual income tax burden.

2. In addition to this shift of a portion of the tax burden from individuals to corporations, they make major changes in the Federal tax base and rate structures. The base is broadened and rates are sharply reduced. In the Senate proposal, for example, the number of individual rate brackets is reduced from 15 to 2, and the top individual rate is cut almost in half, from 50% to 279. The top corporate rate is reduced to 33% which is roughly three-quarters of the present rate.

3. The Senate proposal would eliminate the special capital gains rate for individuals (though not for cor-

[1] The Senate proposal's 6.4% reduction occurs only in 1988, the peak year in the Senate proposal of the reduction for individuals. The Senate proposal's reduction in the other years in the 1987-1991 period would be less, in most such years considerably less.

Changes in Individual Income Tax Liabilities

	president's Proposal	House Bill
United States	-9.2%	-9.6%
New York	-4.9%	-8.8%
Connecticut	-11.3%	-10.4%
New Jersey	-10.1%	-10.6%
Pennsylvania	-9.9%	-10.4%

This relatively harsh impact on New Yorkers of the changes in Federal tax liabilities will be compounded by the impact of the Federal changes on the State tax liabilities of New Yorkers. The Federal tax-base changes that will be automatically reflected in the New York tax base will result in a sharp increase in the State personal income tax liabilities of New Yorkers -- unless New York takes action to prevent this from happening. The increase for New Yorkers will be greater than for the residents of most states, according to the ACIR numbers. It will also be greater than for residents of most of our neighboring states, as reflected in the following ACIR estimates. The increased after-tax burden of state and local taxes, caused by lower Federal rates, will make such differences particularly noticeable to taxpayers.

Potential Automatic Effect of Federal Reform on State Personal Income Tax Revenues

	president's Proposal	House Bill
New York	7%	5%
Connecticut	5%	8%
New Jersey	0	0
Pennsylvania	0	0

1975 Per Capita Figures

	Tax Capacity	Tax Effort
All U.S.	100%	100%
New York	98%	159.6%
Connecticut	110.3%	98.7%
New Jersey	108.6%	102.8%
Pennsylvania	98.4%	93.0%
California	110%	119.4%

The New York numbers are so significantly out of line with those of other states that adoption of the proposed Federal tax reforms will undoubtedly put pressure on New York not only to adjust its tax structure but also to reduce the level of its expenditures.

Approach Recommended For New York State

The first step that New York State should take is to develop estimates of the revenue increases that will result from the automatic reflection of the Federal base- broadening reforms in the New York tax base. These estimates should be developed separately for (1) individuals and (2) corporations. The second step for New York is to determine how much of the tax burden on individuals would have to be shifted to corporations if New York were to redistribute from individuals to corporations the same percentage of its overall tax burden that the Federal government proposes to redistribute to corporations.

Next, New York should determine how much the individual and corporate rates could be reduced if (1) all of standard deduction amounts are political questions which we refrain from expressing recommendation.

2. In adjusting its individual income tax rates, New York will have to consider what to do about the present differential between its rates on unearned income and its rates on earned income. The Federal law no longer contains a similar distinction.

3. The Tax Section of the New York State Bar Association has long been a leading advocate of conformity between the New York State and the Federal income tax base. Such conformity serves the important interests of simplicity and efficient administration. In recent years, New York has departed from the conformity principle in several instances. An example is its uncoupling from the Federal depreciation system. We urge that in adjusting to the Federal tax reforms, New York apply conformity as the overriding principle governing its tax base. This would include the computation of depreciation. Conformity does not

extend, however, to tax rates or to the amounts of the personal exemption or standard deduction.

4. The Federal reform proposals would eliminate the investment tax credit. This is one of the items that allows rates to be reduced. New York State has its own investment tax credit. Conformity with the Federal

7. Special attention may also have to be given by New York to capital gains. Depending on where New York sets its regular rates, New York may find for competitive reasons that it will have to retain a preferential rate for capital gains. The argument for doing so (as well as for eliminating the rate differential between investment and earned income) is that taxpayers with substantial capital gains (and investment income) are likely to be particularly mobile. Because they are also more likely than other taxpayers to own or control' business operations, when they leave a state or decide not to enter it they may have a disproportionate impact on the decisions of businesses to leave or enter a state. On the other hand, principles of simplification and conformity would be served if New York were to follow the Federal lead with respect to retention or elimination of the capital gains preference.

8. At present, New York has a minimum tax on tax preferences for individual but not for corporate tax purposes. Less than a third of the states have a minimum tax on tax preferences. The New York individual minimum tax does not conform

with either the present or the proposed Federal minimum tax structure. New York should either conform the structure of its minimum taxes to the Federal models, or it should eliminate them. If

b. Second, as an alternative, New York could adjust to the Federal changes by retaining its present rate and exemption structure and then superimposing a “negative surcharge”. The latter would be a percentage reduction in tax computed under the existing rate and exemption structure equal to the percentage by which the Federal base-broadening would otherwise increase the New York tax. Thus, if the Federal base-broadening, would increase the New York personal income tax collections by 108, the “negative surcharge” applied to each taxpayer's tax would be 10% (or, if some of the individual tax burden is to be shifted to corporations, by an appropriately adjusted number in excess of 10%). Such a “negative surcharge” may be more attractive as a short-run expedient than as a final solution, since New York may need to flatten its rates, as the Federal proposals do, more than such a surcharge would permit.

c. Third, as yet another approach, New York might adopt a system like that of Vermont or Rhode Island, whereby the state income tax on individuals is simply computed as a percentage of the individual's Federal tax liability. The argument in favor of such a system is that it can be the simplest and