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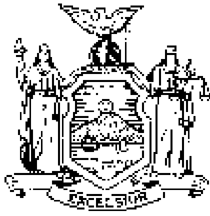

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The Effectiveness of the ITC

An evaluation of New York's Investment Tax Credit

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Executive Summary

New York State has allowed an investment tax credit (ITC) since 1969. The original legislative intent sought to encourage manufacturers to modernize existing production facilities and equipment in New York.

Critics have made the most cogent arguments against tax incentives at the federal level. Their arguments suggest that capital formation incentives such as the ITC distort investment decisions and capital flows in the economy. However true these arguments might seem at the national level, different factors become apparent on the State level.

Taxes can become the financial tiebreaker in decisions on where to invest.

No study or economic analysis has determined what would have happened in New York State without the ITC. In some cases, taxpayers have claimed tax benefits for activities that would have happened anyway. However, a substantial body of evidence concludes that certain factors influence corporate location and investment decisions. These factors include energy costs, cost and availability of skilled labor required for the investment, and proximity to markets. In decisions where all else remains equal, taxes can become the financial tiebreaker in decisions on where to invest.

For New York, the ITC has a substantial impact in reducing corporate income taxes on investment. New York taxpayers face one of the heaviest state and local tax burdens in the nation. In addition, manufacturers also face particularly high energy and labor costs. These concerns become more pronounced in the metropolitan region, where the cost of living and doing business represent the highest in the nation for manufacturers. The ITC serves as a crucial offset to these cost factors.

Over the past decade, tax law changes have undermined the value and effectiveness of the ITC in New York. The changes include the imposition of the alternative minimum tax (AMT), which limits the use of credits; the limitation of the credit carryforward; and the reduction in the rates and bases of the ITC. These changes directly affect the value of the credit for each dollar of invested property. For example, given the ITC's current rate of 5 percent, one dollar in credits leverages $20 in investment. During 1982-1986, when the ITC was most generous, for

every dollar received in credits, manufacturers leveraged $13 in invested property. Since its enactment in 1969, New York companies used nearly $1.65 billion of investment credits. These credits result from a direct offshoot of capital investments in the State totaling more than $40 billion. The increase in economic activity caused by investment indirectly affects the State's economy by increasing income and sales.
Repeal of the ITC would eliminate a significant capital formation incentive for manufacturers. As neighboring jurisdictions intensify their efforts to attract new investments and expansions from New York, the value of the ITC takes on more significance. The ITC remains the single most valuable incentive New York has to offer manufacturers under the corporate franchise tax.[1] The critical question in the debate over a capital formation incentive, like the ITC, becomes whether it is worth the revenue expended.

Impetus for the Study

This study, conducted by the Office of Tax Policy Analysis of the New York State Department of Taxation and Finance (OTPA), responds to legislative requests for information on the effectiveness of the ITC for corporate taxpayers. It analyzes the Article 9-A ITC and all of its components, including manufacturing property, research and development property, air pollution control facilities, industrial waste treatment facilities, and rehabilitated retail enterprise property. The analysis also includes the employment incentive credit (EIC). While the study focuses primarily on the ITC, it also provides historical background on the business facility credit, in effect from 1968-1983, and the retail enterprise rehabilitation expenditure credit enacted in 1981.

Data limitations require that, for years 1987 and thereafter, the study analyze the various components of the ITC and the EIC in total. Data examining the ITC for years prior to 1987 do not include research and development property, air pollution control facilities, and industrial waste treatment facilities because such property did not comprise a component of the ITC. Data prior to 1987 did not capture the credit for rehabilitated property for retail enterprises.

This study uses data from 1992, representing the most recent year available, and makes projections to illustrate the effect of tax law changes after 1992. The study discusses changes in the tax law and how such changes influence the efficacy and usage of New York's ITC. It also addresses a number of questions. These include: how the ITC affects corporate investment; how corporate tax managers and major site

consultants view the effectiveness of the ITC; whether the ITC achieves its purpose; and how New York compares with other states. The study sets forth possible policy options for enhancing the effectiveness of the ITC. It presents data profiles of the ITC, including credit used and earned by industry type, income, asset size, and number of taxpayers.

Major findings fall into three categories:

New York's ITC once represented the most generous capital formation incentive in the nation. The incentive programs of New York's competitors now rival it.

The majority of other states, including Massachusetts, New Jersey and California, allow ITCs.

Thirty-four other states allow some form of capital formation incentive to stimulate investment and create jobs. States may apply these credits statewide, or limit them to specific geographic locations. Many states, such as Connecticut, Ohio and Tennessee, allow a general ITC for manufacturing investments. Other states, including Alabama, Arizona and Indiana, limit the credit to enterprise zones or industrial recovery sites.

Twenty-two states allow credit for research and development property. Massachusetts, New Jersey, and California recently enacted generous ITC provisions. Repeal would place New York at a competitive disadvantage compared with other states.

Tax law changes created uncertainty and undermined the value and effectiveness of the ITC, particularly the imposition of the AMT in 1987 and limits on credit carryforward.

While the ITC remains an important incentive, its value diminished over the past decade due to tax law changes.

The data show that the imposition of the AMT in 1987 and the statutory changes reducing both the ITC bases and rates made the ITC less valuable as an incentive to invest in New York. Also beginning in 1987, the law limited the ITC credit carryforward to seven years, negatively affecting the rate of return on capital investment.[2] Before 1987, taxpayers, given sufficient profitability, could expect to collect 100 percent of the credit in the year following the investment. Taxpayers could carry forward the credit indefinitely.

Since 1987, the after-tax rate of return on the investment has become less predictable. Continual changes in the AMT base and rate that limited ITC usage produced a climate of uncertainty in which to make long-term

planning and investment decisions. In 1990-1993, in some cases, taxpayers could collect less than a third of the original value of the credit in the year following the investment. Thus, it would take three years or more to exhaust the credit completely. Tax law changes affecting the AMT enacted in 1994 and 1995 will partially reverse this trend and allow taxpayers to recoup some of the benefits of the ITC.

A significant majority of national and international site location consultants, and corporate tax managers believe New York's ITC encourages investment.

The majority of location consultants found the ITC influential.

The majority of leading site location consultants responding to a survey found the ITC influential in their advice to clients to expand in New York. The majority responding ranked the ITC/EIC as moderately important or very important. The respondents also found energy costs, proximity to labor, and labor costs as important factors in a business location decision.

A significant majority of respondents to a corporate tax manager survey claimed the ITC. Nearly 20 percent of those responding to a question on the impact of the ITC considered it a significant factor in their decision to expand in New York. The survey revealed that some taxpayers did not know New York allows an ITC and EIC. A significant number of respondents did not realize new businesses could take a refund of the ITC rather than carry the credit forward. An overwhelming majority believed reducing the corporate franchise tax rate would have an impact on encouraging investment in the State. The respondents ranked, among other factors, state and local taxes, energy costs, labor costs, and skilled labor as very important.

Policy Options

Since its enactment in 1969, New York's ITC has garnered strong industry support. The significance has increased in light of repeal of the federal ITC and the enactment of ITCs by neighboring states. Tax policy changes could help to restore the original legislative intent of the ITC.

Lawmakers may want to consider tax policy reform to enhance the effectiveness of the ITC.

The analysis of the ITC presents a number of policy options to consider. For example, as New York changes from a manufacturing to service economy, policymakers may want to consider expanding the ITC to the service industry. However, a proposal to expand the ITC to nonmanufacturers presents many challenges that fall beyond the scope of this report. The options presented here represent straightforward

alternatives to current law based on the conclusions drawn from the analysis. The policy options range from those affecting all taxpayers to those affecting only small business taxpayers.

Large Businesses

Policy changes primarily affecting large business taxpayers could include three alternatives to the AMT: eliminate provisions of the AMT that limit the use of the ITC and its components against AMT tax liability; repeal the AMT in its entirety; or replace the AMT with a limitation on credits. Additional options include allowing the ITC for leased property and reducing the corporate franchise tax rate.

Eliminating the AMT credit limitation would allow taxpayers to fully utilize the ITC against tax liability, while repealing the AMT would allow taxpayers to fully utilize all credits. This option would also reduce taxpayers' paperwork burdens. Eliminating the AMT and replacing it with a credit limitation would still achieve the original intent of the AMT, that is, to ensure that taxpayers with income pay a percentage of income in tax.

All three options could encourage increased investment in the State and enhance the State's business climate. Allowing the ITC for taxpayers who lease property would provide parity vis-a-vis those who purchase property. This would also help small businesses and high technology firms that have a higher percentage of leased, rather than owned, property. Reducing the corporate franchise tax rate would enhance the attraction of New York to business.

Small Businesses

Policy options targeting small businesses include allowing a refund of unused ITC and subsequent years' employment credit; and extending the EIC to small businesses, such as S corporations, limited liability companies (LLCs), limited liability partnerships (LLPs), and partnerships, whose owners become taxable under the personal income tax.

Extending the ITC refundability would provide small businesses with an immediate infusion of cash. It would ease cash flow problems that often cause many small businesses to fail. Extending the EIC to the personal income tax would ensure that owners of flow through entities receive the same tax benefits as small businesses taxable under the general corporate franchise tax. These entities include S corporations, LLCs, LLPs, and partnerships.

Background

Legislative History of the New York State Investment Tax Credit and Employment Incentive Credit

To stimulate new capital investment, New York enacted legislation effective in 1964 permitting individuals and corporations to claim double depreciation on specified types of facilities.[3] The legislation aimed to accelerate the rate of economic growth in the State and to create new and improved job opportunities through special tax incentives for capital expenditures. The law allowed depreciation deductions up to twice that allowed for federal tax purposes on all new plant, machinery, equipment and other depreciable property located in the State. The statute also allowed a one-year depreciation write-off for the cost of depreciable property used for scientific research and development.

Legislation enacted in 1968 revised these provisions to limit double depreciation to production facilities.[4] The law stipulated that taxpayers must use the property principally in the production of goods. Production included, for example, manufacturing, mining and farming. The law also equalized the advantage of the deduction for firms operating exclusively in New York compared with those engaged in interstate commerce.[5] In addition, it eliminated the deduction for additional depreciation with respect to tangible personal property that the taxpayer leased to someone else. Lessors received unwarranted tax relief because they could claim accelerated depreciation without any requirement that they pass the tax relief or tax savings on to the lessees of the property.[6]

The legislative intent of the ITC sought to encourage modernization of production facilities.

In 1969, the Tax Structure Study Committee comprising representatives of the Division of the Budget, the Department of Commerce and the Department of Taxation and Finance requested the introduction of legislation to create an investment tax credit (ITC). Supporters of the bill professed that, if Congress approved President Nixon's recommendation to remove the federal investment credit, an investment credit provision in New York would take on added significance.[7]

Based on these recommendations, lawmakers adopted legislation in 1969 to create an ITC.[8] They hoped to encourage the modernization of antiquated production facilities and to make New York a more attractive location for manufacturers.[9] The law substituted a simpler and more equitable tax credit for the double depreciation allowance. Proponents

deemed the use of an ITC more desirable than double depreciation for three primary reasons: its simplicity, its direct relation to investment in productive capacity located in New York, and its quick availability of benefits. The tax credit equaled 1 percent of qualified capital investment, including buildings, equipment, and facilities with a useful life of at least four years and used for production. A taxpayer could continue to elect either the investment credit or other State benefits, such as the one-year depreciation write-off for costs of research and development property, for any particular qualified investment.

Table 1 shows the rate history of the ITC beginning in 1969.

Table 1: Investment Tax Credit — History of Tax Rates

The ITC rate and base were most generous from 1982-1986.

Investment Year	Rate and Applicable Investment Tax Credit Base
1969 - 1973	1% Optional one-year depreciation write-off for research and development property Industrial waste treatment and air pollution facilities qualify for elective deductions
1974 - 1977	2% Optional one-year depreciation write-off for research and development property Industrial waste treatment and air pollution facilities qualify for elective deductions
1978	3% Optional one-year depreciation write-off for research and development property Industrial waste treatment and air pollution facilities qualify for elective deductions
1/1/79 - 5/31/81	4% Optional one-year depreciation write-off for research and development property Industrial waste treatment and air pollution control facilities qualify for elective deductions
6/1/81 - 6/30/82	5% 10% rate on research and development property acquired after 6/30/82 Industrial waste treatment and air pollution control facilities qualify for elective deductions
7/1/82 - 1986	6% 10% rate on research and development property Industrial waste treatment and air pollution control facilities qualify for elective deductions
Beginning in 1987, 1988 and 1989	5% of the first $500 million 4% of the amount above $500 million 10% rate on research and development property repealed-- An optional 9% rate on research and development property becomes effective in 1987 as a component of ITC Investments in industrial waste treatment property, air pollution control facilities no longer qualify for elective deductions, but remain eligible for ITC Credit carryforward limited to 7 years
Beginning in 1990	5% of the first $425 million 4% of the amount above $425 million An optional 9% rate on research and development property Credit carryforward remained limited to 7 years

Beginning after 1990	5% of the first $350 million 4% of the amount above $350 million An optional 9% rate on research and development property 1994 law extended credit carryforward from 7 to 10 years

The Business Tax Reform and Rate Reduction Act of 1987 (BTRRRA) significantly changed the ITC and the research and development credit. It retained the ITC for manufacturing firms investing in New York, changing the credit rate from 6 percent with no base limitation, to 5 percent of the first $500 million of investments, plus 4 percent over that amount. The law repealed the 10 percent credit for research and development property and consolidated it into the ITC. It also incorporated investments in industrial waste treatment property and air pollution control facilities under the ITC. Industrial waste treatment property and air pollution control facilities no longer qualified for optional expense deductions.

In many respects, New York's present investment credit conforms to the federal "regular" investment credit, as it existed before its repeal by the federal Tax Reform Act of 1986.[10] General business corporations, subject to Article 9-A of the Tax Law, may claim an ITC for the tax year in which they place the qualified property in service.[11]

Qualified property for the ITC includes buildings and structural components of buildings that:

- are depreciable according to federal law;
- have a useful life of four years or more;
- were acquired by the taxpayer by purchase (the ITC does not apply to property that a taxpayer leases from or to another); and
- are located in New York State.

The qualified property must also meet one of the following requirements:

- the taxpayer must use the property principally in producing goods by manufacturing, processing, assembling, refining, mining, extracting, farming, agriculture, horticulture, floriculture, viticulture or commercial fishing;

- the taxpayer must use the property in its trade or business as an industrial waste treatment facility or air pollution control facility;

- the taxpayer must use the property in research and development; or
- the taxpayer must rehabilitate property used in a retail enterprise.

Taxpayers must recapture ITC previously allowed if, for example, the property was disposed of before the end of its useful life, destroyed, or removed from the State. The recapture does not apply to property used for more than twelve consecutive years. New businesses eligible to claim an ITC may elect to receive a refund of its unused ITC instead of carrying the credit forward. The credit may not reduce the tax due to less than the higher of the alternative minimum tax (AMT) or the fixed dollar minimum. Taxpayers may carry forward an ITC allowed for tax years beginning on or after January 1, 1987, for up to ten tax years.

Legislative History of the Additional ITC and the EIC

Prior to 1987, taxpayers allowed an ITC could also claim the additional investment tax credit based on increases in employment. After 1987, taxpayers allowed an ITC could claim the employment incentive credit (EIC). The EIC also reflected increases in employment. The following description provides the legislative history of both tax credits.

Additional Investment Tax Credit

Chapter 895 of the Laws of 1975 enacted the additional investment tax credit. The legislation provided an employment incentive to taxpayers allowed an ITC on property acquired, constructed, reconstructed or erected on or after January 1, 1976. It applied to each of the three years next succeeding the taxable year in which the taxpayer claimed the ITC. The credit equaled 50 percent of the credit allowed under the ITC. The credit required that the average number of employees during the tax year equal at least 101 percent of the average number of employees (except general executive officers) during the tax year immediately prior to the year in which the taxpayer claimed the ITC. The credit could not reduce the tax payable to less than the fixed dollar minimum. The taxpayer could carry forward any excess credit into the next taxable year.

The BTRRRA sunsetted the credit. The credit does not apply to qualified property acquired on or after December 31, 1986.[12] Taxpayers could not carry the credit over to taxable years commencing on or after January 1, 1994. In 1994, legislation extended the carry over period to 1997.[13]

Employment Incentive Credit

BTRRRA replaced the additional investment tax credit with the employment incentive tax credit.[14] The new credit applies to taxpayers

The EIC has become less generous over time.

allowed an ITC with respect to property acquired, constructed, reconstructed or erected during tax years beginning on or after 1987. Like the original credit enacted in 1975, this credit acts as a link to capital investment in the State. The EIC applies to each of the two years following the taxable year in which the taxpayer claims the ITC. For taxable years beginning in 1987, 1988 or 1989, the EIC rate equaled 2 percent of the first $500 million of the ITC base, with a 2.5 percent rate applying to the ITC base in excess of $500 million. To receive the credit, the taxpayer's average number of employees must exceed 101 percent of the average number of employees (except general executive officers) it employed during the tax year prior to claiming the ITC. The EIC cannot reduce the tax payable to less than the alternative minimum tax or the fixed dollar minimum. Taxpayers could carry forward any excess credit into the next tax year.

Table 2 shows the EIC rate in the ITC base for property placed in service beginning in 1987. A taxpayer allowed an EIC for tax years beginning on or after January 1, 1987, may carry forward the credit up to ten tax years. The law does not impose any recapture provisions for the EIC.

Table 2: Employment Incentive Credit — History of Tax Rates

Year Property is Placed in Service	Average Number of Employees During the Tax Year Expressed as a Percentage of those in the Employment Base Year	Additional Credit as a Percentage of the Investment Credit Base
Tax Years Beginning in 1987, 1988 or 1989	At least 101%	2% of the first $500 million 2.5% in excess of $500 million Credit carryforward limited to 7 years
Tax Years Beginning in 1990	At least 101%, but less than 101.5%	2% of the applicable ITC base
	In excess of 101.5%	2.5% of the applicable ITC base Credit carryforward remained limited to 7 years
Tax Years Beginning After 1990	At least 101%, but less than 102%	1.5% of the applicable ITC base
	At least 102%, but less than 103%	2% of the applicable ITC base
	At least 103%	2.5% of the applicable ITC base 1994 law extended credit carryforward from 7 to 10 years

Beginning in 1968, taxpayers could claim a credit against tax liability for

Eligible Business Facility Credit

eligible business facilities in depressed urban areas. The credit sought to encourage the retention and expansion of business and job opportunities in depressed urban areas. The law established the Job Incentive Board to administer the plan. To qualify, the facility had to be in a designated area of a city having a population of 125,000 or more that served a larger area; retain or create at least five jobs in the area; and operate an approved training program. The calculation of the credit depended on the amount of eligible property and the wages of the taxpayer.

The law changed in 1971 to expand the credit to eligible business facilities in low-income rural counties. The law required the location of the designated area in a city have a population of 50,000 or more; or in a rural county in which the per capita income was 25 percent or more below the statewide average.

The qualifications for the eligible business facilities credit changed in 1983. The law generally required the taxpayer to have a certificate of eligibility prior to April 1, 1983. After this time, the law denied all initial credits. The law stipulated that taxpayers could use the credit in subsequent years through tax years beginning before January 1, 2000.

Credit for Rehabilitation Expenditures of a Retail Enterprise

Legislation enacted in 1981 established a credit for certain retail enterprises that invested in a qualified rehabilitated building.[15] The credit applied to retail enterprises not eligible to claim the ITC. The law required that the rehabilitated building be located in New York State. The credit only applied to that portion of the property employed in retail activity. The amount of the credit equaled the rehabilitation expenditures calculated by the ITC tax rates and bases.

The law generally remains unchanged since 1981. Recapture provisions applicable to the ITC also apply to property allowed under the rehabilitation credit.

The Investment Tax Credit for Taxpayers Subject to the Personal Income Tax

Taxpayers subject to the personal income tax, such as shareholders of S corporations, members of limited liability companies (LLCs) and limited liability partnerships (LLPs), and partners of partnerships, may claim an ITC for 4 percent of the cost of tangible property depreciable under federal law. The criteria mirrors that under the ITC for corporate taxpayers. The same types of property uses qualify for the credit.

The credit for research and development property equals 7 percent for personal income taxpayers, rather than the 9 percent allowed for corporate taxpayers. The credit for rehabilitation expenditures of a retail enterprise also applies to taxpayers subject to the personal income tax.

Personal income taxpayers cannot claim the EIC. This credit applies only to taxpayers subject to Article 9-A.

Like corporate taxpayers, personal income taxpayers may carry forward these credits for ten years. In the case of a new business, the taxpayer may receive the credit as a refund.[16]

Legislative History of the New York State Alternative Minimum Tax

The AMT has undergone significant changes since 1987.

The AMT has undergone substantial changes since its enactment in 1987. Rates, enacted in 1987 for future years (1988 and 1989), were amended before even becoming effective. The following discussion traces the legislative history of the AMT.

The BTRRRA created an AMT for corporations as a separate taxable income base.[17] The original intent of the AMT sought to ensure that all corporations with income pay a minimum percentage of income in tax, regardless of their allowable use of credits, preferences, deductions and exclusions.

The AMT operates as a system parallel to the regular tax on entire net income (ENI). Taxpayers calculate tax liabilities under the regular tax, the capital tax and the AMT and pay the greater of the three. One essential element in the workings of the minimum tax is a limitation on the use of tax credits, such as the ITC. Taxpayers cannot employ credits to reduce liability below the tax computed under the minimum tax base or the fixed dollar minimum base. The AMT effectively limits credit usage to 2/3 of tax liability.

The Business Tax Reform and Rate Reduction Act of 1987

The BTRRRA established two minimum taxable bases pre- and post-1990. For taxable years beginning in 1987, 1988, and 1989, the tax was scheduled to equal 3.5 percent of the pre-1990 minimum taxable income base.[18] The computation of AMT used the basic three-factor formula of property, payroll and receipts. However, the receipts factor was only considered once, rather than double weighted as in the regular (ENI) tax computation. Taxpayers could apply net operating loss deductions (NOLDs) in computing minimum taxable income.

For tax years beginning on and after 1990, BTRRRA dropped the tax rate to 3 percent of the taxpayer's minimum taxable base.[19] The law replaced the pre-1990 base with a more complex AMT calculation. The State AMT base more closely paralleled the federal model. The 1990 minimum tax required extensive modifications to ENI in order to calculate the minimum taxable income base. The modifications involved many of the adjustments and tax preferences under sections 56 through 58 of the Internal Revenue Code, such as the depreciation adjustment, and disallowance of passive activity losses.[20] As under the previous calculation, taxpayers could not use tax credits (except the minimum tax credit) against the AMT. In addition, taxpayers could not use NOL carryovers and carrybacks to reduce minimum taxable income. The business allocation percentage formula required single weighting of the receipts factor. If the tax on the ENI base or capital base before credits exceeded the minimum tax, taxpayers could apply credits to reduce the tax to the level of the minimum tax. Taxpayers could carry forward the balance of unused credits depending on the nature of the credit. Some could not be carried forward, some for seven years and others with no limitation.

Chapter 61 of the Laws of 1989

In 1989, prior to the 1987 BTRRRA tax law changes taking effect for 1989 and subsequent years, the law increased the AMT rate from 3.5 percent to 5 percent of the taxpayer's pre-1990 minimum taxable income base. The 5 percent rate effectively limited credits to slightly less than 50 percent of tax liability. The law also stipulated that, for taxable years beginning in 1990, the 5 percent rate applied to the taxpayer's minimum taxable income base. The rate was scheduled to drop to 4.5 percent in 1991 and to 3.5 percent for taxable years beginning after 1991.

Chapter 166 of the Laws of 1991, Chapter 55 of the Laws of 1992, Chapter 57 of the Laws of 1993

Lawmakers changed the provisions of the AMT again in 1991 and 1992.[21] For taxable years beginning in 1990 through 1994 the AMT rate equaled 5 percent. For taxable years beginning after 1994, the rate equals 3.5 percent of the taxpayer's minimum taxable income base.[22] This rate represents present law.

Chapter 170 of the Laws of 1994

Legislation enacted in 1994 allows taxpayers the prospective use of a NOLD in computing alternative minimum taxable income.[23] The deduction comprises all NOLs existing at the beginning of the 1994 tax year and any accumulated after that. The law also provides that firms that paid additional AMT tax during the 1990 through 1993 period, because of disallowed NOLs, will receive credit against future regular (ENI based)

tax liability. Taxpayers may calculate this part of the AMT credit retroactively for taxable years after 1989 and apply it annually in the first five years (1994-1998). The taxpayer may carryforward indefinitely any amount not used within this five year period. A third statutory change allows the double weighting of receipts in the AMT formula used to allocate business income to New York. This change results in lower tax bills for corporations that have a large number of plants and jobs in New York while selling throughout the nation.

Appendix A provides highlights of significant corporate franchise tax law changes (1984-1995).

Tax Incentives of Other States

States have a long history of using tax incentives, direct expenditures, property tax exemptions, regulations and public relations to encourage economic development within their borders. Besides capital formation incentives, many states also provide tax credits for qualified research and development property. Thirty-five of the forty-five states with a corporate income tax allow ITCs.[24] States may target these credits to investment in an enterprise zone, or to the construction of a specific facility. For example, Arizona allows an income tax credit to corporate taxpayers for the construction of an environmental technology facility. Iowa's ITC depends on investments made within a "quality jobs enterprise zone." Some states, such as Massachusetts and California, also allow ITCs for leased, rather than purchased, property. Generally, New York allows the ITC for purchased property only.[25] Twenty-two states, including New York, offer credit for research and development property.

States offer a variety of tax incentives.

Generally, these incentives encompass four categories:

- broad-based tax incentives such as credits, exemptions and deductions for qualified property;
- targeted tax incentives, such as incentives aimed at attracting particular industrial ventures (prominent past examples include the Saturn and Mercedes-Benz plants);
- selectively applied tax incentives, including property and utility tax abatements; and
- non-tax related incentives, including direct financial-assistance programs and special business-support training programs.

Over the past 15 years, various states have offered a number of high profile economic incentive packages to certain companies. These incentives differ from those offered for less lucrative plant locations. Often, the state's highest government officials publicly promote and negotiate targeted tax incentives. Governors, lawmakers and economic development officials play a key role in shaping the final package. Businesses engage in bargaining with states and encourage competition among states for the best package of incentives.

Appendix B provides more detail on each state's 1995 investment tax credits, research and development credits and corporate tax rates.

Surveys of Site Location Consultants and Corporate Tax Managers on the New York State Investment Tax Credit

The Office of Tax Policy Analysis (OTPA) conducted two separate confidential surveys to determine the influence of the ITC, including the research and development component, and the EIC on corporate investment and expansion in New York. OTPA developed the surveys to answer questions raised by legislators during Commissioner Urbach's testimony on the 1995 Tax Expenditure Report. The surveys, one to corporate tax managers and the other to major site consultants, attempted to capture the different perspectives and areas of expertise of each professional group. They sought to answer a number of questions such as: Does the credit really work? Is it worth the cost? Would other policy changes do more to spur investment? The surveys generate insight into New York's business tax incentive programs and provide a policy tool for lawmakers. Appendix C contains copies of each survey and a detailed statistical analysis.

Site Consultant Survey

OTPA's survey to major site location consultants focused on their national and international experience in assisting taxpayers in making investment and business location decisions. It comprised 19 participants, including large accounting firms. Generally, small companies rely on outside accounting firms and advisors, while large companies use in-house tax managers and financial advisors for tax advice. The survey response rate neared 60 percent. Most of the responding consultants advised manufacturing firms. A significant majority found the ITC influential in their advice to clients to expand in New York. The site consultants found that, despite New York's ITC, companies expanded in other states primarily because of lower overall tax burdens. The majority found labor costs, skilled labor, proximity to labor and proximity to

market as very important factors in advising clients on locational decisions.

Corporate Tax Manager Survey

The corporate tax manager survey participants included large and small manufacturers, nonmanufacturers, those who claimed the ITC and those who did not. The sample also included some taxpayers earning the research and development credit who were not manufacturers. Of the 160 firms in the initial sample, 150 agreed to participate. A total of 77 corporate managers responded to the survey, exceeding a 50 percent return rate.

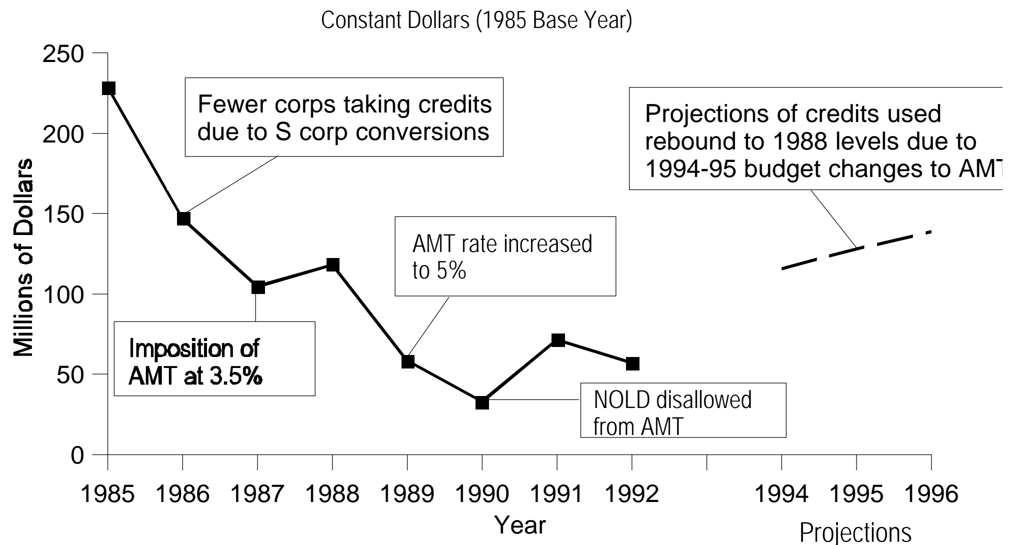
The majority of companies responding to the survey originated in New York (rather than relocating or expanding into New York from another state or country) and claimed the ITC. A number of taxpayers did not know New York allows an ITC and EIC. In addition, a significant number did not realize that new businesses could take a refund of unused ITC, rather than carry the credit forward to use against future tax liability. Thirty-seven percent believed the ITC affected the company's decision to invest. The majority ranked energy costs, labor costs, skilled labor, state and local taxes, and tax incentives/exemptions as very important.

Of all the factors to consider in expanding a business, labor costs emerged as the most important. A recent paper by a leading economist found that businesses in high tax states must compensate for taxes by paying higher wages, particularly for higher paying skilled jobs. The report pointed out that, by increasing the cost of hiring skilled workers, high marginal tax rates increase the cost of doing business.[26]

Findings

Analysis Reflecting Significant Changes in the Tax Law

Figure 1: Credits Used Over Time and Effects of Significant Tax Law Changes



The alternative minimum tax has thwarted the original intent of the ITC.

Figure 1 shows the effect of the declining use of investment tax credits (ITCs) in constant dollars[27] as changes in the tax law became effective. Changes in the tax law, especially the imposition of the alternative minimum tax (AMT) in 1987, have significantly curtailed the use of the ITC and thwarted its original intent. The most severe declines appear upon the imposition of the AMT in 1987, and in 1989 when the AMT rate increased from 3.5 percent to 5 percent. Taxpayers paying under the AMT cannot use tax credits, such as the ITC, against AMT income. Beginning in 1987, the law also limited the ITC credit carryforward to 7 years.

In 1990, two significant events occurred which also affected credits used. The law reduced the ITC threshold from 5 percent of the first $500 million of qualifying investment and 4 percent on amounts above $500 million, to 5 percent of the first $425 million of qualifying investment and 4 percent on amounts above $425 million. The law also disallowed net operating loss deductions (NOLDs) under the AMT. Requiring taxpayers to add back their NOLDs when calculating the AMT base increased

taxable income. As a result, more taxpayers paid under the AMT base limiting the use of credits.

In addition to the tax law changes, the State economy experienced a widespread recession in 1990, affecting most industries. The effect of disallowing NOLDs became somewhat diminished. Taxpayers did not have the profits during the 1990 recession to offset losses. The effect, therefore, of disallowing NOLDs did not become apparent until later years when companies began to increase profits. By 1992, this effect became more pronounced on credit usage.

Tax law changes to the AMT in 1994 and 1995 will begin to offset the negative impacts. These changes include lowering the AMT rate, allowing previously disallowed NOLDs, providing a credit against future entire net income liability and changing the AMT formula to double weight the receipts factor. In 1994, the law also extended the credit carryforward limit from 7 to 10 years. Projections in Figure 1 indicate that the amount of ITC used as a result of these tax law changes will rebound beginning in 1994 to 1988 levels.

Figure 2: ITC: Credits Earned, Used, Claimed and Carried Forward Over Time

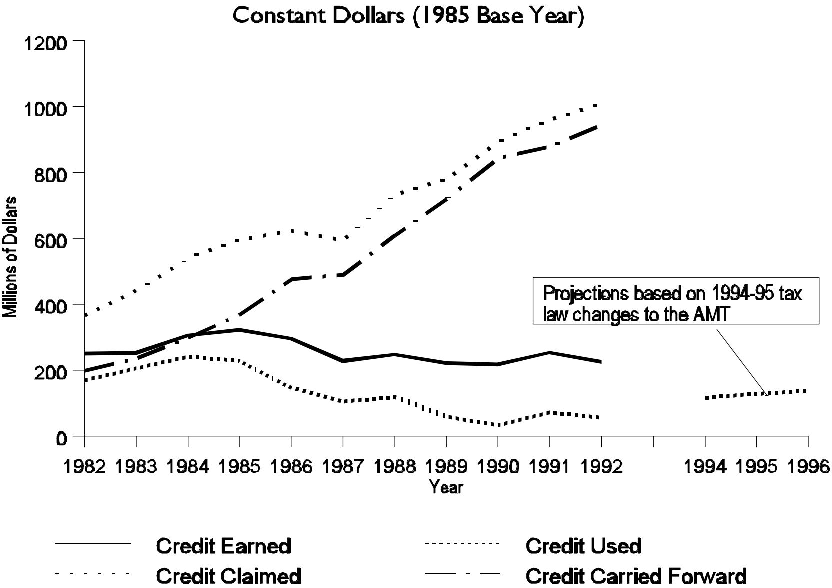


Figure 2 shows the amount of ITC used has declined over time.[28] This is primarily due to the imposition of the AMT in 1987 and subsequent tax

law changes affecting both the AMT and the ITC. By 1992, the difference between credit used and credit carried forward had become dramatic. This contrasts sharply against 1982 when the difference in these amounts was slight. The data illustrate that, in recent years, most taxpayers cannot use a substantial portion of their credits and, therefore, must carry such credits forward into the next tax year. Tax law changes made to the AMT in 1994 and 1995 will positively affect the amount of ITC used by taxpayers. Figure 2 illustrates these projected positive benefits as the amount of ITC used begins to mirror 1988 levels.

The data in Figure 2 appear to show that the amount of ITC earned has not changed significantly since 1987. However, a number of factors make this lack of change troublesome. First, data before 1987 understates investment because it excludes research and development property, air pollution control facilities, rehabilitation property and industrial waste treatment facilities. Post 1987 data includes these investments. Second, when contrasted against other states and the U.S. average for manufacturing capital expenditures during this period, New York's actual level of investment activity is unimpressive. New York's percent change in manufacturing capital expenditures between 1982-1987 equaled 0.4 percent, versus the U.S. average of nearly 6 percent. During 1987-1992, New York's performance became more troubling. The U.S. average climbed to nearly 32 percent, while New York's expenditures declined to 0.3 percent. (See figures 11 and 12, pages 34 and 35 for a more detailed description of manufacturing shipments and expenditure data.) Third, the number of taxpayers earning the ITC has fallen dramatically since 1984. Figure 3 illustrates the decline in the number of taxpayers.

Figure 3: Total Number of Taxpayers Over Time by ITC Earned

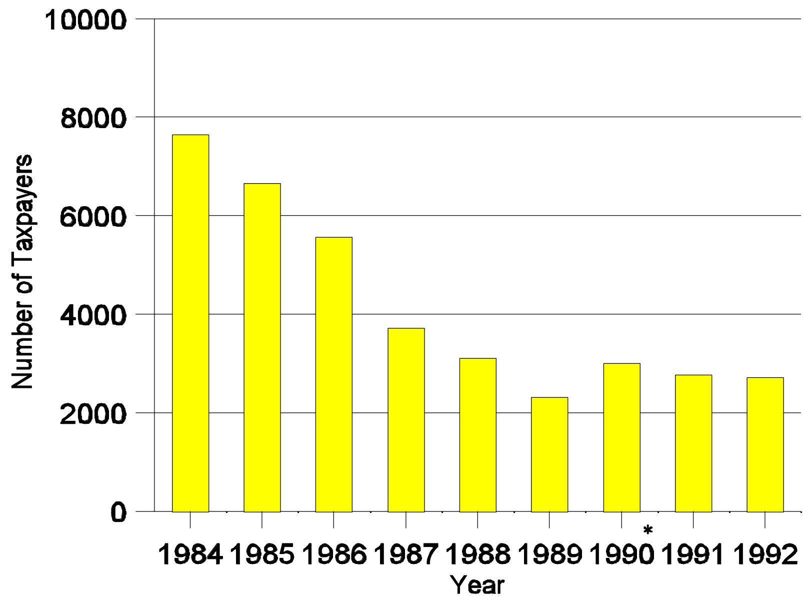
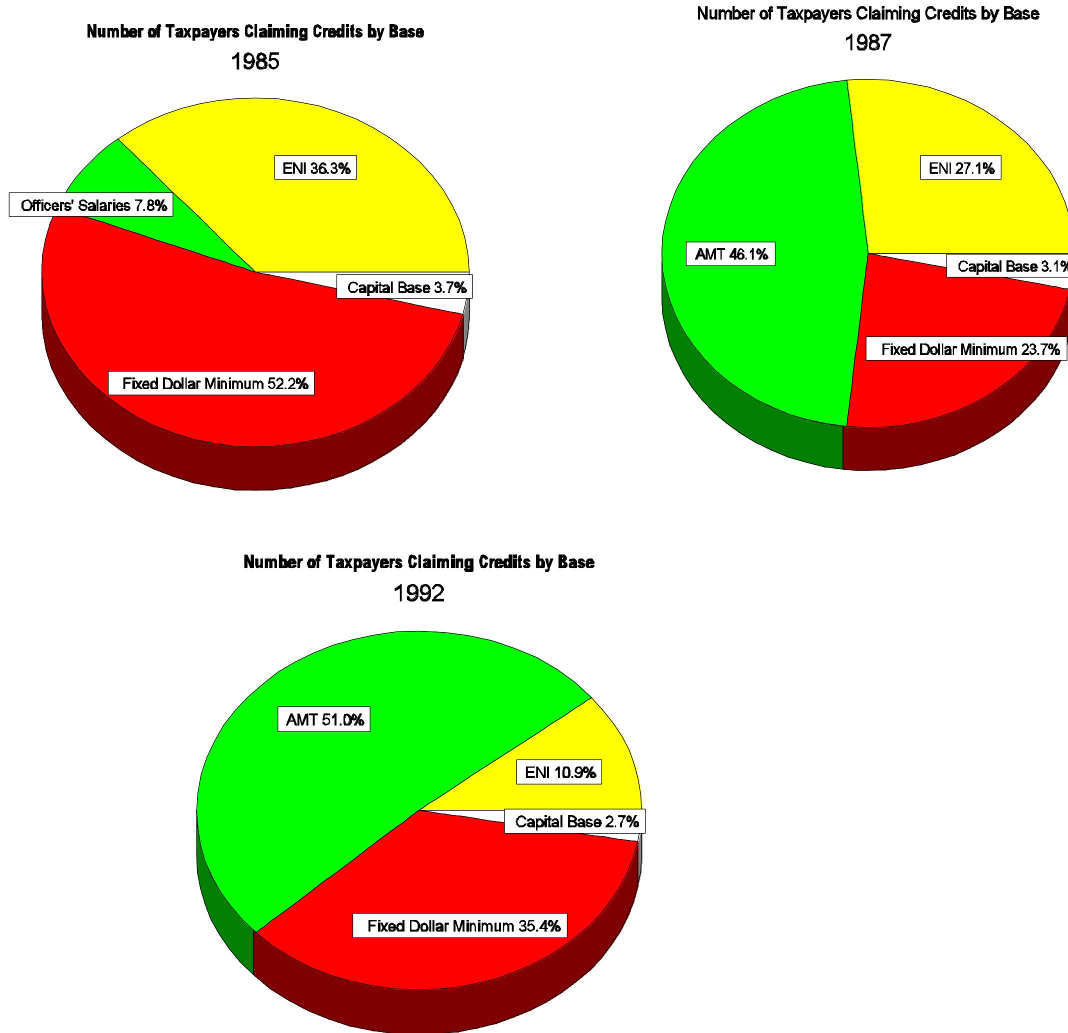


Figure 4 illustrates the tax base paid by taxpayers who claimed credits. The data demonstrate the significance that tax law changes play in each corporate tax base.

In 1985, most taxpayers with credits paid the fixed dollar minimum.[29] The law had not yet imposed the AMT. Entire net income (ENI) generated the second largest base. This changed significantly in 1987 on imposition of the AMT. In this year, the majority of taxpayers claiming credits paid under the AMT. Slightly greater than 23 percent paid the fixed dollar minimum. By 1992, the majority of taxpayers claiming credits continued to pay under the AMT. The number of taxpayers paying under the ENI base fell from 36.3 percent in 1985 to 10.9 percent in 1992.

Figure 4: Distribution of Taxpayers Claiming Credits by Base for Select Years



How the AMT Limits Credit Usage

Table 3 illustrates how the AMT limits credit usage. A taxpayer paying under the ENI base can use tax credits to reduce its tax to the higher of the fixed dollar minimum or the AMT. In this example, the taxpayer reduces its ENI base by using tax credits to the AMT base. The AMT limits the amount of credit the taxpayer can use to effectively 60 percent of ENI tax liability before credits.

Table 3: Credit Limitation Under the AMT Base

Factors	Corporation A Calculation Under ENI Base	Corporation A Calculation When Shifted To AMT Base
Taxable Income	$10,000	$10,000
Tax Rate	9%	3.5%
Tax Liability Before Credits	$ 900	$ 350
Credits Available	$ 900	$ 900
Credits Used	$ 550	$ 0
Tax After Credits	$ 350*	$ 350

*Taxpayer shifts to AMT base, which is higher than fixed dollar minimum base ($325)

Figure 5 shows how the amount of ITC carried forward over time has changed by base. Prior to the imposition of the AMT in 1987, the fixed dollar minimum represented the highest base under which taxpayers carried forward ITC. This changed in 1987 due to the AMT. In this year and thereafter, two events happened. First, taxpayers began carrying forward tax credits under the AMT base, rather than under the fixed dollar minimum base. Second, the total amount of credits carried forward also began to increase beginning in 1987. During recession years, companies have negative income which brings them under the fixed dollar minimum base. By 1992, the amount of ITC carried forward under the AMT base increased dramatically from prior levels. (The chart does not reflect ITC carried forward under ENI or the capital base because these taxpayers have switched to other bases through the use of credits.)

Figure 5: ITC: Credits Carried Forward Over Time by Base

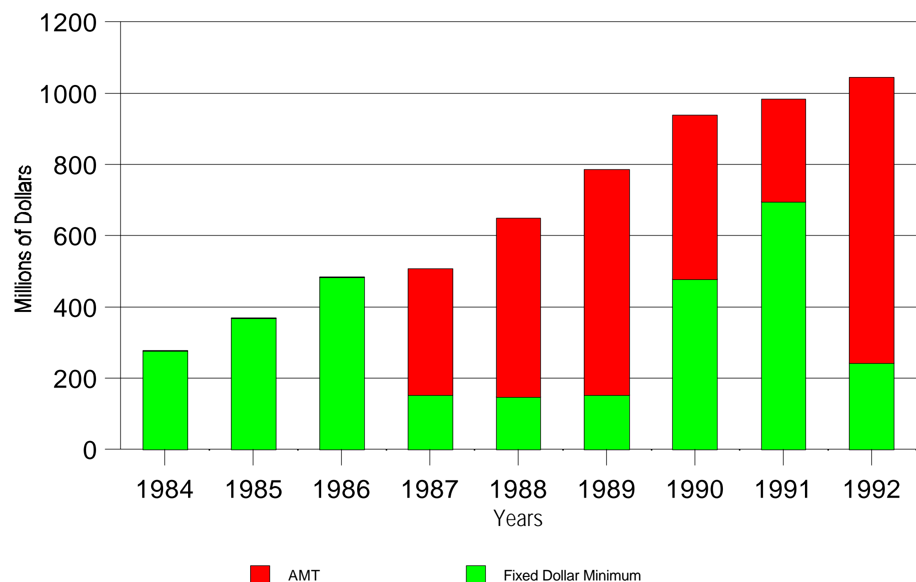


Figure 6 illustrates the declining number of taxpayers using ITCs over time. In 1982, the number of corporations using ITCs totaled over 8,000. By 1987, the number of corporations had dropped to nearly half, to 4,295. This downward trend continued until 1992 when the number of corporations using the ITC began to rebound slightly.

Figure 6: Total Number of Taxpayers Over Time by ITC Used

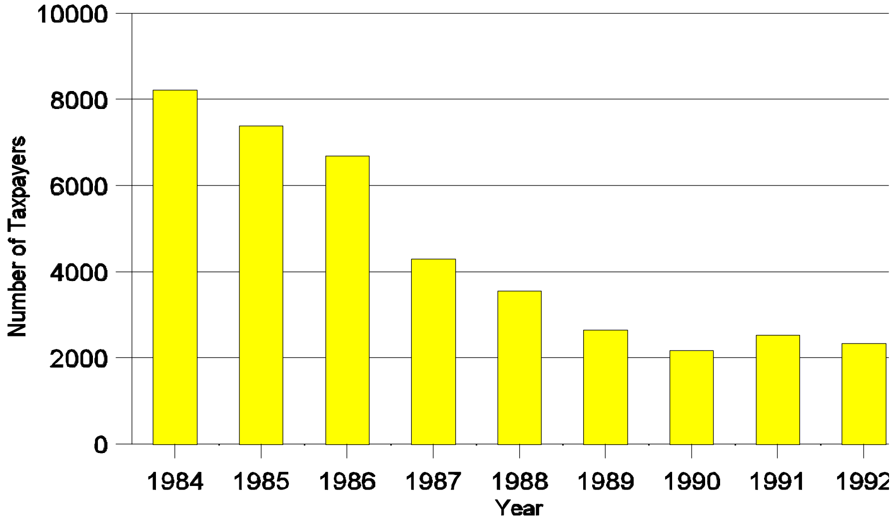


Table 4 illustrates the amount of ITC earned categorized by major industry group in 1992.[30] Not surprisingly, credits earned by the manufacturing industry clearly exceeds all other industries, accounting for over 89 percent of the total.

Table 4: Profile of New York State Investment Tax Credit By Major Industry Group -- Credit Earned

Major Industry Group	Number of Taxpayers	Amount of Credit Earned	% of Credit Earned	Mean Credit Earned	Median Credit Earned
Unidentifiable	100	$ 6,174,906	2.47	$ 61,749	$ 2,535
Agriculture	172	815,898	0.33	4,744	2,041
Mining	48	3,231,748	1.30	67,328	8,470
Construction	48	234,037	0.09	4,876	943
Manufacturing	1,903	222,890,129	89.33	117,126	5,027
Trans., Comm., Pub. Utilities Services	18	2,496,169	1.00	138,676	14,606
Wholesale Trade	144	1,688,235	0.68	11,724	2,507
Retail Trade	65	1,512,688	0.61	23,272	1,050
Finance, Insurance and Real Estate	51	6,255,647	2.51	122,660	6,250
Services	165	4,203,864	1.68	25,478	2,147
Total	2,714	$249,503,321	100.00	$ 91,932	$ 3,940

Table 5 profiles the ITC by size of ENI in 1992. Taxpayers with ENI totaling $500 million and above earned the greatest percentage of ITC, equaling over 40 percent. The average credit earned by these taxpayers equaled $16.8 million. This represents 6 corporations from a total of 2,714. Those with ENI between $500,000 and $999,999 represent the smallest percentage of total credit earned. The average credit earned by these taxpayers equaled $17,516. The greatest number of taxpayers who earned the ITC, totaling 947, had either no income or a net loss. The average credit earned by these taxpayers equaled $50,747.

Table 5: Profile of New York State Investment Tax Credit By Size of Entire Net Income -- Credit Earned

Size of Entire Net Income	Number of Taxpayers	Amount of Credit Earned	% of Credit Earned	Mean Credit Earned	Median Credit Earned
Zero or Net Loss	947	$ 48,057,480	19.26	$ 50,747	$ 3,024
$ 1 - $ 99,999	792	5,533,331	2.22	6,987	1,743
$ 100,000 - $ 499,999	393	5,163,331	2.07	13,138	4,628
$ 500,000 - $ 999,999	139	2,434,729	0.98	17,516	7,778
$ 1,000,000 - $ 24,999,999	336	27,857,018	11.16	82,908	27,753
$ 25,000,000 - $ 49,999,999	34	5,959,742	2.39	175,287	90,797
$ 50,000,000 - $ 99,999,999	28	11,355,043	4.55	405,537	108,619
$100,000,000 - $499,999,999	39	42,256,616	16.94	1,083,503	250,364
$500,000,000 and Over	6	100,886,031	40.43	16,814,339	1,640,032

Total	2,714	$249,503,321	100.00	$ 91,932	$ 3,940

Figure 7 shows total earned income credit (EIC) and ITC earned over time. The ITC data exclude research and development property at the optional 9 percent rate because taxpayers cannot take this and the EIC together. The EIC data reflect a one-year lag to more realistically illustrate how taxpayers earn these credits. The total EIC earned by taxpayers does not closely reflect ITC earned. From 1982-1985, EIC earned increased significantly, while ITC earned increased slightly from 1983-1984, but then leveled off from 1984-1986. Beginning in 1987, both credits declined. In 1988, ITC earned increased significantly, while EIC earned decreased significantly. The downward trend in EIC earned has continued since 1988. ITC earned has continued to increase since 1990.

Figure 7: ITC and EIC: Total Credits Earned Over Time

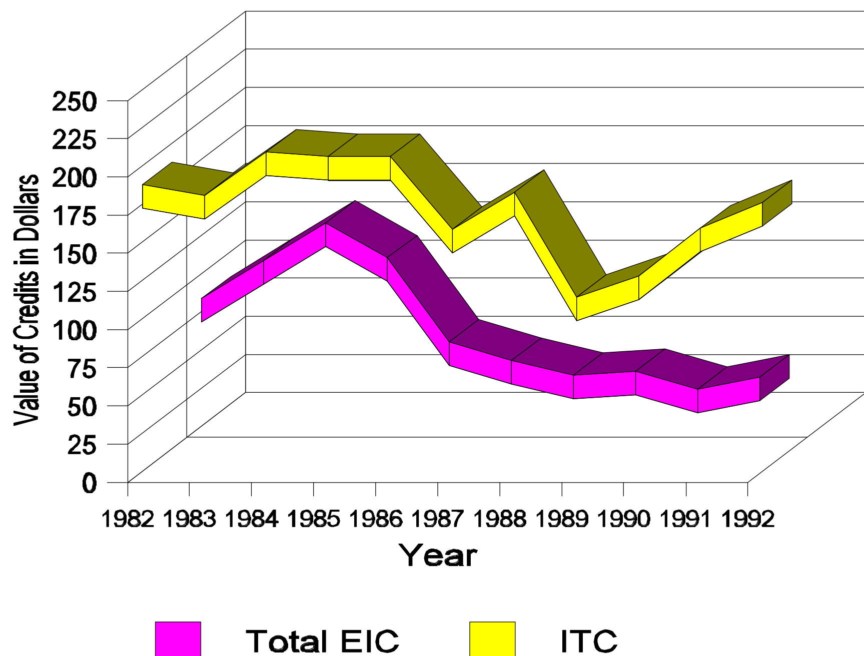


Table 6 profiles the ITC by size of assets in 1992. The table shows that corporations with assets over $1 billion had the greatest amount of ITC earned, totaling $157.4 million. The number of corporations in this category equaled 87 from a total population of 2,714. The largest number of taxpayers, 1,023, or nearly 40 percent, had assets ranging from

$1 million to $10 million. The total ITC earned by taxpayers in this category equaled $13.7 million in 1992.

Table 6: Profile of New York State Investment Tax Credit By Size of Assets -- Credit Earned

Size of Assets	Number of Corporations	Amount ($)
Zero or Not Reported	24	1,711,318
$ 1 - $ 100,000	97	3,856,807
$ 100,000 - $ 250,000	160	207,393
$ 250,000 - $ 500,000	305	701,297
$ 500,000 - $ 1,000,000	387	1,475,416
$ 1,000,000 - $ 10,000,000	1023	13,699,083
$ 10,000,000 - $ 50,000,000	359	21,327,590
$ 50,000,000 - $ 100,000,000	86	11,805,634
$100,000,000 - $ 200,000,000	76	7,296,146
$200,000,000 - $ 500,000,000	66	13,157,318
$500,000,000 - $1,000,000,000	44	16,855,733
Over $1,100,000,000	87	157,409,586
Total	2,714	249,503,321

How the ITC Affects the Rate of Return on Capital Investment

Table 7 provides a simplified, hypothetical example to illustrate how the ITC acts as a capital formation incentive to increase the rate of return on a capital investment.

The rate of return on an investment may be expressed as its yield relative to its cost. The rate of return will depend on a number of different factors, such as the rate of profit expected, the amount of equity invested, and the interest rate at which the company borrows money. The ITC, however, does serve to enhance the rate of return on the investment. This benefit may be a significant consideration in a company's decision to expand or locate a business in New York.

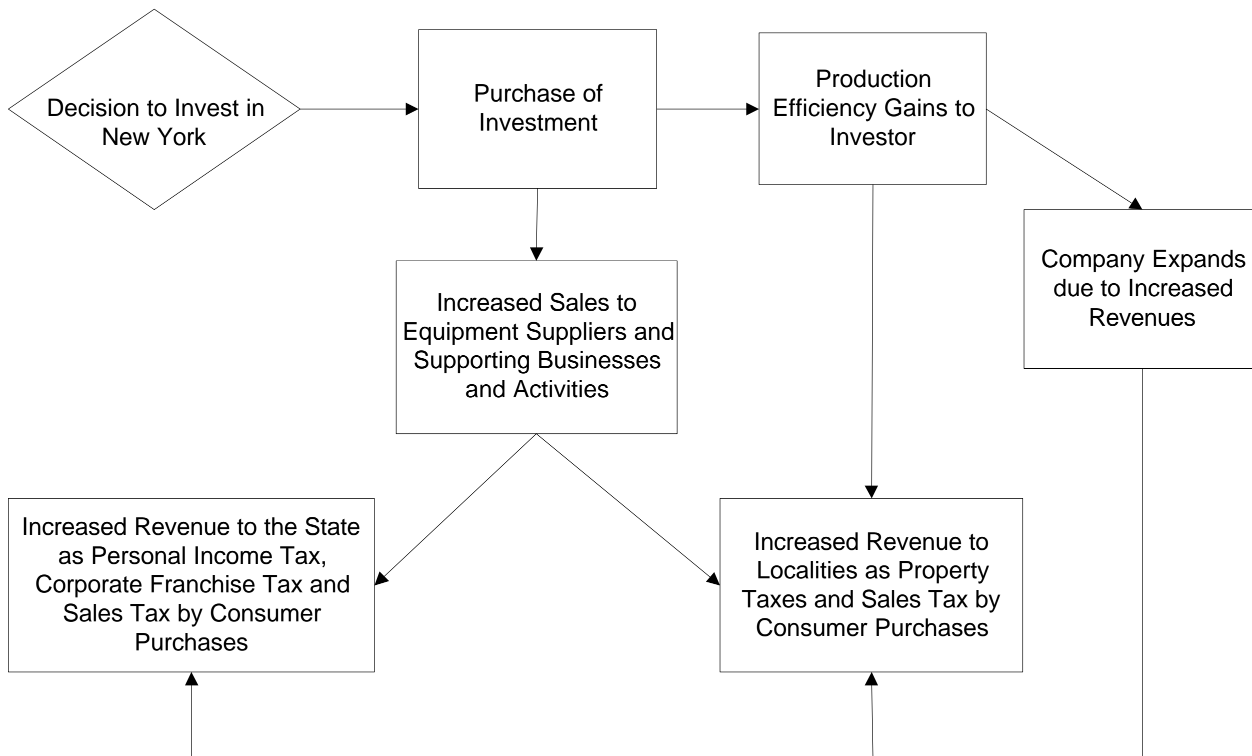
Table 7: Rate of Return on a Capital Investment with and without the Investment Tax Credit

Cost of Plant	$1,000,000
Gross Profit Rate	20%
First Year Profits	$200,000
Percent Borrowed	80%
Equity Invested	$200,000
Interest Rate	10%
Borrowing Costs	$80,000
Net Profit (after interest payments)	$120,000
Return on Equity, year one (without the ITC)	**60%**
ITC benefit, year one	$25,000
Return on equity, year one (with the ITC)	**73%**

In this example, the ITC directly increases the first-year rate of return on equity by 22 percent. Without the ITC, the taxpayer's rate of return equaled 60 percent. New York's ITC provides an enhanced benefit, by increasing the rate of return on the investment to 73 percent. In this example, the taxpayer can only utilize 50 percent, or $25,000, of its earned ITC. If the taxpayer utilized 100 percent of its ITC, or $50,000, the first-year return on equity would have risen by 42 percent to 85 percent.

In addition to enhancing the State's business economy, the growth of a New York company has positive effects on other sectors of the economy. Expansion of a new plant generates additional property and sales taxes for local governments. An increase in high-paying manufacturing jobs also contributes to the State's personal income tax and sales tax revenues. Figure 8 illustrates the multiplier effect of an expanding business.

Figure 8: Indirect Benefits of Capital Investment on the State and Local Economies



Other Factors that Influence the Effectiveness of the ITC

Table 8 contrasts numeric examples to illustrate how capital investment in New York changes the property allocation factor, depending on the company's initial presence in the State. A number of considerations may influence changes in the property factor of the business allocation percentage (BAP). These include, for example, the size of the investment relative to the size of the firm, and whether the property is new property for an expansion or replacement of existing property. New property would increase the property factor. Replacement of existing property would have a smaller effect on the property factor. New investment generally results in increased profit, thereby affecting tax liability. The key consideration in an investment decision becomes the overall place to locate or expand. An increase in the company's BAP in New York generally means a decrease in other states, with the exceptions of states without corporate franchise/income taxes or states that use a single receipts factor. If the taxpayer makes an investment outside New York,

its tax would potentially increase in that jurisdiction and decrease in New York. The impact of the investment on a taxpayer's total state tax liability cannot be determined. It depends on the taxpayer's presence in the other states and those states' tax structures. A number of corporate tax comparison studies, including 1989 Corporate Tax Climate: A Comparison of Nineteen States, issued by the Wisconsin Department of Revenue, have found New York's effective corporate tax rate lower than California's and Ohio's rates.

Table 8: Impacts of Existing Conditions and Allocation Factors that Impact the Effectiveness of the ITC

	Example I -- Existing New York firm		Example II -- Existing firm with small presence in New York	
	Existing Conditions ($)	Conditions after Investment ($)	Existing Conditions ($)	Conditions after Investment ($)
Entire Net Income	50,000	150,000	50,000	150,000
Receipts Everywhere	160,000	160,000	160,000	160,000
Receipts NY	24,000	24,000	24,000	24,000
Property Everywhere	5,000,000	6,000,000	5,000,000	6,000,000
Property NY	5,000,000	6,000,000	5,000	1,005,000
Payroll Everywhere	10,000	10,000	10,000	10,000
Payroll NY	10,000	10,000	500	500
Receipts Allocation	15.0%	15.0%	15.0%	15.0%
Property Allocation	100.0%	100.0%	0.1%	16.8%
Payroll Allocation	100.0%	100.0%	5.0%	5.0%
BAP	57.5%	57.5%	8.8%	12.9%
ENI Tax	2,588	7,763	395	1,747
AMT Tax	1,006	3,019	154	679
Fixed Dollar Minimum	325	325	325	325
Capital Tax	18	18	1	1
ITC Credit Earned	0	50,000	0	50,000
ITC Credit Carried forward from Prior Years	500	0	0	0
Total ITC Available	500	50,000	0	50,000
Tax Before Credits	2,588	7,763	395	1,747
Tax After Credits	2,088	3,019	395	679
ITC Credit Used	500	4,744	0	1,067
ITC Carried to Future Years	0	45,256	0	48,933
Investment	1,000,000			
Additional Income	100,000			

Example 1

This example shows an existing New York firm with a significant physical and employment presence in New York. The firm makes a $1 million investment in New York that fully qualifies for the ITC. The investment

For an existing New York firm with a significant presence in New York, capital investment in the State does not affect the property factor of the BAP.

results in the firm earning a $50,000 ITC and $100,000 in additional income in the first year after the investment. The company's property and payroll factors were 100 percent New York. In this example, because the company's property and payroll remained in New York, the investment did not affect these factors. If the company's location changed, and it invested in plant and equipment out of state, this would decrease the New York BAP. The additional income generated by the investment increased the company's income and, therefore, its tax liability. Without the ITC, the company would have paid $7,763 in taxes under the ENI base. With the ITC, the company can reduce its tax liability. After using $4,744 in ITC, it now becomes subject to the AMT base. The company pays $3,019 in total taxes in the year after the investment. This represents a 44 percent increase in tax liability over the prior year. If the taxpayer decided on the same investment without the benefit of the ITC (for either year), its tax liability would have increased nearly 200 percent.

Example 2

Example 2 illustrates that, for an existing New York firm with a small property presence in New York, capital investment in the State affects the property factor component of the BAP.

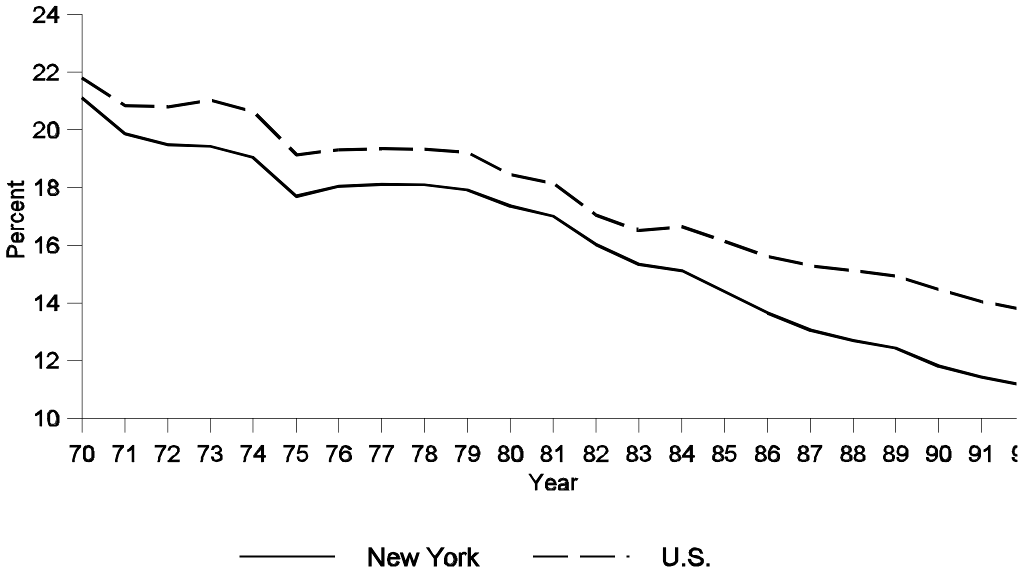
This example shows an existing New York firm with a small presence in New York. This company makes the same investment as the firm in Example 1. The investment results in the firm earning a $50,000 ITC and $100,000 in additional income in the first year after the investment. In the previous example, the additional investment did not affect the firm's property factor in the BAP because the company already had a 100 percent presence in the State. In this example, the company has a small presence in the State. Its property factor equals 0.1 percent prior to the investment. After the firm makes the investment, its property factor increases to 16.8 percent, affecting its BAP. After the investment, the company's ENI tax increases from $395 to $1,747. The company reduces its tax liability to the AMT base by using $1,067 in ITC against tax liability. The company pays $679 in total taxes in the year after the investment. This represents a 72 percent increase in tax liability over the prior year, taking into consideration the use of the ITC. If the taxpayer decided on the same investment, without the benefit of the ITC (for either year), its tax liability would have increased over 300 percent.

Manufacturing Employment

Figure 9 shows that, like the nation's, New York's manufacturing employment, as a share of total employment, has steadily declined over the past two decades. (The U.S. employment shares exclude New York.) However, the magnitude of the decline in New York has exceeded that of the nation as a whole. New York's share of manufacturing employment exceeded 20 percent in 1970. Two decades later, by 1992, this share had

declined to 11 percent. The nation's share in 1970 neared 22 percent, while by 1992, this share had dropped to slightly less than 14 percent.

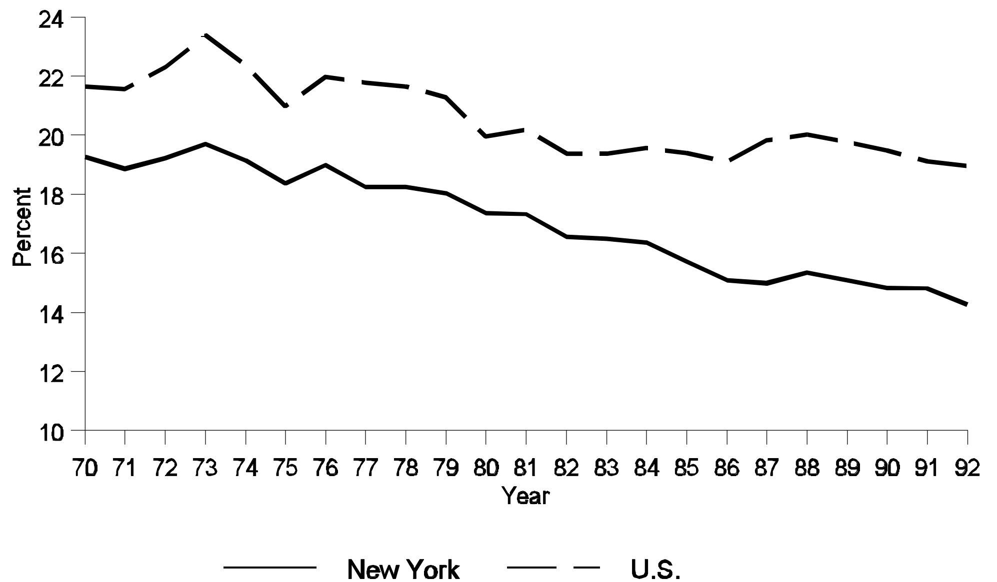
Figure 9: Manufacturing Employment as a Share of Total Employment -- New York versus U.S. 1970 - 1992



The decline in manufacturing employment reflects technological changes in industry. Labor-saving technology, such as robotics, common in the automobile, appliance, and primary and fabricated metals industries, has negatively affected manufacturing employment. The decline also mirrors New York's structural shift from a manufacturing to a service-based economy. Data from 1960 -1992 show that employment in the combined finance, insurance and real estate and services sectors has increased, with New York's share of employment in these sectors increasing at a faster rate than that of the entire United States.

Figure 10 illustrates that, during the 1970's, New York's trend in manufacturing gross state product (GSP) as a share of total GSP closely tracked the national average. (The U.S. GSP shares exclude New York.) The trend indicates a steady decline in manufacturing GSP as a percent of total GSP. Beginning in 1982, however, New York's decline in manufacturing GSP begins to accelerate at a faster rate than the national average. While the nation's manufacturing GSP rebounded in 1992 to over 18 percent, nearly equaling its 1982 share, New York did not recover. By the end of the decade, New York's manufacturing GSP as a share of total GSP equaled slightly more than 14 percent, its lowest level in two decades.

Figure 10: Manufacturing GSP as a Percent of Total GSP -- New York versus U.S. 1970 - 1992



Figures 11 and 12 represent data compiled by the U.S. Commerce Bureau on the value of shipments and capital expenditures for select states and the U.S. average. The data reflect economic activity in the manufacturing industry. The value of shipments refers to the net selling values (exclusive of freight and taxes) of all products shipped by manufacturers. Expenditures for new plant and equipment refer to permanent additions and major alterations to manufacturing establishments. It also includes depreciable new machinery and equipment. The totals exclude expenditures for used plant and equipment, expenditures for land, and the cost of maintenance and repairs. With the exception of used property, this federal definition closely mirrors New York's definition of qualified property under the ITC.

Figure 11 illustrates the percent change from 1982-1987 for the value of shipments and capital expenditures for select states. It also includes the U.S. average for these expenditures. New York significantly lagged behind the U.S. average for both manufacturing shipments and capital expenditures during 1982-1987. New York's capital expenditures during this period appear especially weak. Massachusetts outperformed New York, California, Connecticut, New Jersey and Pennsylvania in both categories. Texas stands out distinctly as performing extremely poorly in both categories during this time period due to recessions in the oil and real estate markets.

Figure 11: Manufacturing Shipments and Capital Expenditures for Select States: Percent Change 1982-1987

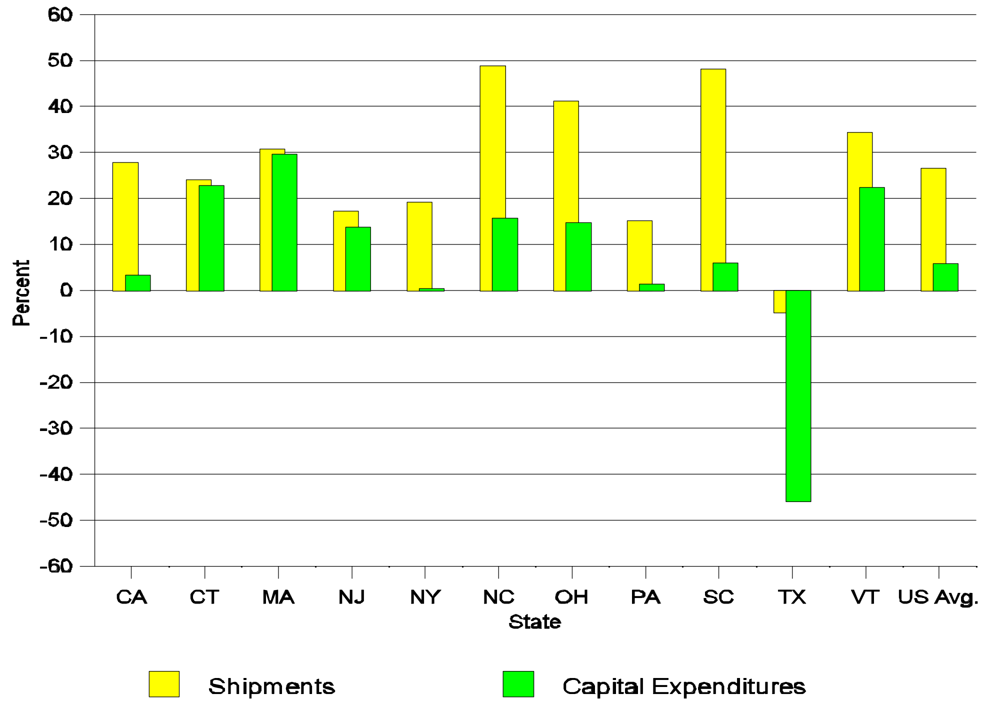
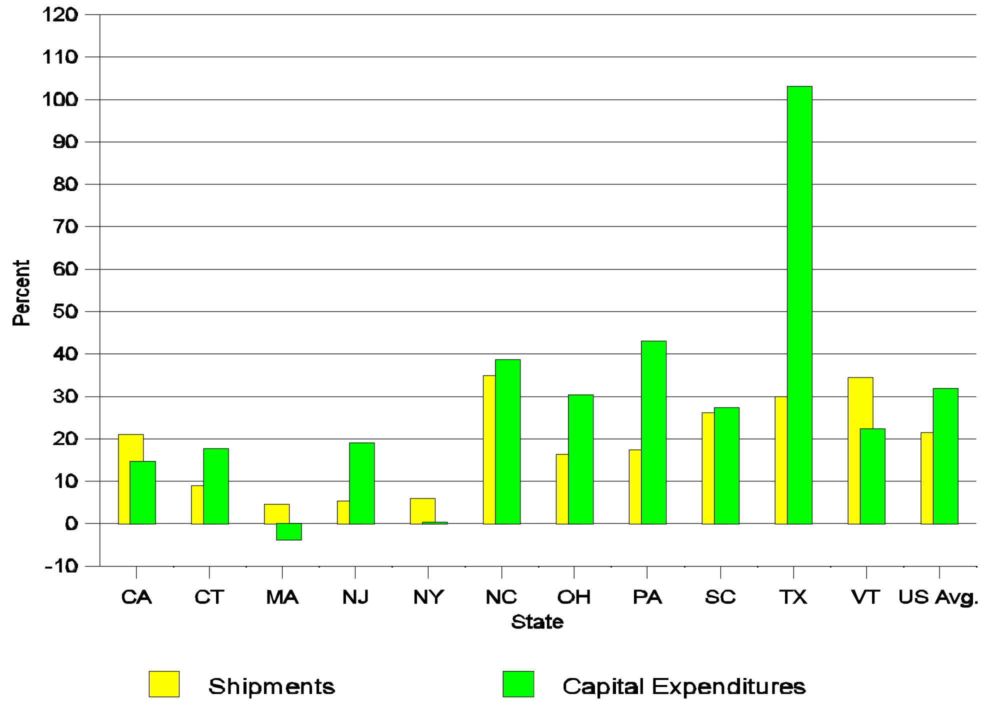


Figure 12 illustrates New York's performance in manufacturing shipments and capital expenditures from 1987-1992. While New York's value of shipments slightly exceeded that of Massachusetts and New Jersey, it did not outperform any other state in the analysis. It also fell far below the U.S. average in both categories. Massachusetts performed poorly in both categories. California, Connecticut and New Jersey had comparable levels of capital expenditure growth. Texas, which had performed poorly from 1982-1987, had the greatest percent change in capital expenditures between 1987-1992.

Figure 12: Manufacturing Shipments and Capital Expenditures for Select States: 1987 - 1992



Appendix D provides more detail on data methodology and data sources.

Results of the Surveys on the Efficacy of the Investment Tax Credit

The ITC is influential, however, other states have lower overall tax burdens.

Major Site Location Consultants' Survey

The Office of Tax Policy Analysis' (OTPA's) survey elicited responses from major site consultants representing all regions of the state. The response rate to the site consultant survey proved exceptional, nearing 60 percent. The majority found the ITC influential in their advice to clients to expand in New York. They ranked the ITC/EIC as moderately important or very important. However, the majority of respondents also believed that businesses expanded in other states despite the credit. This occurred because other states had overall lower tax burdens.[31] The respondents ranked, among other factors, labor costs and skilled labor as very important. In ranking specific taxes, the respondents considered the corporate franchise tax as very important, with the AMT as moderately important.

Corporate Tax Manager Survey

Corporate tax managers indicated that reducing the corporate tax rate would encourage investment in New York.

OTPA's business survey targeted to corporate tax managers elicited a response rate over 50 percent. In total, 150 managers received the survey. The sample of firms represented credit-takers and non-credit takers equally. The majority of respondents did claim the ITC. Several respondents did not know New York allows an ITC and EIC. A significant majority also did not realize that new businesses could take a refund of unused ITC, rather than carry the credit forward against future tax liability.

The two most common types of qualified property used in the ITC base included manufacturing property and research and development property. When questioned whether the ITC affected their decision to expand in New York, the respondents claiming the ITC represented an even split. Of forty-two respondents to the question, twenty-one considered it either a significant or small factor, while an equal number believed it did not become a factor in their decision to expand in the State. In determining locational decisions, the majority of respondents ranked the ITC/EIC as moderately important. The respondents ranked, among other factors, energy costs, labor costs and skilled labor as very important. The majority of respondents felt that a reduction in the corporate tax rate would most encourage investment in New York. In addressing specific taxes, the respondents ranked the corporate franchise tax as very important and the AMT as moderately important. A number of other states, including New Jersey, Pennsylvania, Massachusetts, North Carolina and South Carolina had contacted the respondents seeking the relocation of their companies.

New York's Competitive Position Vis-a-vis Other States

Thirty-five states offer an ITC and twenty-two offer a research and development credit.

States use a variety of incentives to stimulate capital investment and employment. Thirty-five of 45 states with a corporate income tax allow capital formation incentives. Twenty-two states, including New York, offer credits for research and development property. Many states, including Alabama, Minnesota and Tennessee, willingly provide multi-million dollar incentive packages in addition to each state's investment tax credit. A number of states, including neighboring Massachusetts and New Jersey, have recently enacted ITC legislation. New Jersey's credit equals 2 percent of the cost of the manufacturing equipment in addition to an employment credit based on increases in employment. New Jersey also allows a "new jobs investment tax credit," for qualified investment in a new or expanded business facility. In contrast to New York,

New York needs to keep the ITC to maintain its competitive position vis-a-vis other states.

New Jersey, Massachusetts and California allow credit for leased property. In these states, the taxpayer leasing the property becomes eligible for the credit. See Appendix B for more detail on the ITCs and EICs allowed by these states.

Table 9 illustrates how the ITC affects the tax liabilities of two different companies, one that leases equipment and the other that purchases equipment. In New Jersey, Massachusetts and California, the hypothetical tax liability of each company would be the same because these states allow the ITC for leased property.

Table 9: Hypothetical Example of ITC Eligibility for Company Leasing Equipment versus Company Purchasing Equipment

Conditions	Company Leasing Equipment	Company Purchasing Equipment
Amount of Investment	$1 million	$1 million
Additional income generated from investment (net of annual payments for acquisition)	$ 50,000	$ 50,000
Tax Before Investment	$ 25,000	$ 25,000
Total tax before Credits at 9% rate	$ 29,500	$ 29,500
ITC Earned	$ 0	$ 5,000
Tax after credits	$ 29,500	$ 24,500
Credits Used	$ 0	$ 5,000

Policy Options and Revenue Estimates

Large Businesses

Allow the Use of the ITC Against the AMT

This tax policy alternative would allow the use of the investment tax credit (ITC) against alternative minimum tax (AMT) liability. Current law does not allow taxpayers who pay under the AMT base to use ITCs against tax liability. Allowing the use of the ITC against the AMT would result in a revenue loss of approximately $85 million.

Repeal the AMT

An alternative would repeal the AMT. It would allow taxpayers to fully utilize tax credits against tax liability and reduce paperwork burdens. This proposal would result in a revenue loss of approximately $90 million, taking into consideration changes to other tax bases.

Repeal the AMT and Limit Credit Usage to a Percentage of Tax Liability

Another alternative would repeal the AMT and limit the use of credits by taxpayers to a certain percentage of tax liability. The proposal would achieve the original intent of the AMT law, that is, to ensure that taxpayers with income pay a certain percentage of income in tax. This would also reduce paperwork burdens on taxpayers because the separate calculation of the AMT would no longer be necessary. The revenue estimate would depend on the credit limitation percentage. For example, a 2/3 limit on credits would be approximately revenue neutral.

Lower the Corporate Franchise Tax Rate

This policy option would lower the current corporate franchise tax rate. An overwhelming majority of corporate tax managers responding to the survey believed lowering the corporate tax rate would encourage capital investment in the State. Lowering the corporate tax rate to an amount equal to the estimate provided under the option to eliminate the limitation on credit usage under the AMT ($85 million), would result in a reduction of the rate from 9 percent to 8.5 percent.

Small Businesses

Allow the Investment Tax Credit for Leased Property

This tax policy alternative would extend the ITC to qualified leased property. Current law does not allow a taxpayer to claim an ITC with respect to property that it leases to any other person or corporation. This would achieve parity with purchasers under the ITC and keep New York's leasing industry competitive. Extending the ITC to leased property would result in a revenue loss of approximately $20 million.

Refund of Unused ITC and EIC for Small Businesses

Extending the ITC refundability to small businesses would provide these taxpayers with an immediate infusion of cash. It would ease cash flow problems that often cause many small businesses to fail. Currently, any qualified *new* business subject to the corporate franchise tax may elect to receive a refund of unused ITC, in lieu of carrying the balance forward to subsequent years during its first four taxable years in the State. This proposal would result in an annual return to small business taxpayers of approximately $6.5 million.

Extend the EIC to the Personal Income Tax

Extending the EIC to the personal income tax would ensure that members of limited liability companies and limited liability partnerships, partners of partnerships and shareholders of S corporations would receive the same tax benefits as small businesses taxable under the general corporate franchise tax. This proposal would result in an additional $2.5 million in tax credits available.

These policy alternatives may result in increased economic activity, including increased profitability for small businesses, additional job creation and increased personal income tax revenues.

Conclusion

New York's investment tax credit (ITC) was once an effective benefit for manufacturers, research and development firms, and other companies in the State. The data demonstrate that, over the past decade, tax law changes have undermined the value of the original ITC. Because investments, by their nature, require long-term planning, the uncertainty imposed on firms with the continual changes to the tax law limited the ITC's effectiveness. These changes include the imposition of the alternative minimum tax in 1987, which limits the use of credits against taxable income; reductions in the ITC bases and rates; and limits on the carryforward of the ITC.

A stable tax environment will encourage investment in New York.

Changes made in 1994 and 1995 will help to recoup some of the benefits of the ITC by providing taxpayers the ability to use the credit. A stable tax environment will allow these changes to be most effective. This becomes even more important as neighboring states intensify their efforts to lure companies from New York. The effectiveness of the ITC takes on added significance because these competing jurisdictions have enacted generous ITC provisions.

Endnotes

1. New York allows a sales tax exemption for machinery and equipment for use or consumption in the production of tangible personal property, gas, electricity, refrigeration or steam for sale by manufacturing, processing, generating, assembling, refining, mining or extracting. In 1993, the value of this exemption equaled $479 million. Approximately 30 percent of this amount, or $143.7 million, represents the value of this exemption to utilities.

   New York also allows a sales tax exemption for gas, electricity and other fuel used in manufacturing processes and research and development activities. In 1993, the value of this exemption equaled $161 million. Approximately 40 percent of this amount, or $64.4 million, represents usage by utilities in their generation of electricity and steam.

2. A change in 1994 increased the carryover period to ten years.

3. Chapter 446 of the Laws of 1963.

4. Chapter 873 of the Laws of 1968.

5. Under prior law, taxpayers were allowed to deduct twice the amount of their federal depreciation for New York tax purposes. Taxpayers who allocated only a portion of their income to New York (because of the interstate nature of their business) were allowed to deduct the full amount of accelerated depreciation (without reduction for allocation) if the asset was located in the State. The law limited the maximum amount which a taxpayer was entitled to deduct for any year or years to the cost of the asset multiplied by the percentage of the taxpayer's income allocated to New York in the first year the deduction was taken. It applied to both the accelerated depreciation deduction and the one year research and development write-off. These provisions limited the revenue cost of the incentive. (See New York State Department of Taxation and Finance Commissioner Joseph H. Murphy's letter to Governor Nelson A. Rockefeller, May 14, 1968.)

6. Ibid.

7. See New York State Department of Commerce Memorandum on Senate bill 5143-A, May 9, 1969.

8. Chapter 1072 of the Laws of 1969.

9. See Governor Nelson A. Rockefeller's Approval Memorandum filed with Senate bill 5143-A, May 26, 1969.

10. Internal Revenue Code §49, as enacted by the Tax Reform Act of 1986 and prior to amendment by the Revenue Reconciliation Act of 1990.

11. See Article 9-A, section 210.12 of the Tax Law for statutory provisions of the ITC for general business corporations. Taxpayers subject to Article 22 of the Tax Law, the personal income tax, may also claim an ITC under provisions detailed in section 606.

12. Chapter 817 of the Laws of 1987.

13. Chapter 170 of the Laws of 1994.

14. Chapter 817 of the Laws of 1987.

15. Chapter 103 of the Laws of 1981.

16. Article 9-A, Section 210.12(j) defines a new small business eligible to claim an ITC refund of unused credit. Generally, a new business is a corporation that has not been subject to the corporate franchise tax for more than four years, prior to the tax year during which the taxpayer becomes eligible for the ITC.

17. Chapter 817 of the Laws of 1987. The provisions of the 1987 Act were changed in 1989 before becoming fully effective. (See discussion of 1989 tax law changes.)

18. The pre-1990 minimum taxable income base was defined as the portion of entire net income allocated to New York.

19. The AMT tax rate was amended in 1989 from 3 percent to 5 percent. (See discussion of 1989 tax law changes.)

20. The modifications do not include the ACE adjustment or book income adjustment. See Business Tax Analysis: The Minimum Tax-Taxation of Preference Items, New York State Department of Taxation and Finance, Office of Tax Policy Analysis, August 1990.

21. Chapter 166 of the Laws of 1991: the rate equaled 5 percent in 1990, 1991 and 1992. After 1992, the rate dropped to 3.5 percent. Chapter 55 of the Laws of 1992: the rate equaled 5 percent in 1990, 1991, 1992 and 1993. After 1993, the rate dropped to 3.5 percent.

22. Chapter 57 of the Laws of 1993.

23. Chapter 170 of the Laws of 1994.

24. This does not include Michigan, Nevada, South Dakota, Washington and Wyoming.

25. The credit may apply to certain property involved in a sales-leaseback transaction. See opinion of counsel (August 25, 1995) for a discussion of this issue.

26. See M. Feldstein and M. Vaillant, *Can State Taxes Redistribute Income?* (Cambridge, Mass., NBER Working Paper No. 4785, June 1994).

27. Constant dollars means dollar values adjusted for inflation. The data were adjusted with an implicit price deflator for Gross Fixed Private Nonresidential Investment.

28. ITC earned means the amount of credit generated in the current tax year. ITC claimed means the amount of credit which the taxpayer is entitled to use during the taxable year, including credit carried forward from prior years. ITC used means the amount of credit which the taxpayer actually used to reduce tax liability. ITC carried forward is any unused amount of credit which is allowed to be used to offset tax liability in future years.

29. The fixed dollar minimum equaled $250 in 1985. This amount remained unchanged until 1989. See Appendix A for more detail.

30. See Analysis of Article 9-A General Business Corporation Franchise Tax Credits for 1992 for more detail of credit activity.

31. The survey did not segregate the components of "overall tax burden."