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STATE TAX REFORM FOR THE EIGHTIES: THE NEW YORK TAX STUDY COMMISSION

by Richard D. Pomp*

If fashions in state taxation exist, now appears to be the season for tax studies. It is a rare state that has not had some type of temporary study commission. Although these studies and commissions differ widely in their organization, budgets, subject matter, and approach, all have one characteristic in common: they are a sign of a state's institu-

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This article, reflecting the author's experiences with the New York Tax Study Commission, is a testament to Dean Phillip Blumberg's willingness to indulge and support the faculty in their quasi-academic pursuits. Once the Dean had become convinced that such pursuits would ensure professional growth and had substantial intellectual content (no easy criteria to satisfy given the standards that Phillip holds out for himself and, by example, for the faculty), his encouragement and cooperation were unfailing. Moreover, during those inevitable enervating periods when one was tempted to scrap professional growth and escape back to the bosom of the Law School, the Dean proved to be a fount of comforting and perceptive counsel. By personally providing a model of intellectual vigor and by creating an atmosphere that nurtured scholarly inquiry, Phillip's aspirations were the faculty's inspiration.

1. States with recent or current tax study commissions include: Connecticut, see The Bipartisan Comm'n on State Tax Revenue & Related Fiscal Policy, Final Report (1983); Georgia, see Georgia Tax Reform Commission Combined Report (1981); Hawaii; Iowa; Massachusetts; Minnesota; Ohio, see Joint Committee to Study State Taxes, Final Report and Recommendations (1982); Pennsylvania, see Pennsylvania Tax Comm'n, Final Report (1981); Texas; West Virginia, see A Tax Study for West Virginia in the 1980's (1984); the District of Columbia, see Financing an Urban Government (1978). For recent reports that were not conducted as part of a tax study commission, see Indiana's Revenue Structure: Major Components and Issues (J. Papke ed. undated); Michigan's Fiscal and Economic Structure (H. Brazer & D. Laren eds. 1982); State Tax Policy: Evaluating the Issues (A. Reschovsky, G. Topkian, F. Carr, R. Crane, P. Miller & P. Smoke eds. 1983); New York City Business Tax Task Force, Taxes and Tax Policy in New York City (1980).

2. Recognizing that state tax studies are a growth industry, the Lincoln Institute of Land Policy recently sponsored a conference consisting of those persons who have been intimately involved with such undertakings. The conference primarily focused on procedural issues involved in a tax study commission and examined the roles of the governor, legislature, lobbyists, institutions, advisory groups, public hearings, and the media. The conference also considered control of the
tional weakness. Ad hoc, temporary tax study commissions are no longer an adequate response to the dynamic nature of today's economy, which requires the constant monitoring and oversight of any tax system. Recent developments and trends present a challenge to the premises that underlie a traditional state tax system. State policymakers have had to cope with changes in the judicial climate, a relaxation of federal controls, especially in the areas of transportation and banking.

Research agenda and staffing of the study (e.g., central staff versus outside consultants). Finally, particular studies were examined to determine whether they addressed major or limited policy issues, whether they were intended to develop solutions to specific problems, and to what extent the research was economic or legal in approach. Procedurally, the studies appeared to have little in common, each being conducted in a different political milieu. More commonality of interests probably exists with respect to substantive rather than procedural issues. The participants at the conference seemed to agree, however, that, unlike an earlier generation of tax studies during the 1950's and 1960's, recent commissions deal with far more complex and sophisticated issues that defy easy resolution.

3. Recently, the Supreme Court has been unusually active in addressing issues of state corporate taxation. See, e.g., Mobil Oil Corp. v. Commissioner of Taxes, 445 U.S. 425 (1980) (upholding the imposition of Vermont's corporate income tax on dividends received by Mobil from its subsidiaries and affiliates doing business abroad); Asarco, Inc. v. Idaho State Tax Comm'n, 458 U.S. 307 (1982) (striking down the application of Idaho's corporate income tax to the dividends, interest, and capital gains received by Asarco); F.W. Woolworth Co. v. Taxation & Revenue Dep't, 458 U.S. 354 (1982) (striking down the levying of New Mexico's corporate income tax on dividends received by Woolworth from its foreign subsidiaries); Container Corp. of America v. Franchise Tax Bd., 103 S. Ct. 2933 (1983) (upholding California's use of a combined worldwide report for Container and its subsidiaries).

4. States have traditionally taxed transportation activities on the basis of their gross receipts. See, e.g., N.Y. TAX LAW § 184 (McKinney Supp. 1983-1984). The various rationales offered in defense of taxing a business on its gross receipts, rather than on its net income, have never been very satisfying. The recent relaxation of federal regulations involving airlines and trucking further undermines the legitimacy and vitality of this form of taxation. For a detailed discussion, see N.Y. LEGISLATIVE COMM'N ON THE MODERNIZATION & SIMPLIFICATION OF TAX ADMINISTRATION & THE TAX LAW, STAFF REPORT, TRANSPORTATION TAXES IN NEW YORK STATE 21-23 (May 1983).

The case of Aloha Airlines, Inc. v. Director of Taxation of Hawaii, 104 S. Ct. 291 (1983), which prohibits state taxation of gross receipts that are attributable to the sale of air transportation, will require states using this common approach to formulate an alternative. The most logical alternative would be to tax airlines on their net income under a specially designed apportionment formula, a method that only a few states employ at present. See, e.g., ILL. ANN. STAT. ch. 120, § 3-304(a) (Smith-Hurd 1974). For airlines currently operating at a loss, taxation on their net incomes rather than on their gross receipts would result in a tax savings. For profitable airlines, the switch to net income may or may not result in a savings, depending on the tax rate previously applied to their gross receipts, the rate that would be applied to their net income, and the relationship between their gross receipts and their net income.

A state should not re-examine its taxation of airlines independently of other sectors of the transportation industry, such as trucking and rail, which compete for certain types of freight hauling. Consequently, by forcing a state to restructure its taxation of the airlines, Aloha may help overcome the normal legislative inertia and trigger a reform of the taxation of the entire transportation sector.
5. Banks have typically been subject to state tax regimes that are different from those applied to general business corporations. See, e.g., N.Y. Tax Law §§ 1450-1468 (McKinney 1975 & Supp. 1983-1984). The recent de facto and de jure deregulation of banking will eventually require states to reconsider their existing approaches. As banks become increasingly involved in interstate operations and undertake new activities that compete with brokerage houses, insurance companies, and the real estate industry, the arguments for taxing banks in the same manner as most other corporations become compelling. For a nontechnical discussion of the transformation occurring in the banking industry, see Carrigan, Financial Fracas, Wall St. J., Mar. 22, 1984, at 1, col. 6; McMurray, Financial Fracas, Wall St. J., Mar. 23, 1984, at 1, col. 6.

6. For example, orthodox approaches to the definition and taxation of investment income may appear simplistic when corporations have the ability to shift funds around the world nearly instantaneously. For a discussion of federal tax concepts that might be adapted by a state wishing to revamp its taxation of investment income, see Pomp & Rudnick, Federal Tax Concepts as a Guide for State Apportionment of Dividends: Life After Asarco, 17 Tax Notes 411 (1982).

The increasing use of home computers will allow new modes of business operations, such as video shopping, to flourish, which will make traditional concepts of taxing jurisdiction appear atavistic. See infra note 8 for a discussion of video shopping and of Pub. L. No. 86-272. For a perceptive article on the relationship between traditional concepts of tax jurisdiction and technological change, see Corrigan, Interstate Corporate Income Taxation—Recent Revolutions and a Modern Response, 29 Vand. L. Rev. 423 (1976).

7. States that utilize either a corporate or a personal income tax model those laws, with varying degrees of fidelity, on the Internal Revenue Code and thereby incorporate federal concepts and definitions of gross income, adjusted gross income, taxable income, and so forth. Recent federal changes that have caused states to question their emulation of the Internal Revenue Code include the Asset Cost Recovery System, I.R.C. § 168 (1982), the short-lived rules on safe harbor leasing, I.R.C. § 168(f)(8) (1982) (before amendment by § 208(a)(2)(A), (b)(1)-(4)), Tax Equity and Fiscal Responsibility Act of 1982, and the taxation of social security benefits, I.R.C. § 86 (Law. Co-op. Supp. 1984). See infra note 36 and accompanying text. If incorporated into state tax law, some of these federal provisions would result in a loss in tax revenue without achieving any significant state goal. Accordingly, many states have refused to adopt such changes.

8. Unlike the federal government, a state is not constitutionally permitted to tax a U.S. corporation on its worldwide income. A corporation can only be taxed on that amount of income which is fairly attributable to activities conducted within the state. Determining the amount of income that is properly subject to a state's taxing power involves complexities that are greatly exacerbated when corporations conduct their activities through several entities and in numerous jurisdictions. The more complicated the corporate structure and the greater the number of jurisdictions in which corporate activities occur, the more elusive the goal of calculating a state's legitimate share of taxable income.

A fundamental policy decision confronting all states in dealing with conglomerates and multinational corporations is the extent to which separate but related corporate entities will be honored for tax purposes. For example, should a parent corporation and its wholly-owned subsidiary conducting similar businesses be treated as two unrelated taxpayers or should their corporate veils be pierced and their operations combined for tax purposes? Although the rules vary greatly, most states will either permit or require related corporations to file a combined report of their operations, at least if only U.S. corporations are involved.

This principle of combining separate U.S. corporations conducting a similar business—domestic unitary combined reporting—has been long accepted by both the courts and the
business community. The extension of this principle to foreign corporations—worldwide unitary combination—has been more controversial. Worldwide combination is often associated with California, which has been instrumental in developing both the conceptual underpinnings and the administrative viability of the principle when applied to foreign corporations. In Container Corp. of America v. Franchise Tax Bd., 103 S. Ct. 2933 (1983), the Supreme Court upheld California's use of worldwide combined reporting in a situation involving a U.S. parent and its foreign subsidiaries. Whether the court would uphold this method if applied to a foreign parent and a U.S. subsidiary is unclear. See id. at 2956 n.32. (From the perspective of those who would oppose worldwide combined reporting, Container was probably an ill-chosen case to have reached the Court first because it did not present a very sympathetic fact pattern. A U.S. corporation owned by a foreign corporation, and one that could have shown a greater disparity between the tax consequences resulting from combined reporting and those which would have otherwise resulted, would have presented a more persuasive case for the taxpayer.) For a general introduction to the issues involved in worldwide combined reporting, see Church & Pomp, The Unitary Method: Thirteen Questions and Answers, 10 Tax Notes 891 (1980).

Ultimately the Congress and not the Supreme Court is the arbiter of tax issues and, after Container was decided, the controversy over worldwide combination shifted from the courts to Washington. A working group was formed under the direction of Secretary of the Treasury Regan, consisting of representatives from the states and the corporate community. The working group's report should be issued shortly, but is unlikely to provide a definitive resolution.

This sequence of events may evoke a sense of déjà vu. In Northwestern States Portland Cement Co. v. State of Minnesota, 358 U.S. 450 (1959), the Supreme Court upheld a state's right to tax a corporation on its income arising from interstate commerce. After the decision, pressure was exerted on the Congress to limit the case's scope. The result was Pub. L. No. 86-272 and a major study, the so-called Willis Report. See H.R. Rep. No. 1480, 88th Cong., 2d Sess. 7 (1964) (Willis Committee Report).

Pub. L. No. 86-272 prevents, inter alia, a state from imposing a net income tax on the income derived within its borders by a person whose only activities are the solicitation of orders. In today's economy, an out-of-state corporation can achieve substantial market penetration and still qualify for Pub. L. No. 86-272's exemption by soliciting through the use of radio, television, telephone, and the mail; the statute thus appears to embody an antiquated concept of tax jurisdiction. Recasting Pub. L. No. 86-272 in terms of a threshold level of gross sales above which jurisdiction to tax would be deemed to exist would more equitably balance the interests of the states and of taxpayers.

The need to revise Pub. L. No. 86-272 will be heightened as home computers become widespread, which will allow out-of-state vendors to achieve even greater market penetration than at present and yet remain exempt from income taxation. Using a home computer, consumers will be able to examine a vendor's goods on a screen and, by using special programs or 800 telephone numbers, to obtain immediate responses to any questions they might have. A sale will be consummated through the use of a credit card or through an electronic transfer of funds from the customer's account to that of the vendor. For a discussion of video shopping, see New Video Game: Shopping, N.Y. Times, Apr. 26, 1984, at D1, col. 3. Over time, technological developments will make the antediluvian approach of Pub. L. No. 86-272 increasingly obvious. For similar reasons, National Bella Hess v. Department of Revenue of Illinois, 386 U.S. 753 (1967), needs re-examination. For many states, federal changes in Pub. L. No. 86-272 and Bella Hess are probably more important in terms of the revenue at stake than is the issue of worldwide combined reporting.

With the exception of Pub. L. No. 86-272, the Congress has shown little interest in adopting legislation regulating the taxation of interstate commerce, although such bills are periodically introduced. Whether the issue of worldwide combined reporting will motivate the Congress to act remains unknown.
from manufacturing to services.  

The inherent weakness of a temporary tax study commission is that by the time its recommendations work their way through the legislative process, a whole new set of problems will have emerged. Recent developments can easily overtake such recommendations and render them naive. Needed instead is what might be called "institutionalizing" the process of tax reform—imposing some kind of permanent management system on the process of tax planning.  

Most states lack any meaningful institutional leadership regarding tax planning and policy. One of the agencies that might be considered a candidate to assume that role—the state tax department—is typically too busy responding to each new crisis and is usually one crisis behind.  

9. The interaction between the shift in the economy from manufacturing to services and a state's tax structure is graphically illustrated in the context of a sales tax. See infra text accompanying notes 13-27.  

Some states grant investment tax credits, which favor capital rather than labor-intensive activities, and these credits probably reflect a legislative desire to aid manufacturing. To the extent that a state's economy is shifting from capital-intensive manufacturing to labor-intensive services, the continued use of investment tax credits may be counter-productive. Even for states not undergoing this shift, investment tax credits may be misguided and merely divert legislative attention away from more fundamental problems of economic development. See Legislative Comm'n on the Modernization & Simplification of Tax Administration & the Tax Law, Staff Report, The Effect of the Corporate, Sales, and Property Taxes on Business Locational Decisions (forthcoming December 1984); Pomp, Kanter, Simonson & Vaughan, Can Tax Policy Be Used to Stimulate Economic Development, 29 Am. U.L. Rev. 207 (1980) (proceedings of a conference on state and local tax policy).  


11. State tax departments are commonly viewed as a source of expertise on all matters of taxation, including policy issues. In reality, state tax departments usually have little insight into policy issues, notwithstanding their considerable expertise in administrative areas. The skills needed to administer a tax are simply different from, although complementary to, those needed to design a tax. It is no more logical to assume that personnel in the tax department are knowledgeable about the design of a tax system than it is to assume that personnel in the motor vehicles department are knowledgeable about the design of an automobile. To be sure, policy decisions are inescapably made through administrative actions and this blurring of functions is not only inevitable but also not necessarily undesirable. What should be avoided, however, is a situation in which no agency or group is explicitly charged with developing a coherent and principled tax policy.  

The weakness in relying on a tax department for policy analysis is demonstrated by a typical lament of a study commission— inadequate data. Logically, a tax department should be a cornucopia of useful data. Often, however, the criterion used for compiling data is whether they will be useful in auditing taxpayers. Information critical for policy analysis may be unavailable if it is not needed by tax auditors.  

In some states, tax department officials purposely avoid policy analysis in order to insulate themselves from "political issues." In these states officials often describe themselves as "technocrats" and try to sanitize the tax department by refusing to comment on proposed tax changes
fare no better. Consequently, few states have a "game plan" for what their tax system should look like today, let alone in five or ten years.

Because of this lack of leadership, a state tax system commonly evolves (perhaps mutates might be more appropriate) through a series of poorly researched or drafted laws that are often adopted in the closing days of a legislative session. These changes, typically Band-Aids rather than major surgery, are superimposed upon existing law with which they may actually be working at cross-purposes. Moreover, statutes that have long outlived their usefulness nonetheless remain memorialized. Regrettably, the result is too familiar—a tax structure that is uncoordinated, complex, cumbersome, and lacking any conceptual framework. The very complexity of the system may ensure that it cannot be administered or implemented fairly or uniformly, thus accomplishing few of a legislature's goals.

Institutionalizing the process of tax reform planning is certainly no panacea or guarantee that these problems will not continue. But the creation of a permanent state body, perhaps somewhat akin to the Congress' Joint Committee on Taxation, charged with protecting the integrity and intrinsic harmony of the tax structure might be able to reduce the frequency of piecemeal legislation and to coordinate the different viewpoints of affected groups. This type of permanent body could undertake necessary research and analysis, educate a legislature about how the law is operating, evaluate alternatives, initiate proposals, and draft legislation more thoughtfully and carefully than is usually possible. The need for such systematic planning is self-evident. Indeed, it was partially this sentiment that led to the creation of New York's Temporary Tax Study Commission. Certainly, the creation of a permanent, rather than temporary, group is unlikely to be less effective than the already feeble attempts that most states make toward tax planning.

**Administrative Constraints on State Tax Policy**

One of the special characteristics of New York's Tax Study Commission is the emphasis placed on the interplay between tax policy and tax administration. A legislature often pays inadequate attention to the administrative burdens it places on taxpayers and the tax department; yet taxes are what they turn out to be in the real world and not

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12. Not all of the reports cited supra note 1, for example, particularly emphasize administrative constraints on state tax policy.
what a legislature intended them to be in an ideal world. "Good tax policy" and "bad tax policy" can look remarkably similar if the law requires a higher order of administrative capability than actually exists. Issues of tax administration have too frequently played the role of a stepchild to the favored child of tax policy. In many states the result might be a total overload on taxpayers and tax administrators.

One source of these administrative problems in New York is the very age of the state tax structure. The system is old enough to be encrusted with both the wisdom and the folly of the ages and to serve as the repository for whatever was the learning of the day. Instead of purging the law, however, and ridding it of inconsistencies and anachronisms, the legislature merely adds new provisions on top of old ones, and taxpayers and the tax department are expected to deal with them all. One of the many questions that the New York Tax Study Commission is raising is whether certain of these provisions are worth the administrative effort that they require.

_unnecessary distinctions in the sales tax produce complexity_

The New York sales tax presents a very clear example of a law that imposes formidable administrative burdens on both taxpayers and the tax department in the pursuit of questionable goals and one that perhaps has unintended effects. Although the state sales tax was adopted in 1965 and appears relatively modern if compared to the rest of the tax system, it was modeled with few changes after the 1935 New York City sales tax. Its provisions illustrate a host of rather problematic or moralistic judgments. Some are petty and chauvinistic: New York State flags, for example, are exempt from sales tax, but other state flags are not—a provision that may well prove to be unconstitutional if anyone cared enough to challenge it. Others present more serious questions of equity: baseball tickets are taxable, but Broadway tickets are not. Other provisions may reflect more sympathetic legislative goals, but nonetheless create significant administrative hurdles.

One glaring illustration, just the tip of the iceberg (icebergs, by the way, are taxable if sold as ice, but would be exempt if melted and transported through pipelines), is New York's exemption for "drugs and medicines." Any drug or medicine intended for "the cure, mitigation, treatment, or prevention of illness or diseases" is exempt from the

This wording may have been acceptable in 1935 when pharmacies were not a cross between hardware stores and supermarkets. Today, however, to administer this one provision requires the tax department to publish and continually update a list delineating the taxable status of over six thousand items. New Yorkers will be relieved to know that this list resolves many of today's burning social issues. Prell shampoo, for example, is taxable, but Head and Shoulders shampoo is not, presumably because the latter is intended to treat dandruff, which is considered to be an illness or disease. Sterilized cotton is exempt, non-sterilized cotton is not. Do such distinctions really achieve any significant social goals? The Tax Study Commission's experience is that most legislators are unaware that these distinctions exist at all. But even if the legislature affirmed its desire to tax Prell and exempt Head and Shoulders, are these goals important enough to justify the costs of administration? Indeed, can the supermarkets and pharmacies even implement the law?

A local NBC news affiliate must have asked the identical question because it sent a reporter into seven different pharmacies. The reporter bought the same basket of goods in each pharmacy and was charged seven different amounts of sales tax. Not one amount, incidentally, was for the correct sales tax, thereby providing a new twist on the concept of a "tax lottery." Some owners of pharmacies have told the Tax Study Commission that they cannot afford to hire the caliber of employee needed to interpret the drug and medicine exemption and that it is cheaper to negotiate the issue should it be raised on an audit. All


18. Id. at 16, 30.


20. A recent survey conducted by the New York Consumer Protection Board indicated that 82% of the drug stores and 54% of the food stores were charging sales tax on exempt items. Keeney, Sales Tax Inconsistencies Tax Merchants, Shoppers, Sunday Times Union, Apr. 15, 1984, at D1, col. 1.

21. Conceivably, a pharmacy having optical scanning equipment could program the tax department's list of over 6000 items so that the product's price would correctly reflect its taxable
too often, auditors know that the drug and medicine exemption is likely to be a fertile issue to raise. Owners of pharmacies have come to view the exemption as part of a conspiracy in the restraint of understanding, and the more cynical among them are convinced that the complexity of the law is merely a disguised way for the legislature to raise money. Putting the merits aside, clearly the drug and medicine exemption does little to improve New York’s “business climate.”

The sales tax exemption for food presents another area where administrative costs may outweigh social goals. Under existing law and its interpretation, supermarkets must distinguish between fruit juices, which are exempt, and fruit drinks, which are taxable. Is there really an important policy being furthered when consumers can buy Tang tax-free, but not Awake? Should we feel proud to be citizens of a state that exempts small marshmallows and taxes big marshmallows, that taxes chocolate-covered peanuts but exempts plain peanuts? And on and on it goes from head to toe. Managers of major supermarkets report that most consumers do not know or care whether an item is exempt. Supermarkets may care a great deal, however, when a sales tax issue is raised at an audit and no consumer is available from whom the tax can be collected.

The common problem under most state sales taxes of distinguishing between services (or intangible property) and tangible personal property demonstrates how a shift in the nature of the economy can challenge the very heart of a tax. The New York sales tax, like that of most other states, treats tangible personal property differently from services. Tangible personal property is generally taxable unless specifically excluded, whereas services (or intangible property) are generally exempt. A provision in the tax law that requires this order of sophistication, however, must be seriously questioned.

22. N.Y. TAX LAW § 1115(a)(1) (McKinney 1975). Supermarkets also confront all the problems flowing from the drug and medicine exemption.


25. Foot powders that eliminate excessive perspiration are exempt because they prevent athlete’s foot, whereas foot powders that only deodorize are taxable; lip ices that prevent chapped lips are exempt but suntan lotions that presumably prevent “chapped bodies” are taxable, even though products used to treat sunburn are exempt. New York State Sales and Use Tax Regulation § 528.4(b)(3), ex. 8, 9, 11 (McKinney 1977).
empt unless specially enumerated. When sales taxes first became widespread during the 1930's, most state economies were manufacturing- and mercantile-oriented, rather than service-oriented. The percentage of a state's gross product that resulted from the sale of tangible personal property was no doubt far in excess of the percentage contributed by the sale of services. Under those conditions, it was perfectly logical for a sales tax to be drafted with its primary focus on tangible personal property.

Nothing in the logic of a retail sales tax, however, which theoretically should reach all final consumer expenditures, necessarily justifies this distinction between property and services. Both can be purchased by consumers for their personal gratification. Furthermore, because tangible personal property embodies both capital and labor, most legislators fail to appreciate that services are in fact already taxed under all sales taxes if they are embodied in taxable property. The difference between tangible personal property and services is really one of degree rather than of kind. As states like New York shift away from manufacturing and towards a service-oriented economy, the traditional demarcation between personal property and services becomes subject to increasing pressure and tension, forcing tax departments and taxpayers to struggle with questions that are irrelevant.

The issue of computer software nicely illustrates this problem. Is computer software taxable as tangible personal property or exempt as a service (or as intangible property)—a wonderful metaphysical question that has provided much grist for the law review mills. This intellectual outpouring is regrettable because the issue should be irrelevant. A normative retail sales tax should not distinguish between personal property and services, but rather between business inputs and consumer goods and services. In other words, the fundamental distinction that should be drawn is whether a particular good or service is likely to be purchased primarily by businesses or primarily by consumers. Determining whether software is a tangible good or a service requires both the tax department and taxpayers to engage in a meaningless exercise.


27. See J. Due, Sales Taxation 291-93 (1957); J. Due & J. Mikesell, Sales Taxation: State and Local Structure and Administration 2 (1983); State and Local Taxes 446 (O. Oldman & F. Schoettle eds. 1974).
The Complications of Separate Income Tax Returns

New York's personal income tax shows how state law can be subtly overtaken and rendered obsolete by federal developments. New York's personal income tax was first enacted in 1919. At that time, for purposes of the federal income tax, most married couples filed separate returns in which each spouse reported his or her "own income." For New York to adopt a similar approach of using separate returns was perfectly logical. In 1948, however, when joint returns became the dominant federal form of filing for married couples, New York law remained unchanged. In New York, most married couples still file separate state returns, with each spouse reporting his or her own income and deductions. The result is that New York taxpayers and the tax department must resolve a plethora of issues that are simply irrelevant for federal purposes, such as the attribution of income arising from jointly-owned property. Because the Congress and the I.R.S. have had little reason to consider the attribution of property income between spouses, the corresponding federal rules are relatively undeveloped. New York, however, requires exactly such attribution rules in order to determine which spouse has received which items of property income. Consequently, the state has had to shoulder the responsibility for administering an important part of its income tax without federal assistance.

One way of discharging this responsibility would have been to have written a detailed set of family income attribution rules to fill the federal void. Instead, New York law states that "[i]f husband and wife determine their federal income tax on a joint return but determine their New York income taxes separately, they shall determine their New York adjusted gross incomes separately as if their federal ad-

30. See N.Y. LEGISLATIVE COMM'N ON THE MODERNIZATION & SIMPLIFICATION OF TAX ADMINISTRATION & THE TAX LAW, STAFF REPORT, THE STATE PERSONAL INCOME TAX: TAXATION OF THE FAMILY AND LOW INCOME RELIEF (July 1984). The discussion in the text draws heavily upon this report, which was prepared by Professor Michael J. McIntyre of Wayne State Law School. This report concludes that the administrative considerations discussed in the text present an overwhelming case on behalf of the adoption of a joint return in New York. A joint return with full income splitting, similar to the federal approach from 1948 to 1971, would not involve the so-called "tax on marriage."
justed gross incomes had been determined separately."^{31} The effect of this provision is to incorporate into New York law all the uncertainties and petty distinctions that characterized the federal system of marital income attribution rules prior to 1948, but without the benefit of assistance by the I.R.S. and the federal courts in resolving fresh disputes.

The uncertainties of the pre-1948 federal system are difficult to overststate and are nicely captured by considering the common joint savings account. A recent federal revenue ruling states that "[f]or federal income tax purposes, if two or more persons hold a savings account as joint tenants, the interest earned is owned by each person to the extent that each tenant is entitled under local law to a share of such income."^{32} For New York spouses, therefore, the proper taxpayer on a joint savings account turns first on whether the husband and wife hold the account as joint tenants, and second, on the rights of joint tenants under state law. Under New York law, income from joint accounts is taxable in equal share to the joint tenants, but only if they do nothing to change their initial one-half ownership rights. The most common way to change those rights would be for one spouse to withdraw money from the account. By withdrawing money from a joint account, a joint tenant thereby reduces his or her rights to the balance, unless the withdrawal was made for the joint benefit of the tenants or represented a gift from one tenant to the other. Realistically, the rights of joint tenants in an active savings account with many deposits and withdrawals are essentially unknowable, at least for a tax department with limited resources. The practical result in many cases is that married taxpayers can divide their interest income between themselves and report it on their separate state income tax returns in the most advantageous manner possible without challenge by the tax department. Because the manner in which the couple divides their interest income for New York purposes is irrelevant for federal purposes if they file a joint return, neither a couple's federal joint return nor any other information the I.R.S. is likely to have is useful to the state tax department in determining how the interest income should have been reported by the spouses.

Equally difficult problems arise in determining who the proper taxpayer is regarding income received from property held as tenants in common or as tenants by the entirety. Without any fully developed fed-

eral rules and without any assistance from the I.R.S., the New York Tax Department is generally forced to accept without challenge the income attribution positions taken by married persons on their New York tax returns. The result is that in the case of wages, couples have very little opportunity to shift income to a spouse subject to a lower marginal tax rate, but they can shift property income by resolving many of the gray areas of the law in their favor.

Similar attribution problems arise in the allocation of capital gains and losses between spouses. The federal rules for reporting capital gains and losses on a separate return suffer from the same ambiguities and lacunae that characterize the issue of which spouse should report property income. Venturesome New York taxpayers can interpret the law so that they treat the spouse subject to the higher state marginal tax rate as the "owner" of any property generating a loss, and treat the lower rate spouse as the "owner" of property generating a gain. It is unrealistic to expect the New York Tax Department to have the capacity to determine the true ownership of the property in these cases and no guidance is forthcoming from the I.R.S. because, again, if a joint return is filed, the issue is irrelevant for federal purposes.

Sophisticated lawyers and accountants know how ambiguous federal law is regarding the attribution of property income and that these ambiguities can be resolved in favor of their clients. Indeed, as the joint savings account example indicates, a detailed inquiry into which spouse should properly report which items of income might actually cost both the state and the taxpayer more than the amount at stake. Not surprisingly, therefore, taxpayers often resolve the problem by allocating property income in the most advantageous manner possible.

New York's use of separate returns also means that the state is susceptible to all the tax avoidance techniques that were rendered ineffective at the federal level when joint returns were adopted. Consider, for example, a married couple having just one income-earner. This couple can reduce its state tax if its income is equally divided between the spouses. One technique for achieving this result is to have the higher-income spouse borrow money from the lower-income spouse at the highest defensible rate of interest. The higher-income spouse receives an interest deduction and the lower-income spouse reports the interest as income. Enough money is borrowed until the marginal tax rate of each spouse is equal. In this manner, the couple minimizes its state income tax. This strategy is cost-free at the federal level because in a joint return the interest income of the creditor-spouse is completely
offset by the interest deduction of the debtor-spouse, resulting in a wash. The I.R.S. has no reason to inquire into whether a bona fide loan even exists between the spouses. The New York Tax Department is unable to monitor this situation, nor should it be expected to do so. The result is what might be called "self-help income-splitting" for the well-advised.\textsuperscript{33}

In addition to the administrative complications and burdens that arise from the use of separate returns, another equally significant problem results. Because nearly all married couples file joint returns at the federal level, tax legislation is drafted focusing primarily on this group. The impact of changes on married persons filing separately is simply of secondary importance to the Congress, notwithstanding its critical importance for New York taxpayers.

The recent changes in the taxation of social security benefits prove that the federal treatment of married couples filing separate returns can have an unintended, but dramatic consequence for New York. These recent federal changes generally tax up to one-half of a recipient’s social security benefits in excess of a base amount.\textsuperscript{34} The base amount is $25,000 for single persons and $32,000 for married persons filing a joint return. For married persons filing separate returns, however, the base amount is zero. In other words, for federal purposes, a married individual filing a separate return is taxable on one-half of the first dollar received of social security benefits because no base amount is applicable. Whatever the federal rationale for this result, the unintended effect in New York is to tax married individuals filing separate state returns on one-half of the first dollar received of their social security payments because this would be the treatment if they had filed separate returns federally.\textsuperscript{35} Although New York law was recently

\textsuperscript{33} For other techniques of income-splitting that are available under a separate return system, see N.Y. LEGISLATIVE COMM’N ON THE MODERNIZATION & SIMPLIFICATION OF TAX ADMINISTRATION & THE TAX LAW, STAFF REPORT, THE STATE PERSONAL INCOME TAX: TAXATION OF THE FAMILY AND LOW INCOME RELIEF 12-17 (July 1984).


\textsuperscript{35} A similar problem used to arise in New York’s taxation of unemployment compensation. For federal purposes, part or all of a recipient’s unemployment compensation in excess of a base amount is taxable. See I.R.C. § 85 (1982). The base amount is zero for married taxpayers who file separate returns and who do not live apart at all times during the taxable year. Id. § 85(b)(3). For New York purposes, such taxpayers used to be taxable on their first dollar of unemployment compensation, for the reasons discussed in the text. New York law was recently changed, however, to tax only the amount that is taxable federally. N.Y. TAX LAW § 612(f) (McKinney 1975), amended by 1984 N.Y. Laws ch. 71, § 2.
changed to exempt social security benefits from income taxation,\textsuperscript{36} the need to respond at all to the federal change indicates the type of problem that can arise when a state's approach is out of harmony with the federal approach.

\textbf{State Tax Expenditures}

Another source of administrative difficulties is tax expenditures—those special credits, exemptions, and deductions which are not part of the normative structure of a tax but are used to achieve extraneous goals.\textsuperscript{37} A provision that exposes the foibles of using a tax expen-

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Overlooked in the New York debate was the state's exemption from taxation of the first $20,000 of pension income received by persons over 59 1/2 years of age. See N.Y. Tax Law § 612(c)(3-a) (McKinney Supp. 1983-1984). An alternative to exempting social security benefits would have been to have classified the amount taxable federally as pension income for state purposes. The combination of the federal base amount of $32,000 and the $20,000 New York pension exemption would have meant that very few taxpayers would have had their social security benefits subjected to state taxation. Those who would have paid some tax would have had more than $32,000 of adjusted gross income and more than $20,000 of pension income—not exactly the proverbial "poor little old widows" who are traditionally conjured up in debates over the taxation of social security benefits.

Treating social security benefits as pension income would have had a strategic advantage from the perspective of the Tax Study Commission. The current $20,000 pension exemption violates principles of horizontal equity and, because income is taxed at progressive rates, has the perverse effect of being worth more to upper-income taxpayers than to lower-income taxpayers. If the legislature were persuaded to modify or eliminate the exemption, such changes would automatically apply to social security benefits if they had been treated as pension income. If, after exempting such benefits, the legislature were to decide to modify its treatment of pension income, the taxation of social security will have to be debated afresh.

37. The tax expenditure concept was developed by Professor Stanley S. Surrey and was based on his experience as Assistant Secretary for Tax Policy under Presidents Kennedy and Johnson, as well as on the insights garnered through his academic and scholarly pursuits. The concept has been described as the "major innovation in tax and public finance during the last twenty or thirty years." Kierans, \textit{The Tax Reform Process: Problems of Tax Reform}, 1 Can. Tax. 22 (1979). Since 1968, the United States has published a tax expenditure budget estimating the revenue loss attributable to tax expenditures in the federal personal income tax. See \textit{Budget of the United States Government, Special Analysis G} (1984). A number of states also publish a tax expenditure budget, including California, Michigan, and Wisconsin. Massachusetts is developing a similar budget, as are a number of foreign countries.

The literature on tax expenditures is voluminous; for a small sampling, see S. Surrey, \textit{Pathways to Tax Reform} (1973); J. Willis & P. Hardwick, \textit{Tax Expenditures in the United
diture at the state level is New York's so-called PASS (Parents' and Students' Savings) fund. Under this plan, a taxpayer receives a $750 deduction for money transferred to a qualified higher education fund. The income accruing to this PASS fund is completely exempt from state income tax, although not necessarily free of federal income tax. Money can be withdrawn from the fund and used to pay the college expenses of eligible beneficiaries who are usually dependents of the parent creating the PASS fund. After finishing college, the beneficiary is taxable over a five-year period on funds used to pay his or her expenses.

Presumably, the purpose of the fund is to encourage persons to save for the college expenses of their dependents. Using the tax system to encourage this goal, however, is inefficient in a number of respects. First, the benefit of the deduction is equal to its amount multiplied by the marginal tax rate of the taxpayer. Because the New York income tax uses progressive rates, the deduction is worth more to upper-income persons than to lower-income persons. For a taxpayer subject to the highest marginal tax rate in New York—fourteen percent—the $750 deduction is worth $105 ($750 x 14%). For an individual subject to the lowest marginal tax rate of two percent, the deduction is worth only $15 ($750 x 2%). For a person too poor to be subject to the personal income tax at all, the deduction is worthless. The deduction thus has a perverse aspect to it, because the richer the taxpayer, the more the benefit; yet the richer the taxpayer, the less the need for a tax incentive to save for college expenses.

This method is inefficient even assuming that the deduction was intended to help upper-income taxpayers more than lower-income taxpayers. State and local taxes are itemized deductions for purposes of...
the federal personal income tax and thus some of the benefit of the state tax savings is "appropriated" by the federal government. In other words, for a taxpayer who itemizes, the reduction in state personal income tax that results from the $750 deduction increases the amount of personal income taxes paid at the federal level. Assume, for example, that the New York taxpayer is in the fifty percent marginal tax bracket for federal purposes and itemizes his or her personal deductions. The $105 maximum state tax savings ($750 x 14%) increases the taxpayer's federal taxes by $52.50 ($105 x 50%). Consequently, the $105 of state savings is reduced by half to only $52.50. Using the state tax system to encourage savings is therefore inefficient because New York must forgo $105 of its own revenue in order for the taxpayer to save $52.50. A perverse form of revenue sharing results since the federal government is the beneficiary of up to one-half of the revenue forgone by the state. Had the state decided to use the $105 to finance tax-free scholarships, each dollar of revenue given up by New York would have actually resulted in a dollar of benefit to the recipient.

The $750 deduction is inefficient in yet another respect. As a percentage of the cost of college, the modest net reduction in taxes is unlikely to affect any parent's decision to save. Admittedly, most taxpayers would rather pay a reduced tax than not, even if the reduction is modest, but the only relevant inquiry is whether the PASS plan actually encourages taxpayers to save more than they otherwise would. Quite possibly, the deduction does not increase the overall amount of money saved for college but only shifts money into PASS accounts from other investment vehicles, such as money market funds, certificates of deposit, or passbook savings accounts.

The deduction is also inefficient as a matter of tax planning. For sympathetic a hearing would Legislator X receive if he or she proposed an explicit spending program to assist parents in saving for the higher education costs of their children, but one that gave more assistance to upper-income taxpayers than to lower-income taxpayers and that provided no assistance whatsoever to the very poorest?

41. See I.R.C. § 117 (1982). If the state wished, the scholarships could be earmarked for the children of those income groups who benefit the most from the existing deduction. More generally, every tax expenditure could be replaced by its equivalent spending program. A spending program, even if equivalent in effect to a tax expenditure, has two additional advantages—visibility and accountability. For example, if the state replaced its PASS accounts with a program of scholarships, it would have to decide on the appropriate level of funding. At present, the revenue forgone through the use of PASS accounts is not determined by the state, but rather by the number of taxpayers who avail themselves of the program. The PASS plan thus represents an unlimited appropriation of state funds which does not appear in the budget and is not re-examined annually by the legislature.
federal tax purposes, the income accruing to PASS funds will most probably be taxable to the parent.42 A taxpayer motivated by tax considerations is better advised to create a trust that would shift income from the parent for both federal and state purposes. Alternatively, parents might make interest-free loans to their children, who can then invest the principal, pay tax on the income at their lower tax rates, and use the remaining money for their college expenses.43 Of all the techniques available, the PASS fund is likely to rank low on a tax planner's list.

Evidently, most taxpayers agree with this analysis because PASS funds have not resulted in a large revenue loss to New York. But another cost must be taken into account, a cost that is typically overlooked by the legislature—the administrative expense incurred by the tax department in implementing the PASS program. Regardless of how few persons actually take advantage of the $750 deduction, the tax department nevertheless had to develop special forms, regulations, and instruction booklets and had to train its staff regarding the use of PASS funds. A host of questions had to be resolved. For example, who can be a trustee of a PASS fund: the parent, the beneficiary, or only a disinterested third party? What kinds of assets can be contributed to such a fund: only cash or also appreciated property? What types of schools can a student attend: technical schools, correspondence schools, schools abroad, or those on the high seas? What are the expenses for which the proceeds from a fund can be used: the costs of books, home computers, educational travel? How can the state be assured that the beneficiaries will actually report their use of funds from the PASS account five years after graduation, especially if they are nonresidents at that time?

The tax department's regulations and brochure on PASS funds represent an intellectual tour de force.44 The question, however, is

42. The federal tax treatment of PASS funds is obviously independent of state tax law. The federal tax consequences are controlled by I.R.C. §§ 671-679 (1982).
43. In Dickman v. Comm'r, 104 S. Ct. 1086 (1984), the Supreme Court held that an interest-free demand loan constituted a taxable gift. Generous statutory exemptions from the gift tax exist, however, which limit the impact of the case for many taxpayers. See, e.g., I.R.C. §§ 2503(b), 2503(e), 2513(a) (1982). See also I.R.C. § 2505 (1982). In Dickman, the Court assumed that an interest-free demand loan would successfully shift income from the creditor to the debtor. Such an assumption, however, is highly questionable. See Joyce & DelCotto, Interest-Free Loans: The Odyssey of a Misnomer, 35 TAX L. REV. 459 (1980). The tax planning technique described in the text is safest when the interest-free loan involves a term greater than ten years.
44. NEW YORK STATE & CITY OF NEW YORK, PUBL. NO. 320, TUITION DEDUCTION AND THE PASS PLAN (1982); New York State Personal Income Tax Regulations §§ 100.8; 145.16;
whether all this effort is a worthwhile use of the department's limited resources. Should New York be enacting these kinds of laws that divert the tax department's limited resources from revenue raising functions?

The PASS account is just one example of a state tax expenditure; investment tax credits, employment incentive credits, and special treatment of investments in new small businesses represent other, and more costly, examples of provisions directed at economic development. The temptation to use the tax system in this manner is easy to understand. Any legislature has only limited tools for intervening in a state's economy, which is primarily at the mercy of the national economy. Legislators are often frustrated at not being able to alter or control significantly the course of economic events, and the temptation to do something (or to be perceived as doing something) about the state's economy is so great that many special tax incentives get adopted without any analysis or research. Because of the political pressure to adopt these measures, the burden of proof is often not on those who propose such incentives, but rather on those spoilsports who would oppose them until evidence is presented indicating their effectiveness. It is during

152.16; TSB-M-79(1)I; TSB-M-79(3)I.
46. Id. § 210(12-A).
47. Id. § 612(o)(1).
48. For an attempt at measuring the effectiveness of these provisions using computer modeling and microsimulations, see LEGISLATIVE COMM'N ON THE MODERNIZATION & SIMPLIFICATION OF TAX ADMINISTRATION & THE TAX LAW, STAFF REPORT, THE EFFECT OF STATE TAXATION ON BUSINESS LOCATIONAL DECISIONMAKING (July 1984). This report underscores and reinforces nearly three decades of learning indicating that state taxation does not play a significant role in business locational decisionmaking. The reason that legislative forays into the business tax laws of the state are unlikely to be successful can be summarized as follows. First, innumerable factors are important to a business in its decision where to locate. Depending on the type of business at issue, the locational decision can be influenced by plant or site availability, access to transportation, quality of labor, proximity to markets and supplies, access to utilities, regulatory environment, quality of a state's schools, colleges or universities, availability of housing, or a state's ambience and quality of life. In any particular situation, one or more of these considerations may be determinative.

Second, taxes are one of the many costs of doing business, and the magnitude of these other costs may easily swamp the amount of state taxes involved. For example, based on an analysis by the staff of the New York Tax Study Commission of those corporations which allocate their income for purposes of the state franchise tax, a group that contributes approximately 70% of the corporate tax revenues, labor costs in New York are 53 times as large as their state corporate tax payments. A 2% wage differential is equivalent, therefore, to a 106% corporate tax differential. For a labor-intensive corporation, a few pennies difference in the hourly wages paid to employees might reduce its costs by more than any conceivable tax savings that would result from locating in one state rather than another. Indeed, many studies have concluded that regional differences in labor costs, construction costs, and energy costs are generally too large to be offset by differences
periods of slow economic growth that the pressure to institute these
tax levels. See, e.g., G. CORNIA, W. TESTA & F. STOCKER, STATE-LOCAL FISCAL INCENTIVES AND ECONOMIC DEVELOPMENT (Urban and Regional Development Series No. 4, Academy for Contemporary Problems 1978).

Third, state and local tax payments are deductible for purposes of the federal corporate income tax. The effect of this deduction, the so-called federal offset, is to reduce both the absolute burden of state and local taxes and the differences in burdens among the states. For example, consider a corporation subject to a 46% federal corporate marginal tax rate. Assume that this corporation is deciding whether to move from State A to State B. Taxes would be $200 in State A but would be only $100 in State B, a $100 difference. After taking into account the federal offset, however, the out-of-pocket cost of state taxes is $108 in State A and $54 in State B. The net difference in taxes between A and B is reduced to $54 ($108-$54), from $100 ($200-$100).

The effect of the federal offset has another important implication for policymakers. Because the federal offset reduces the value of the tax benefit that accrues to a firm from a reduction in its state taxes, some researchers have concluded that corporations favor government expenditures, such as job training and screening programs and improved transportation, over tax abatements. The former, provided they do not merely reduce costs the taxpayer would have otherwise incurred, provide tax-free benefits to a corporation whereas a similar amount of tax abatement may be offset in part by an increase in its federal corporate income tax. See, e.g., Wheeler, Interstate Differences in Tax Costs to Corporations: A Look at Some Accounting Studies, in MICHIGAN'S FISCAL AND ECONOMIC STRUCTURE, supra note 1, at 257. From the perspective of a state, a tax incentive is an inefficient way to grant relief to a corporation. A state may forgo $2 in revenue; yet a corporation may, after taking into account the increase in its federal corporate income tax, receive less than $2. The difference between what a state forgoes and what the corporation receives inures to the benefit of the federal fisc, revenue sharing in reverse.

Fourth, differences in state and local taxes may reflect differences in the level and quality of state and local public services, which also affect business locational decisions. Low taxes are not necessarily an attraction to businesses if a firm will have to supply at its own expense what is supplied through the public sector in other states or other jurisdictions. Furthermore, if low taxes mean inferior schools, a state may lack the educated and literate labor force that is essential to certain types of businesses.

Fifth, to the extent that tax rate differentials are capitalized, their impact will be reduced. For example, low property taxes in one jurisdiction might mean that land sells for a higher price there than it would sell for in another jurisdiction having higher property taxes. In other words, land located in a high-property tax jurisdiction may sell for less than an equivalent parcel of land in a low-tax jurisdiction, assuming that differences in taxation are not reflected in differences in public services, which might also be capitalized.

Sixth, most companies contemplating a major locational decision plan to stay at their new site years longer than any group of elected officials are likely to be in office. Consequently, current tax levels, special concessions, or special features of the tax law may not be a reliable basis upon which to make a multi-million dollar investment. What one group of legislators might grant today by way of concession another might eliminate tomorrow, especially if financial conditions change significantly.

Seventh, state tax incentives may contain their own seeds of destruction. If incentives are effective at all, a state will gain only a short-lived advantage over other states because they can be expected to adopt similar ones. A tax incentive that is adopted by all states, however, is equivalent in its effect on locational decisions to no incentive at all, except that tax revenue is needlessly lost. In reality, states are often afraid of letting any other state obtain an advantage, and thus tax incentives are often adopted without evaluating the results that occurred elsewhere.
special tax provisions is the greatest, but ironically it is then that a state can least afford any inefficiency, waste, or slippage in its tax structure.

A MISGUIDED APPROACH TO STATE TAX POLICY

New York has probably squandered any state's greatest asset in the area of taxation: a broad and relatively pure tax base, free of refined and moralistic judgments, coupled with the low rates that a broad base facilitates. A state simply does not have to fine-tune its system the way the Congress feels it must in the context of federal marginal rates that can reach forty-six percent in the corporate income tax and fifty percent in the personal income tax. With its lower tax rates, a state can avoid becoming entangled with all of the rarefied distinctions that characterize the federal system and that lead to its spiralling complexity.

Indeed, the administrative cost of many of these distinctions found in New York law may actually exceed any benefits that inure to the state.

The view being expressed, that a broad tax base and lower rates are desirable, is no different from the philosophy underlying the various income tax proposals being discussed in Washington. There is, however, a critical difference. Because of a state's comparatively low rates, a legislature has much less to fear than does the Congress about the economic consequences that might flow from eliminating many of a state's existing provisions.

As an illustration, consider a state like New York that allows all of the itemized deductions that a taxpayer claims under the federal personal income tax. Examined individually, each itemized deduction can be questioned at the state level. The deduction for charitable contributions provides one case. A combination of introspection and a non-scientific survey of tax lawyers and accountants leads to the conclusion that few, if any, taxpayers would contribute less to charities if New York eliminated this itemized deduction. For example, a taxpayer subject to New York's highest marginal tax rate on earned income—ten percent—saves $100 in state income tax by making a $1,000 charitable

49. A survey by the Advisory Commission on Intergovernmental Relations found that support for business tax incentives is strongest where economic growth has been slowest. See Vaughan, State Tax Incentives: How Effective Are They?, CUED COMMENTARY, Jan. 1980, at 3.

50. Once the bases of the major taxes were relatively pure, the legislature could then address such issues as the proper share of revenue that should be raised from each source. Revenue shortfalls could be dealt with through the use of surtaxes rather than by adopting new provisions under severe time constraints.
contribution ($1,000 x 10%). The net out-of-pocket savings are actually less, however, because the $100 reduction in state tax increases the taxpayer's federal income tax. If the taxpayer is subject to a fifty percent federal marginal tax rate, the $100 reduction in state tax increases his or her federal taxes by $50 ($100 x 50%), so that the net out-of-pocket savings are only $50 ($100-$50). Compared with the $500 that this taxpayer saves federally ($1000 x 50%), the additional net state savings of $50 may have no effect on a decision whether to contribute to charity; that decision may be driven solely by federal considerations.

New York's deduction for charitable contributions is questionable for yet another reason. New York residents can claim the deduction regardless of the identity of the charity and the location of its beneficiaries. For state tax purposes, a contribution to an out-of-state university or to a charity with exclusively non-New York beneficiaries is identical to a contribution to a charity that aids the homeless in New York City. For federal purposes, these differences should be irrelevant; for state purposes, however, perhaps such differences should not be ignored. 51

Similar issues can be raised regarding most of the other itemized deductions. These questions cannot be easily dismissed because the price paid for any unnecessary or inefficient base erosion is a combination of reduced government goods and services and higher rates of tax than would otherwise be required. If itemized deductions were eliminated in New York, for example, $1.6 billion in revenue would become available 52 and could be used to reduce tax rates and to increase services. Further, higher taxes or reduced services create additional pressure on a legislature to enact special relief provisions, and these merely

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51. A number of states limit their charitable contribution to only in-state activities. Michigan, for example, provides a tax benefit for: (1) amounts contributed to Michigan colleges and universities, including fund raising agencies under their control; (2) the Michigan Colleges Foundation; and (3) public libraries and public broadcasting stations located in Michigan. Mich. Comp. Laws § 7.557 (1960). Indiana and North Dakota follow somewhat similar rules. See Ind. Code § 6-3-3-5 (Supp. 1981); N.D. Cent. Code § 57-38-01.7 (1983). Illinois recognizes only contributions to designated groups, such as the Illinois Non-Game Wildlife Conservation Fund, and the Illinois Veterans Home Fund. 1983 Ill. Laws 406, 1052.

The charitable deduction has been defended as part of the normative structure of an income tax. See Andrews, supra note 16, at 344-75. If this view is accepted, arguments about the efficiency of the deduction in stimulating charitable contributions become irrelevant. The federal deduction for charitable contributions, however, is generally described as a subsidy to charitable giving and characterized as a tax expenditure. See supra note 37 for a discussion regarding the tax expenditure budget.

52. The revenue estimate is based upon an analysis by the staff of the New York Tax Study Commission.
result in another cycle of more base erosion and still higher taxes or reduced services.  

The preceding examples and discussion suggest that New York, like so many other states, has proceeded totally backwards in developing its tax laws by adopting inefficient and misguided measures that erode the tax base, increase the administrative burden on taxpayers and the tax department, and result in upward pressure on tax rates. This trend must be reversed; the legislature must stop worrying about Tang, Awake, miniature marshmallows, and Head and Shoulders shampoo and return the tax system to its basics.

The test of a state tax system should not be what new provisions can be piled upon an existing, cumbersome tax structure—that test is limited only by legislative imagination, something never in short supply. The test ought to be what can be deleted from the tax structure without sacrificing anything of value. At the federal level, it is sometimes asserted that a conflict exists between simplicity and equity; a complex system is needed in order to draw those distinctions that make the system fairer. At the state level, however, simplicity and equity should be viewed as allies. And one of the goals of any tax study commission should be to design a tax structure in which equity and simplicity can co-exist.

53. From a business lobbyist's perspective, the combination of high nominal rates and a narrow tax base may be preferable to low nominal rates and a broad base. A high nominal rate provides an effective club that can be waved in order to persuade a legislator to support some arcane change in the tax law. One of a lobbyist's predictable tools—the incantation of "business climate" and "economic development"—depends on high nominal rates for maximum impact.