

Testimony of Martha E. Stark
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On Improving the Economic Environment For Freelancers
and Independent Workers

Before the City Council
Committee on Small Business

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Good morning Chairman Yassky and members of the Committee on Small Business. As you know, I am Martha Stark, New York City's Finance Commissioner. Thank you for inviting me to testify today at this oversight hearing on ways to improve the economic environment for freelancers and independent workers. My Assistant Commissioner for Tax Policy, Michael Hyman, who testified before you in January, joins me today.

You have just heard Comptroller Thompson discuss this critical and growing segment of the City's workforce. I am pleased to have this opportunity to provide you with background information about the tax structure that affects freelancers and independent workers. First, let me provide an overview of the City's business tax structure with a focus on the Unincorporated Business Tax, the tax that freelancers and independent workers most often pay in addition to personal income taxes.

Next, I will discuss some of the initiatives we are undertaking to make the Unincorporated Business Tax fairer and simpler. Finally, as always, I am happy to answer your questions.

Unincorporated Business Tax Overview

By way of background, New York City collects four different types of business income taxes. Depending on how freelancers and independent workers organize their business, they might have to pay the City's General Corporation Tax and Unincorporated Business Tax.

In New York City, unlike other taxing jurisdictions and the federal government, S-Corporations pay the General Corporation Tax. This tax will generate an estimated \$2.8 billion in revenue in the current fiscal year from 270,000 taxpayers. Nearly half of all General Corporation Tax payers are S-corporations.

New York City is also unique in its taxation of unincorporated businesses through its Unincorporated Business Tax, which affects partnerships, limited liability companies and individual proprietors. In Tax Year 2004, the latest year for which data is available, 22,000 individual proprietors and 9,000 partnerships and limited liability companies paid the Unincorporated Business Tax. The tax, which is imposed at the rate of four percent on New York City taxable income, will bring in an estimated \$1.4 billion in revenue this fiscal year. Of this amount, individual proprietors will pay about \$200 million.

It's important to remember that individual proprietors can deduct \$10,000 and also take a credit that fully offsets the first \$1,800 of taxes owed. Those with tax liabilities between \$1,800 and \$3,200 receive a partial credit.

Misconceptions about Business Taxes

It may be helpful to give some further context on these taxes. It is often said that New York City's economy should be more diverse, and that the City's fiscal fortunes are too closely tied to Wall Street and the real estate market. While it is certainly true that the City relies heavily on those sectors of our economy, I would

argue that we have a far more diverse base than many other cities, and one that has been growing steadily since 9/11.

The Unincorporated Business Tax is one of the reasons our tax base is as diverse as it is. Nationally, an increasing number of firms are organizing themselves as limited liability companies and S-corporations as a way to avoid paying corporate income taxes. Of course, accountants call this tax planning. Others call it tax avoidance or sheltering. Whatever you call it, it seems clear that this trend has led to a nationwide decline in corporate tax revenues. Studies show that average effective state corporate income tax rates have dropped in the past 20 years from approximately 7 percent to 5 percent.

While some of this is certainly due to tax law changes intended to reduce state-level corporate taxes, aggressive tax planning strategies have also played a role. Indeed, national data show that state corporate tax revenues as a percentage of total state taxes has declined from approximately 10 percent to six percent over the past 25 years.

In New York City, however, we have been able to buck this trend. In the same period, New York City's business taxes have not dropped. Part of the reason is our ability to tax people regardless of how they choose to conduct business. In fact, New York City receives more in tax revenues from S-corporations and unincorporated businesses than it receives from traditional C-corporations.

There is an even more compelling argument for including S-corporations and unincorporated businesses in a business income tax system: These firms compete directly with regular corporations in the marketplace. As with regular C-corporations, the revenues generated through the taxation of flow-through entities comes primarily from a relatively small number of firms with large profits. As a result, the top 10 percent of S-corporation and partnership taxpayers, based on liability owed, pay 80 percent of City business taxes owed by the entity types. And the largest payers, not surprisingly, are engaged in finance and professional service economic activities - the same as other profitable businesses subject to tax.

Smaller firms, including freelancers and independent workers, are also subject to City business taxes. However, many of these taxpayers either pay nothing or only a very small amount. In Tax Year 2004, for example, of the 122,000 proprietors who filed Unincorporated Business Tax returns with the City, 100,000 did not owe taxes because of deductions and credits provided by the tax. Most of these filers benefited from a credit that offsets the first \$1,800 of liability owed by a firm, which is equal to \$45,000 of taxable income. By raising filing thresholds, the City has relieved many businesses of the burden of having to file a tax return. But many people who are not required to file still find comfort in filing returns in order to be on record as complying with City tax law.

About two-thirds of the 22,000 proprietors who do owe the Unincorporated Business Tax pay less than \$5,000 in taxes. As a

group, proprietors paid \$138 million in Unincorporated Business Taxes in 2004.

Changes Proposed to Help Small Businesses

Although the relative tax burden on freelancers and independent workers is smaller than is perceived, we recognize that the Unincorporated Business and General Corporation taxes are far from perfect. That's why Mayor Bloomberg is advocating a package of reforms in Albany meant to bring further relief to people liable for these taxes - in particular, unincorporated businesses and S-corps. Let me run through each of the proposals, which collectively would bring nearly \$250 million in small business tax relief when fully implemented.

Personal Income Tax Credit

The first and most serious issue is one being tackled in a bill promoted by Speaker Quinn with strong support from the Bloomberg Administration. S-Corporations, Limited Liability Companies and Sole Proprietorships owned by City residents are subject to a double tax burden -- once at the entity level through the Unincorporated Business Tax, and then a second time at the personal level on the income to individuals. But the burden is more direct for these entities and their owners.

City business owners who live outside of the five boroughs and business owners of unincorporated businesses are not subject to double taxation. Nonresidents, of course, don't pay the Personal

Income Tax, and business owners receive a credit against their own business income taxes for Unincorporated Business Tax paid by unincorporated businesses.

Of course, the double-tax burden of City residents is already partly addressed by means of a credit against the Personal Income Tax. City residents with taxable income of \$42,000 or less receive a 65 percent credit against Unincorporated Business Tax liability that flows through to them. The credit phases down to a 15 percent credit for individuals who earn more than \$142,000. We are grateful that the Speaker's bill proposes increasing these credit levels by an across-the-board 50 percent so that those at lower income levels would receive a far more reasonable 100 percent reduction.

The bill also proposes adopting a personal income tax credit for owners of S-corporations based on the current 65 percent - 15 percent Personal Income Tax credit.

UBT \$5,000 Deduction

Distributions to owners of unincorporated businesses are not deductible against Unincorporated Business Tax taxable income, because they are in part a return on capital to the owners. However, they are also frequently remuneration for services provided by owners.

In lieu of a compensation deduction, the Unincorporated Business Tax allows a \$5,000 deduction per active partner or proprietor. This \$5,000 amount hasn't changed since the City

enacted the Unincorporated Business Tax in 1966. As a first step, our bill calls for doubling the deduction to \$10,000.

Conclusion

Freelancers and their advocates here today should be assured that we are well aware of many of the challenges faced by the self-employed. During my tenure as Commissioner, we have worked to make Finance an agency where all New Yorkers, including hard working self-employed people paying the General Corporation Tax or the Unincorporated Business Tax, are treated fairly and well. This means clarifying our rules, giving people lots of ways to pay us, and listening to people's concerns. We are grateful for the incredible contributions that freelancers and independent workers make to our City. There's clearly a lot more to be done and I look forward to hearing the recommendations that come out of this hearing.

Thank you, and I will be happy to answer your questions.