OTPA

*New York State Department of Taxation and Finance*

Office of Tax Policy Analysis

SPECIAL REPORT

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# Small Business Report:

*Statistics for Tax Year 1995*

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# Executive Summary

- In 1995, there were over 1 million small businesses operating in New York. Small business accounted for over 50 percent of total employment and almost 50 percent of total receipts in the State.

- This statistical report uses the Economic Development Law (Section 131) definition of a small business. A business is considered small if it has fewer than 100 employees in New York State. The report is based upon information drawn from State withholding and corporate tax returns as well as federal tax return information shared by the Internal Revenue Service with the Department of Taxation and Finance (the Department). In instances where the Department lacked employment information, data from State and federal sources was used to estimate employment. The estimates were performed using the regression technique. This method made it possible to use the employment characteristics of firms for which we had data to impute employment values for similar firms for which we lacked employment information.

- Companies employing no more than ten people accounted for almost 90 percent of all the small businesses. The sole proprietorship was the dominant entity type among companies with five or fewer employees; average receipts of these firms were about $35,500.

- The choice of an entity type is influenced by the industry which is the primary focus of the business. In agriculture, most small businesses were schedule C or F filers. In manufacturing, over 50 percent of the companies were schedule C filers and only 2.1 percent were partnerships. The wholesale trade was dominated by C and S corporations. In the finance, insurance and real estate sector, partnerships accounted for nearly one-third of the companies.

- The report contains information pertaining to corporate conversions to LLC and LLP organizations.

- The tax laws that affect small business have changed significantly recently as a result of legislation, administrative initiatives, and the State's conformity to changes in federal law. These tax changes affected small business directly, indirectly, or acted as incentives. The report contains an appendix that lists the changes that have had an impact upon small business.

Over the last four years, the Department of Taxation and Finance has also undertaken numerous regulatory changes which have eased tax filing requirements for many small businesses.

For example, the Department:

- Adopted new regulations to allow for 100,000 additional businesses to file sales tax returns on an annual basis, rather than quarterly. Previously, any individual or business collecting more than $250 in sales tax monies during a particular year was required to file a sales tax return each quarter, four times a year, even if the business had no taxable sales during that quarter. Under the new regulations the sales tax liability threshold increases from $250 to $3,000 per year.

- Adopted a new regulation that allows as many as 75,000 more businesses employers to file the less complicated corporation tax short form, saving these smaller businesses almost $2 million in annual tax preparation costs.

- Eliminated the requirement that seasonal employers file withholding and wage reporting forms for quarters in which they don't pay wages.

- Established a system which allows those businesses with no taxable activity to file their sales tax return via the telephone. This offers a simple alternative to taxpayers who would otherwise have to file a paper return to report they owed no tax.

- Worked with the Department of State to revamp the corporate dissolution process. It once took as long as six months for the Department to approve a request from a company to dissolve. Today, for a small business to dissolve, it takes less than a week and the process can be completed over the telephone.

- Conducted an ongoing “housecleaning” eliminating hundreds of pages of regulations, almost 25 percent of which existed prior to 1995, that were either obsolete or unnecessarily burdensome on many small businesses.

# Introduction

The Office of Tax Policy Analysis (OTPA), in conjunction with The Small and Independent Business Council, conducted a study profiling small business in New York State during 1991. The Small and Independent Business Council has asked OTPA to prepare a follow-up study.

This report updates the earlier study using the most recent completed year available, 1995. The methodology used in this study contains significant improvements over the process used in the prior report. The section on methodology describes these changes.

One of the key questions in this study is: what is a "small business"? The definition of a small business used in this analysis follows the Economic Development Law definition (Section 131). A business is considered small if it has fewer than 100 employees in New York State.

Small businesses organize themselves in many different forms. The most prevalent organizational form for small business is the sole proprietorship. Sole proprietors may or may not employ additional workers. They file tax returns under the personal income tax for both federal and New York State purposes using federal Schedule C to compute their business profit or loss.

Many farms are also organized as a type of sole proprietorship. The farm owner may hire workers and pay them wages subject to withholding tax. The farmer will also pay tax under the personal income tax, but will use federal Schedule F to compute farm profit or loss.

Partnerships are another small business form. Partners pay income tax on their distributive share of income derived from the partnership. The partnership entity also files informational returns with the State and federal governments. Additionally, limited liability companies (LLCs) and limited liability partnerships (LLPs) are treated as partnerships for income tax purposes.  Appendix A provides additional detail concerning LLCs and LLPs in New York State.

Some small businesses decide to incorporate.  Businesses that pay a New York State entity tax under the general business corporate franchise tax (Article 9-A) are referred to as C corporations.  Small businesses, including some farms, may choose this organizational form to insulate the business owners from liability.

General business corporations with 75 or fewer shareholders can elect subchapter S status for both federal and New York State tax purposes. This election causes the income from the S corporation to flow through from the entity to the shareholder.  Each shareholder pays income tax on their pro rata share of the corporation's income.  With personal income tax rates generally below corporate tax rates, S corporation status confers tax benefits on these business owners.  In New York State, the S corporation entity also pays an entity level tax.

There are also small business corporations that are classified as transportation, transmission, and utility companies.  These include mainly trucking companies, but may also include small railroads, telephone, and water companies.  Unlike other corporations, these companies pay the Corporation and Utilities taxes under Article 9 of the Tax Law.  However, trucking and railroad companies now have the option of paying tax either under Article 9 or under the general corporate franchise tax, Article 9-A.

Since 1995, New York State has undertaken a series of important tax reductions that have provided benefits to small businesses.  These tax cuts can be categorized into three distinct types.  First, there are tax reductions that directly affect small businesses.  The centerpiece of these direct tax cuts was the three year reduction in the personal income tax enacted in 1995.  As discussed above, all small businesses except those organized as C corporations, pay their tax under the personal income tax. Other significant direct tax relief provisions for small businesses include reductions in the S corporation entity level tax, reductions in tax rates on C corporations, and a credit for farmers for school property taxes paid. Please refer to Appendix B for more detail on these provisions as well as a complete listing of all tax relief provisions enacted beginning in 1995.

A second type of tax relief affects small businesses indirectly. For example, legislation enacted in 1997 commenced reductions in the gross receipts tax paid by gas, electric and telecommunications utilities during 1998, and further reduces these taxes on January 1, 2000. As these tax cuts get passed through to end users in the form of lower prices, as mandated in the statute, small business consumers of utility services will enjoy lower costs. Another example of indirect tax relief is the estate tax reductions that began in 1998 and that will continue into next year. These provisions will allow family owned businesses to be passed on to the next generation without onerous estate taxes causing liquidation of the business assets just to pay the tax.

The final category of tax relief are those provisions that provide incentives for consumers to utilize New York businesses. A prime example of this type of relief is the various sales tax on clothing exemption weeks enacted over the past few years. The exemption becomes a permanent fixture in law beginning December 1, 1999.

Finally, other non-tax initiatives also provide substantial relief to small businesses. Among these are regulatory reform, and workers compensation relief. While immensely important, these measures are not within the purview of the Department of Taxation and Finance. Therefore, they will not be discussed further in this analysis.

Given the number of important changes to New York's tax climate, this report, the first in a series, will profile the status of the small business community. Over 1 million separate business entities operating in the State are classified as "small." These small businesses account for over 50 percent of the total employment and almost 50 percent of total gross receipts generated in New York State.

# Methodology

Small businesses are defined as those businesses that employ fewer than 100 employees in New York. The only data available from Tax Department sources for determining number of employees is from withholding tax returns. The major data source for sole proprietors, partnerships, and Schedule F farmers comes from federal tax returns, shared with the Department from the IRS. Data on S corporations and C corporations are available from both State and federal tax returns.

The flow charts in Appendix C depict the data sources used, as well as the process of merging information from State entity tax returns with the withholding and federal tax return files. Federal information supplements the State tax return information for C corporations, S corporations, and Article 9 filers. For example, C corporations are required to provide to the State information on their gross receipts only if they allocate their net income. However, many small businesses are wholly present in New York. Therefore, the information available about their gross receipts is available from the federal tax return files. The merging of the files was based on the employer identification number.

To obtain information on the number of employees, each of the tax return files were merged with the withholding information. The merge success rate with the withholding files, differed among entity types, but was not completely successful for any given entity. Because the study attempts to profile the population of businesses, a complete analysis required imputing employment, based on other characteristics, for those entities which did not match successfully with the withholding files.

Regression analysis was used to analyze the relationship between employment and other characteristics such as gross receipts, wages, net income, and other size measures for those entities which did successfully match the withholding file. This procedure allowed the estimation of employment for those businesses for which employment information was not directly available. Separate regressions were performed for each entity type for each industry. The explanatory characteristics differed depending on the data available for each entity type. The explanatory power of the regressions differed substantially among entity types and industries. However, in all cases the results were statistically significant. The results of the regressions were used to calculate employment for those entities which did not successfully match the withholding files using their actual values for gross receipts, income, etc.

The data sources, however, even with these techniques, lacked sufficient information on these other characteristics to impute employment for some entities. These entities are excluded from the remaining analysis, with a note as to the number of them.

Other issues worth noting are:

- Consistent with the prior report, Schedule C filers (sole proprietorships) with less than $10,000 in gross receipts were excluded from the analysis. This decision was an attempt to segregate "hobby" Schedule C activity from active sole proprietorship businesses. A separate table is included which reports the numbers of these entities, and their gross receipts class.

- For sole proprietorships, we added 1 to the actual or imputed employment to account for the sole proprietor him(her)self.

- The regression results for the sole proprietorships were not sufficiently reliable for imputing employment. Therefore, we used the information about the relationships between employment and other tax return variables derived from partnerships to impute employment for sole proprietorships. We then used the actual values for these tax return variables from the sole proprietorship returns.

- For partnerships, the number of partners was added to the actual or imputed employment from the withholding files to account for the partners employed in the entity (for which withholding may not apply).

# Analysis

## Number of Small Businesses by Employment Class

*In 1995, there were over 1,000,000 small businesses in New York State*

As shown in Table 1, in 1995 there were 1,056,272 small businesses in New York State. Nearly one-half, about 45 percent, were sole proprietors (schedule C filers). There were over 26,000 small businesses with income from farming operations (schedule F filers), although these accounted for less than 2.5 percent of small businesses. Many of these represent family farms. Partnerships accounted for almost 10 percent of the small businesses.

There were over 450,000 small business corporations in New York State in 1995 accounting for slightly less than one-half of all small business in the State. S corporations, numbering 236,701, accounted for slightly more firms than the 215,282 general C corporations. There were also over 5,000 corporations that were classified for State purposes as Article 9 corporations. Many of these corporations were trucking companies.

*Companies employing no more than ten people accounted for almost 90 percent of all the small businesses in the State*

Firms with ten or fewer employees accounted for nearly 90 percent of all the small business in New York. The smallest, those with 0-5 employees, accounted for over one-half of all small business firms. The density of the smallest firms in terms of employees is a pattern that holds for all entity types. For example, nearly two-thirds of the C corporations had five or fewer employees.

Table 1: Distribution of Number of Businesses by Entity Type and Employment Class, 1995

| Employment Class | Sole Proprietorships: General Schedule C* | Sole Proprietorships: Farmers Schedule F | Article 9 Corporation | Partnership | S Corporation | C Corporation | Total |
|---|---|---|---|---|---|---|---|
| 1-5 employees | 229,353 | 22,885 | 3,454 | 23,180 | 185,011 | 133,368 | 597,251 |
| 6-10 employees | 226,486 | 2,877 | 836 | 48,271 | 25,271 | 38,902 | 342,643 |
| 11-25 employees | 14,225 | 253 | 645 | 21,910 | 17,419 | 27,557 | 82,009 |
| 26-50 employees | 752 | 67 | 263 | 5,690 | 6,187 | 10,103 | 23,062 |
| 51-99 employees | 614 | 20 | 141 | 2,367 | 2,813 | 5,352 | 11,307 |
| Total Small Businesses | 471,430 | 26,102 | 5,339 | 101,418 | 236,701 | 215,282 | 1,056,272 |
| 100 or more employees | 1,145 | 11 | 128 | 1,483 | 1,838 | 5,025 | 9,630 |
| Total All Businesses | 472,575 | 26,113 | 5,467 | 102,901 | 238,539 | 220,307 | 1,065,902 |
| Number With Missing Employment | 0 | 59 | 925 | 15,982 | 0 | 37,444 | 54,410 |

*Schedule C businesses with fewer than $10,000 in Gross Receipts are omitted from the analysis. For additional information on these companies, see Table 4.

## Small Businesses as a Percent of all Businesses, Employment, and Receipts

*Almost all businesses in New York are small*

Table 2 shows that in 1995, approximately 99 percent of all businesses in the State were small. The lowest concentration of small businesses was for corporations classified as Article 9 corporations, C corporations were only slightly different from Article 9 corporations in terms of the percentage of companies classified as small. Schedule C and Schedule F businesses had the highest percentages of companies classified as small.

*New York's small businesses provide more than one-half of the employment in the State*

All small business types provided about 55 percent of the State's employment. As expected, this percentage varies significantly by entity type. Almost all, over 95 percent, of schedule F farm employment was attributable to small business. Small C corporations accounted for 44 percent of employment. Not surprisingly, in the concentrated utility and transportation sector, small Article 9 corporations accounted for the smallest employment percentage attributable to small business with just under 20 percent.

*New York's small businesses garner nearly one-half of all receipts*

Small businesses accounted for nearly one-half of all business receipts. This percentage varied greatly according to entity type. Small Article 9 corporations, reflecting the presence of large energy and telecommunications companies, accounted for less than 3 percent of receipts. Small schedule F farms accounted for 99.8 percent of receipts.

The receipts of C corporations were evenly split between small and large companies, with small businesses receiving 50.3 percent of the receipts and large companies the balance.

Small partnerships and small S corporations are the two entity types that differed most significantly in terms of the percentage of employment and receipts. Small partnerships accounted for less than 40 percent of total partnership employment and receipts. Small S corporations employed over 70 percent of S corporation employees and accounted for over three- fourths of S corporation receipts.

Table 2: 1995 Summary of Small Businesses

| | Percent of All Businesses that are Small | Percent of Employment Accounted for by Small Businesses | Percent of Gross Receipts Accounted for by Small Business |
|---|---|---|---|
| Sole Proprietorship Schedule C* | 99.76% | 73.82% | 93.67% |
| Sole Proprietorship Farmer Schedule F | 99.96% | 95.33% | 99.80% |
| Article 9 Corporation | 97.66% | 19.29% | 2.91% |
| Partnership | 98.56% | 39.82% | 33.26% |
| S Corporation | 99.23% | 70.40% | 76.47% |
| C Corporation | 97.72% | 44.31% | 50.31% |
| All Entity Types | 99.10% | 55.23% | 47.52% |

*Schedule C businesses with fewer than $10,000 in Gross Receipts are omitted from the analysis. For additional information on these companies, see Table 4.

## Average Receipts of Small Businesses by Entity Type and Employment Class

*The average receipts of the smallest sole proprietorships, those with five or fewer employees was about $35,500*

Table 3 shows that the smallest entities by employment class had the smallest average receipts. The average level of receipts tended, with some exceptions, to increase with employment. Sole proprietorship Schedule C and sole proprietorship farmers (schedule F) companies look different in that their average receipts for each employment class tended to be significantly less that the average receipts for the other entities. The average of receipts for each employment class for C corporations was always greater than the average receipts for the same employment class of S corporations. Average receipts for C corporations was also always greater than the average receipts for Article 9 corporations for the corresponding employment class.

Table 3: Average Receipts of Small Businesses by Entity Type and Employment Class, 1995

| | Sole Proprietorship | | | | | | |
|---|---|---|---|---|---|---|---|
| | Schedule C* | Schedule F | Article 9 Corporation | Partnership | S Corporation | C Corporation | Avg. Receipts All Entities |
| 1-5 employees | $35,480 | $25,207 | $100,132 | $108,026 | $175,775 | $1,277,610 | $417,898 |
| 6-10 employees | $88,220 | $188,599 | $409,699 | $212,226 | $709,429 | $1,537,824 | $310,320 |
| 11-25 employees | $478,675 | $317,353 | $1,219,982 | $936,040 | $1,840,175 | $2,904,368 | $1,896,505 |
| 26-50 employees | $1,539,487 | $395,197 | $2,805,682 | $4,328,638 | $3,922,743 | $6,910,298 | $5,805,685 |
| 51-99 employees | $787,459 | $560,462 | $8,579,192 | $8,996,450 | $8,593,904 | $13,084,067 | $11,015,664 |
| Avg. Receipts for All Small Employment Classes | $77,569 | $47,412 | $629,127 | $678,843 | $649,375 | $2,092,388 | $677,565 |

*Schedule C businesses with fewer than $10,000 in Gross Receipts are omitted from the analysis. For additional information on these companies, see Table 4.

## Gross Receipts Distribution for Schedule C Filers with Gross Receipts Less Than $10,000

*There are nearly one-half million sole proprietorships with less than $10,000 in gross receipts*

As shown in Table 4, nearly one-half million New Yorkers were involved with a small business with less than $10,000 in receipts as evidenced by schedule C filers in 1995. Over 100,000 had receipts of $1,000 or less. The average level of receipts for schedule C filers that had less than $10,000 in receipts was just over $3,500.

Table 4: Gross Receipts Distribution Sole Proprietorship - Schedule C Filers with Gross Receipts Less Than $10,000 — 1995

| Gross Receipts Class | Number Businesses | Average Receipts |
|---|---|---|
| $0 | 2,825 | NA |
| $ 1 - $1,000 | 100,491 | $553 |
| $1,001 - $2,500 | 114,423 | $1,701 |
| $2,501 - $5,000 | 117,692 | $3,691 |
| $5,001 - $7,500 | 81,699 | $6,210 |
| $7,501 - $9,999 | 61,858 | $8,704 |
| Total | 478,988 | $3,612 |

Table 4 provides information about the very smallest sole proprietors as measured by gross receipts. These companies were excluded from the statistical analysis presented in the other tables and figures contained in this report.  However, because these companies are so numerous, and are indicative of the vitality of the entrepreneurial spirit in New York, it is important to provide some description of their activity.

There are a number of explanations for an entity with extremely low gross receipts.  Such companies could be start-up companies that were created during the year.  In their first year of operation such companies could have very low gross receipts, either because of their creation late in the year, or because of the nature of initial operations.  Schedule C filers may also engage in part-time business operations to supplement their wage income or their family income.  Many individuals conduct business operations from their homes on a part-time basis.  Frequently these operations involve the sale of nationally known and advertised retail products.  Often the gross receipts of such business activity is less than $10,000.  Other schedule C activity is generated by individuals whose business is more in the nature of a hobby.  This "hobby" activity could generate receipts during a year that would require the filing of a schedule C return.

## Distribution of Entity Types for Each Employment Class

*The sole proprietorship is the dominant entity type among companies with five or fewer employees*

Two of the more interesting findings to emerge from the analysis of the data concern the choice of the type of entity and the level of employment or business activity.  Businesses in the various sectors of the State's economy tended to chose to organize themselves to conduct business in different ways.  The study shows that the most likely choice of an entity type was strongly influenced by the type of economic activity in which the business was engaged.  In addition, the study shows that the size of small firms in terms of employment was also an important factor in the choice of an entity type.

As illustrated in Figure 1-A, for the smallest businesses, as measured by having five or fewer employees, the most common entity type was the sole proprietorship, with about 38 percent of the companies, followed closely by S corporations, with about 31 percent of the companies.  Figure 1-B shows that in the range of employment of six to ten employees the sole proprietorship retained domination, with about 66 percent of businesses; but partnerships became significant, accounting for 14 percent of businesses, followed by C corporations and S corporations.

In the employment classes of more than ten employees, Figures 1-C and 1-D show that the C corporation form became the dominant entity type. S corporations and partnerships were significant as well. The sole proprietorship accounted for fewer business entities in these employment classes.

Fig. 1-A: Distribution of Entity Types for
Employment Class 1-5

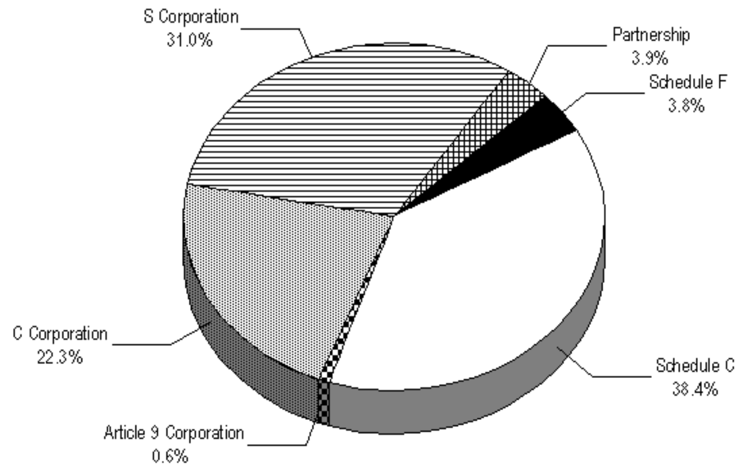



Fig. 1-B: Distribution of Entity Types for
Employment Class 6-10

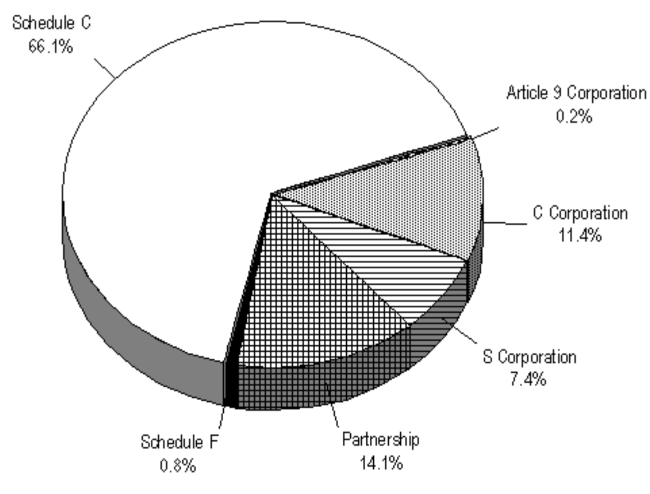


Fig. 1-C: Distribution of Entity Types for
Employment Class 11-25

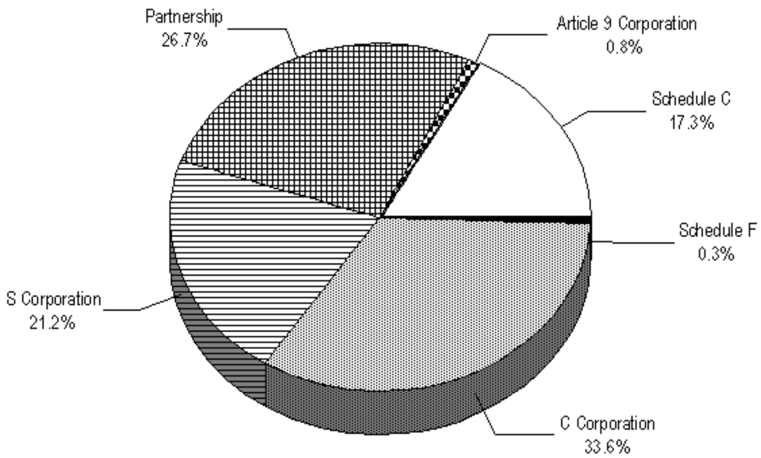



Fig. 1-D: Distribution of Entity Types for
Employment Class 26-50

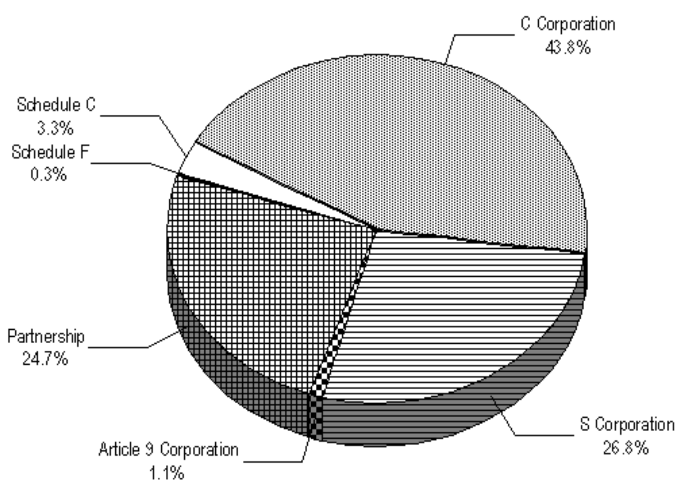
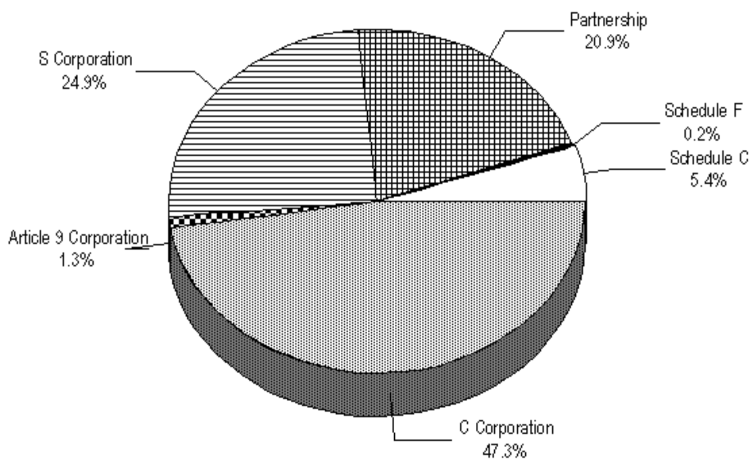


Fig 1-E: Distribution of Entity Types for
Employment Class 51-99



## Distribution of Entity Types for Each Industry for Small Businesses

*The choice of an entity type is influenced by the industry which is the primary focus of the business*

Using tax reporting documents as the source for industry information creates unique problems in reporting agricultural industry statistics. The nature of the agricultural sector results in the reporting of agricultural activity in different ways. An understanding of how agricultural activity is captured for tax reporting is helpful in interpreting the statistics contained in the report. In recognition of family farming as a primary agricultural activity, farming conducted by sole proprietorships is reported on schedule F. However, farming operations conducted by corporations would be captured as C corporation agricultural activity. In addition, the agricultural SIC classification includes activities other than farming that support agricultural activity. As a result, farming activity conducted by a sole proprietorship would be reported on schedule F and non-farming income classified as from an agricultural activity conducted by a sole proprietorship would be reported on schedule C. Corporate farming activity and non-farming agricultural support activities would be placed within the agricultural SIC code and be reported under C corporation agriculture. As shown in Figure 2-A, in the agricultural sector, most small businesses were schedule C filers, or schedule F filers.

Figure 2-B shows small businesses in the mining industry were also predominantly schedule C filers. In the construction industry, Figure 2-C, the corporate form of organization takes on more importance. Over 80 percent of small construction firms were corporations. Nearly one-half of small construction firms were S corporations, and over one-third were C corporations.

In manufacturing, Figure 2-D, the schedule C sole proprietorship was dominant, with over 50 percent of the small manufacturers. C and S corporations were almost evenly split, with each at about 20 percent. Partnerships accounted for only 2.1 percent of the small businesses engaged in manufacturing.

Figure 2-E shows, that in the transportation, communication and public utility sector, the corporate form was dominant; however, the schedule C was the largest single entity type, accounting for over 30 percent of all small companies. S corporations represented almost 25 percent of these companies followed by C corporations and Article 9 corporations.

The wholesale trade, Figure 2-F, was noteworthy for the dominance of the corporate form. Together C and S corporations accounted for over 90 percent of small businesses.  C corporations accounted for almost one-half of the firms, with nearly 50 percent, S corporations represented over 44 percent.

The composition of the retail trade, as shown in Figure 2-G, was more diverse.  S corporations were predominant, representing over one-third of the firms, followed closely by C corporations with 30 percent of small businesses.  Over 25 percent of the firms were schedule C filers, and less than 8 percent were partnerships.

The finance, insurance and real estate (FIRE) sector (Figure 2-H) is the only sector in which the partnership form of organization was dominant among small businesses.  In this sector, partnerships accounted for nearly one-third of the small business firms.  Schedule C filers, with about 25 percent and S corporations, with slightly less, were nearly evenly split, followed by C corporations with almost 20 percent.

The schedule C filer was the dominant form of enterprise in the service sector.  Schedule C filers represented nearly one-half of all firms.  S and C corporations were nearly evenly split with between one-fourth and one-fifth of the firms.  Partnerships represented about 8 percent of the firms.

Figure 2-J summarizes the distribution of small businesses by entity type.  It shows that nearly half of all small businesses in the State were sole proprietorships.  Just over 40 percent were corporations approximately evenly divided between C and S corporations.  Almost 10 percent were partnerships.

**Fig. 2-A: Distribution of Entity Types for Agriculture**

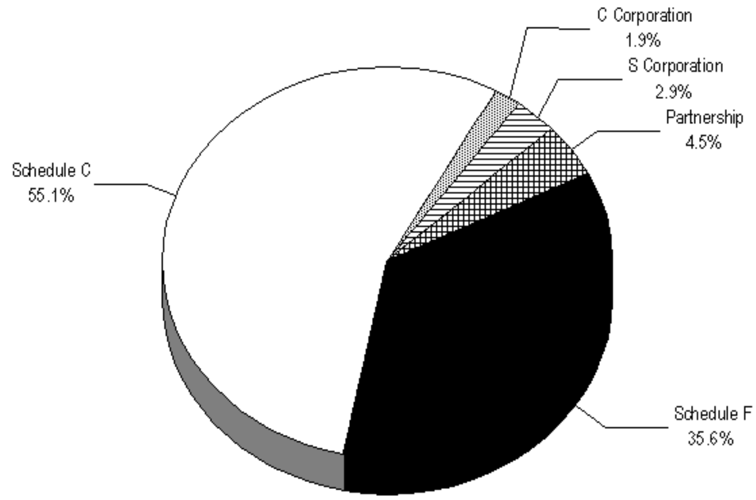



Fig. 2-B: Distribution of Entity Types for Mining

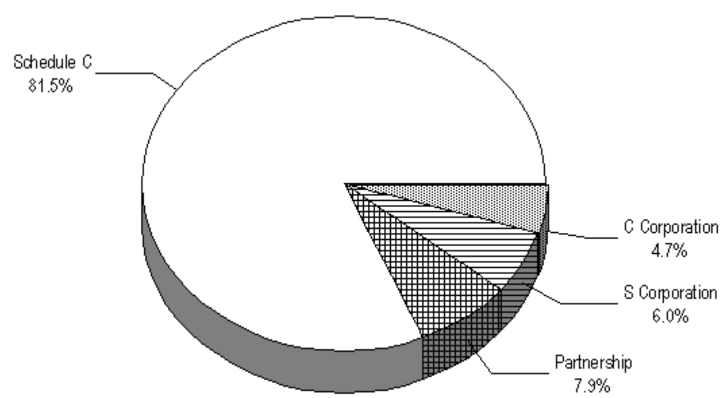


Fig. 2-C: Distribution of Entity Types for Construction

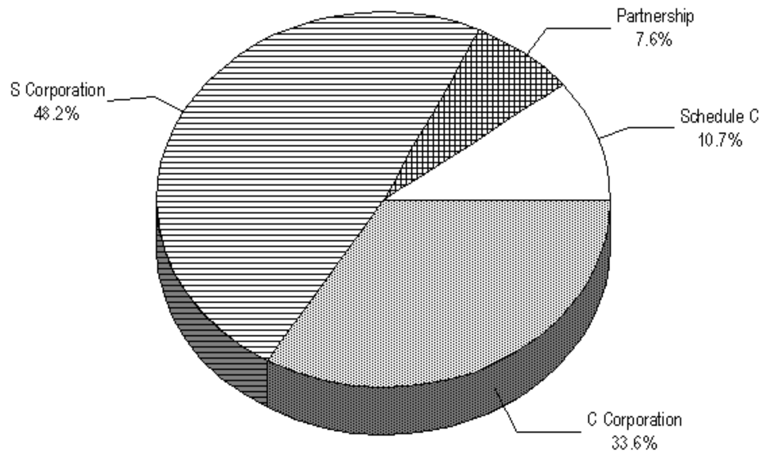



**Fig. 2-D: Distribution of Entity Types for Manufacturing**

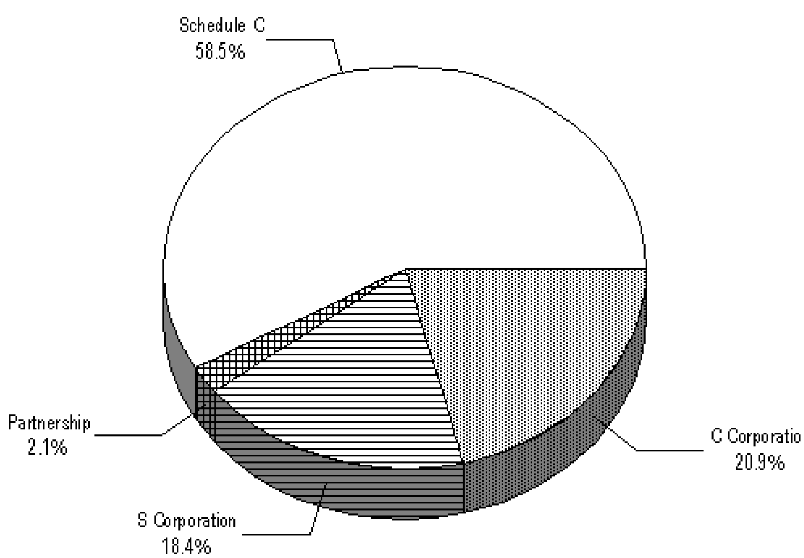


Fig. 2-E: Distribution of Entity Types for Transportation, Communication & Public Utilities

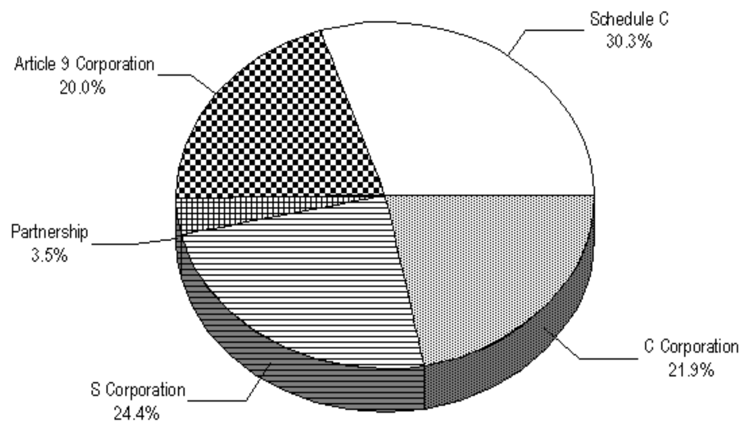



Fig. 2-F: Distribution of Entity Types for Wholesale Trade

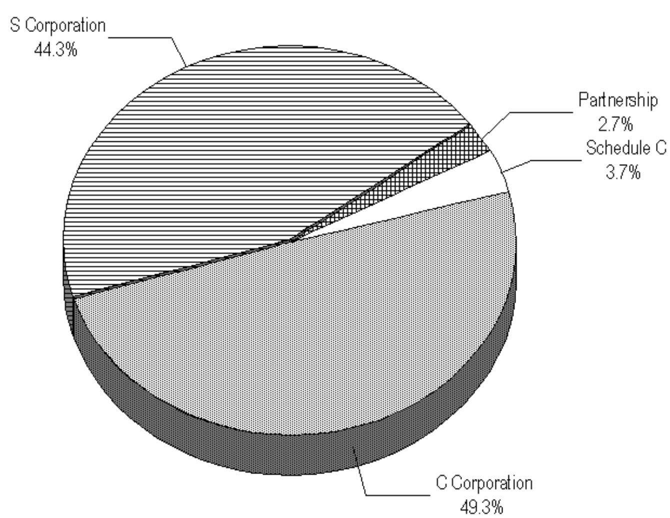


Fig 2-G: Distribution of Entity Types for Retail Trade

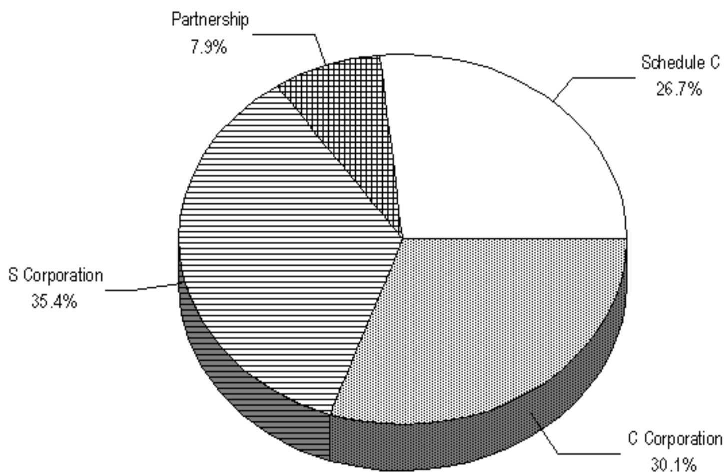



Fig 2-H: Distribution of Entity Types for
Finance, Insurance, Real Estate

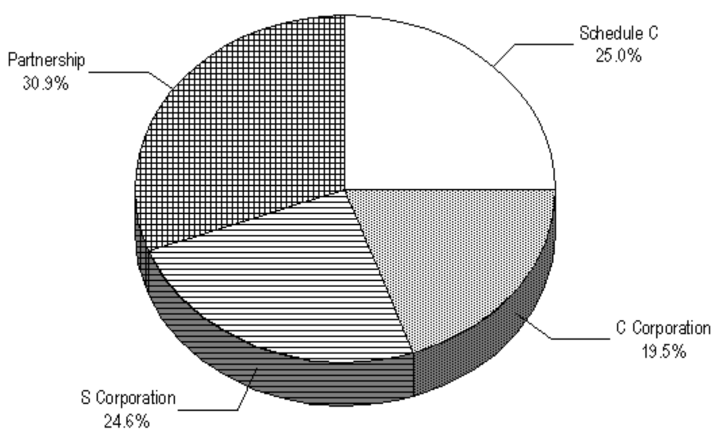


Fig 2-I:  Distribution of Entity Types for Services

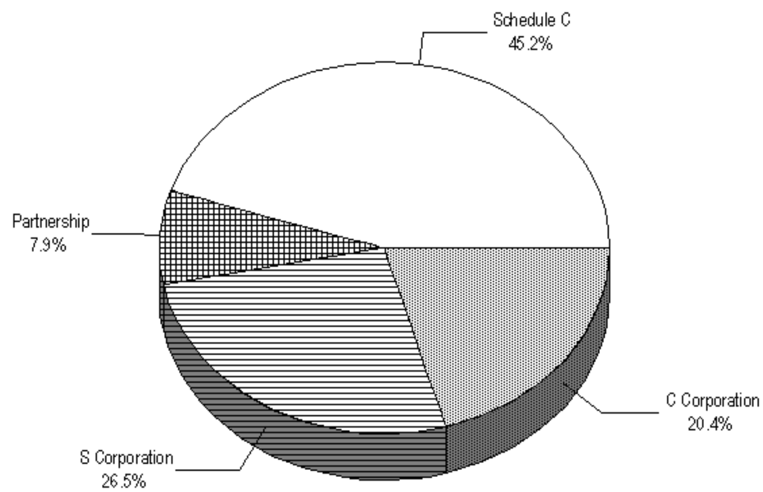
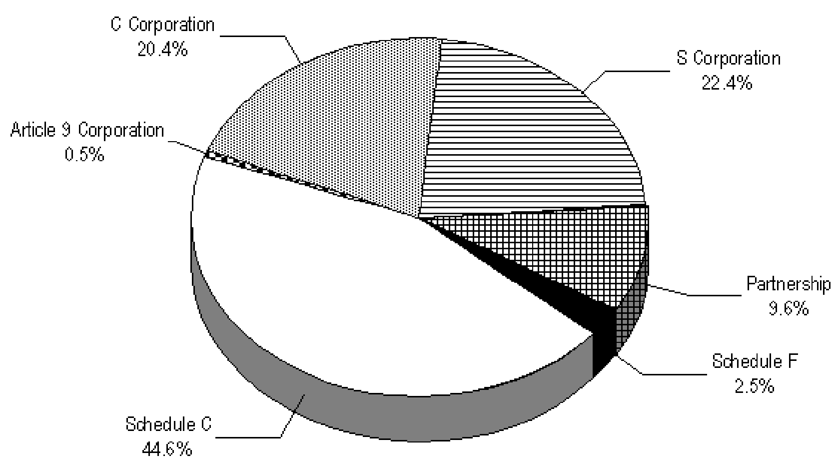



Fig 2-J:  Distribution of Entity Types for All Industries



# Appendix A:  LLC's and LLP's

A limited liability company (LLC) provides members with the limited liability aspect of corporate form while retaining federal and State partnership tax treatment.  In this respect, any income earned by the LLC passes through to members for inclusion in their personal income tax return or, in the case of a corporate member, their corporate franchise tax returns.

Limited liability partnerships (LLP) closely resemble LLCs both in formation and tax treatment.  One key difference between an LLC and an LLP is that Partnership Law governs the LLP while Limited Liability Law governs an LLC.  Moreover, every LLC or LLP that is treated as a partnership and has any New York-source income must pay an annual fee in lieu of the entity-level tax.  The fee equals $50 multiplied by the number of members of the LLC or partners of the LLP.  The fee may not be less than $325, nor more than $10,000 in any year.

The following table sets forth LLC and LLP formation and conversion activity for the period January 1, 1995 to December 31, 1995.  However, the tax liability for these entities is based on tax year 1993, the latest information available.

The following table shows LLC activity during the 1995 calendar year.

## Selected Information on LLC and LLP Organizations January 1, 1995 - December 31, 1995

| Item | Total | Professional LLCs and LLPs * | Other LLCs |
|---|---|---|---|
| Number of Firms | 9,045 | 1,212 | 7,833 |
| Number of Domestic | 8,550 | 1,190 | 7,360 |
| Number of Foreign | 495 | 22 | 473 |

## Corporate Conversions to LLC and LLP Organizations January 1, 1995 - December 31, 1995

| Item | Total Number | Total 1993 Liability |
|---|---|---|
| Total C and S Corporation Conversions | 443 | $642,818 |
| C Corporation Conversions | 198 | $433,650 |
| S Corporation Conversions | 245 | $209,168 |
| C and S Corporation Conversion Minimum Taxpayers in 1993 (estimated full-year and part-year) | 249 | $84,591 |
| C Corporation Conversion Minimum Taxpayers in 1993 (estimated full-year and part-year) | 69 | $25,575 |
| S Corporation Conversion Minimum Taxpayers in 1993 (estimated full-year and part-year) | 180 | $59,016 |
| C and S Corporation Conversion Non-minimum Taxpayers in 1993 (estimated) | 194 | $558,227 |
| C Corporation Conversion Non-minimum Taxpayers in 1993 (estimated) | 129 | $408,075 |
| S Corporation Conversion Non-minimum Taxpayers in 1993 (estimated) | 65 | $150,152 |

*This category includes professional service limited liability companies (PLLCs) and LLPs. Both PLLCs and LLPs can only be formed by professionals.

# Appendix B: Important Tax Changes Affecting New York's Small Business

Tax laws that affect New York's small business population have changed significantly over the last four years. This has been due to several factors including: the enactment of legislation as part of the State budget and legislative processes; administrative initiatives undertaken to resolve issues raised under New York's current tax structure; and New York's conformity to enacted federal legislation and administrative rulings.

## State Budget and Legislative Actions

Legislation enacted after 1994 contained a significant number of tax reductions and other incentives aimed at increasing New York State's competitiveness and reducing tax burdens on individuals and businesses. These changes are presented by tax type.

This analysis considers three types of tax changes, direct, indirect and business incentives. Direct tax changes apply to income or earnings of a taxable entity, for instance, the personal income or corporate franchise taxes. Indirect taxes apply primarily to inputs, and are part of business operating costs. Indirect taxes include the telecommunications and corporate utilities taxes, the petroleum business tax and various fuel use taxes. Indirect taxes also include taxes triggered by non-recurring transactions, for instance, real property transfer and gains taxes. Business incentives include changes to the tax law that enhance the overall business climate of the State such as tax credits or exemptions.

### Direct Taxes

**Personal Income Tax**

The centerpiece of the tax changes accompanying the fiscal 1995-96 budget was a multi-year reduction in personal income taxes. These changes:

- Reduced the top tax rate incrementally, from 7.875 percent in 1994 to 6.85 percent in 1997 and subsequent years;

- Raised the standard deduction from $9,500 to $13,000 for married couples and from $6,000 to $7,500 for individuals; and

- Expanded the income threshold by 1997 where the top rate becomes effective from $26,000 to $40,000 of taxable income for married filers, and from $13,000 to $20,000 for individuals.

**Corporate Business (Franchise) Tax**

Legislation enacted as part of the State budget process and legislative sessions also contained corporate tax reduction. The most significant provisions included:

- Corporation franchise tax rate reduction - incrementally reduced the rate imposed under the entire net income (ENI) base of the Article 9-A corporate franchise tax. The rate reduction phases in over three years, from 9 percent currently to 7.5 percent for taxable years beginning after June 30, 2001;

  Small businesses with ENI of not more than $200,000 will realize a rate reduction from 8 percent to 7.5 percent, effective for taxable years beginning before June 30, 1999. A separate formula applies to small businesses with ENI of more than $200,000, but not over $290,000. This rate reduction takes effect for taxable years beginning after June 30, 1999 and before July 1, 2001. For taxable years beginning after June 30, 2001, the tax rate will equal 7.5 percent;

- Alternative Minimum Tax Rate Reduction - reduced the alternative minimum tax rate from 3.5 percent to 3 percent for taxable years beginning after June 30, 1999;

- Fixed dollar minimum rate reduction - reduced the fixed dollar minimum tax for small business taxpayers. The fixed dollar minimum tax decreases from $325 to $100 for taxpayers with gross payrolls of $250,000 or less. The fixed dollar minimum tax decreases from $325 to $225 for taxpayers with gross payrolls of more than $250,000 but not more than $500,000;

- S Corporation rate differential reduction - decreased the S corporation entity-level tax over a three year period, from 1.125

percent to 0.65 percent for taxable years beginning after June 30, 2001. For small business taxpayers with entire net income (ENI) of not more than $200,000, the entity level tax falls to 0.05 percent for taxable years beginning after June 30, 1999;

- Fulfillment service businesses -- provided that foreign corporations that use a New York fulfillment service businesses (unless the service provider is an affiliate) will not have nexus with New York for purposes of the Article 9-A franchise tax on business corporations and;

- Completed the elimination of the temporary business tax surcharge as of 1997.

**Other Corporate Taxes**

Other corporate tax law changes:

- Reduced the Section 184 gross receipts tax rate applicable to trucks and railroads from 0.75 percent to 0.6 percent beginning in 1997 to 0.375 percent on July 1, 2000; and

- Provided that trucking and railroad companies would be taxed on income beginning in 1998, with an option to remain under the Article 9 gross receipts tax base.

## Indirect Taxes

**Estate and Gift Tax**

Legislation enacted as part of previous State budgets expanded tax benefits with respect to the Estate and Gift Tax. The most significant changes:

- Enacted a new estate tax deduction equal to a maximum of $250,000 of the equity in the decedent's principal residence;

- Increased the unified credit against the estate tax from $2,950 to $10,000, and thereby increased the exemption equivalent from $115,000 to $300,000, beginning on or after October 1, 1998;

- Increased the unified credit for gift taxes for gifts up to $300,000 made on or after January 1, 1999;

- Repealed the gift tax for gifts made on or after January 1, 2000; and

- Replaced the estate tax with a "pickup" of the tax equal to the maximum federal credit for State death taxes, increased the exemption level for estates to the current federal level beginning February 1, 2000 and added a $1 million cap on the exemption equivalent of the pickup.

More recently, State budget legislation updated the conformity of the estate and gift tax to the Internal Revenue Code, from November 5, 1990 to August 5, 1997. This incorporated the federal legislation enacted in 1997, most notably including a new estate tax exclusion for assets in family-owned businesses. The exclusion cannot exceed $675,000 in 1998, and estates which elect the exclusion cannot use the current State credit for closely held business assets. The conformity legislation also helps ensure that when the pickup tax takes effect on February 1, 2000, it will not apply to estates that are not subject to federal estate tax.

**Telecommunications and Utilities Taxes**

Aside from rate reductions, the most significant change in Article 9 taxation involved the restructuring of New York's franchise and excise taxes on telecommunications. In addition to this change, more recent legislation was enacted to provide relief from high energy and operating costs. These changes:

- Reduced tax rates for corporation and utilities providing electricity, gas and telephone services from 3.5 percent to 3.25 percent on October 1, 1998 (and further reduced rates to 2.5 percent on January 1, 2000); and

- Reduced the Section 184 corporate franchise tax on transportation and transmission from 0.75 percent to 0.375 percent effective July 1, 2000.

- Through the Power for Jobs Program, created a new tax credit against the tax on the furnishing of utility services.

**Sales and Use Tax**

Recent legislation included several sales and use tax changes, for example:

- Promotional materials - expanded the exemption for printed promotional materials and related services, including storage services, when the promotional materials are mailed or shipped to customers in New York State. (The budget also exempted the purchase of certain services ancillary to the exempt promotional materials.);

- Coin-operated devices - provided relief to various businesses and consumers selling and purchasing goods and services through coin-operated devices (vending machine sales of food and hot drinks, car washes, photocopy machines, luggage carts, and bulk vending);

- Vendor allowance - increased the vendor allowance to three and one-half percent of the State sales tax collected and raising the cap from $100 to $150 per quarter;

- Telephone central office equipment - extended the exemption for telephone central office equipment to include central office equipment or station apparatus used directly and predominately in receiving, amplifying, processing, transmitting and transmitting telephone or telegraph signals;

- Computer system hardware - exempted, as of June 1, 1998, computer system hardware used directly and predominately in designing and developing computer software for sale;

- Mandated emissions testing equipment - exempted equipment used for enhanced emission inspections of motor vehicles; and

- Alternative fuel vehicles and vehicle conversions - extended the current exemption for five years and broadened it to include equipment installed at alternative vehicle refueling facilities.

## Miscellaneous Taxes

State budget legislation in the miscellaneous taxes has featured tax reductions and exemptions. These changes, made to a variety of taxes:

*Motor Fuel Excise Tax:*

- Reduced the diesel motor fuel excise tax from 10 cents to 8 cents per gallon;
- Provided an up-front exemption from the motor fuel excise tax for retail sales of aviation gasoline;

*Petroleum Business Tax (PBT):*

- Reduced the petroleum business tax on aviation fuels to 5.2 cents per gallon (before surcharge), reduced the monthly minimum petroleum business tax $25 to $2 and permitted non-airline aviation businesses to file annually rather than monthly;
- Reduced the supplemental PBT rate on automotive diesel product by 0.75 cents per gallon effective January 1, 1998, and by an additional 1 cent per gallon effective April 1, 1999;
- Exempted residual petroleum product and non-automotive diesel product used for manufacturing purposes beginning January 1, 1998;
- Exempted residual petroleum and non-automotive diesel product used for commercial purposes from the supplemental tax effective March 1, 1997;
- Increased the credit allowed against the PBT on residual petroleum product and non-automotive diesel product used to generate electricity by 0.5 cents per gallon effective April 1, 1999;
- Provided for reimbursements of petroleum business taxes on aviation fuel;

- Clarified the operation of the PBT and granted refunds and credits under the PBT and motor fuel excise tax;

*Truck Mileage and Fuel Use Tax*

- Reduced the supplemental tax portion of the truck mileage tax (TMT) by 50 percent as of January 1, 1999;

- Extended the time period to claim a fuel use tax or carrier tax refund for fuel purchased within the state but consumed outside the state, and to claim a refund for erroneous payments under the highway use tax from two to four years;

*Real Property Transfer/Gains Taxes*

- Extended the qualifying periods for the real property transfer gains tax builder's exemption;

- Eliminated the real property gains tax, as of June 15, 1996. This tax, which was enacted in 1983, imposed a 10 percent levy on the gain derived from non-residential property transfers over $1 million; and

- Made permanent existing provisions contained in both the State and New York City real estate transfer taxes concerning newly formed real estate investment trusts (REITs), and provided temporary additional tax relief for property transferred into existing REITs; and

*Other Tax Changes*

- Eliminated the one cent non-refillable beverage container tax (Article 18-A) as of October 1, 1998.

## Credits and Other Business Incentives

Legislation produced several new incentives for New York's business community. It also enhanced other existing incentives and provided targeted relief to various taxpayers. These incentives include the following:

Personal Income Tax

- School property tax credit - enacted a school property tax credit for farmers beginning in 1997 for taxpayers that derive at least two-thirds of their total income from farming (also available under the Article 9-A corporate franchise tax). Subsequent legislation enhanced the credit by exempting up to the first $30,000 of non-farm federal gross income in determining credit eligibility and providing for subtracting principal payments on farm debt when calculating the income limit for the phase-out of the credit. More recent changes include increasing the acreage limitation under the credit from 175 acres to 250 acres for the 1998 tax year;

- Historic barns - enacted a tax credit for the costs of rehabilitating historic barns in the State (also available under the Article 9-A corporate franchise tax);

- Employment incentive credits - extended the employment incentive credit and economic development zone employment incentive credit to businesses taxable under the personal income tax; and

- Emerging technologies - provided a gain deferral for investments in emerging technology companies (also available under the corporation franchise tax).

Corporate Incentives (in addition to those described in the personal income tax section above as being available under the Article 9-A corporation franchise tax)

- Allowed a new wage credit for businesses operating in eligible areas;

- Extended the investment tax credit carryforward period from 10 to 15 years;

- Allowed credits for electric vehicles, clean fuel vehicles using natural gas, methanol and other alternative fuels, and clean fuel refueling facility property;

- Created a new tax credit for employers who employ individuals with disabilities;

- Made the investment tax credit available to corporations, banks and personal income taxpayers that are brokers or dealers in securities;

- Provided through the New York State Emerging Industry Jobs Act, tax credits for qualified emerging technology companies that invest in research and development in New York State. Provisions include:

- an employment tax credit equal to $1000 for each individual employed full time over a base year level; and

- two emerging technology capital credits that vary (10 percent or 20 percent, respectively) depending on how long the investment is held.

### Sales Tax Provisions

- Clothing exemption - exempted clothing and footwear costing less than $110 from the 4 percent State tax and the 0.25 percent tax imposed in the twelve county Metropolitan Commuter Transportation District (MCTD) beginning December 1, 1999. As with the past temporary exemptions, localities will have the option to decide whether to participate.

- Bus services - exempted sales of and services to buses used to provide passenger transportation service, including charter and tour services;

- Parking services - exempted municipal parking services from the State sales tax, local sales tax outside New York City, and the 6 percent parking tax imposed in New York City;

### Other Significant Provisions

Budget legislation has included several other significant changes, some of which cover more than one tax. For example, legislation:

- Established a tax amnesty program for the personal income tax, the Article 9-A corporate franchise tax, certain taxes imposed under Article 9, and the sales and use tax during the period November 1, 1996 to January 31, 1997; and

- Created the Taxpayer Bill of Rights Act of 1997.

## Departmental Initiatives and Administrative Changes

### Personal Income Tax and Corporate Franchise Tax

- Expanded lookup tables to save small businesses from having to make complicated withholding tax calculations for their employees;

- Changed Form CT-4 reporting requirements to increase the availability of the shorter corporate franchise tax return to more small businesses;

### Sales Tax

- Annual filing threshold - increased the threshold for annual filing from $250 to $3,000 in annual sales tax liability, allowing more than 100,000 additional businesses to file sales tax returns annually rather than quarterly;

- Internet access - implemented a policy effective February 1, 1997, to exempt internet access charges from sales and telecommunications excise taxes. The new policy also provided that an out of state company with no nexus in New York would not have nexus created merely by having its advertising appear on a New York server;

- Data entry services - exempted from the state and local sales tax as of September 1, 1996, data entry services performed by independent contractors and temporary service contractors or similar service providers that furnish personnel to perform data entry services;

- Silo foundation material and protective clothing - amended sales tax regulations to exempt protective clothing and materials used to construct the foundation of a silo;

- Telephone filing - permitted sales tax vendors having no taxable activity during a reporting period to file returns by telephone effective September 1, 1997;

- Motion picture production - in concert with the motion picture industry and the Governor's Office of Motion Pictures, developed a publication to address many areas of uncertainty regarding application of the sales tax to motion picture production; and

- Forms simplification - using established behavioral science and graphic arts techniques, redesigned sales tax returns to make them much easier to complete.

## Conformity to Federal Legislation

New York generally conformed to many changes occurring at the federal level with the enactment of the Small Business Protection Act of 1996 (the Act). Highlights of the Act that affected small businesses included:

- Increased expense treatment for small businesses - increased the annual expense in lieu of depreciation incrementally from $17,500 to $25,000 by 2003;

- Treatment of storage of product samples - extended the deduction for home office expenses by individuals and S corporations to the storage of product samples;

- Class life for gas station convenience stores and similar structures - provided a 15 year MACRS life (formerly 31.5 or 39 years) to business property which is a retail motor fuels outlet (whether or not associated with convenience store operation). Taxpayers can elect to apply the new class life to property placed in service prior to the effective date of the change;

- Deductibility of health insurance premiums for self-employed individuals - raised the above-the-line deduction for insurance premiums incrementally to 80 percent beginning in tax year 2006;

- Independent contractor safe haven - provided that taxpayers may treat independent contractors as not being an employee for employment tax purposes (and thus State withholding tax) regardless of the worker's actual status under the common law test, unless no reasonable basis for such treatment exists; and

- Establishment of savings incentive match plans for employees (SIMPLE) of small employers - authorized establishment of SIMPLE pension plans by employers of 100 or less.

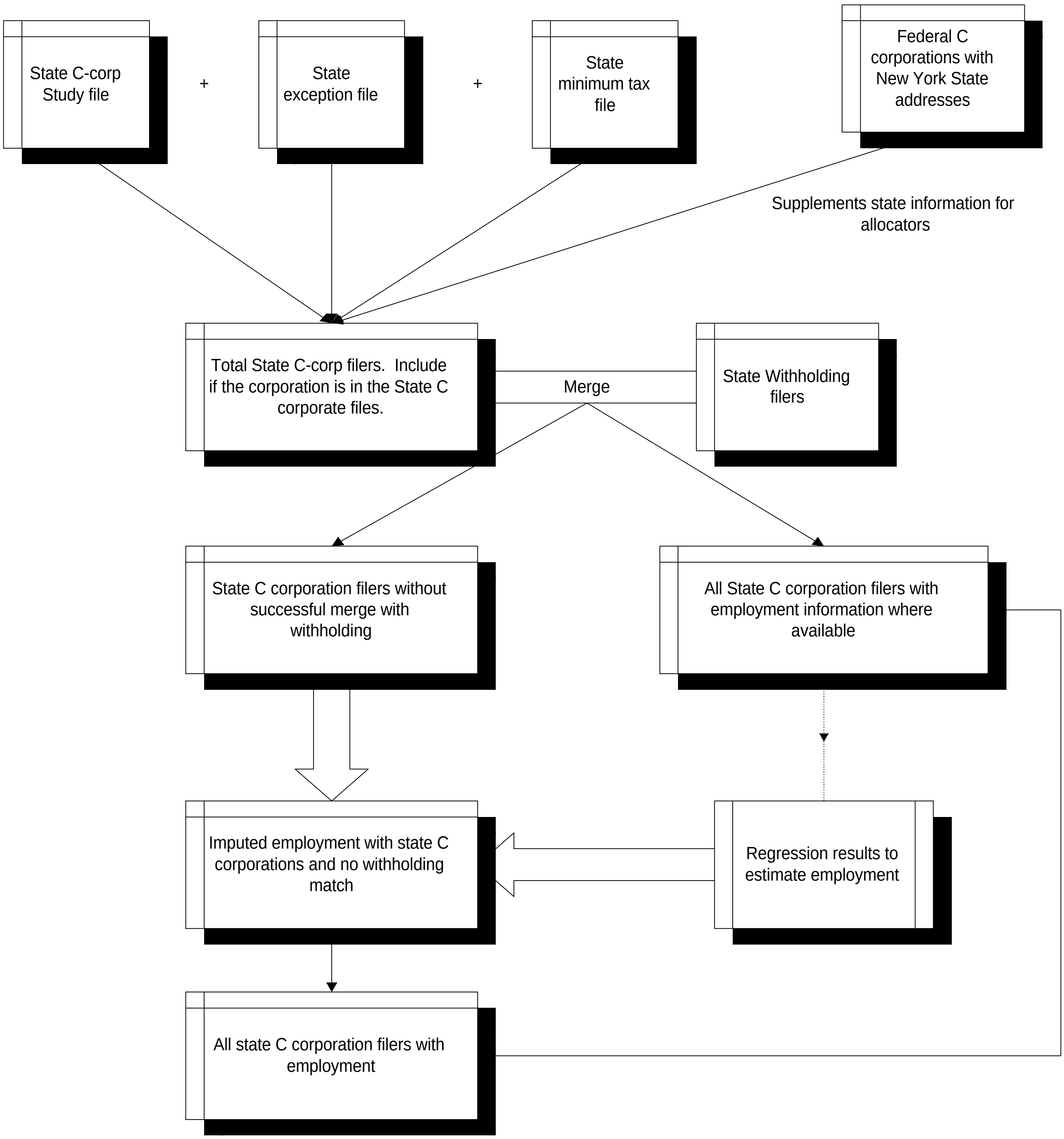
Significant changes were also made to federal S corporation provisions. These changes:

- Permitted S corporations to have up to 75 shareholders;
- Permitted electing small business trusts (ESBT) to be S corporation shareholders;
- Permitted tax exempt organizations which are shareholders of a federal S corporation, and which are subject to the New York tax on unrelated business income (nonprofit organizations and pension plans), to be C corporation shareholders;
- Permitted S corporations to hold both C and S subsidiaries;
- Liberalized rules relating to inadvertent terminations and invalid elections of S status;
- Provided for pass-through tax treatment of qualified Subchapter S subsidiaries (QSSS) - (A QSSS is not a separate entity for federal tax purposes; all assets, liabilities, and items of income, deduction and credit are treated as belonging to the S parent); and
- Permitted a single owner business entity, not required to be classified as a corporation, to elect classification as an association or to have the organization disregarded as an entity separate from its owner.

# Appendix C:  Data Compilation Flow Charts

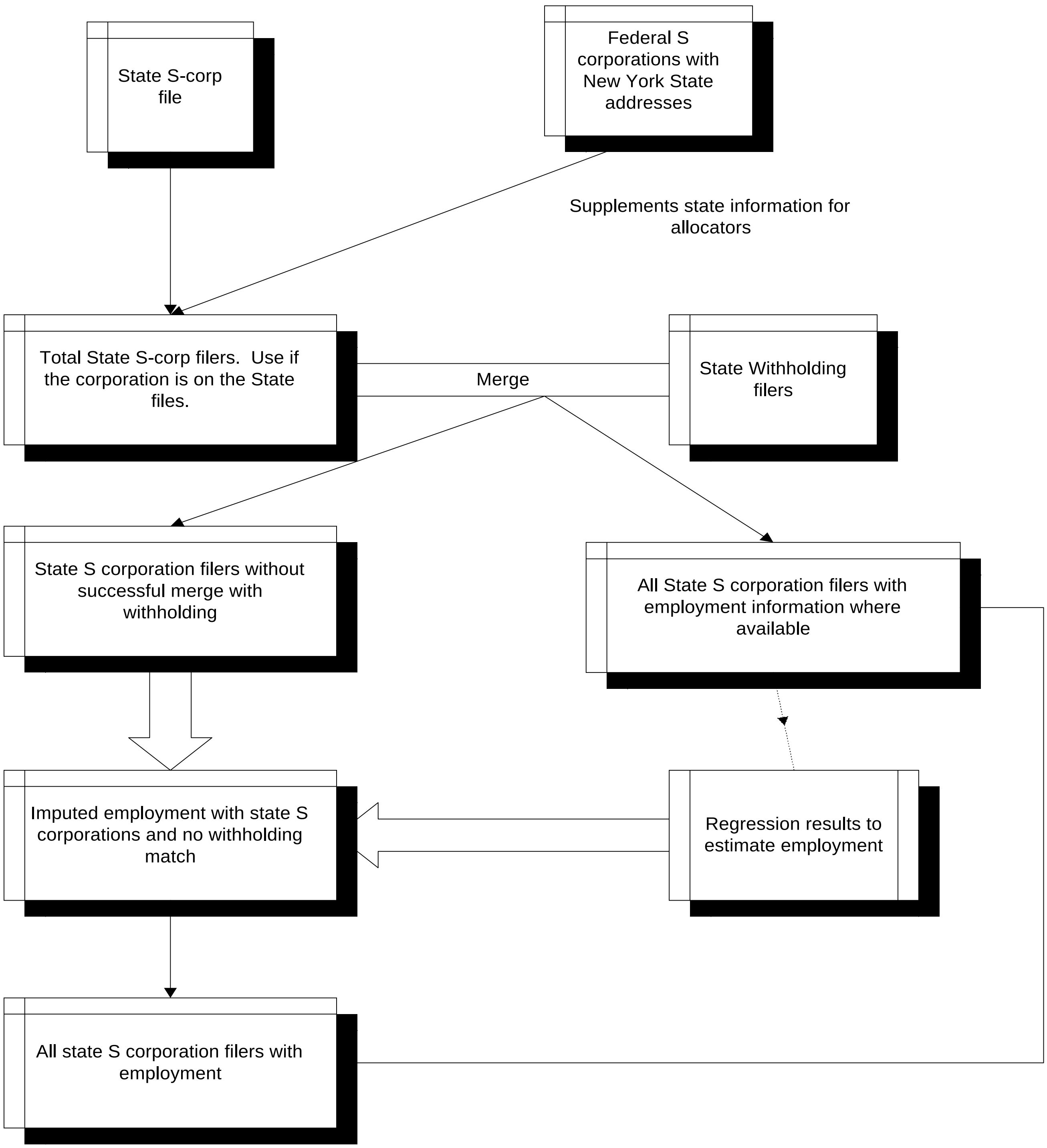
## C Corporations

Development of Total C corporation filers with supplemental federal and state withholding information

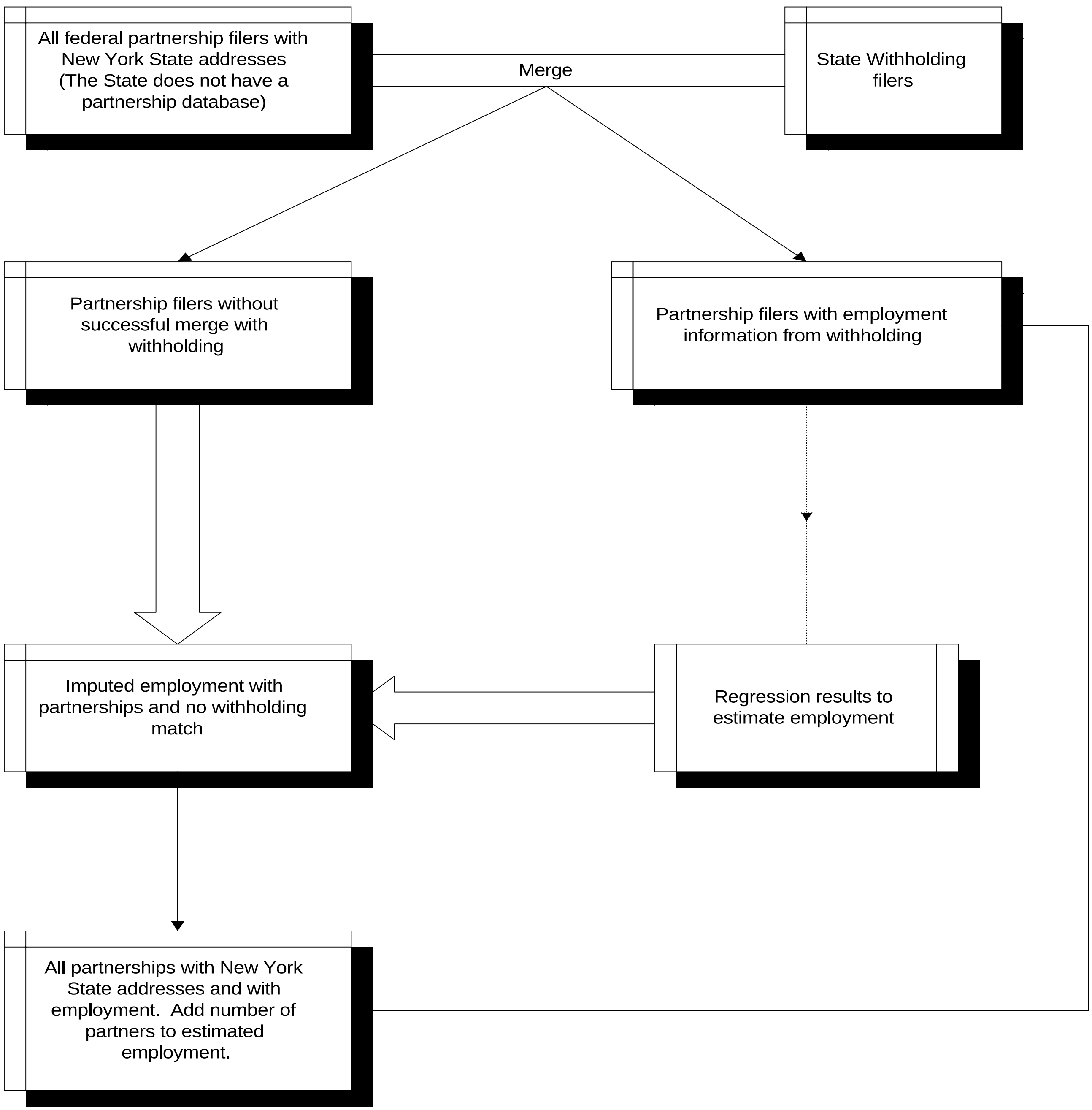


**S Corporations**

Development of Total S corporation filers with supplemental federal and state withholding information

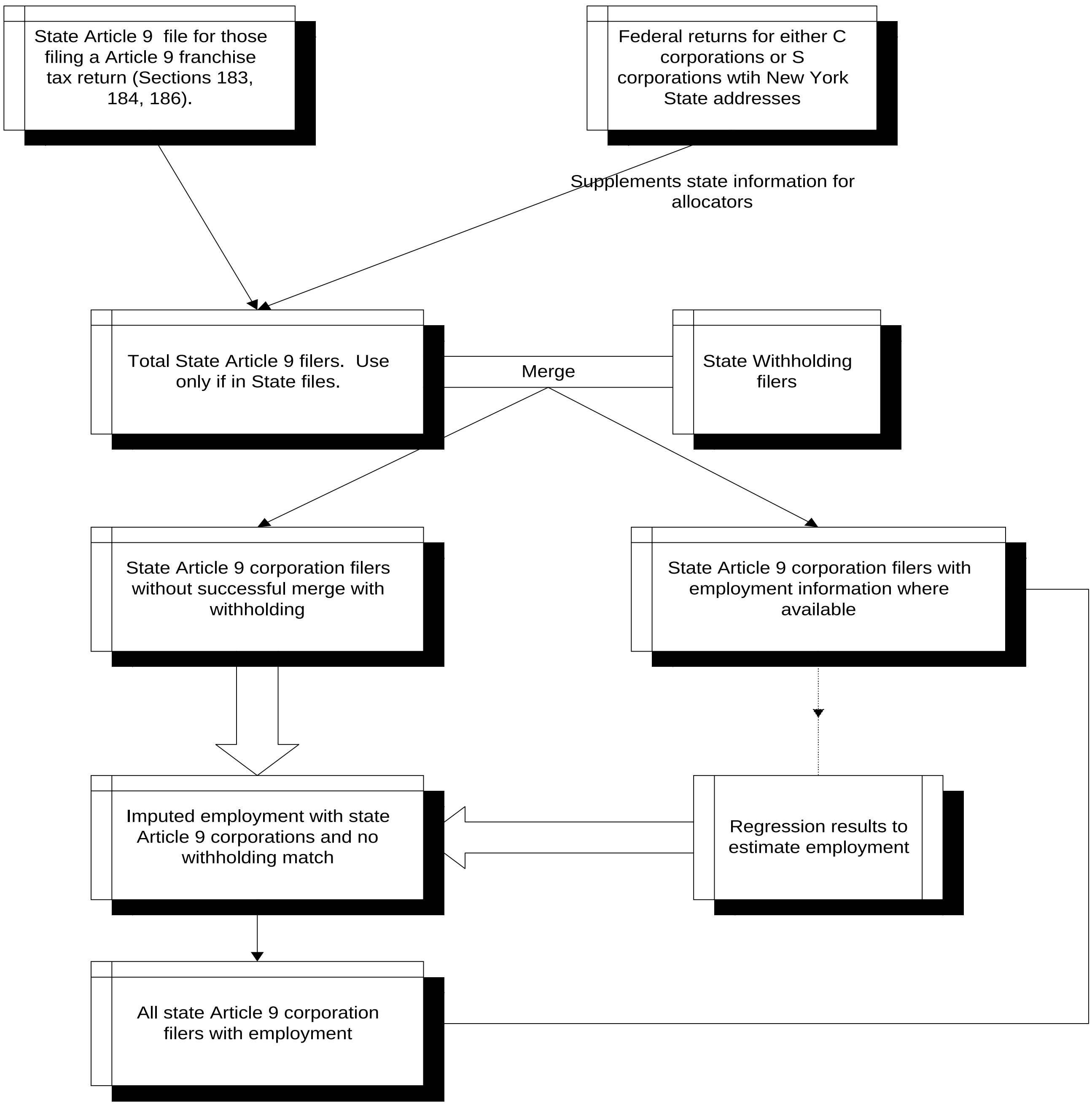


## **Partnerships**
Development of Partnership filers with state withholding information



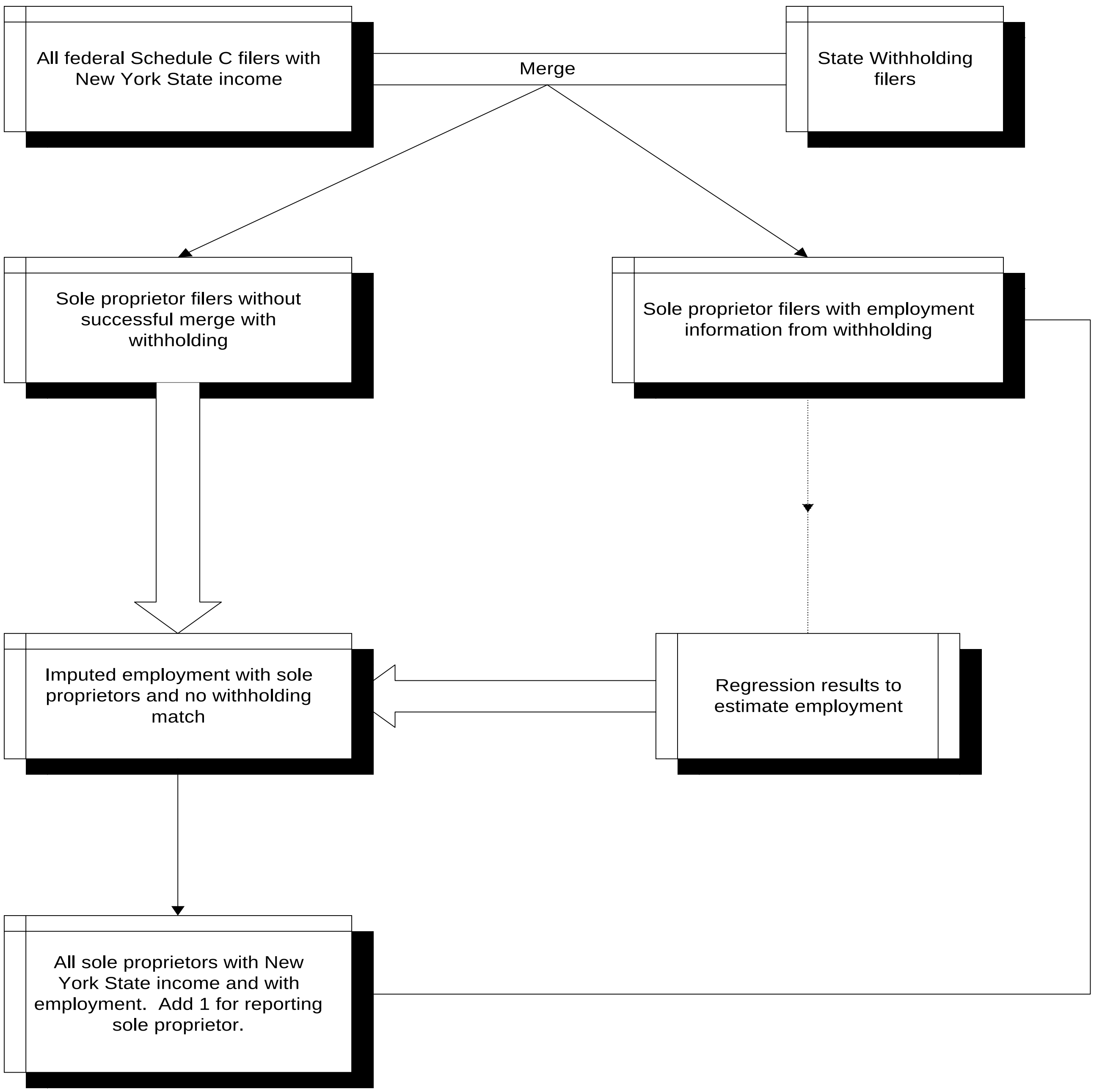
## Article 9 Corporations

Development of Article 9 corporation filers with supplemental federal and state withholding information



## Sole Proprietors

Development of Sole Proprietor filers with state withholding information



**Farmers**

Development of Farmer filers with state withholding information