RESEARCH BRIEF

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The Governor's Surprise

How to evaluate the gross receipts tax proposal

Gov. John Bel Edwards jolted the public discussion on tax reform recently by suggesting the state consider adopting a new type of business tax in place of the current corporate income and franchise taxes paid by companies in Louisiana. The idea – a gross receipts tax – is modeled on a method used in Ohio and is akin to the Texas-style margins tax. Whether this concept will be a formal part of the governor's fiscal reform plan remains to be seen. He has pledged to flesh out the proposal.

This report by the Public Affairs Research Council of Louisiana explains the pros and cons of the tax in a Louisiana context, notes the experience in Ohio, identifies the greatest challenges, and reviews the right and wrong ways to implement such a plan. While we should examine the merits of a gross receipts tax in principle, we should also evaluate whether the proposed tax would be a significant improvement over the current system in Louisiana. No tax system is perfect; the question before us is whether a better tax structure could be put in place.

WHAT IS THE PROPOSAL?

Put simply, a corporate income tax is basically a tax on company profits, a franchise tax is a tax on company wealth or capital, and a gross receipts tax is a tax on company sales revenue. Louisiana has a corporate income and a corporate franchise tax. The initial plan floated by the governor is to eliminate both of those tax types and create a new gross receipts tax.

The concept of a gross receipts tax has harsh critics among both conservative and liberal economists, and indeed few states employ it and several states in recent years have abandoned this type of business taxation. Yet some economists see comparative virtues of fairness, stability and simplicity in this form of revenue collection. Ohio and Nevada are relatively recent converts while a few other states continue to flirt with the notion. Other states that use major elements of a gross receipts tax are Delaware, Washington and Texas. New Mexico has a form of gross receipts tax that is considered more of a sales tax. New Jersey and Kentucky have a corporate income tax that is supplemented by a gross receipts method serving as an alternative minimum tax.

SIMILAR STRATEGY IN OHIO

Ohio launched its Commercial Activity Tax (CAT) in 2005 while phasing out its corporate franchise tax and its business personal property tax, which was paid to local governments. The property tax was similar to Louisiana's inventory tax. The CAT is applied to gross receipts generated in the ordinary course of business and pertains to sales to customers within the state of Ohio. The tax rate for the CAT is 0.26 % multiplied by the taxable gross receipts less the first million dollars of gross receipts. In 2016 it generated just over $1.6 billion.

Most businesses pay it, with manufacturers, retailers and wholesalers among the bigger contributors. Non-profit organizations, certain financial institutions and businesses with less than $150,000 in gross receipts are among those who are exempt. Ohio does not allow a business to charge its customers separately for the CAT.

The Buckeye State hoped that the CAT, combined with the phase out of the more antiquated taxes, would help turn around the state's declining manufacturing sector and improve capital investment and economic performance overall. The state's manufacturing sector has continued to decline although examples of success can be cited. The Tax Foundation, which is critical of the gross receipts tax, still gives Ohio exceptionally high rankings for a good business climate. Of course, taxes are but one factor affecting business growth in a state economy.

State Comparisons

State	Dec 2016 GDP by State *(Billions)*	2016 Gross Receipts Tax Collections *(Millions)*	Collection as % of GDP
Texas	$1,630	$3,881	0.24%
Washington	$445	$3,633	0.82%
Delaware	$69	$234	0.34%
Ohio	$611	$1,641	0.27%
Nevada	$140	$144	0.10%
Louisiana	$240	$456*	0.21%

**LA number is a 2015 net total of Corporate Income and Franchise Tax*
Source: Data from Federal Reserve of St. Louis & State Depts. Of Revenue

HOW WOULD IT WORK IN LOUISIANA?

The governor's team has been working on the plan's details, many of which are not yet known. The rate, the kinds of receipts to be counted, and the types of businesses subject to the tax will all be important factors. The optimal gross receipts tax would aim to inflict the lightest pain possible on the greatest number of entities possible. That means it should be a low rate applied to as many businesses and receipts as can be included.

This broad base and low rate, which is likely to be below 1%, would contrast dramatically to the current corporate income tax. Louisiana's corporate income tax, with a top rate of 8%, only taxes a company's net profits, not its sales. Also, each year many Louisiana companies do not pay a state corporate income tax because they report zero income or an accounting loss. But those companies would not escape the gross receipts tax.

Here's another key point that we expect will be a centerpiece of the debate: Many companies are incorporated in a manner that allows them to file under the federal individual income tax rather than the federal corporate income tax. The companies include S Corporations, LLCs, partnerships and sole proprietorships. These companies use the federal system to determine their taxable income, which is then used to help figure their taxes on the state's individual income tax form. They don't have to pay federal or state *corporate* income taxes.

But under a gross receipts system in Louisiana, these companies would be liable for gross receipts taxes even as they continue to pay individual income taxes. They would likely get deductions on both their federal and state income tax forms for gross receipt taxes paid. Still, these companies, most of them relatively small, could face a double tax. To address this issue partially, Ohio doesn't charge a tax on gross receipts up to $150,000 and charges only a minimal tax on sales revenue up to $1 million. Louisiana might be expected to take a similar approach.

HOW MUCH MONEY ARE WE TALKING ABOUT?

How much state revenue would a Louisiana gross receipts tax have to generate to make up for the elimination of the corporate income and franchise taxes? The state collected $456 million from these two taxes in the 2015 fiscal year, according to the most recent annual report from the Louisiana Department of Revenue. However, this lone figure is misleading. The department also reports that the combined liabilities of these taxes was about $1.3 billion, but a variety of tax credit programs reduced how much businesses actually had to pay the state.

Louisiana Tax Liability and Amount Paid FY 2014-15 (Millions)		
	Tax Liability	Amount Collected*
Corporate Income Tax	$793	$343
Corporation Franchise Tax	$537	$113
Total	**$1,330**	**$456**

**Amount Collected after credits and adjustments*
Source: LDR 2014-2015 Annual Report

In figuring the impact of a gross receipts tax, we would need to take into consideration the state credit and rebate programs that the state might continue to offer under the new system. This point is especially important because a gross receipts tax is often described by advocates as a way to eliminate "loopholes" and special favors, when in fact it can be just as cluttered with credits, exceptions and complications as any other type of tax.

WHAT ARE THE ARGUMENTS IN FAVOR?

If the goal of tax reform is a broad base and low rates, a gross receipts tax has some advantages when considered as a replacement to the state corporate income and franchise taxes. Keep in mind that some of these presumed benefits are seen as problems by the critics.

- It is broader than a corporate income tax because it taxes business sales activity and not just profits. It covers all types of businesses as opposed to just corporations.
- Policy makers who feel corporations manipulate their tax filings may find it attractive since it has an "everyone pays something" or "fairness" quality.
- It brings so-called "pass-through" companies into the state business tax structure and creates a "business tax" that covers corporate and individual income filers. Over time, many businesses have migrated or have been created to become pass-through entities for tax reasons. They now account for much of the nation's economy. As noted in the problem section below, a new tax on these companies can also be viewed as a bad thing.
- Profits, especially those of large multistate companies, can be juggled to minimize tax liability under a corporate income tax structure. The need to define a company's profit is eliminated under a gross receipts tax.
- Some accountants and economists say a gross receipts tax, compared to the corporate income and franchise taxes, is easier for the state to administer and for company compliance.
- The revenue from a gross receipts tax is likely to be much more predictable and stable than the corporate income tax. An erratic and unpredictable corporate income tax has been a contributor to mid-year budget shortfalls for the state.
- Ohio's experience can serve as a guidepost and the new system could be rolled out fairly quickly in Louisiana.
- Although a conversion to a gross receipts tax could create new winners and losers, it could be structured in a way that allows the main tax burden to continue to fall on most of the current groups of major corporate taxpayers.
- Over the decades, the revenue productivity of the corporate income tax has been diminished by tax planning, tax competition and policy

choices. Some economists believe the gross receipts tax is less vulnerable to these trends.

- An elimination of the corporate franchise tax would be a major step forward. It is an antiquated type of tax on wealth and capital that discourages investment, inhibits economic development and causes costly compliance and auditing problems. Five states recently eliminated their franchise tax and two more are phasing theirs out, leaving only 14 states charging this type of tax.

- Louisiana is an outlier with the franchise tax; most other states that still have this type of taxation maintain it as a minimal tax or are far less dependent on it as a source of revenue.

WHAT ARE THE POTENTIAL PROBLEMS?

Critics point to a number of problems associated with the gross receipts tax. In fact, the "fairness" argument cuts both ways:

- A major concern is the issue of tax pyramiding. Unless a company is vertically integrated, each stage of production is taxed as businesses sell services and supplies in the process that leads to a final product. These taxes are compounded by the time the product reaches the point of final sale to consumers. This distortion can put in-state companies at a disadvantage to out of state companies. It also favors vertically integrated companies because they may not pay a gross receipts tax on each stage of product development.

- For similar reasons, some analysts view the gross receipts tax as a hidden form of sales tax that is passed on to the consumer. They see it as a regressive tax that especially penalizes low to moderate income households.

- Some critics say companies that do not post a profit should not be taxed in this way. The gross receipts tax would be especially hard on companies suffering from an economic or industry downturn, on companies with large sales volumes and low profits, and on start-up companies trying to build momentum to grow.

- The gross receipts tax will change the mixture of winners and losers. Under the proposal, equally profitable businesses could pay different taxes. Also, the burden could shift generally from regular corporations to pass-through entities, manufacturers and service enterprises. As noted above, some view this shift as a good thing.

- Businesses that file under the state individual income tax form would face a new, additional tax that they do not pay now. This effect would be felt most by businesses with revenue exceeding $1 million, or whatever threshold is established for the regular gross receipts tax rate to kick in.

MAJOR QUESTION MARKS REMAIN AT THIS STAGE

Until the details and the effects of an actual implementation of a Louisiana gross receipts tax are known, a number of question marks will remain:

- In the early implementation stage, the amount of revenue from a Louisiana gross receipts tax will be very difficult to estimate. An uncertain period of transition could create problems for navigating the state finances.

- How will the state's many tax credit and rebate programs be handled under the gross receipts tax? Would we simply transfer those incentive programs – totaling hundreds of millions of dollars in state costs – over to the new system, or would we get rid of some of them and opt instead for lower rates for everyone?

- Decisions will have to be made about how and whether to compensate corporations that have reported net operating losses on their corporate income tax forms and were seeking to compensate for those losses in tax filings in future years.

- Major industries could be impacted on various ways, depending on the structure of the tax. For example some economists see oil and gas companies affected unfavorably while chemical companies might be better off.

- How will the state handle taxation of businesses that already pay other forms of tax? For example, banks already pay a form of local tax in lieu of corporate income tax. Insurance companies have a premium tax that also can serve as a credit against their corporate income tax. Gambling and alcoholic beverage companies have special tax structures.

- Health care companies, particularly non-profit hospitals that currently pay no corporate taxes, could be greatly affected depending on how the tax is applied. Utility companies, whose rates are regulated, would also be closely monitoring the proposal. Car dealerships—with high sales volumes and thin profits—could be at risk.

- How would this tax policy shift affect Louisiana's rankings for business climate and as a tax friendly state? For example, the Tax Foundation, known for its extensive state ranking methods, disapproves of the gross receipts tax but also assigns poor scores for the franchise tax.

OVERALL GUIDANCE AND WARNINGS

PAR recommends several major points to keep in mind as this debate plays out.

- What is the real purpose of the gross receipts tax? Is this a policy shift in favor of more revenue stability and to rid ourselves of the onerous franchise tax, or is this really a plot to substantially raise state revenue and therefore state spending? This question will be key in the debate.

- In addition to substituting the revenue from the corporate income and franchise taxes, is the eventual purpose of the gross receipts tax also to offset revenue from a proposed lower state sales tax rate, or some other form of state tax adjustment? In other words, how much reform or revenue offsets are we trying to buy with this new gross receipts tax?

- As the debate unfolds, the political calculations are likely to become entwined with the policy implications. Hoping to gain a popular edge on his political rivals, the governor might sell the proposal to the general public with the argument that Louisiana would have fewer tax scofflaws and that more taxpayers would be paying their fair share. He might also appeal to certain elements of the business community in order to mute his opposition. All of that is fair game, but we hope the real policy prescriptions do not get lost in the political hubbub.

- Could the gross receipts tax be structured to take the place of the franchise tax while keeping the corporate income tax? Could the new tax then serve as an alternative minimum tax companion to the corporate and individual income taxes?

- The public and policymakers should keep in mind that businesses pay a variety of taxes, including property taxes, sales taxes, fuel taxes, employee wage taxes, local business taxes and fees pertaining to particular industries. It's not as if the gross receipts tax would become the only business tax.

BETTER OR WORSE

If the state chooses to adopt a gross receipts tax, PAR recommends several points.

A gross receipts tax would be made better if:

- It is kept simple. Dozens of tax rates and multiple calculation steps would take away some of the power of the gross receipts tax.

- It is broad based. Ohio has an inclusive base that allows a low rate. A lot of the ills of the gross receipts tax are minimized if the rate is very small.

A gross receipts tax would be made worse if:

- It keeps all the same complicated set of credits and deductions. Moving to a new system is an opportunity to shed credits and deductions to apply business taxes more evenly and with better revenue stability.
- It penalizes start ups. New businesses are the future of the Louisiana economy. Fortunately there are a number of ways of addressing this issue, including zero or minimum payments for smaller businesses.
- It creates a large new burden through double taxation. This issue would be less serious if the rate can be kept low.
- It dedicated the revenue proceeds to particular spending programs. Proceeds should be put into the state general fund without restrictions.

THE MAJOR CHALLENGES

Stepping back and looking at the big picture of the governor's gross receipts proposal, we can identify several major challenges it will face:

- It might be too much too fast. This idea is not familiar territory for state legislators or the public. An intensive education process will be needed, and time is short. The session begins in less than three weeks.
- If the business community and conservative legislators view the proposal as a Trojan Horse in the name of tax reform, if in fact it is meant as a major revenue raising tool, it will be distrusted and will be hard to pass.
- The concerns of small businesses that file under the individual income tax and now would be subject to the gross receipts tax are likely to be heard loud and clear.
- Strong resistance could come from companies putting pencil to paper and figuring out they might be worse off.

FINAL THOUGHTS

As the actual proposal for a gross receipts tax becomes clearer, some of the questions raised in this report can be better addressed. PAR will continue to monitor the initiative and provide updated analysis if the proposal moves to the spotlight. While PAR has not looked favorably on a gross receipts tax, we also have not liked the existing franchise tax, which is arguably a worse system. The discussion should consider whether the new proposal would provide a significantly better tax system than the one we have now.

Public Affairs Research Council of Louisiana
4664 Jamestown Ave., Suite 300, Baton Rouge, LA 70808

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