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Commentary

The Public Affairs Research Council of Louisiana

The State Corporate Tax Structure Revisited

Changes to Louisiana's system could achieve greater stability, competitiveness and fairness

Through its own publications and participation in state task force groups, the Public Affairs Research Council has provided analysis and commentary on many state budget and tax issues, including income and sales tax policy. This document reviews state corporate tax policies and identifies some options for the future, whether taken up now or in the years ahead. A larger burden of overall corporate taxes on business is not recommended. However, changes could be made to eliminate or curb the worst features of Louisiana's corporate tax system, to make the state more competitive and to increase the stability of the corporate tax structure. These steps could be taken in a revenue neutral manner overall, although the impacts for particular businesses would vary.

The corporate tax system in Louisiana is relatively unattractive to profitable corporations, relatively attractive to corporations with net operating losses, and unstable for the state's fiscal outlook.

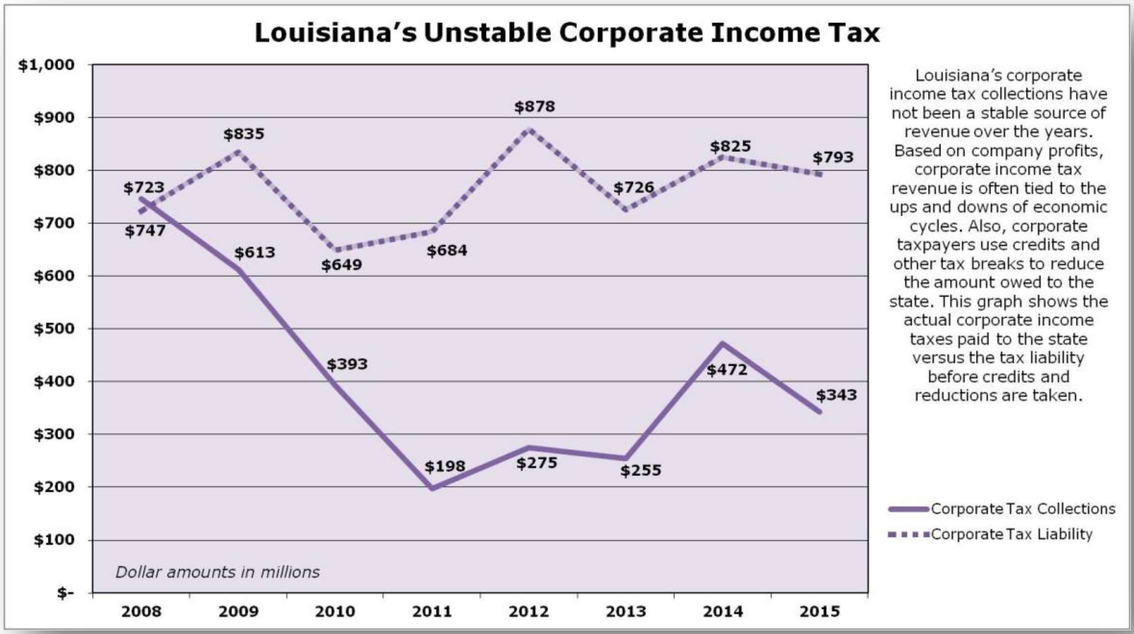
Louisiana's corporate taxes

Louisiana has a corporate income tax, based on profits, and a corporate franchise tax, based on measures of capital, stock and retained earnings. In addition, the state has a variety of incentive programs in the form of tax credits, rebates and exemptions that can reduce corporate tax obligations. The overall net revenue expected from these combined factors is relatively small compared to the state's revenue from the sales tax and the individual income tax. The forecast for next year's net state revenue from corporate income and franchise taxes is $452 million, compared with $2.9 billion from the individual income tax and $4.3 billion from general and vehicle sales taxes. Gambling and insurance business taxes, which have their own separate structures, also raise more net revenue than the corporate taxes.

Businesses are taxed and assessed fees in many ways, and it should be noted that corporate taxes are not the only sources of business-generated revenue for government. Many businesses and business partners pay through the individual income tax system. Corporations are major contributors to the sales tax base for local and state governments as well as to local property tax bases. Companies pay various local and state business and regulatory fees.

Business tax changes for stability and development

Louisiana's corporate income tax has a comparatively high upper rate of 8% and constitutes an erratic source of revenue for the state. (See chart on page 2.) Corporations are vulnerable to economic cycles, and so state tax revenue based on corporate profits has fluctuated more over time than other revenue sources, such as sales, personal income and gambling taxes.



Also, many companies reduce their tax bills by carrying forward past net operating losses from prior years or by taking advantage of credits or rebates the state offers as incentives or competitive protections. In fact, in recent years the majority of corporate income tax filers have reported zero taxable state income. Meanwhile, a growing number of companies acting as pass-through entities, in Louisiana and nationwide, have chosen to file under the individual income tax system. All of this has led to a corporate tax system in Louisiana that is relatively unattractive to profitable corporations, relatively attractive to corporations with net operating losses, and unstable for the state's fiscal outlook.

Important changes have been made to Louisiana's corporate income tax in the past couple of years. Members of the Legislature have paid a good deal of attention to this tax type hoping to make it more fair and stable. These changes include moves to single sales factor apportionment, market-based sourcing and so-called add-backs requirements. The Legislature also adjusted taxable capital gains and temporarily reduced credits and exemptions. The eventual revenue impact of these changes is still unclear.

Last year, the Legislature proposed a constitutional change to disallow the federal income tax deduction on state corporate income tax forms. In return, corporations would get a lower, flat tax rate. Voters statewide rejected that idea on a November ballot. Looking to the future, other strategies could be employed to achieve offsets and a lower corporate rate, while at the same time adding degrees of stability to the state's tax revenue base. Some will say the only way to increase the state's fiscal stability is to raise more revenue; however, a restructuring of corporate taxes in Louisiana could provide greater revenue stability, reduce favoritism and potentially improve economic competitiveness while remaining revenue neutral.

For example, corporate rates could be lowered to coincide with reductions in tax incentive programs, such as the inventory tax credit, the horizontal drilling credit or rebate programs. A portion of the business utility sales tax could stand in as an offset to allow a lower corporate tax rate. All of these measures would likely contribute to more reliable revenue estimates for the state. Some of these changes, especially if added to a more ambitious attempt to eliminate the federal tax deduction, could result in substantially lower corporate tax rates while maintaining similar overall revenue levels for the state measured over time. An improved tax structure might also lead to more business investment, jobs and tax revenue.

Corporate clean base

Another component of this strategy would be to establish a "clean base" of corporate income tax in order to set a baseline of revenue stability and to act as an offset to temper the overall corporate income tax rate. The goal would be to establish a predictable revenue source within the corporate income tax structure that brings in, say, $50 million, in exchange for slightly lower rates. The goal would be a revenue neutral offset.

A "clean base" would mean that corporate filers would be subject to the corporate income tax up to a very small amount – for example, in the range of $900 – not protected by any exemptions, credits or deductions. For example, the net operating loss, the inventory tax credit, and any other credits or rebates would not be used to reduce tax liability up to this very small amount. Companies actually paying net income taxes would not pay anything extra; their regular tax payments would cover their clean base tax obligation. In fact these profitable companies would pay at a slightly lower tax rate under this plan. The situation for companies reporting actual losses would not change; they would still not pay any corporate income tax or even this "clean base" tax.

Although the individual amounts from each company would be small, they would add up because the clean base could capture a large number of companies reporting zero taxable income based on credits and operating loss accounting. The "clean base" would not apply to pass-through entities. Companies with net operating loss carry-forwards would not be seriously affected by the "clean base" tax because the amount of the tax would be small and would not affect their deferred tax assets; however, these companies would encounter a recalculation in their deferred tax assets due to lower corporate tax rates.

Corporate franchise tax phase out

Another potential goal would be to phase out the Louisiana corporate franchise tax. This is a different strategy, as it is aimed at eliminating an onerous tax type that inhibits economic development. Some have proposed that the tax be slowly phased out, as Mississippi is doing, without offsetting state revenue streams to make up the difference. However, in the following proposed approach, the goal could be achieved in a revenue neutral manner. The offsetting revenue could be raised by emphasizing the role of the corporate income tax with reduced deductions, exemptions and credits. Slightly higher corporate income tax rates could be part of the equation. Whereas voters last year rejected the idea of eliminating the corporate federal tax deduction in exchange for a flat tax rate, they might be better inclined to eliminate the deduction as a revenue offset to get rid of the franchise tax.

Louisiana's franchise tax is a disincentive to heavily capitalized corporations, which are desirable companies to attract or keep in the state. That is one of the reasons few states have a franchise tax. Only 16 states have a franchise or capital stock tax, and two of those, including Mississippi, are phasing theirs out. Five other states eliminated their franchise taxes in the past five years. Louisiana has a comparatively high rate and is one of only eight states without a franchise tax ceiling.

A phase-out would rid the Louisiana economy of the distortion and the stigma of the franchise tax. This plan would be a significant added savings to business because of less accounting and litigation related to the corporate franchise tax. It would improve Louisiana's rankings for its business tax environment. If done properly, there would be no larger tax burden on business overall, although there would be winners and losers. Many of the current major taxpayers under the franchise tax would still be the major taxpayers under the corporate income tax; many of the big players getting out of the corporate franchise tax would be faced with a larger corporate income tax instead.

If combined with a "clean base" for corporate income tax, this plan would tend to provide an expected minimum base of corporate income tax except in serious recessionary periods. The shift in revenue emphasis would be toward the corporate income tax, which would be expected to produce larger revenues for the state. In the future, large surges in corporate income tax collections would not result in surges in the state operating budget, because the voters in 2016 passed a constitutional amendment that re-routes corporate income tax collections above $600 million into long-term priorities such as pension debt, rather than to the regular operating budget. In sum, even with a shift of state revenue from the corporate franchise to the corporate income tax, some budget stability would be provided. Also, the reduction of credits or an emphasis on business utility taxes as an offset would likely contribute to revenue stability.

Actual franchise tax collections are low. The tax liability for the franchise tax in 2015 was $537 million, but the net amount contributed to state revenue after credits and prepayments was only $113 million. A law passed in 2016 will extend the franchise tax to a broader class of businesses, possibly adding $90 million in state revenue for the next fiscal year. If a tax reform intends to be revenue neutral with the elimination of the franchise tax, the total revenue liability of the tax must be taken into consideration and not just the net revenue received by the state. Also, credit obligations sometimes take years to materialize as an actual impact on the state budget, and so a phase-out of the franchise tax would need to take that into consideration.

Some states, such as Arkansas, collect a franchise tax in a form that is essentially a minimal fee generating modest revenue. This form of taxation has been discussed by state task force members and others as a possible replacement of Louisiana's current franchise tax.

The drilling credit

Global energy and economic forces, including new industrial developments, are the major determinants for the price of gas and the activity and need of horizontal drilling, which has brought a bonanza of energy resources. The state's horizontal drilling incentive program was created in the 1990s and was intended to assist the industry's growth during an era when the expensive technology was being improved and gas prices were relatively high. The industry has matured, and the incentive program remains.

For this reason, the Legislature eventually will be tempted to seek a reduction or elimination of the horizontal drilling credit, with the savings likely contributed to the state operating budget. However, if the Legislature at some point decides to reduce or eliminate the credit, the savings could be used as an offset for lowering other state taxes, such as the corporate income tax rate or the franchise tax.

In general, the Legislature has favored the use of tax credit and rebate reductions of various types to add revenue to the state budget. An alternative would be to use such reductions of incentives toward lower tax rates or obligations. Good tax policy generally favors low rates and broad bases and disfavors exceptions. Using the right tools aimed at the best goals, the Legislature could make substantial and positive reforms to the corporate income tax structure in Louisiana.

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