Testimony before the Louisiana Senate Revenue and Fiscal Affairs Committee March 16, 2020

by
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Chair Allain, Vice-Chair Luneau, and Members of the Committee, thank you for inviting me to provide the Council On State Taxation's views on improving administrative practices and procedures for Louisiana's business taxes. My testimony will focus on Louisiana's tax climate and steps the Legislature can take to improve taxpayers' perceptions of the tax system as fair, efficient, and easily administered.

About COST

COST is a nonprofit trade association consisting of approximately 550 multistate corporations engaged in interstate and international business. COST's objective is to preserve and promote equitable and nondiscriminatory state and local taxation of multijurisdictional business entities.

Are Businesses Paying Their Fair Share of Louisiana Taxes?

EY, in conjunction with COST, annually estimates the total state and local tax burden imposed on businesses in each state. Our seventeenth annual report *"Total State and Local Business Taxes, FY 2018"* was released in October of 2019.

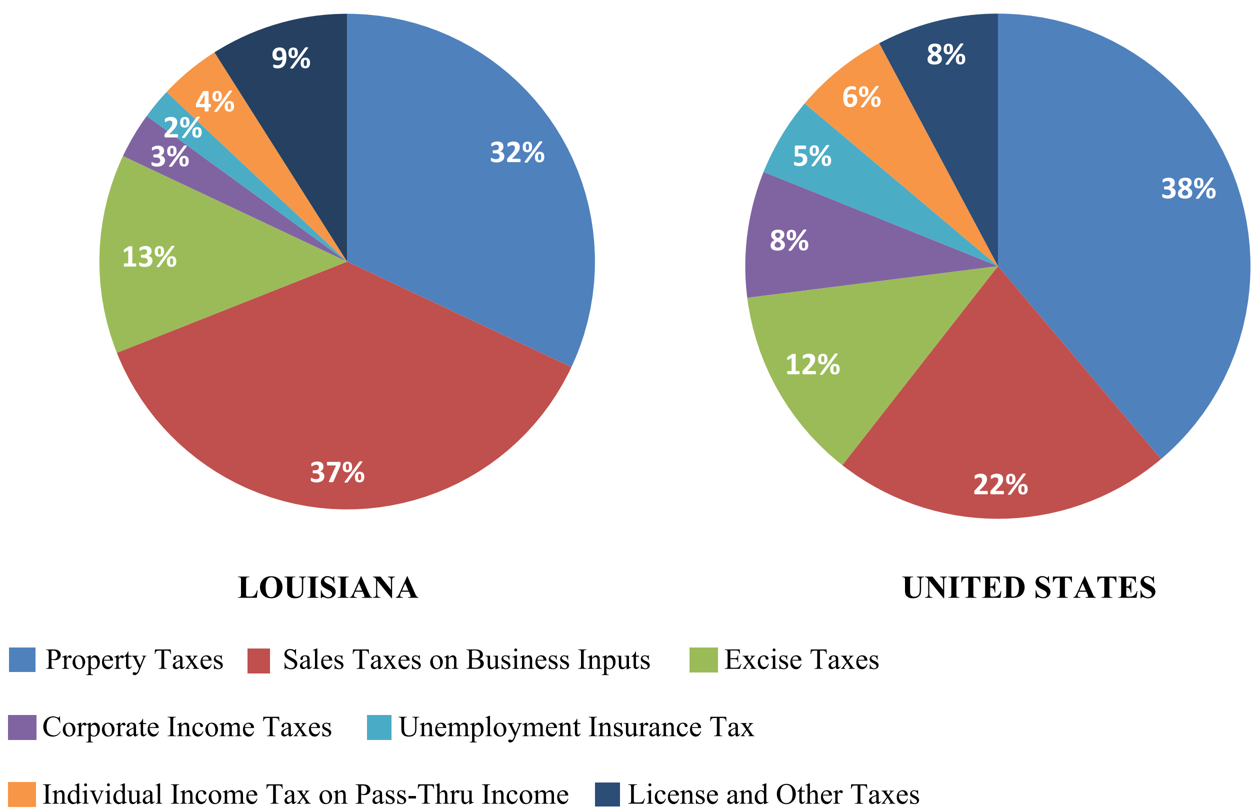
This "State Tax Burden" study provides estimates of the total taxes paid by businesses in each state, an important first step in any evaluation of business taxes or tax reform. The total tax burden paid by businesses includes corporate income taxes, franchise taxes, property taxes, sales taxes on business inputs, excise taxes, business taxes paid through the personal income tax by pass-through entities, unemployment taxes, and license taxes. To enable comparisons across states, the study also measures benefits received by businesses due to government spending and calculates a tax-benefit ratio to estimate the extent businesses are "getting what they paid for" through their tax dollars.

The annual study was developed to answer questions from legislators asking, "Are businesses paying their fair share of taxes?" Increasing economic competition among states and around the globe has transformed the initial question into a more fundamental query: "What is the basis or rationale for business taxation at the state or local level?" The basic rationale for business taxes, recognizing that the economic burden of business taxes is ultimately borne by consumers or owners of factors of production (including workers), is to pay for government services that directly benefit businesses.

If state and local business taxes are equal to the value of the benefits business received from state and local public services, they would be considered a payment for services, and taxes would not influence business location decisions or impact competitiveness. However, if state and local business taxes exceed the value of the benefits received from government services, the difference represents an excess cost to business that will reduce profitability in the absence of shifting the tax through higher prices or lower payments to labor. When such excess costs exist, they can affect a company's choice of locations.

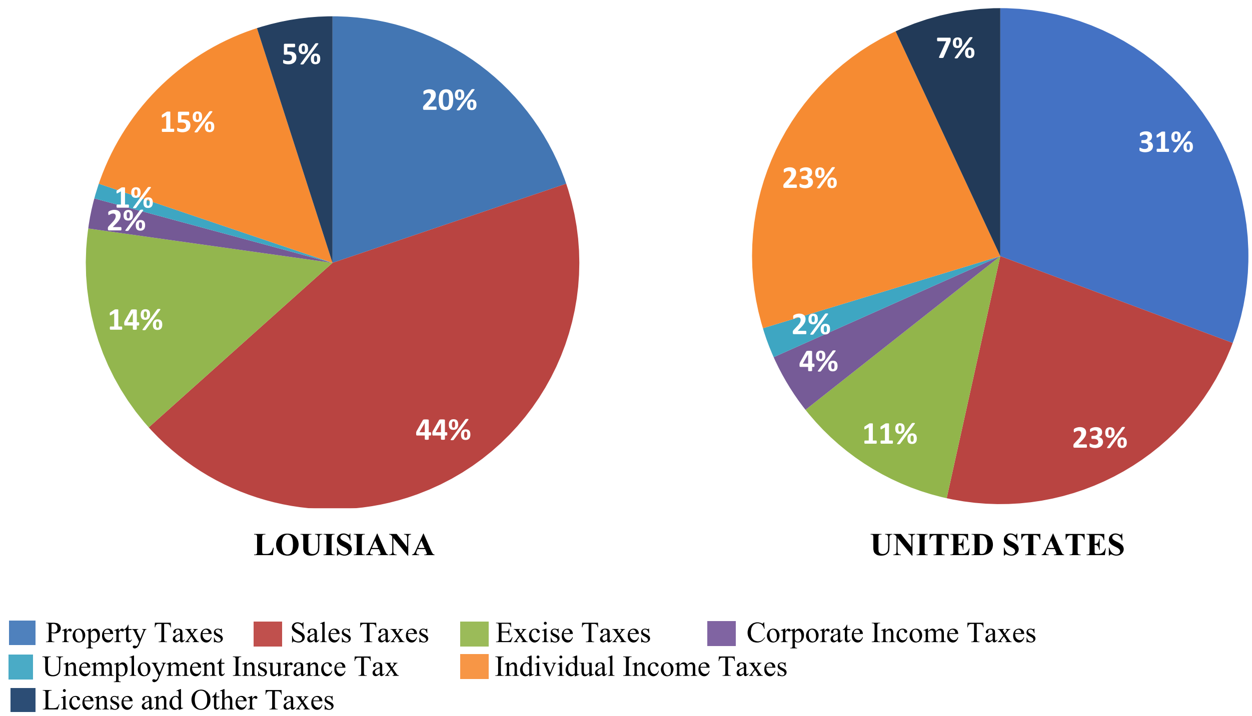
In FY 2018, the Study[1] estimates that Louisiana businesses paid $10.7 billion in state and local taxes, or 48.5% of all taxes collected in Louisiana. Neighboring states are generally similar in the business share of their respective tax burdens: Arkansas – 39.4%; Mississippi – 50.0%; Oklahoma – 48.3%; and Texas 62.3%. Nationwide, businesses contributed $781.5 billion, or 43.5% of all state and local taxes.

Composition of State and Local *Business* Taxes by Type, FY 2018



[1] Total State and Local Business Taxes: State-by-State Estimates for Fiscal Year 2018; October 2019, available at: https://www.cost.org/globalassets/cost/state-tax-resources-pdf-pages/cost-studies-articles-reports/fy18-state-and-local-business-tax-burden-study.pdf

Composition of ALL State and Local Taxes by Type, FY 2018



Louisiana also fares generally well against its surrounding states when evaluating the amount of taxes paid by businesses as compared with the value of benefits received by businesses through government spending. Using the Study's mid-range assumption for education spending deemed to benefit business (25%), Louisiana's tax benefit ratio is 1.75; that is, for every $1.75 paid in state and local taxes, Louisiana businesses receive $1.00 in government benefits. Tax benefit ratios for surrounding states are as follows: Arkansas – 2.1; Mississippi – 2.3; Oklahoma – 2.5; and Texas – 3.1. The national average mid-range tax benefit ratio for all states is 2.3.

Evaluating State Corporate Income Taxes

State corporate income taxes seem to garner an inordinate amount of attention from policymakers, commentators, and interest groups – perhaps because the tax is often perceived by the uninformed to be the primary source of business taxation levied by states. In fact, state corporate income taxes contribute relatively small amounts to state coffers. Nationally, in FY 2018, state corporate income taxes generated only 8.4% of total state and local business taxes. In Louisiana, it comprises approximately 3.4% of all business taxes. Yet because the tax is inherently unstable (it only operates when a corporation earns income) and because the myriad of bases, rates, and rules among states allow tax planning opportunities, it is widely vilified as rife with "loopholes" that need "closing." State corporate income taxes are also tremendously complex, creating costs of compliance and tax administration that are far out of proportion to other significant taxes paid by businesses, such as property or sales taxes. Indeed, many public finance economists "find little justification for the state corporate income tax" in the first instance.[2] Professor Charles McLure of the Hoover Institution says:

> *It is hard to think of a good reason to tax corporate income…. The case against state corporate income taxes is even stronger. It is common among economists to acknowledge that a small open economy (one that cannot affect the world price of capital) should not tax the return required to elicit investment within its boundaries…. The difficulty of actually taxing corporate income where it originates is a further reason for not trying to tax it.*[3]

Despite the economic consensus that the state corporate income tax is a poor tax, it exists. And, because of the erroneous public perception that the corporate income tax is the primary business tax, it is often the focus of "corrective" legislation in efforts to "save" the tax. In many cases, however, attempts to fix the tax can have greater repercussions from a competitiveness and economic development perspective than the tax itself. Because the corporate income tax is inherently volatile and difficult to administer, policymakers should not rely on the tax as a consistent and stable source of revenue. Instead, programs and legislation that ease the burdens of the tax can be a significant economic development tool and a means of improving the State's business climate.

Steps to Improve Louisiana's Business Tax Administration and Tax Climate

Improve State Tax Appeals and Procedural Requirements:

COST regularly evaluates states' statutes, rules, and practices that impact taxpayer access to an independent appeals system and that impact fairness and efficiency. In the latest COST administrative scorecard (December 2019),[4] Louisiana received a grade of "D". Below are our findings that contributed to that grade, including any updates to our prior research.

- *Independent appeals forum*: We commend the effort that constituted the Louisiana Board of Tax Appeals as an independent appeals forum to handle tax disputes. We also acknowledge and welcome the fact that the BTA is now available for local tax disputes. However, if the Department (or local collector) chooses not to issue a formal assessment and instead files suit, taxpayers must pay under protest if they wish to remove the suit to the BTA. And although no prepayment or bond is required to appeal to the BTA, in all cases, subsequent appeals require posting of a bond to move forward.

- *Interest rate differential*: Louisiana's interest rate on underpayments is charged at an annual rate of 9%. The rate charged on overpayments is 6%. This is an easy fix: interest rates are meant to compensate for the time-value of money, and the rate (and its application) should be equal for both refunds and tax deficiencies.

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[2] Fox, William F., Matthew N. Murray and LeAnn Luna, "How Should a Subnational Corporate Income Tax on Multistate Businesses Be Structured?" National Tax Journal, March 2005.
[3] McLure, Charles, "How to Improve California's Tax System: The Good (But Infeasible), the Bad, and the Ugly," California Commission on the 21st Century Economy, February 2009
[4] COST Scorecard on Tax Appeals & Procedural Requirements, December 2019, available at: https://www.cost.org/globalassets/cost/state-tax-resources-pdf-pages/cost-studies-articles-reports/admin-scorecard-final-dec-2019.pdf

- *Reporting of federal changes*: COST supports clear and consistent rules for determining when a "final determination" of a federal income tax audit triggers a reporting requirement to a state.[5] Final determination is not defined in State law and it is not clear reporting is based on exhaustion of all appeals for a tax year. We recommend that Louisiana conform to the model language promulgated by the Multistate Tax Commission (developed collaboratively with interested parties, including COST) for reporting federal partnership adjustments which contains new reporting requirements and a definition of final determination. Finally, Louisiana should limit the scope of audits triggered by federal changes to only the issues in the federal audit.

- *Additional issues impacting fair and efficient tax administration*:
  - **Nonresident withholding for traveling employees:** Nonresident employees are currently subject to liability and withholding on their first day of travel in the State. A 30-day safe harbor is recommended, with language and safeguards drawn from the federal Mobile Workforce Proposal.
  - **Additional safeguards needed for Treasury Offset Program:** Louisiana participates in the federal Treasury Offset Program's State Reciprocal Program without ensuring effective or adequate safeguards, often creating a bureaucratic web very difficult to unravel by either the State or the affected taxpayer.
  - **Local taxing jurisdictions:** Separate parish taxing authorities create onerous interpretive and compliance burdens for taxpayers. Parishes should be discouraged from using outside counsel to prosecute tax cases.
  - **Contingent fee audits:** Louisiana should prohibit the hiring of third-party consultants using contingent fee arrangements by local tax jurisdictions.
  - **Funding the DOR through penalty imposition:** This is a practice that harms the perception of fair tax administration – whether right or wrong -- and should be discontinued.
  - **Aggressive transfer pricing audits:** The Department should be discouraged from hiring outside consultants to conduct complex transfer pricing audits after a thorough review of the aggressive use of data analytics and settlement offers for questionable transfer pricing methodologies.

<u>Avoid Mandatory Unitary Combined Reporting:</u>

One of the most controversial business tax policy issues currently debated by state legislators, tax administrators, and corporate taxpayers is how a state should determine the corporate income tax base for multistate corporations with multiple businesses and entities. One method -- mandatory unitary combined reporting -- is touted by proponents as a "loophole closer" and as a way to stop "income shifting" to low tax jurisdictions. In actuality, however, mandatory unitary combined reporting carries severe economic consequences: it arbitrarily

[5] For COST's policy position and a recommended definition of "final determination," see http://www.cost.org/uploadedFiles/About_COST/Policy_Statement/COST%20Federal%20Tax%20Changes%20(RAR)%20POLICY%20%20FINAL%204.%2016.15.pdf.

assigns income to a state, negatively impacts the real economy, and imposes significant administrative burdens on both the taxpayer and state.[6]

The administrative and compliance burdens of mandatory unitary combined reporting can be severe, particularly if the state revenue department expects to achieve what are often "aspirational" fiscal estimates. The concept of a "unitary business" is uniquely factual and universally poorly defined. It is a constitutional (Due Process) concept that looks at the business as a whole rather than individual separate entities or separate geographic locations. In order to evaluate a taxpayer's determination of a unitary relationship, state auditors must look beyond accounting and tax return information. Auditors must annually determine how a taxpayer and its affiliates operate at a fairly detailed level to determine which affiliates are unitary. Auditors must interact with a corporation's operational and tax staff to gather this operational information. In practice, however, auditors routinely refuse to make a determination regarding a unitary relationship based on operational information and instead wait to determine unitary relationships until after they have performed tax computations. In other words, the tax result of the finding that a unitary relationship exists (or does not exist) often significantly influences, or in fact controls, the auditor's finding. Determining the scope of the unitary group is a complicated, subjective, and costly process that is not required in separate filing states and often results in expensive, time-consuming litigation.

Phase Out the Franchise Tax

Louisiana's legislative leaders should begin taking steps to gradually phase out the State's corporate franchise tax. The gradual elimination of the tax will encourage business investment and job creation by significantly reducing the direct costs imposed on businesses seeking to expand or relocate in the State. The corporate franchise tax – a direct tax on *all* new and existing investments in the state – is truly an anachronism. Only 10 states levy a franchise tax with no upper limit, and many of those states are also taking serious steps to eliminate a tax widely viewed by economists as a disincentive to economic growth. Repealing the franchise tax over time is a fiscally responsible approach and reflects a growing trend. Mississippi, Missouri and New York are currently phasing out their respective franchise taxes; West Virginia, Rhode Island, and Pennsylvania recently completed similar phase-outs. In Pennsylvania, the phase out was sustained across multiple administrations headed by both Republican and Democratic Governors.

Participate in National Sales Tax Simplification Efforts:

COST has regularly participated in the Streamlined Sales Tax project since its inception, representing the business community in working cooperatively with state tax administrators and legislators in seeking to simplify and harmonize state sales tax and use tax systems. COST encourages Louisiana to take incremental steps to move the State towards conformity with and

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[6] A thorough discussion of the problems associated with MUCR can be found in the study prepared for COST by Ernst & Young LLP, "Understanding the Revenue and Competitive Effects of Mandatory Unitary Combined Reporting" (https://www.cost.org/globalassets/cost/state-tax-resources-pdf-pages/cost-studies-articles-reports/combined-reporting-study.pdf).

adoption of the Streamlined Sales and Use Tax Agreement (SSUTA). The SSUTA provides multiple definitional "toggles" designed to allow states to maintain current exemptions and exclusions while providing clarity and ease of administration. While we realize that Louisiana's Parish system makes centralized collection very difficult, the SSUTA has numerous benefits beyond the definitional categories (including uniform exemption administration provisions and rate and address databases) that would be a major benefit for Louisiana businesses, regardless of whether the state seeks SSUTA membership.

In the 2019 COST Scorecard on State Sales Tax Systems[7], Louisiana was one of three states to receive an "F". While local tax administration and lack of uniformity with other states were primary reasons for the poor grade, 41% of Louisiana's sales tax base is levied on business inputs through taxation of business-to-business transactions. A well-designed sales tax exempts business-to-business (B2B) purchases. Our research shows that companies subject to high sales taxes on their purchases of goods and services are put at a competitive disadvantage to many of their competitors in other states and in foreign markets. Further, B2B sales taxation violates fundamental principles of a well-designed retail sales tax, resulting in tax pyramiding and multiple other harmful effects.[8] We urge the Legislature to examine ways to reduce Louisiana's reliance on sales taxes on B2B transactions.

Conclusion

Louisiana, like most states, is grappling with fiscal problems, often due to factors beyond the State's control. Prior to the current crisis, most economic indicators suggested that the economy has been steadily improving. Louisiana's tax system currently relies on a balanced "three-legged stool" of income, property, and sales taxes, with rates and compliance burdens that are relatively competitive with neighboring states. Business taxes can either help drive or hinder State economic growth. Accordingly, in making recommendations regarding tax reform, this Committee should seek opportunities to minimize obstacles to investment and job creation. Please feel free to contact me with any questions or comments at *dlindholm@cost.org*.

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[7] The Best and Worst of State Sales Tax Systems: COST Scorecard on Sales Tax Simplification, Uniformity & Exemption of Business Inputs; April, 2018; Available at https://www.cost.org/globalassets/cost/state-tax-resources-pdf-pages/cost-studies-articles-reports/the-best-and-worst-of-state-sales-tax-systems-august-17-2018-final.pdf

[8] For COST's study on the taxation of business inputs, see https://www.cost.org/globalassets/cost/state-tax-resources-pdf-pages/cost-studies-articles-reports/1903-3073001_cost-ey-sales-tax-on-business-inputs-study_final-5-16.pdf