OVERVIEW OF GOV. EDWARDS' PROPOSED COMMERCIAL ACTIVITY TAX

HB628 by Rep. Sam Jones

April 21, 2017

WHAT IS THE COMMERCIAL ACTIVITY TAX?

The proposed Commercial Activity Tax (CAT) is a tax on the gross receipts or revenue of all businesses operating in Louisiana, except those with receipts less than $150,000. Beginning **January 1, 2018,** the CAT would be imposed on every corporation, partnership, limited liability companies, association, or anyone doing business in the state above that threshold.

Unlike an income tax, which applies to net profits, the Commercial Activity Tax will apply to all revenue a business receives from rents, royalties, sales, construction, repair, services, estates, trusts, and more. Gross receipts taxes are often compared to an expanded sales tax, which applies not only to the final sale but to all transactions including intermediate business-to-business purchases of supplies, raw materials, services and equipment.

WHAT ARE THE PROPOSED RATES OF THE COMMERCIAL ACTIVITY TAX?

The proposed tax is highly complex, and various rates and amounts will be charged, depending on the type of business entity, level of receipts, and industry sector. In short, there are three categories:

1. Businesses that are organized as **pass-through entities**, which pay income tax as individuals rather than corporations, will pay a flat amount of gross receipts tax ranging from $250 to $12,500 annually. The owners would still pay individual income tax on the profits of that business.
2. Businesses that are **taxed as corporations at the federal level** will pay the greater of:
   - The existing Louisiana corporate income tax after credits are applied; OR
   - A flat payment ranging from $250 to $750 if the company's gross receipts are less than $1.5 million – If above this threshold, the company would pay a .35% tax on Louisiana gross receipts.
3. Businesses that are taxed as corporations at the federal level that are engaged in **manufacturing, merchandising, or gaming** would pay the greater of:
   - The existing Louisiana corporate income tax after credits are applied; OR
   - A flat payment ranging from $250 to $750 if the company's gross receipts are less than $1.5 million. However, if above this threshold, the company would pay the lesser of:
     - A .35% tax on Louisiana gross receipts, OR
     - A 2.76% tax on Louisiana gross profits.

WHAT ARE THE MAJOR CONCERNS WITH THE COMMERCIAL ACTIVITY TAX?

Research by the Council on State Taxation (COST), the Institute on Taxation and Economic Policy (ITEP) and the Tax Foundation raise significant concerns with a gross receipts tax in general, noting it violates a number of tax policy principles such as transparency, fairness and competitiveness.

- It taxes the first dollar of receipts or revenue without regard to profitability or ability to pay.
- It is a tax on business inputs, which leads to increased costs of production because it is applied multiple times on the final product and is hidden from the consumer in the price of goods and services due to "pyramiding". As a result, similar to a sales tax, it is regressive, requiring disproportionately more from low-income consumers.
- Businesses organized as pass-throughs entities, such as LLCs or sole proprietorships, are likely to be taxed twice because the business income also remains subject to the individual income tax.
- Effective tax rates vary by industry sector and individual business types. Businesses engaged in high-volume, low-profit sectors are adversely affected, as are start-up companies that generally lose money in the initial years of operation.
- Companies with longer production chains are exposed to a higher tax burden. It encourages vertical integration, so that large companies minimize external transactions and decrease their purchase of materials or services from smaller companies. It also can discriminate against service companies and suppliers in-state where the tax is levied, pushing companies to find vendors outside the state.

WHICH STATES HAVE A COMMERCIAL ACTIVITY TAX?

In general, gross receipts taxes have largely been abandoned by developed countries and the United States since the Great Depression, when this was a revenue source states chose during a time of deficit. Of note, **four states have recently repealed their gross receipts tax**: Indiana, Kentucky, Michigan and New Jersey. The latter three states repealed it only a few years after enacting it due to the significant and immediate negative impact on their economies. In fact, the Tax Foundation cites two recent studies that actually link the repeal of gross receipts taxes with increased production efficiency and growth in GDP per capita.

Today, only five states have a form of gross receipts tax statewide. **Ohio** has a .26% Commercial Activities Tax that replaced both the corporate income tax and tangible personal property tax for business. **Texas** has a Margin Tax instead of income tax, but maintains partial deductions for both compensation expenses and cost of goods sold that makes the Margin Tax more closely resemble an income tax. In 2016, Texas reduced the top rate from .95% to .75% and is deliberating a phase-out in the current legislative session.