Financial Risks to the State Associated with the Inventory Tax Credit

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Overview

- Cost of credit has grown in recent years
- Increased cost likely due to weak oversight
- Better auditing and better definitions in law could reduce cost

Introduction

- Between 2007 and 2014, state granted:
  - $157 million in potential excess inventory tax credits paid
  - $229 million (through 2013) in credits paid to companies with primary business activity other than manufacturing, distributing, or retailing
- Excess credits likely attributable to lack of oversight of self-reported information

Background on Inventory Tax Credit

- Credit against state income tax to offset property taxes paid to local governments on inventories
- Modified during Second Extraordinary Session of 2016 to reduce cost of credit
  - Act 4: Credit partially or non-refundable for credit amounts in excess of certain thresholds, retains full refundability for small credit amounts
  - Act 5: Credit nonrefundable for manufacturers also claiming industrial tax exemption
- Only 14 states tax inventory
- Louisiana and Mississippi – only states to offer inventory tax credit

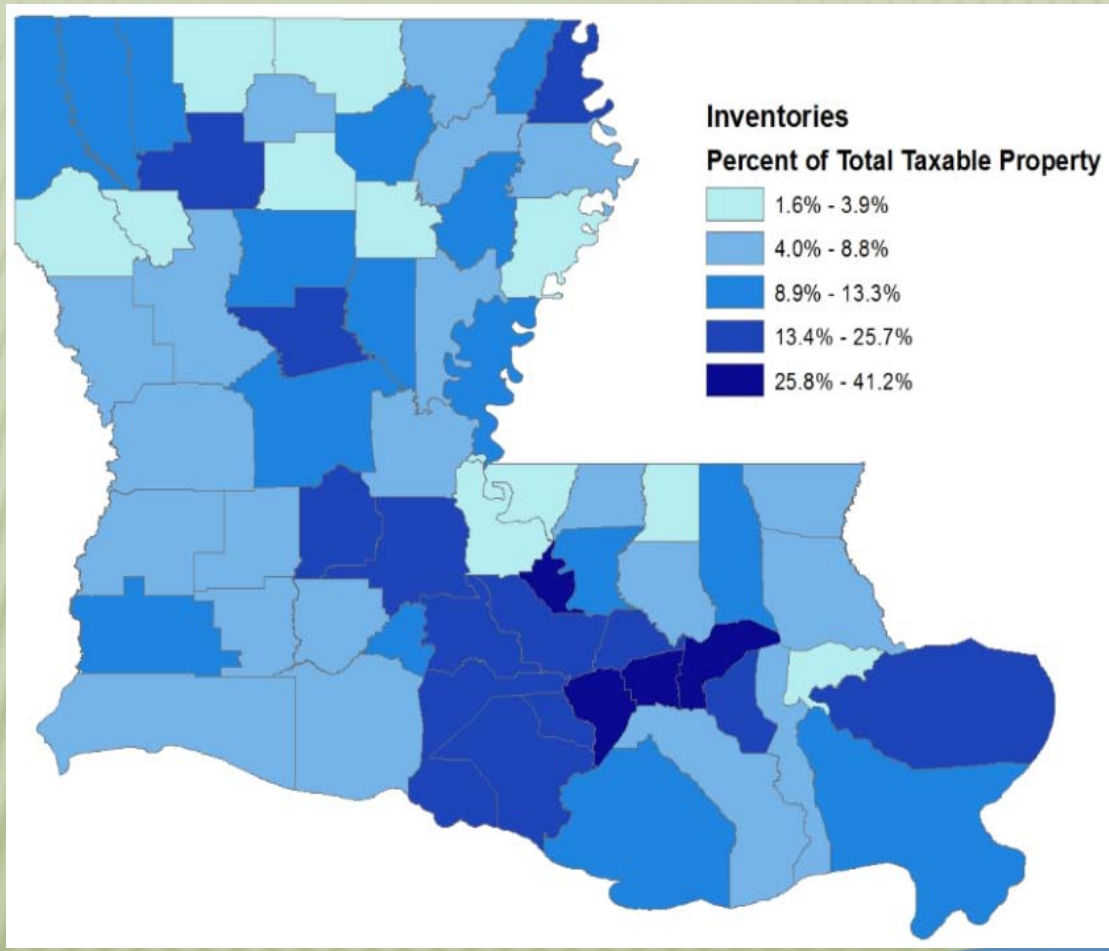
Legal Requirements

- Credit created in RS 47:6006
- Eligible inventory
  - Goods or commodities awaiting sale
  - Goods or commodities in course of production
  - Raw materials and supplies consumed in manufacturing process
- Eligible industries
  - Manufacturers
  - Retailers
  - Distributors

Why We Conducted This Audit

- The inventory tax credit currently costs the state around $400 million dollars annually.
- Difficult to administer because locals levy tax while state grants credits.
- The Louisiana Tax Study found that the inventory tax is "not a productive economic development policy."
- Some local governments heavily rely on revenue from the inventory tax.

Inventories as a Percentage of Taxable Property, 2015



Financial Risks to the State Associated with Inventory Tax Credit

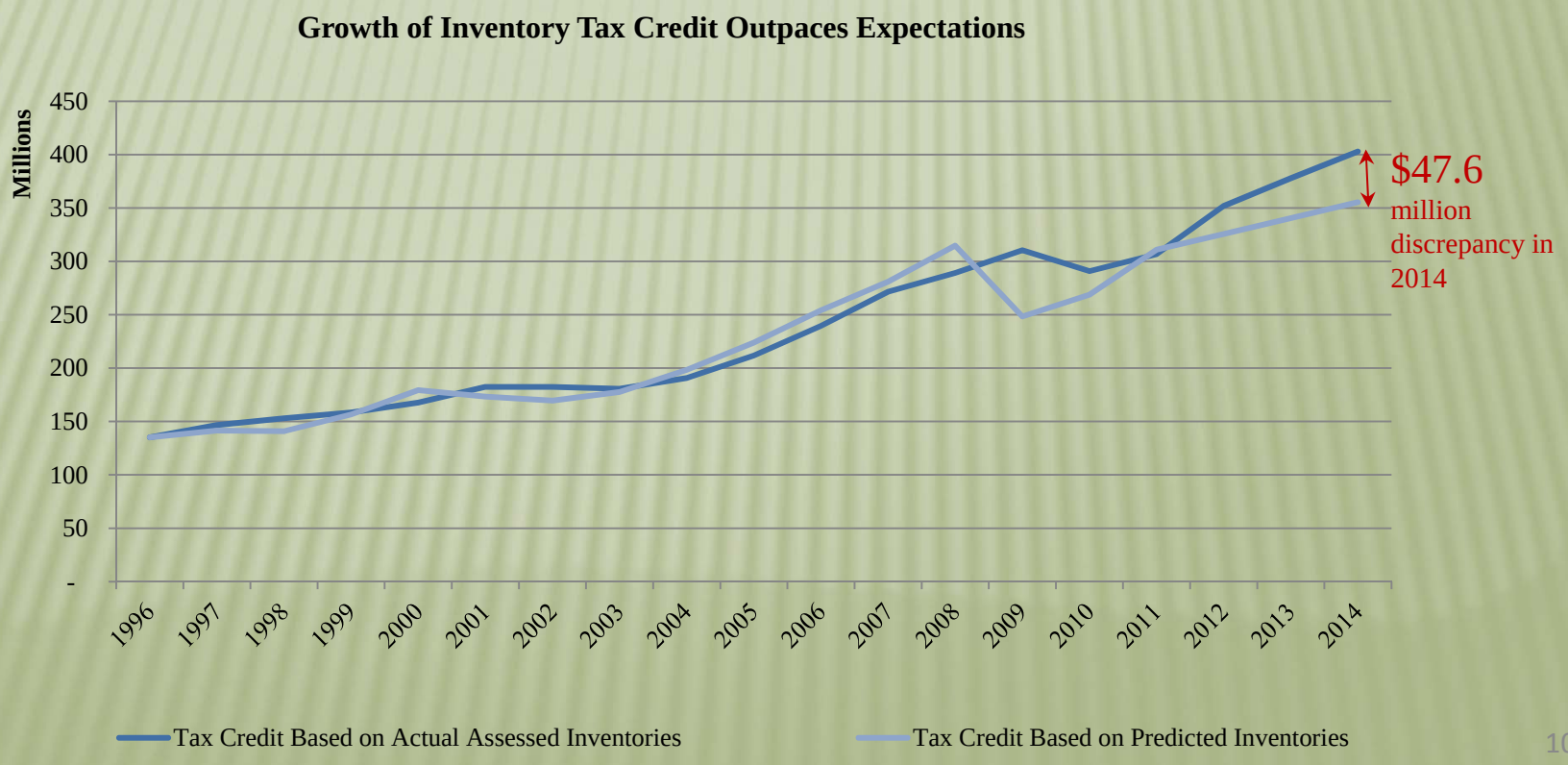
- Credits claimed by companies with primary business activity other than manufacturing, distributing and retailing
- Credits given based on self-reported information without supporting documentation for amounts claimed
- LTC only audits approximately 0.03% of companies that claim the credit

Importance of Mitigating Risks

- Credit has grown by 50% (approximately $135 million) from tax years 2007 to 2014.
- Our analysis shows that approximately $157 million has been or will be claimed in potential excess tax credits for these tax years

Potential Excess Credits

- Between 2007 and 2014, approximately $157 million dollars in credits could not be explained by underlying economic conditions. In 2014 alone, excess credits were $47.6 million.



Potential Excess Credits- Economic Conditions Considered

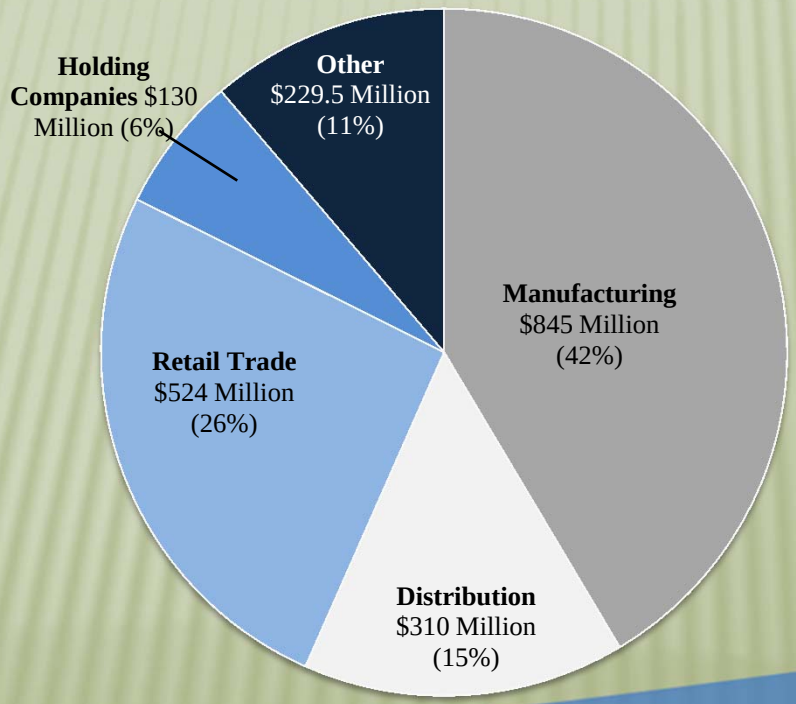
- Not all growth in credit could be accounted for by underlying economic conditions such as changes in:
  - Manufacturing wages
  - Transportation, trade, and utilities wages
  - Wages for all other industries
  - National corporate inventories
  - Oil prices

Credits for Companies in Industries Other than Retailing, Distributing, and Manufacturing

- Statute limits credit to manufacturers, retailers, and distributors.
- Statute does not require companies to have a primary business activity of retailing, distributing, or manufacturing or a corresponding North American Industry Classification System (NAICS) code.
- Other types of tax incentives do require this.
  - Quality Jobs
  - Manufacturers sales tax exemption

Credits for Companies in Industries Other than Retailing, Distributing, and Manufacturing

- Companies without these primary business activities claimed 11%, or $229.5 million, of credits from 2007 to 2013.



Top Five Industries with Primary Business Activities Other Than Manufacturing, Retailing, and Distributing

Industry and Sub-Industries classified by North American Industry Classification System (NAICS) Codes	Credits Claimed TY07-13 (millions)
Mining, Quarrying, and Oil and Gas Extraction (Other than oil stored by producer prior to first sale) (NAICS 21) 1) O&G Extraction (61%) 2) Support Activities for Mining (35%) 3) Mining (except Oil and Gas) (4%)	$61.4
Utilities (NAICS 22) 1) Natural Gas Distribution (87%) 2) Electrical Power Generation, Transmission and Distribution (13%) 3) Water, Sewage and Other Systems (<1%)	$42.6
Transportation and Warehousing (NAICS 48-49) 1) Pipeline Transportation (46%) 2) Air Transportation (24%) 3) Water Transportation (13%) 4) Warehousing and Storage (8%) 5) Support Activities for Transportation (6%) 6) Truck Transportation (3%)	$22.8

Top Five Industries with Primary Business Activities Other Than Manufacturing, Retailing, and Distributing (cont.)

Industry and Sub-Industries classified by North American Industry Classification System (NAICS) Codes	Credits Claimed TY07-13 (millions)
Professional, Scientific, and Technical Services (NAICS 54) 1) Scientific Research & Development Services (43%) 2) Architectural, Engineering, and Related Services (8%) 3) Management, Scientific, and Technical Consulting Services (3%) 4) Computer Systems Design and Related Services (2%) 5) Other Professional, Scientific, and Technical Services (44%)	$18.0
Finance and Insurance (NAICS 52) 1) Securities, Commodity Contracts, Other Financial Investments and Related Activities • Securities and Commodity Contracts Intermediation and Brokerage (14%) • Securities and Commodity Exchanges (3%) • Other Financial Investment Activities (68%) 2) Other Investment Pools and Funds (12%) 3) Credit Intermediation and Related Activities (3%)	$17.8

Credits for Companies in Industries Other than Retailing, Distributing, and Manufacturing

- Other specific examples:
  - Dry cleaners
  - Children's day care services
  - Lessors of real estate
  - Gambling industries

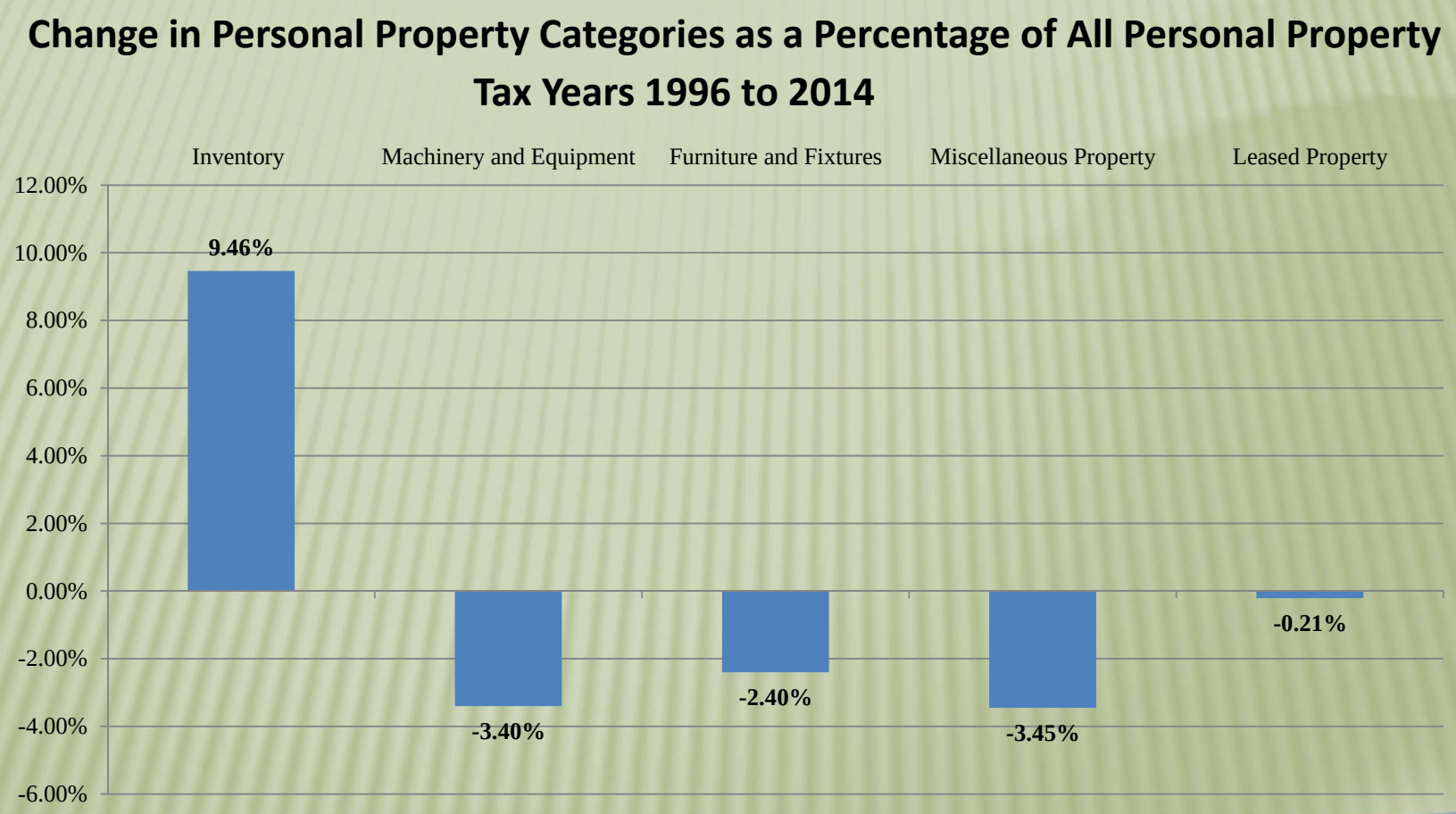
Credits Based on Self-Reported Information

- Companies report inventory using LAT-5 form
  - Requires aggregate inventory values by month
  - Does not require documentation supporting inventory values, i.e., itemized list
  - Requires itemized lists of non-inventory personal property such furniture and fixtures, and machinery and equipment.
- Risk of companies improperly categorizing non-inventory personal property as inventory to receive credit
- No verification process in place to determine whether taxpayer correctly categorized personal property

Credits Based on Self-Reported Information

- Since the credit was fully implemented in 1996, personal property classified as inventory has increased as a percentage of all personal property while the other categories have decreased, as shown on next slide.
- Personal property classifications are self-reported by the tax payer

Credits Based on Self-Reported Information



Possible Ways to Reduce Costs of Credit

- Increase audits to ensure that inventories are correctly reported and that claimants are eligible
- Require companies to provide supporting documentation for inventory values reported on LAT-5
  - Would provide mechanism for identifying ineligible inventory, making current or increased level of audits more effective
  - LTC has agreed to add language requiring itemization to LAT-5 form

Possible Ways to Reduce Costs of Credit

- Clarify definition of manufacturer, retailer or distributer in RS 47:6006.
  - Could use NAICS codes for determining eligibility
  - May result in up to 11% ($44.6 million for tax year 2014) annual savings to the state, **without affecting local governments' ability to levy the tax**

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