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Louisiana Legislature Sends Mixed Signals to the Business Community

By

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There was good news and bad news for Louisiana business taxpayers following the conclusion of the recent special session of the Louisiana legislature. On March 23, 2004, Governor Blanco signed into law Act No. 1 (House Bill No. 2), which enacts a sales/use tax exclusion for machinery and equipment used in manufacturing, and Act No. 2 (House Bill No. 3), which removes "borrowed capital" from the corporation franchise tax base. On the surface, these are a couple of the good developments. In reality, however, the "good news" is tempered by the fact that the changes will not be fully operable until 2011!

The Governor's stated purpose in making these changes was to encourage businesses to locate or expand in Louisiana. Unfortunately, with surrounding states already effectively providing similar benefits in full, it is unlikely that the benefits provided by this new legislation, by themselves, will lead to the desired economic growth until around 2011. In addition, the potential impact of the manufacturing machinery and equipment exclusion on economic development will be significantly diminished by the fact that there is a "local option" feature in the new legislation. This means that cash-strapped local taxing jurisdictions can make their own decisions whether to enact the same, similar or no exclusion with respect to manufacturing machinery and equipment. This local option provision not only dilutes the benefits of the exclusion, but it also creates a different exclusion structure between state and local sales/use taxes. Just last year, the legislature made great strides to harmonize many aspects of state and local sales/use tax laws. *See* Act No. 73 of the 2003 Regular Session of the Louisiana Legislature. The local option aspect of Act No. 1 is a definite step backward and is one that businesses certainly will find "unfriendly" in Louisiana.

Also on the bad news front, the legislature continued the "temporary" suspension of certain sales/use tax exemptions that has been in effect since 1986. This is not surprising - keep in mind that in Louisiana, the legislature is supposed to define and suppress "gambling," but gambling is everywhere in Louisiana. Why? "Gaming" is OK because it's excluded from the definition of "gambling." So, why should one be surprised that a suspension of exemption that has been in place continually since 1986 is still called a "temporary" suspension in Louisiana. In addition, the legislature made more permanent the suspension of exemption on certain utilities.

Back to the good news. The legislature also enacted laws to (i) clarify the sales/use tax treatment of what the Louisiana Civil Code calls "other constructions," (ii) reenact legislation to allow unused motion picture investor tax credits to be carried over for ten years, (iii) make permanent the state and local sales/use tax exemption for trucks used at least eighty percent of the time in interstate commerce, and (iv) extend the benefits of the rehabilitation tax credit and the Quality Jobs Program until January 1, 2008.

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Act No. 1 (House Bill No. 2)

After many years of watching as manufacturing businesses relocated to surrounding states that provide a sales and use tax exemption for manufacturing machinery and equipment, Louisiana finally decided to jump on the bandwagon, albeit late in the game and with a long, slow, half hearted leap. The new exclusion for manufacturing machinery and equipment applies with respect to sales, use and lease taxes and will be phased in over a long period of time as follows (or more quickly, depending on the estimates of the State General Fund (Direct), which is available for appropriation for the states' fiscal year 2004-2005):

(i) For the period beginning July 1, 2005, and ending on June 30, 2006, the tax base[1] will be reduced by 14%;

(ii) For the period beginning July 1, 2006, and ending on June 30, 2007, the tax base will be reduced by 28%;

(iii) For the period beginning July 1, 2007, and ending on June 30, 2008, the tax base will be reduced by 42%;

(iv) For the period beginning July 1, 2008, and ending on June 30, 2009, the tax base will be reduced by 56%;

(v) For the period beginning July 1, 2009, and ending on June 30, 2010, the tax base will be reduced by 70%;.

(vi) For the period beginning July 1, 2010, and ending on June 30, 2011, the tax base will be reduced by 84%; and

(vii) For all periods beginning on or after July 1, 2011, the tax base will be reduced by 100%.

For purposes of the exclusion, a "manufacturer" is defined as a person whose principal activity is manufacturing, as defined in Sector 11 (agricultural, forestry, fishing and hunting) or Sectors 31 - 33 (manufacturing) of the 2002 edition of the North American Industrial Classification System code. "Manufacturing" is defined as putting raw materials through a series of steps that brings about a change in their composition or physical nature to make a new or different item of tangible personal property to be sold to another. Placing materials into containers, packages, or wrapping in which they are sold to the ultimate consumer is part of the manufacturing process. Manufacturing, however, excludes the following: repackaging or redistributing; cooking or preparing food products by a retailer in the regular course of retail trade; storage of tangible personal property; delivery of tangible personal property to or from the plant; delivery of tangible personal property to or from storage within the plant; and actions such as sorting, packaging, or shrink wrapping the final material for ease of transporting and shipping.

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[1] For sales tax, the tax base is the "sales price," as defined in La. R.S. 47:301(13). For use tax, the tax base is the "cost price," as defined in La. R.S. 47:301(3). For lease tax, the tax bases are described as the "gross proceeds," the "monthly lease or rental price," or the "monthly lease or rental price contracted or agreed to be paid."

For purposes of the exclusion, "machinery and equipment" is defined as tangible personal property that is eligible for depreciation for federal income tax purposes and that is (i) used as an "integral part" either (i) in the manufacturing of tangible personal property for sale, or (ii) the production, processing, and storing of food and fiber or of timber. Machinery and equipment also is defined to include the following types of property: computers and software used directly in manufacturing; pollution control equipment; and machinery and equipment used to test or measure raw materials. Machinery and equipment does not include the following: buildings and their structural components, unless the building or structural component is so closely related to the machinery and equipment that it houses or supports that the building or structural component can be expected to be replaced when the machinery and equipment are replaced; HVAC systems, unless necessary for the manufacturing process; and machinery and equipment used to transport or store raw materials or manufactured goods.

In order to be eligible for the exclusion, the machinery and equipment must be ". . . used by a manufacturer in a plant facility predominately and directly in the actual manufacturing for agricultural purposes or the actual manufacturing process of an item of tangible personal property, which is for ultimate sale to another and not for internal use, at one or more fixed locations within Louisiana. In addition, a manufacturer must obtain a certificate of exclusion from the Louisiana Department of Revenue (the "Department") and present the certificate at the time of the purchase, use or lease in order to take advantage of the exclusion.

There are a couple of provisions in Act No. 1 that may cause many businesses to frown. First, as mentioned above, local taxing jurisdictions may choose to adopt or not adopt the new exclusion. This option is bad enough in and of itself. Worse is the fact that the local taxing jurisdictions may choose to (i) not to enact any part of the exclusion, (ii) pick and choose among the sales, use and lease tax components of the exclusion, and (iii) have the local exclusion, if adopted, apply immediately or phase it in over the same or a different time period as the state-level exclusion. From a uniformity standpoint, this local option provision is as unfriendly as it can get if locals choose to adopt different rules. The local option will work in favor of businesses only if local taxing jurisdictions "jump on the bandwagon" and adopt the exclusion in full and with an immediate effective date. Local taxing jurisdictions should avoid, and the Governor should encourage the avoidance of, adopting different parts of the exclusion and different phase-in periods for local sales/use tax purposes. Otherwise, confusion, uncertainty and lower taxpayer compliance will be a certainty.

The other unusual provision likely will confound taxpayers and administrators, but could prove to be mildly helpful in the long run. The phase-in percentages and periods for the manufacturing machinery and equipment exclusion may take one of two more aggressive tracks (they still won't be fully phased in until 2010) if the "bean counters" (a/k/a the Revenue Estimating Conference) revise the state general fund budget estimates for the Fiscal Year 2004-2005 and "find" some additional funds. While this provision might help implement the new exclusion more rapidly, it certainly will cause confusion as the bean counters conduct their revenue estimates and make adjustments. In other words, application of the new exclusion is like trying to hit a moving target.

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Act No. 2 (House Bill No. 3)

Currently, the Louisiana corporation franchise tax is imposed on a company's issued and outstanding capital stock, surplus, undivided profits and "borrowed capital." La. R.S. 47:602. "Borrowed capital" is defined as all indebtedness of a corporation maturing more than one year from the date incurred or not paid within one year from the date incurred. La. R.S. 47:603. All amounts owed to an affiliate are included in borrowed capital regardless of the date of maturity. This provision makes the franchise tax very onerous for corporations that might not be able to raise capital through equity offerings (for example, start up corporations, expanding corporations or corporations in financial difficulty) because they do not get a franchise tax break when they are forced to borrow money to finance operations. In almost every other state imposing a franchise tax, the tax is not imposed on borrowed capital.

The Louisiana corporation franchise tax on borrowed capital will be phased out as follows:

(i) For taxable years beginning after December 31, 2005, and before January 1, 2007, taxable capital will include 86% of borrowed capital;

(ii) For taxable years beginning after December 31, 2006, and before January 1, 2008, taxable capital will include 72% of borrowed capital;

(iii) For taxable years beginning after December 31, 2007, and before January 1, 2009, taxable capital will include 58% of borrowed capital;

(iv) For taxable years beginning after December 31, 2008, and before January 1, 2010, taxable capital will include 44% of borrowed capital;

(v) For taxable years beginning after December 31, 2009, and before January 1, 2011, taxable capital will include 30% of borrowed capital;

(vi) For taxable years beginning after December 31, 2010, and before January 1, 2012, taxable capital will include 16% of borrowed capital; and

(vii) For taxable years beginning after December 31, 2011, taxable capital will not include borrowed capital.

Act No. 2 also added new rules regarding "related party" debt. Pursuant to new section La. R.S. 47:605.1, the excess of a corporation's related party[2] debt (less some exceptions for trade debt, utility deposits, etc.) over the sum of its capital stock and surplus and undivided profits, as determined under La. R.S. 47:604 and 47:605, will be included in the taxable base of the corporation notwithstanding the phase-out of the franchise tax on borrowed capital. In addition, Act No. 2 enacts La. R.S. 47:602(G) to phase-out, using the same percentages and time periods above, the deduction from borrowed capital for investments in and advances to subsidiary banking and certain utility corporations.

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[2] For purposes of new La. R.S. 47:605.1, "related party" means any member of a controlled group of corporations, as defined in Section 1563 of the Internal Revenue Code of 1986.

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Act No. 4 (House Bill No. 1)

This Act, which becomes effective on July 1, 2004, continues through June 30, 2009, the "temporary" suspension of certain state-level sales/use tax exemptions that has been in effect in one form or another since 1986. The suspension applies to 3% of the 4% state-level sales/use tax. In addition, the Act suspends 80% of the sales/use tax exemption with respect to 1% of the 4% state-level sales/use tax on utilities. This aspect of the suspension continues through June 30, 2009. For purposes of the utilities suspension, the term "utilities" is defined as ". . . sales of steam, water, electric power or energy, and natural gas." This suspension certainly does not bode will for businesses and creates the lack of uniformity that has plagued the Louisiana state and local sales/use tax system for years. The suspension of the exemption with respect to utilities is especially confusing.

Act No. 5 (House Bill No. 8)

Continuing with the theme of "let's send mixed messages to businesses in Louisiana," Act No. 5, which actually sends a good message to specific industry, makes it clear that the exemption for purchases of utilities by steelworks and blast furnaces (La. R.S. 47:305.51) will continue to be fully applicable for both state and local sales/use tax purposes at least though June 30, 2007. The Act, which becomes effective on July 1, 2004, makes it clear that the exemption continues to apply at the state level notwithstanding the provisions of Act No. 4 of the 2004 First Extraordinary Session, which is discussed above. Thus, a "win" for the steelworks and blast furnace industry in Louisiana.

Act No. 6 (House Bill No. 9)

Another "business-friendly" bill, Act No. 6, which became effective on March 25, 2004, brings state sales/use tax law into line with local sales/use tax law by providing that the term "tangible personal property" does not include an "other construction," a Louisiana Civil Code term, that is permanently attached to the ground regardless of the ownership of the ground underlying the other construction. Thus, "other constructions" now will be treated as immovable property (another Louisiana Civil Code term that is roughly the same as "real estate") for both state and local sales/use tax purposes.[3] This is a win for uniformity!

Act No. 10 (House Bill No. 35)

Act No. 10 makes permanent the exemptions from both state and local sales/use taxes for trucks with a gross weight of at least 26,000 pounds or more and trailers that are used at least eighty percent of the time in interstate commerce and whose activities are subject to the jurisdiction of the United States Department of Transportation. The Act also makes permanent the exemptions from state and local sales/use taxes for contract carrier buses used eighty percent of the time in interstate commerce from state and local sales/use taxes. Act No. 10 will become effective on June 30, 2004.

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[3] Act No. 61 of the 2003 Regular Session of the Louisiana Legislature added La. R.S. 47:301(16)(l) to address the treatment of "other constructions" for local sales/use tax purposes.

Act Nos. 12 and 13 (Senate Bill Nos. 9 and 14)

Act No. 12 extends to January 1, 2008, the income and franchise credits associated with the rehabilitation of certain historic structures located in a downtown development district. Similarly, Act No 13 extends until January 1, 2008, the incentive tax credits or rebates available under the Louisiana Quality Jobs Program.

Parting Thoughts

While it is a positive sign that Louisiana finally is taking meaningful steps to change a tax system that has confounded taxpayers and administrators for years, phasing the two most important "business friendly" changes in over many years is not likely to get many businesses excited about moving to Louisiana. In addition, many provisions of Louisiana's tax statutes (*e.g.*, the "temporarily" suspended state-level sales tax exemptions and the "local option" provision of Act No. 1) further communicate to potential businesses the state's lethargic reform of its tax structure to stimulate business growth. Of even greater concern is the eventual failure of these tentative steps at tax reform to stimulate even modest business or revenue growth in the near term may embolden the legislature to repel any future efforts at tax reform in favor of imposing even higher taxes on the few remaining business in the state. The bottom line is that the nice effort put forth by the legislature at best sends mixed and confusing signals to businesses looking at Louisiana. At worst, the new legislation perpetuates non-uniformity between state and local sales/use taxes and creates more confusion regarding the application of exclusions and exemptions from state and local sales/use taxes. Only time will tell if any of the legislature's recent efforts will play any meaningful role in the development of business in Louisiana.

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Remember that these legal principles may change and vary widely in their application to specific factual circumstances. You should consult with counsel about your individual circumstances. For further information regarding these issues, contact:

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