TERRIBLE T'S OF INVENTORY: TIMING AND TAXES

States that impose inventory taxes put their constituent businesses at a competitive disadvantage.

By Angela Adolph, Esq.

Inventory taxes pose an additional cost of doing business in more than a dozen states, and despite efforts to mitigate the competitive disadvantage the practice creates for many taxpayers, policymakers have yet to propose an equitable fix.

Virtually all states employ a property tax at the state or local level. The most common target is real property, which is land and land improvements; and tangible personal property such as fixtures, machinery and equipment.

Nine states also tax business inventory. Those are Texas, Louisiana, Oklahoma, Arkansas, Mississippi, Kentucky, West Virginia, Maryland and Vermont. Another four states — Alaska, Michigan, Georgia and Massachusetts — partially tax inventory. In these 13 states, inventory tax contributes a significant portion of overall property tax collections.

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From a policy standpoint, however, inventory tax is probably the least defensible form of property tax: It is the least transparent of business taxes; is "non-neutral," as businesses with larger inventories, such as retailers and manufacturers, pay more; and it adds insult to injury for businesses whose inventory is out of sync with finicky consumer buying habits.

A few fixes

Taxpayers have had few options in attempting to reduce inventory tax liability because an inventory's valuation is seldom easily disputed. So modeling a classic game of cat and mouse, some enterprising businesses would move their inventory to the jurisdiction with the lowest millage, frantically shuttling property about before the lien date.

Taxing jurisdictions eventually caught on, however, and many of these states adopted an averaging system whereby taxpayers must report monthly inventory values that are then averaged for the year. So much for gaming the timing of taxes.

The underlying problem is that imposing an inventory tax puts that state's businesses at a competitive disadvantage. At the same time, local jurisdictions cannot easily afford to give up the revenue generated by inventory taxes.

When West Virginia was contemplating phasing out its inventory tax, one state legislator pointed out that the proposal placed elected representatives in the predicament of telling educator constituents the state could not afford to pay them sufficiently, while turning to another group of business constituents and relieving them of a tax burden which would create a hole in the state's revenues.

Some states, including Louisiana and Kentucky, have implemented creative workarounds, such as giving income or corporate franchise tax credits to businesses to offset their inventory tax liability. But these imperfect fixes add uncertainty and unnecessary complexity to a state's tax code.

For instance, when Louisiana implemented a straightforward inventory tax credit in the 1990s, businesses paid local inventory tax and were reimbursed for the payments through a tax credit for their Louisiana corporation income/franchise tax liability. The state Department of Revenue fully refunded any excess tax credit.

Between 2005 and 2015, however, the state's liability more than doubled. In 2015, the Legislature imposed a $10,000 cap on the refundable amount of an inventory tax credit and allowed any unused portion of an excess tax credit to be carried forward for a period not to exceed five years. Then in 2016, lawmakers increased the fully refundable cap to $500,000 and adjusted how the excess tax credit could be taken, but left the carry-forward period unchanged. This has created another inventory tax timing problem: Businesses now lose any unclaimed excess tax credit at the end of that carry-forward period, and businesses have no assurances that the tax credit amounts won't be lowered or otherwise made less user-friendly the next time the state faces a fiscal crunch.

Kentucky recently implemented its own inventory tax credit system. Even less taxpayer-friendly than Louisiana's approach, it provides only a nonrefundable and nontransferable credit against individual income tax, corporation income tax and limited liability entity tax. The state is phasing in the tax credit in 25 percent increments each year until it is fully claimable in 2021.

Texas has taken a different tack by offering businesses a limited, $500 exemption for inventory tax. Unadjusted for inflation since its implementation in 1997, however, the exemption for business personal property has lost relative value as the cost of living has increased. The Texas Taxpayers and Research Association recently evaluated Texas' inventory tax and found that the $500 exemption in today's dollars is equivalent to only $367 in 1997 dollars. The association further noted that a property valued at $500 generates, on average, a tax bill of $13, which is less than the likely cost of administering the tax. Not surprisingly and quite rightly, the association recommended increasing the amount of the exemption.

Clearly, these workarounds are not really working for this problem. What's the best solution for Louisiana, Kentucky, Texas and the rest of the inventory tax states? Join the rest of the crowd and simply abolish the inventory tax, as a task force created by the Louisiana Legislature recommended in 2016. No more cat and mouse games, no more paltry exemptions and no more convoluted tax credits.

At least in this regard, businesses in all states would be on the same competitive footing.

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