Assessing the Texas Franchise Tax

Presented to:

Senate Finance Committee

March 30, 2016

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The Pros and Cons of the Margins Tax

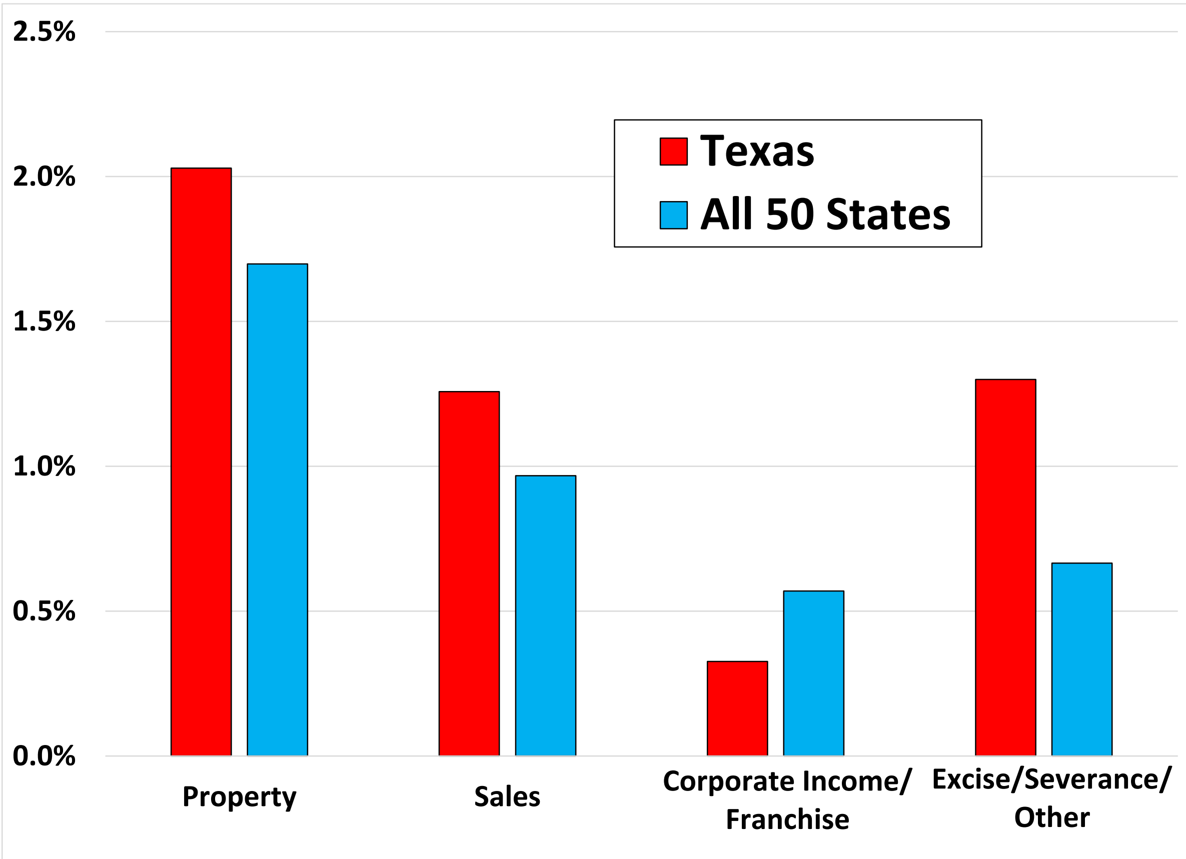
Pros

- The Margins Tax has met most of its stated 2006 reform goals:
  - To provide a source of revenue to reduce property taxes and pay for school finance reforms to prevent a court injunction closing Texas public schools.
  - To rework the tax system to increase the share of taxes paid by service providers and reduce our reliance on taxes levied on goods-producing industries
  - To eliminate some of the common tax planning opportunities available under the old franchise tax:
    - The “Delaware Sub,” by which a company could organize its operations into a partnership and avoid much of the tax
    - The “Geoffrey’s Sub” by which a company could create an out-of-state subsidiary and bill itself for certain costs to reduce its franchise tax bill
- As a general business tax, the franchise tax applies to businesses generally, including corporations, limited liability companies, limited partnerships, professional associations, and other forms of business grated liability-protections under state law.
- Simple alternative calculations are provided to reduce compliance costs for smaller businesses (i.e. those with less than $20 million in total revenues).
- The franchise tax now is roughly 30 percent below the level of general business taxes in other states, but Texas’ sales and property taxes on business remain well above the national average.

Cons

- The tax is complex, often using the same terminology as the Internal Revenue Code, but with different definitions requiring most companies to maintain a special set of books just for calculating their Texas franchise tax liability.
- Though the tax applies to all liability-protected forms of business, the very generous small business exemption results in only 1 in 10 liability-protected entities actually paying any tax.
- Although the franchise tax itself is relatively low compared to business taxes in other states, Texas is still a relatively high tax state for businesses overall when it is combined with our high sales and property taxes.
- As a new tax, both in concept and operation, it was difficult to initially estimate the amount of new revenues that would be generated (this is no longer an issue for what is now a more mature tax).
- However, there are still unsettled issues under review by the Comptroller’s Office, the State Office of Administrative Hearings, and the courts.

State and Local Taxes Relative to Private Sector Output



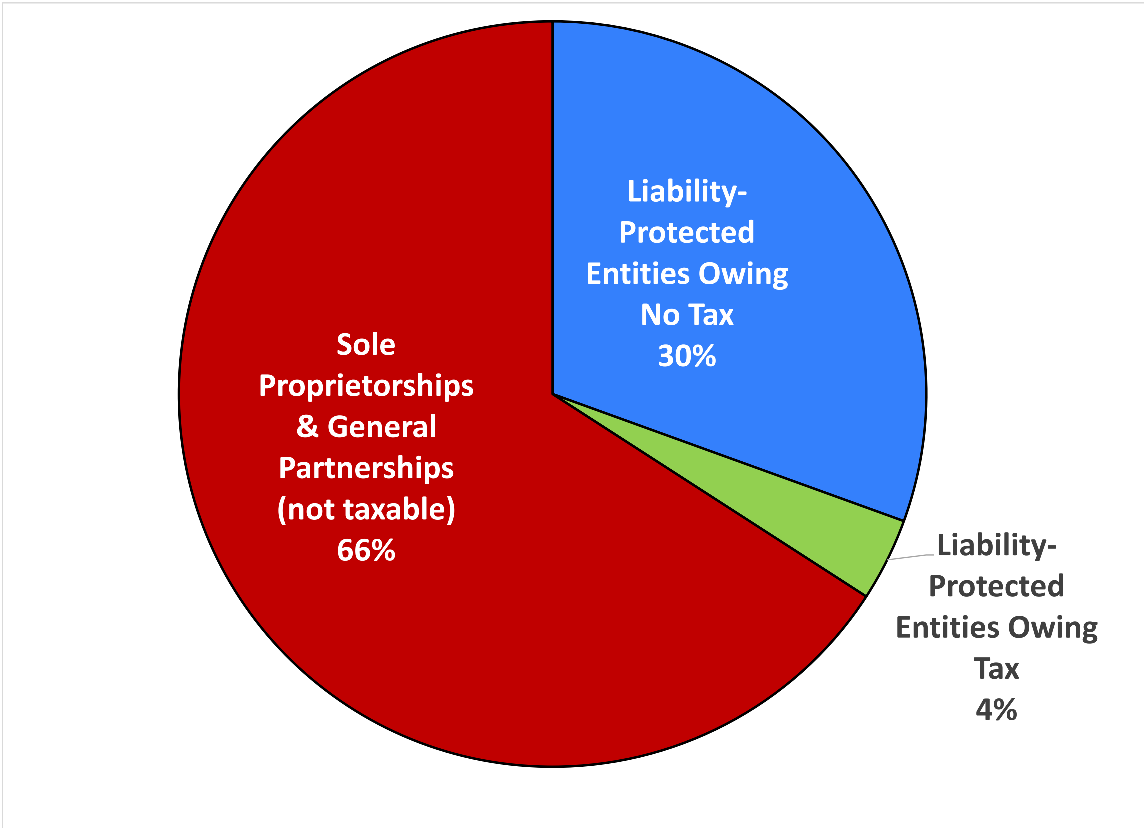
Note: *The above figures reflect taxes directly incurred and paid by a business. It does not include taxes a business collects from its customers and remits to the state.*

Source: *Council on State Taxation, Total State and Local Business Taxes, 2014, Published October 2015.*

The biggest taxes paid by business are property and sales taxes, which are particularly high in Texas.

Direct business taxes (such as the corporate income or the franchise tax), though significant, are substantially less important in state and local tax systems.

The Margins Tax Applies to Only a Small Segment of Texas Businesses



In Texas, there are roughly 3.4 million "businesses." Of these, most (2.3 million) are sole proprietorships, which are afforded no liability protections under state law. These may range from very small businesses to "on the side" endeavors of salaried workers.

Under Texas law, corporations, limited liability companies, limited partnerships, limited liability partnerships, professional associations, etc. are businesses that formally register with the state and are afforded liability protections under the law (i.e. the owners are not personally liable for the debts of the entity). There are 1.2 million liability-protected entities doing business in Texas and "subject" to the franchise tax.

Most liability-protected entities are exempt from paying franchise tax, predominately the result of the state's generous small business exemption. Only 124,000 businesses—just 4 percent of all businesses operating in the state, and roughly one in 10 liability-protected entities, actually owe any Texas franchise tax.

Recommendations

1. Although we believe property tax relief offers a greater economic return to the state, we encourage the legislature to continue on a path to eliminating the franchise tax by reducing the rate of the tax.

2. The small business exemption should be retained at its current level. With only one in ten liability-protected businesses owing any tax, the tax is already very narrow in its application.

3. Should the legislature instead decide to replace the margins-based franchise tax with some alternative business tax, we would suggest:
    a. The alternative tax should be simple in its application and similar to business taxes in other states, for ease of compliance and administration, and
    b. The alternative tax should apply to all forms of business afforded liability protections under Texas state law.

4. We would suggest abolishing the Property Tax Relief Fund and consolidating it within the general revenue fund because:
    a. The Property Tax Relief Fund operates exactly as other funds classified by the LBB and the Comptroller as "general revenue funds." Any change in revenue to the Property Tax Relief Fund results in a direct and corresponding change in general revenue funding; thus, reduced revenue to the fund (such as resulted from the 2015 franchise tax cut) results in an increase in general revenue spending. This is the same manner in which the Available School Fund and the State Textbook Fund operate, which are classified as "general revenue funds;" and
    b. By using a separate Property Tax Relief Fund, any franchise tax cut is shown as a spending increase to the general revenue fund.