Texas Franchise Tax

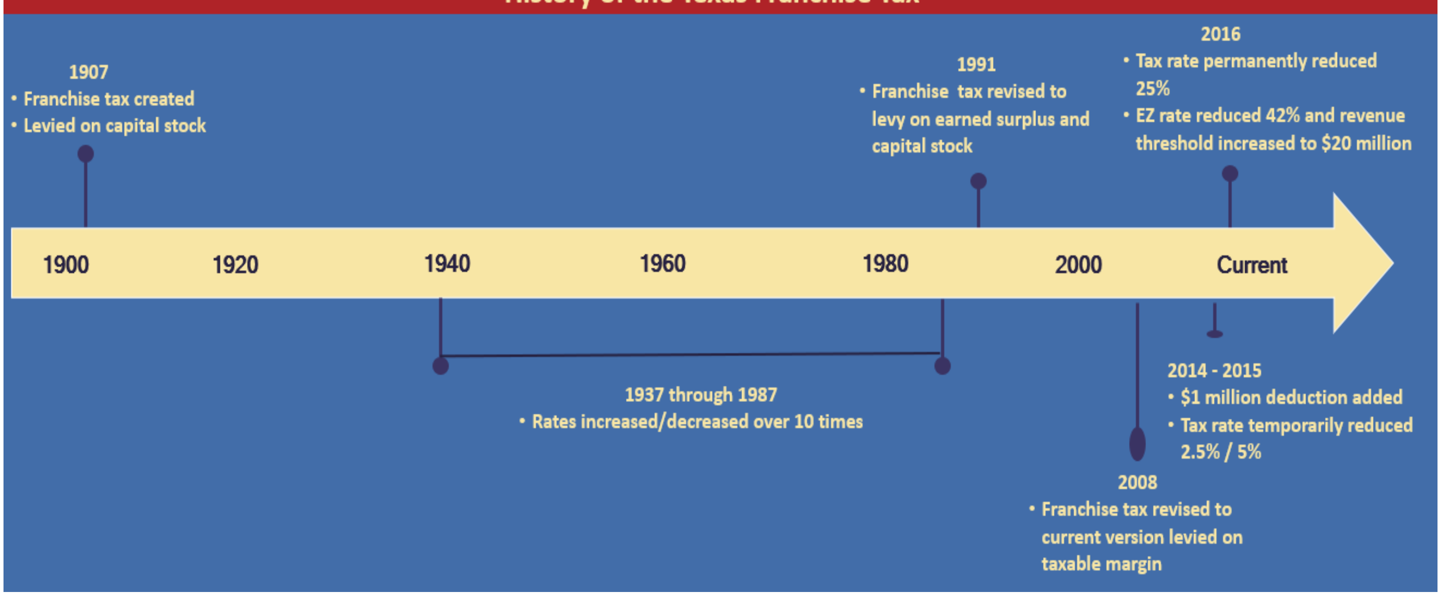
July 2018

The franchise tax has been levied in Texas for over 100 years and has existed in a variety of forms, from a capital stock tax, to a tax on net earnings, to its current form as a tax on margin. As a "privilege" tax, the tax is paid in return for the authorization to do business in Texas.

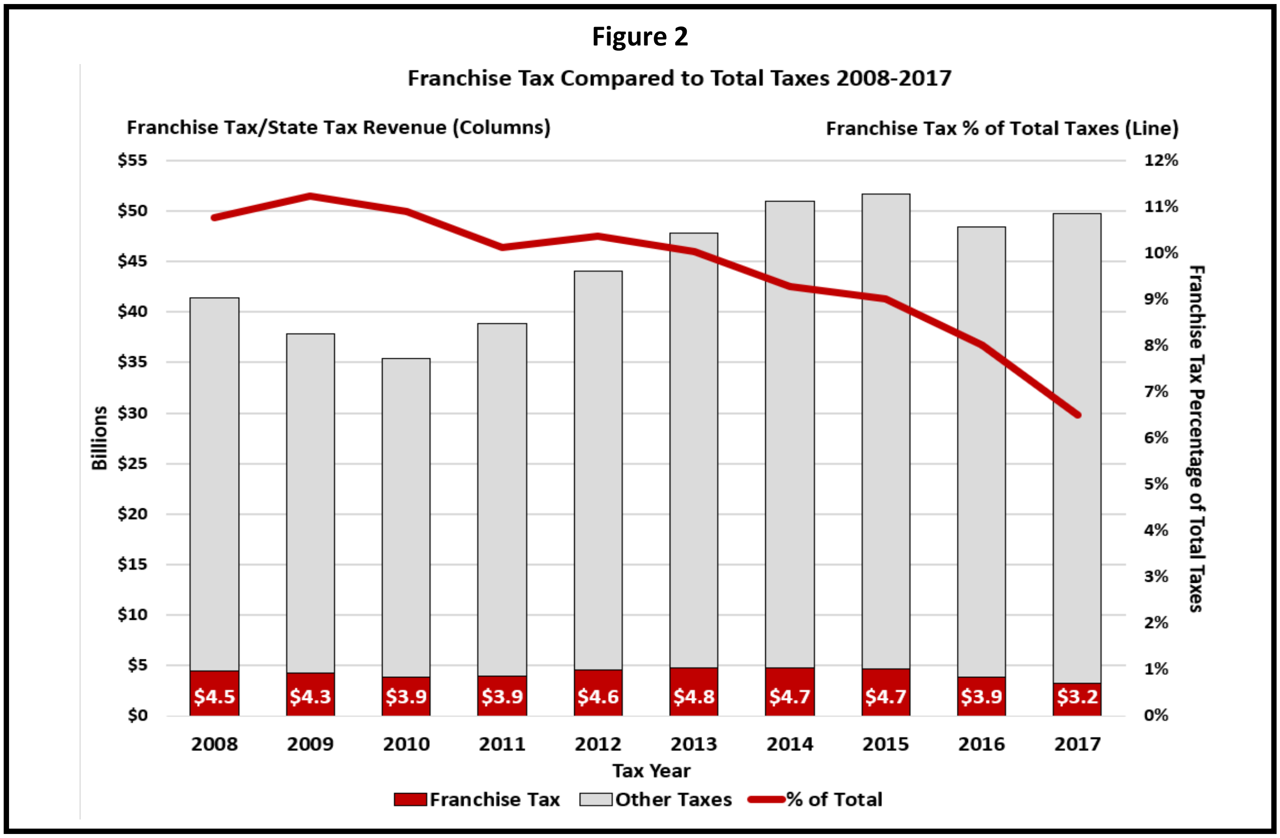
Adjustments to the tax have been made throughout its history, but the franchise, or "margin" tax as we know it today, took effect in 2008. Prior to this date, the tax only applied to a corporation's or limited liability company's earned surplus (i.e. profits) or capital stock (i.e. net assets) (Figure 1). During a 2006 special session, the Legislature rewrote the calculation of the franchise tax to be based on taxable margin. The goal of the rewrite was to find more revenue to reduce tax rates levied by Texas public schools, to eliminate tax avoidance opportunities, and to create a tax more aligned with the modern Texas economy. The tax was also expanded to apply to partnerships and professional associations—business forms that, like corporations and limited liability companies, enjoy liability protection under state law. In addition, the tax base was adjusted to apply to what was termed "taxable margin," generally calculated as total revenue minus either (1) cost of goods sold (COGS), (2) compensation, (3) 30% of revenue, or (4) $1 million, all apportioned to business done in Texas.

The 2008 adjustments to the franchise tax increased tax revenue over 40% that year.[1] However, the revenue estimated to come from these changes fell short of official projections. Subsequent changes resulted in further revenue reductions, diminishing the share of total taxes the franchise tax contributes to the state (Figure 2).

Figure 1
History of the Texas Franchise Tax



[1]Revenue amounts use the most recent figures from the Comptroller's office, which factor in refunds for overpayment of franchise tax. Filed franchise tax reports are used when comparing deductions and reported liability amounts.



Franchise Tax by the Numbers

In 2009, franchise tax revenue accounted for over 11% of all state taxes collected, but since that time its share has steadily declined by almost half to 6.5% in 2017. Franchise tax as a percentage of gross state product also peaked in 2008 and 2009 at 0.36% (soon after the changes went into effect) but has since declined to almost half that amount at 0.19% in 2017. These declines are a result of several factors—the 5% and 25% rate reductions enacted by the Legislature in 2013 and 2015, respectively, being the most impactful. Additionally, continued legislative adjustments favoring small businesses, such as the tripling of the "no tax due" threshold from $300,000 to over $1 million and doubling the availability of the EZ tax rate (both discussed in further detail below), have reduced both the impact of the tax on businesses and the number of businesses subject to the tax.

In 2017, 1.3 million businesses in Texas were subject to the franchise tax. However, only 9%, or approximately 121,000 businesses, owed any tax. The 91% of businesses that did not owe tax either reported total revenue less than the no tax due threshold or their calculated liability was less than $1,000, either of which exempt a business from paying any franchise tax. On average, businesses owing franchise tax reported a liability equal to 0.15% of their Texas revenue.

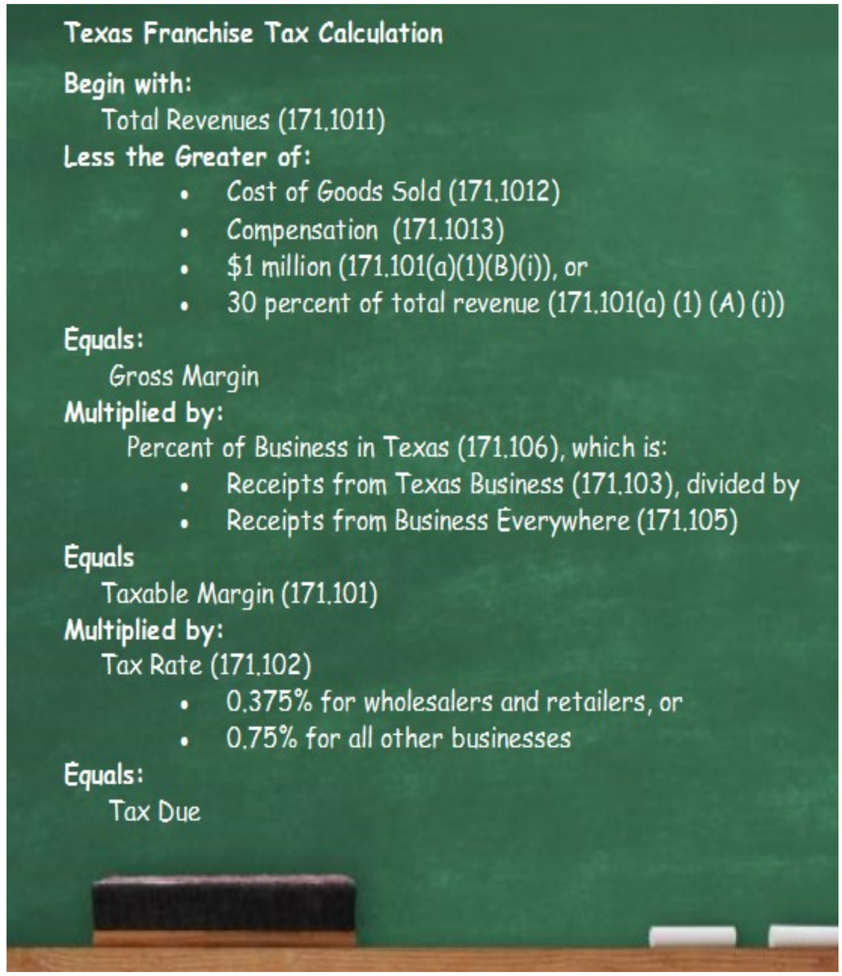
Calculating the Franchise Tax

The franchise tax is simple in concept, but complicated in its application. Essentially taxpayers begin the calculation of their tax bill with their total revenue. From that, they subtract the <u>higher</u> of four deductions:

1. Cost of goods sold
2. Compensation
3. 30% of their total revenues
4. $1 million (indexed to inflation)

The result is apportioned to Texas based on the company's percentage of sales in the state. The appropriate tax rate is then applied to determine the final bill.

Elements for Calculations



Total Revenue

A business' total revenue is generally the amount of income reportable on its federal tax form minus bad debt, foreign dividends, and certain distributions of the business. While relatively straightforward for many businesses, determining total revenue becomes more complicated for others when the many required adjustments are applied. For instance, certain businesses may be entitled to exclude from revenue the amount in payments received paid out to subcontractors, called flow-through funds, while other businesses may exclude from revenue certain healthcare costs. In addition, businesses may be required to file a combined report, in which many intra-company transactions may net out when calculating total revenue.

Combined Reporting

Modern businesses are typically segmented into separately-organized operating entities. Businesses which are a part of an "affiliated group" engaged in a "unitary business" must file a combined franchise tax report. An affiliated group includes businesses which own a controlling interest in other entities, or which have a controlling interest owned by another entity. A unitary business is a single economic enterprise made up of one or more entities that provide a synergy and mutual benefit that produces a value among them. The tax code provides several factors to assist in determining whether entities are engaged in a unitary business, such as whether the entities are in the same line of business or if they are integrated through a strong centralized management. If it is determined the entities are a unitary business, then they are considered a "combined group" and must file a combined group report based on the revenue and deduction amounts of all the member entities businesses. These combined reporting requirements were first implemented in 2008 as a way to prevent tax minimization. However, the subjective nature of what defines a unitary business has resulted in disputes between the Comptroller's office and taxpayers.

Revenue Deductions – Margin

Once a business determines its total revenue, it must decide which one of the four revenue deductions yields the lowest tax bill.

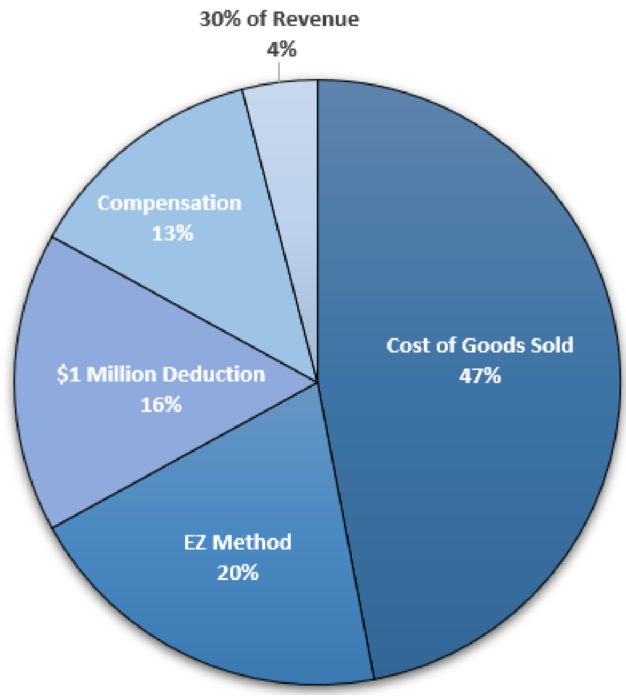
The most popular method to calculate the franchise tax is the COGS deduction with approximately 57,000 of the 121,000 (47%) businesses paying franchise tax using this method. The deductions used less frequently are the $1 million subtraction from revenue, compensation deduction, and 30% deduction of revenue, with 16%, 13%, and 4% respectively (Figure 3). Small businesses may exercise an alternative calculation by simply paying a low tax rate on their Texas gross receipts—the EZ computation (chosen by 20% of businesses paying franchise tax).

Cost of Goods Sold

The COGS deduction is the most used method to calculate franchise tax owed. Texas' definition of "cost of goods sold" draws from, but is not identical to, the definition in federal tax law; consequently, it can be an area of confusion. The COGS deduction includes all direct costs of acquiring or producing goods. The produced or acquired goods may be real or tangible personal property. Direct costs include labor, materials, and storage. On the other hand, costs for providing a service are specifically excluded. In fact, companies primarily engaged in providing services are generally precluded from claiming COGS because they do not produce goods. However, there are exceptions to this exclusion if the service is sufficiently connected to the construction or improvement of real property.

Businesses using the COGS deduction paid over half of the state's franchise tax collections in 2017. Most of the reported liability using COGS—about two-thirds—came from businesses in one of four industries: retail, wholesale, construction, or manufacturing. For all businesses using the COGS deduction, the average reported tax liability was 0.10% of Texas revenue, below the average for all businesses reporting franchise tax of 0.15%.

Figure 3
2017 Franchise Tax Deductions Used by Taxpayers



Compensation

The compensation deduction is the amount entered in the Medicare wages and tips box of an employee's Form W-2 or its equivalent, along with any distributed income and stock awards. In addition, the cost of benefits such as healthcare and employer retirement contributions qualify as compensation. However, no more than $370,000 (as adjusted using the Consumer Price Index) may be subtracted as compensation for any individual employee when determining a business' margin.

The compensation deduction is primarily used by professional services companies, such as law firms and healthcare providers. Service companies do not produce or sell goods, so the COGS deduction is not available to them, making the compensation deduction the most viable option. About 13% of businesses owing franchise tax use this deduction, and they paid about 17% of the franchise tax in 2017. Additionally, their average reported tax liability of 0.31% of Texas revenue is more than double the overall average reported liability of 0.15%.

30 Percent of Total Revenue

A business may choose to subtract 30% of its total revenue to determine its margin. This option was originally designed as a "fail-safe" when neither the COGS nor Compensation deductions offered much benefit, and is the least used method to calculate franchise tax liability. Only 4% of businesses owing franchise tax use this deduction. Of the small number of businesses that use this method, almost half are real estate, finance, or professional service companies. Interestingly, businesses using this deduction reported a liability of over 20% of the total reported franchise tax liability, averaging 0.46% of Texas revenue in tax—an effective tax rate roughly three times higher than the average business paying franchise tax.

$1 Million Deduction

A 2013 amendment allows businesses the simple option to deduct $1 million. The original law exempted companies from paying tax if they had gross revenues of $1 million or less; however, the next dollar of business could trigger a tax bill as much as $7,000. Allowing a minimum deduction of $1 million eliminated this "cliff" for small businesses.

The types of businesses which deduct $1 million from total revenue to determine their franchise tax liability are split relatively evenly across many industries. However, real estate, healthcare, and professional service companies use this method more than any other industry. A total of 16% of businesses owing franchise tax use this method, but these businesses reported a liability of only 1.7% of all franchise tax liability in 2017. These same businesses paid on average 0.16% of their Texas revenue in franchise tax liability, slightly higher than the 0.15% average reported liability for all taxpayers.

Apportionment – Taxable Margin

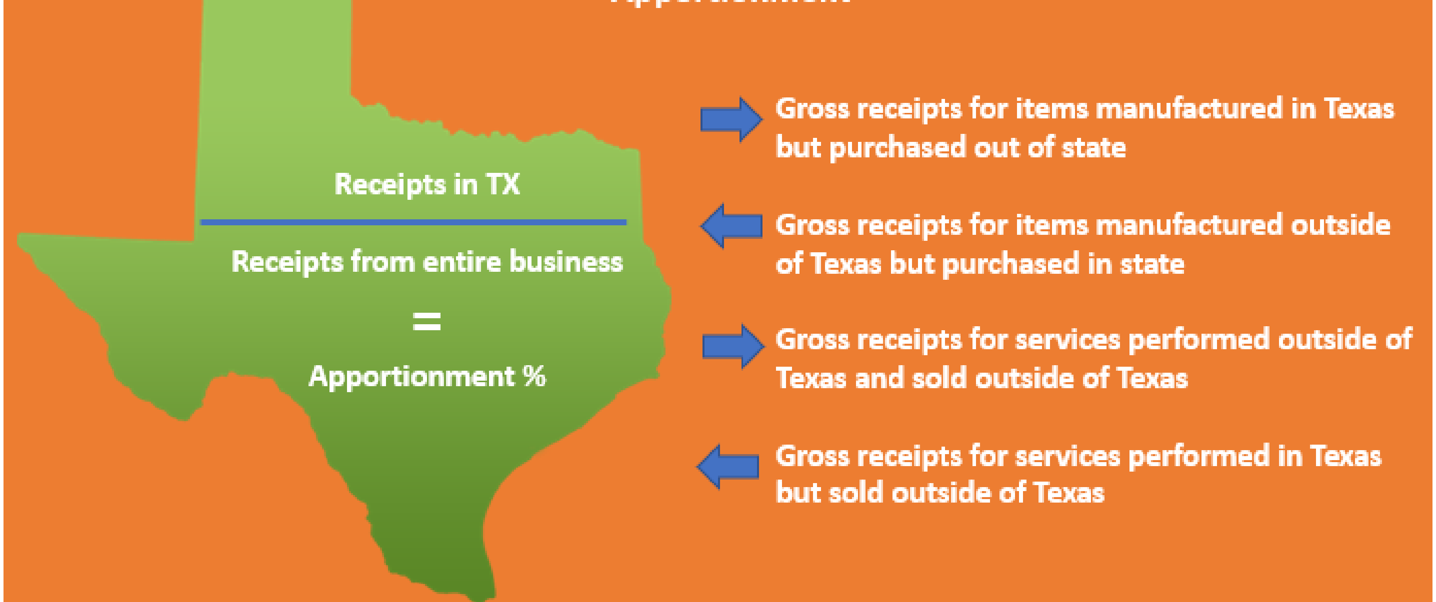
Under federal law, income-based taxes, such as the Texas franchise tax, must fairly reflect the activity of the business in a state. Texas, like many states, uses a mathematical formula based on a single factor—receipts—to apportion a company's tax base to the state. The percentage of a taxpayer's receipts from business in Texas relative to its entire business is applied to its calculated margin to determine the amount that is taxable. The general rule to determine whether to apportion gross receipts to Texas is: Sales of tangible personal property are apportioned to the location of the buyer and sales of services are apportioned to the location where the service was performed (Figure 4). For example, a business making goods in Texas that sells its items out of state will not apportion those gross receipts to Texas; however an out-of-state company doing business in Texas that sells items to Texas customers must apportion those gross receipts to Texas and pay franchise tax. Services are apportioned differently from tangible personal property. A service provider that performs its services here must apportion those gross receipts to Texas regardless of whether they are performed for an in-state or out-of-state customer. These franchise tax apportionment rules favor Texas-based goods makers selling products out of state over Texas-based service providers selling services out of state. Furthermore, the apportionment rules create a disadvantage for a service provider to locate its business in Texas since it may pay franchise tax on its entire nationwide sales.

Tax Rate

For most businesses, the franchise tax rate on taxable margin is 0.75%. However, for businesses primarily engaged in retail or wholesale trade the tax rate is 0.375%, reflecting the lower profit margins of these businesses. These rates were permanently set in 2015, reduced from the 1.0% and 0.5% original rates. Companies with mixed lines of business select the rate based on the majority of their business.

A business must navigate these steps to determine its franchise tax liability. However, for small businesses, a different set of calculations and exemptions are available.

Figure 4
Apportionment



Small Business Tax Relief

Provisions benefitting small businesses have been a part of the franchise tax for many years. However, with the margin tax revisions, small business relief has become increasingly generous.

Currently, businesses with $1.13 million (originally set at $1 million, but updated annually using the Consumer Price Index) or less in total revenue during the year in which the franchise tax is calculated do not owe any tax. This "no tax due" threshold started at $300,000 in total revenue in 2008 (up from $150,000 under the earned surplus tax it replaced) and has increased over the years to its current level. As the no tax due threshold increased, so did the impact of owing tax when a business earned revenue slightly over the threshold. Therefore, the $1 million revenue deduction was added in 2013 to ease the burden on businesses with revenue just above the no tax due threshold.

Provisions benefiting small business:

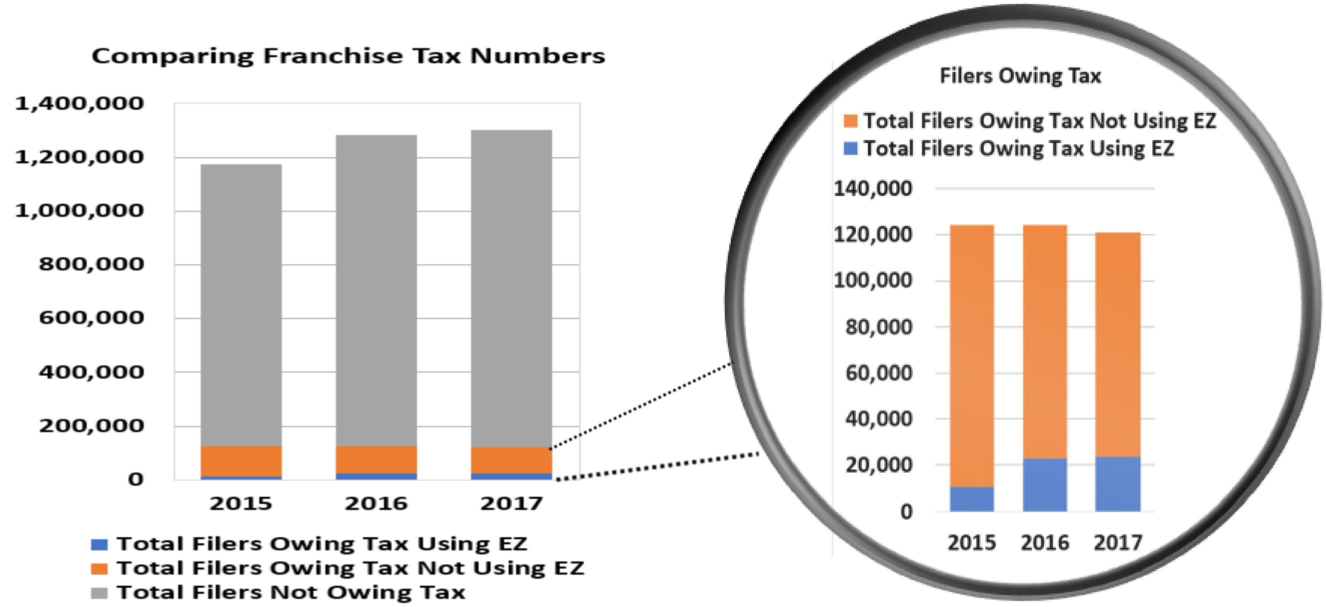
- ✓ No tax due if revenue is $1.13 million or less
- ✓ No tax due if liability is under $1,000
- ✓ $1 million deduction indexed to CPI
- ✓ EZ computation

In addition to the no tax due threshold, a business does not owe any tax if its tax liability is less than $1,000.

Finally, businesses with $20 million or less in total revenue during the franchise tax year have the option to use a separate, simplified calculation called the EZ computation. The EZ computation uses a reduced tax rate of 0.331% multiplied by a business' revenue apportioned to Texas. Much like the no tax due threshold, the EZ computation has been adjusted since its enactment to provide more taxpayers with this option. The original EZ computation using a rate of 0.575% was only available to businesses with $10 million or less in total revenue. In 2016 the revenue limitation was raised to $20 million and the rate was reduced by 42%, allowing more businesses to use the method at an even more reduced rate (Figure 5).

The EZ computation is the second most popular method to calculate the franchise tax, behind using the COGS deduction. Approximately 24,000 of the 121,000 businesses owing franchise tax used the EZ computation in 2017. These

Figure 5



24,000 businesses paid approximately $260 million of the franchise tax in 2017. On average, businesses using the EZ computation reported a franchise tax liability of 0.32% of Texas revenue. In addition, certain industries qualified for and used the EZ computation more than others. Businesses in real estate, professional services, and healthcare accounted for half of all EZ filers owing franchise tax. On the other end of the spectrum, utilities and warehousing companies accounted for less than 1% of EZ filers owing franchise tax.

Exemptions and Credits

In addition to the small business provisions, a number of other exemptions and credits are allowed under the franchise tax code. The majority of these are provided to nonprofit corporations. For example, nonprofit corporations organized for educational purposes, purely for public charity, or providing emergency medical services are all exempt from the franchise tax. In addition, franchise tax credits are provided for clean energy projects, historic structure rehabilitation, and qualified research and development activities. Many of these exemptions were enacted over 30 years ago and are a result of policy decisions made by the Legislature.

Trends

The franchise tax was changed in 2008 to a margins-based tax for several reasons, one of which was so the tax would better mirror the Texas economy. As Texas has moved to a more service-based economy, so has the franchise tax. For the last several years, service-based industries have accounted for increased portions of franchise tax revenue, while portions paid by manufacturing industries have decreased. Although manufacturing industries continue to report more franchise tax liability than any other industry, their share of all reported franchise tax has decreased from 16.6% in 2015 to 14.45% in 2017. Meanwhile, the share of franchise tax liability for several different service industries has increased. Professional service industries, such as lawyers and accountants, reported a liability of 8.45% of all franchise tax reported in 2015 with their share increasing to 9.67% in 2017. In addition, real estate, finance, healthcare, and food service industries all increased their respective shares of reported franchise tax liability in each of the last three years.

In 2015, the industries with the highest reported franchise tax liability were manufacturing, company management, professional services, retail, and real estate. These top five were the same in 2017, with real estate edging above retail for the fourth spot.

As franchise tax payments shift among different industries, the tax's impact on the Texas economy is steadily declining. In 2015, reported franchise tax liability was 0.124% of Texas gross receipts across all businesses. In 2017, this liability has been reduced to 0.10%. In addition, the percentage of businesses with a franchise tax liability is decreasing. In 2015, 10.5% of all businesses subject to the franchise tax actually owed tax; in 2017, only 9.3% of businesses subject to the tax owed anything.

Business Taxes in Other States

Almost all states have some form of a corporate tax, and almost all apply to net income. However, the actual burden of these taxes varies by state. According to a report on state-by-state estimates of taxes paid by businesses in fiscal year 2016 [2], Texas' franchise tax burden was tied with Rhode Island's for the 32nd highest tax burden of all states comparing corporate taxes. In other words, Texas' franchise tax imposes less of a burden on businesses than the corporate tax imposed by the majority of states. The average corporate tax constitutes 8.7% of the total state and local business tax burden in the United States. Texas' franchise tax constitutes 5.7% of a business' state and local tax burden, well below the national average.

[2] Total state and local business taxes; State-by-state estimates for fiscal year 2016. Ernst & Young LLP, Council on State Taxation, State Tax Research Institute (August 2017).

Court Cases

A common critique of the franchise tax is its lack of clarity for businesses trying to comply with its requirements. As a result, there has been a substantial amount of litigation over the franchise tax, including questions of what is allowable as a COGS deduction and what is excludable from revenue. Several recent court decisions have added some clarity to these issues, but uncertainty remains for many businesses. In addition, several cases remain pending that may answer a variety of questions, including, among others, whether heavy equipment machinery rental companies may deduct delivery and pick-up fees as COGS and how to apportion satellite radio subscription receipts. Each of these cases may have broader implications for a variety of industries.

Conclusion

The franchise tax is as unpopular as any state tax. It is complicated, impacts businesses disparately, and lacks clarity. However, for all of its flaws, the tax is less burdensome than many other state and local taxes and certainly less burdensome than most other states' business taxes. The Legislature has shown the desire to continue to reduce the franchise tax burden on businesses as it has done in recent years. If successful, the franchise tax burden will lessen, as will the importance of the franchise tax as a source of state revenue.

Key Court Cases

In Re Allcat Claims Service, L.P. (2011) - Texas Supreme Court decision provided the franchise tax is not a tax on individuals and does not violate the Texas Constitutional provisions relating to a personal income tax.

Combs v. Newpark Resources, Inc. (2013) - Court of Appeals decision expanded the type of labor that is deductible as COGS and clarified that a combined group's business activity is considered as a whole when determining whether it qualifies for a COGS deduction.

Titan Transportation, L.P. v. Combs (2014) - Court of Appeals decision expanded what is considered a service in connection with real property improvements and clarified revenue exclusions related to certain subcontractors.

American Multi-Cinema, Inc. v. Hegar (2017) - Court of Appeals decision allowed expenses of showing a movie to be deducted as COGS, but limited this finding to media products specified in law (not final).

Significant Legislation

House Bill 3928 (2007) - Created the EZ computation for small businesses; created a sliding discount for small businesses.

House Bill 4765 (2009) - Temporarily increased the no tax due threshold from $300,000 total revenue to $1 million.

House Bill 500 (2013) - Temporarily reduced the tax rate by 5 percent; added the revenue deduction option of $1 million; permanently increased the no tax due threshold to $1 million; modified a number of provisions relating to deductions, exemptions, and exclusions.

House Bill 32 (2015) - Permanently reduced the tax rate 25% for large businesses and 42% for businesses qualifying for EZ computation; expanded eligibility of EZ computation from businesses with $10 million total revenue to $20 million.