TTARA

Texas Taxpayers and Research Association

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Understanding the Texas Franchise — or "Margin"—Tax

In 2006, facing a possible shutdown of Texas schools, lawmakers enacted a sweeping overhaul of public school finance. School maintenance and operations taxes were reduced, but cigarette taxes were more than tripled and the state's franchise tax was revamped in an effort to raise revenues.[1] The state also contributed additional dollars from excess general revenues so that the overall reforms resulted in a net tax cut to the Texas economy. Although property taxes soon returned to their upward trend, the package remains the largest tax cut in the state's history. But today looking back five years later, the most widely discussed element of the package is the conversion of the largely profits-based franchise tax to one based on a construct referred to as "taxable margin."

The rewrite of the tax was intended to accomplish a number of policy goals:

- Align the tax with a modern economy,
- Create a simpler business tax,
- Eliminate tax planning opportunities, and
- Raise roughly $3 billion in new state revenue annually.

After several years of experience with the tax, it is instructive to evaluate how it scored on those items, as well as to examine some of the common policy complaints about the tax.

[1] A more thorough review of the 2006 package, especially the property tax changes, may be found in the TTARA Research Foundation's August 2008 study: *Property Tax Relief: The $7 Billion Reality.*

Just What Is A Franchise Tax?

While commonly referred to as the "margin" tax, the formal name of Texas' business tax is still the Texas Franchise Tax—a tax that Texas has levied in some form since the 1800s.[2] The tax is typically assessed in return for the "privilege" of doing business in a state, similar to a fee (in fact, the U.S. Bureau of the Census in its recap of state finances classifies Texas' franchise tax as a fee). As a part of its privilege, the owners of the business receive liability protections under state law—the business is a legal entity separate and apart from them.

Throughout most of the 20th Century, the franchise tax was calculated based on each corporation's net taxable capital—total assets less debt. With the advent of modern accounting principles, the state's definition of "debt" came under fire in the courts resulting in huge amounts of tax refunds in the 1980s. In 1991, the tax was rewritten to apply to "earned surplus"—essentially defined as corporate profits plus compensation paid to officers and directors. The taxable capital calculation was retained, but for all intents and purposes was relegated to being an alternative minimum tax.

[2] To limit confusion, in this publication the term "margin tax" will be used to describe the revised franchise tax.

Figure 1
Differences between the Old and the New Franchise Tax

Item	Pre-2008	Post-2008
Who Pays	Corporations (C and S alike) Limited Liability Companies	Corporations (C and S alike) Limited Liability Companies Partnerships (except general partnerships owned by natural persons) Business Trusts Professional Associations
Tax Base	Earned Surplus: Profits, plus large corporations must add officer/director compensation Capital: Assets less debt	Total Revenue less the greater of: • Cost of Goods Sold • Compensation • 30% of Total Revenues
Apportionment	Sales within Texas/Total Sales	Sales within Texas/Total Sales
Tax Rate	Earned Surplus: 4.5 % Taxable Capital: 0.25 %	Wholesalers/Retailers: 0.5 % All Others: 1.0 %
Key Tax Credits	Research and Development New Investment Jobs Creation	None
Method of Filing	Separate entity: each separately organized entity, including subsidiaries, files a unique tax return	Combined group: a business combines the financial data for its unitary subsidiaries and affiliates into a single tax return
Small Business Exemption	Businesses with less than $150,000 in receipts exempt	Originally businesses with less than $434,782[a] in receipts were exempted; now set at $1 million. Companies owing less than $1,000 are exempt. Businesses with less than $10,000 in total revenues may opt for a simplified "EZ calculation" based on gross receipts.
Annual Revenue	$2.2 to $3.1 billion	$3.9 to $4.5 billion

Notes: [a] While technically the small business exemption was $300,000, because of the $1,000 tax due threshold and a sliding scale discount for taxpayers with less than $900,000 in revenues, business with receipts less than $434,782.60 paid no tax.

The 2006 reforms radically restructured the tax once more (Figure 1), with an eye to raising roughly $3 billion of new tax revenue annually. Previously applying only to corporations and limited liability companies (LLC),[3] the tax was extended to partnerships and professional associations[4]—generally businesses that must formally register with the state and are afforded certain liability protections under state law.

The tax base was significantly expanded, as well. In effect, the tax became something of a hybrid between a tax on gross receipts and a tax on income, though not quite either one. Many of the deductions previously available to taxpayers were stricken, as were tax credits for research and development, jobs creation, and new capital investment. Further, affiliated companies were no longer required to file separate tax returns; instead, they combine their finances into a single return for the entire group.

Taxpayers now start with their total revenue, less some, but not all, types of "flow-through" income.

[3] The LLC was authorized as a form of business in Texas in 1991. In most states and under federal tax law, LLCs may elect whether to be taxed as an entity, or be a "pass-through" entity in which the owners pay tax on their earnings from the LLC.
[4] General partnerships that are owned solely by natural persons and not other businesses are exempt, as are passive entities.

Figure 2
The Private Sector Economy and the Franchise Tax

Industry/Form	Share of: Old Tax	New Tax	Economy	Liability Increase 2008/2007
Agriculture	0%	0%	1%	-8%
Mining	16%	10%	13%	-16%
Utilities	4%	4%	4%	30%
Construction	4%	4%	5%	71%
Manufacturing	18%	17%	15%	39%
Wholesale	12%	8%	7%	-1%
Retail	7%	8%	7%	77%
Transportation	2%	3%	4%	101%
Information	3%	6%	4%	162%
Financial	12%	12%	14%	57%
Profess. Services	7%	9%	8%	88%
General Services	13%	17%	18%	101%
Total, All Indus.	100%	100%	100%	46%

Note: Industry share of the economy is based on gross state product as reported in the Business Tax Advisory Committee Report. All percentages reflect private sector output and exclude government. Unclassified taxpayers account for less than 2% of the total

From this, taxpayers subtract the highest of one of three items:

- **Cost of goods sold**: this includes items such as raw materials and production labor, among other items. While a commonly used federal tax term, Texas has adopted a different definition for margin tax purposes. For a company to claim this deduction it must sell goods; service companies are not eligible,
- **Compensation:** the amount a company pays in salaries (capped at $300,000 per employee, but adjusted for inflation) plus certain benefits, or
- **30% of total revenues:** this option was included for those businesses that have little in the way of compensation or cost of goods sold (typically capital intensive services businesses, such as those in transportation or telecommunications).

The resulting difference is then "apportioned" to Texas, based on the percent of business a company does in the state. This is done to fairly reflect the share of a company's business activity that can reasonably be attributed to Texas.

The rate applied to a company's tax base to determine its liability depends on its line of business. If primarily engaged in wholesale or retail trade, a company pays a tax rate of 0.5 percent; all others are taxed at 1.0 percent.

Five years after enactment, the margin tax reform appears to have accomplished some of the state's goals, but missed others. Further, some segments of the business community have soundly criticized certain aspects of the tax.

Better Align the Tax with a Modern Economy

One of the longstanding criticisms of Texas' tax system is that it does not match well with the structure of the economy. The state and its local entities rely mostly on property and sales taxes—which fall heavily on industries which produce and sell goods. Texas, however, is becoming more of a services-based economy. From 2000 to 2010, goods-producing industries in Texas lost 200,000 jobs, while services-providing industries added 800,000 jobs. A stated policy goal of the 2006 tax reform effort was to shift a portion of the tax burden from goods-producing industries (primarily through property tax reductions) to services-providing industries, and better reflect the fastest growing part of the economy.

The reforms do appear to have advanced towards that goal (Figure 2 above), but given the state's heavy reliance on sales and property taxes, the overall tax system remains heavily weighted

towards goods and capital. Services-providing industries account for 78 percent of the state's jobs and 66 percent of the state's economic output. Under the old franchise tax, they accounted for 57 percent of the tax; under the margin tax, 64 percent.

That realignment did lead to some sticker shock, though, as services-providing industries essentially took on a bigger share of a bigger tax. These increases largely result from the more limited deductions available to services-producing industries. Information companies, especially those engaged in telecommunications, saw a 162% increase in tax liability. Similarly, transportation, general services and professional services companies saw dramatic increases.

On the other hand, some taxpayers benefitted even without taking the corresponding property tax relief into account. Mining companies—primarily oil and gas producers—gained with the shift away from a profits-based tax at a time when income was high (a benefit that may be reduced in periods of lower profitability). Still, the industry's overall share of Texas state and local tax collections remains high.

Simplifying the Tax

Conceptually, the margin tax is very simple: take a few items from a business's federal tax return and calculate your Texas tax. "Total revenues," "cost of goods sold," and "compensation" are all very well understood terms in federal tax practice. Unfortunately, the Internal Revenue Service allows a fair amount of flexibility in what companies may include in these items. In filing their federal return, some companies may include an item as cost of goods sold while another may expense that item as an operating cost. Since it matters little to the bottom line of "federal taxable income," the IRS may allow either interpretation. If Texas were to require that certain numbers from federal tax returns be used, some companies could be at a disadvantage because of their choice of accounting methods. Consequently the margin tax drafters had to develop a specific state definition of these terms. This immediately complicated the tax, because businesses now must maintain two sets of books—one for state and one for federal purposes—each using identical terms but differing definitions. To date, many state terms are not clearly understood, creating confusion and audit difficulties for taxpayers. In the final analysis, the margin tax has proven to be very complex in its application—creating uncertainty for taxpayers and tax practitioners alike.

Unfortunately, it is taxpayers who are penalized for that confusion. As the terminology of the tax becomes clearer, if a company finds that an alternative deduction would have been more appropriate, state law prohibits them from filing an amended return to change their original choice of deductions.

Eliminate Tax Planning Opportunities

Under the old franchise tax there were three common strategies for tax minimization:

- **"Delaware Sub":** a company places its Texas operations into a partnership and creates an out-of-state corporate subsidiary as a limited partner. Neither the partnership nor the out-of-state limited partner were subject to Texas franchise tax, sharply reducing the overall amount of tax due. This structure received much scrutiny when a few publicly-traded companies took advantage of it, but it was also commonly used by medium- and smaller-sized companies.
- **"Geoffrey's Sub":** a company creates an out-of-state subsidiary as owner of intangible property, such as trademarks and patents. The amount a Texas company was charged for the use of these properties was a deduction against their franchise tax, but the income to the out-of-state subsidiary was not subject to tax.

- **Profit Shifting:** certain smaller corporations[5] did not have to add the amount of compensation paid to their company officers and directors to their tax base (as large corporations did). These businesses could pay their earnings as compensation to their officer-director owners, essentially converting profit into a deductible business expense.

Former Texas Comptroller Strayhorn warned that extensive use of franchise tax planning strategies was eroding the tax base. However, the last year the old franchise tax was in effect, 2007, it raised an all-time record $3.1 billion—reflecting 83 percent growth since 2003, as Texas rebounded from a recession.

Figure 3
Revenues of the Old and New Franchise Tax
($ billions)

Year	Actual Collections	Estimates Of Revised Tax	Difference	Share of Total Taxes
2000	$2.1	n.a.	n.a.	8.2%
2001	$2.0	n.a.	n.a.	7.2%
2002	$1.9	n.a.	n.a.	7.4%
2003	$1.7	n.a.	n.a.	6.6%
2004	$1.8	n.a.	n.a.	6.6%
2005	$2.2	n.a.	n.a.	7.3%
2006	$2.6	n.a.	n.a.	7.8%
2007	$3.1	n.a.	n.a.	8.5%
2008	$4.5	$5.9	($1.4)	10.8%
2009	$4.3	$6.0	($1.8)	11.2%
2010	$3.9	$6.4	($2.5)	10.9%

Notes: Estimates of the revised tax were those made at the time the original bill passed. They have since been revised, and the state budget is based on lower estimates.

Under the margin tax, these business structures no longer offer any tax benefit, either because of the redefinition of the tax base or because companies now must combine their business operations onto a single combined tax return. After several years of operation, there is no evidence that the margin tax offers much in the way of tax avoidance strategies.

Raise New Revenue

The margin tax changes were designed to raise new revenue dedicated to reducing local school property taxes. Originally, Comptroller Strayhorn estimated the reforms would essentially double the size of the tax. These estimates proved to be too optimistic. Actual tax revenues increased by near 50 percent, not 100 percent—a difference of $1.4 billion (Figure 3). Revenues resulting from the margin tax reforms were difficult to estimate because of their several moving parts, but it appears much of the gap was attributable to an underestimate of the value of the cost of goods deduction. The gap has increased with the downturn in the economy and the expansion of the small business exemption, though the new tax has remained at about 11 percent of all state tax collections. Even though the state now operates on reduced estimates of the revenues from the tax, the disappointment of failed revenue expectations remains.

Ironically, the fact that the margin tax has generated less income than anticipated has put the tax more in line with business taxes in other states. In 2009, Texas' margin tax ranked 19th highest among state business taxes and just slightly above the national average. Had the margin tax generated the $6 billion annually that was initially forecast, Texas would have had the nation's 6th highest tax, just above business-unfriendly California in 7th place, and almost 50 percent higher than the national average.

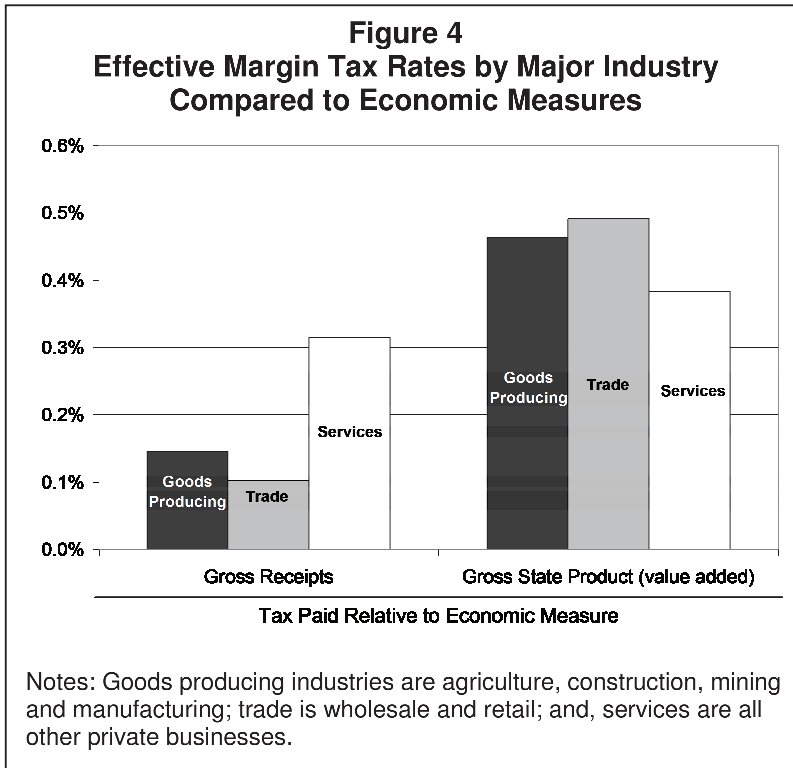
Differing Tax Impacts

The structure of the margin tax creates substantial differences in tax liability across, and in some

[5] S Corporations and corporations and limited liability companies with 35 or fewer shareholders or members.

instances, even within, industry groups. Taxpayers not only may face different tax rates, but the operation of the tax calculation itself creates disparities.

Industries producing or selling goods essentially have a choice of three deductions, while services-related businesses only have two. Wholesalers and retailers, businesses that typically operate on a low margin of profit, are subject to a rate half that of other taxpayers. Not surprisingly, the effective tax rate on services businesses, who may claim neither the cost of goods sold deduction nor the half rate, is substantially higher than that on other industries (Figure 4). Relative to economic output, or value-added, effective tax rates are less disparate.[6]



Notes: Goods producing industries are agriculture, construction, mining and manufacturing; trade is wholesale and retail; and, services are all other private businesses.

The small business community has been particularly vocal in its complaints about the margin tax—objecting to its complexity, the corresponding compliance costs, and the size of their tax bill. In spite of those complaints, very small businesses benefit from a much more generous small business exemption. In the initial 2006 legislation, small businesses were given an additional break from the old franchise tax, as the small business exemption was effectively tripled, increased from $150,000 to just under $450,000.[7] In 2009, the legislature increased the exemption further, to $1 million, where it remains today—at a cost to the state and a savings to small businesses of roughly $270 million annually.[8]

Figure 5
Tax Impact by Size of Business

Business Receipts	Increase 2007 to 2009	Effective Tax Gross Rcpts
Under $1 million [a]	-46%	0.17%
$1 to $10 million	72%	0.26%
$10 to $100 million	49%	0.22%
$100 million to $1 billion	48%	0.23%
Over $1 billion	49%	0.15%
All Taxpayers	46%	0.18%

Notes: [a] This income category was fully exempted in 2010.

Comparing margin tax returns filed in 2009 to those under the old tax in 2007 reveals that businesses with from $1 to $10 million in receipts have seen higher increases than larger businesses (Figure 5). This is not because the tax treats

[6] A comparison relative to profits cannot reasonably be made because there is no clear definition of what constitutes "profit" for a partnership or association.

[7] Technically, the small business exemption was raised to $300,000, but the combination of a sliding scale discount and an exemption for taxpayers owing less than $1,000 resulted in a de-facto exemption of $434,782.

[8] Slated to drop to $600,000, the legislature this session maintained the exemption at $1 million at an incremental cost to the state and a savings to taxpayers of $75 million annually. The *total* impact of the *entire* $1 million small business exemption is $270 million annually.

businesses differently by size, however. It is because: 1) smaller businesses are more likely to be engaged in providing services, a pursuit which tends to have a higher effective tax rate on gross receipts than goods-related industries, and 2) many of the businesses of this size group are partnerships that were previously not subject to tax.

There are a number of disparities within the tax based on how certain companies may be situated or choose to operate. For example, the retail outlet of a manufacturer may be taxed at one percent because the combined group of companies may be classified as a manufacturer. In contrast, an independently-owned retail store is classified as a retailer and pays a half percent tax rate. Auto repair shops that are a part of an automobile dealer are subject to the dealer's half percent tax, while independent repair shops are taxed at one percent. A company that hires its own employees may deduct salaries as compensation; however, a company engaged in the same line of business that chooses to use independent contractors to conduct its operations may not.[9] Companies in the business of *renting* equipment may not deduct the cost of their equipment as cost of goods sold, while companies that *sell* that same equipment may. As a retailer, the company selling equipment will also qualify for a lower tax rate, while the rental company will not because they are considered to be engaged in providing services.

There is substantial tax "pyramiding" as well, because business receipts may be taxed multiple times as they move through the economic chain. Policymakers understood that multiple taxation was a necessary evil to make a low tax rate possible (other state business income taxes can have marginal rates as high as 12 percent). Still, some taxpayers may exclude certain "flow-through" income from their calculation of total revenues; others may not. The exclusion mitigates the potential for double taxation, but only in selected cases.

[9] This was an intentional policy decision to encourage businesses to hire direct employees.

The Tax Under Challenge: An Income Tax on Individuals or Not?

On July 29 of this year, Allcat, an insurance adjustment company organized as a limited partnership, filed suit seeking to invalidate the margin tax. Among its claims was that the tax violates the Texas Constitution's "Bullock Amendment."[10]

In anticipation of such a challenge, the original "margin tax" bill included a provision requiring that such a challenge be filed directly with the Texas Supreme Court, which has 120 days to rule.

Allcat contends that the margin tax is a tax on net income because it allows some items to be deducted from gross revenues. When the tax is applied to a partnership with individuals (natural persons) as partners, it reduces their share of partnership income. Allcat contends that the "Bullock Amendment" requires such a tax be approved by voters before it may take effect, but the margin tax was not. Therefore, Allcat asks the court to invalidate the tax.

The state's response was brief, asserting that the Bullock Amendment prohibits a tax on the incomes of natural persons, but not a direct tax on the partnership itself. In fact, the state notes, Texas law specifically states that a partnership is separate and distinct from its owners. Since the tax is not imposed on the partners, whether it is a net income tax or not is irrelevant, the state argues.

A ruling is due by late November but it is possible the Court could refuse jurisdiction on constitutional grounds and send the case to the lower courts—a process that could take years to reach a final resolution.

[10] Texas Constitution, Article 8, Section 24 states: *A general law enacted by the legislature that imposes a tax on the net incomes of natural persons, including a person's share of partnership and unincorporated association income, must provide that the portion of the law imposing the tax not take effect until approved by a majority of the registered voters voting in a statewide referendum.*

Re-Reforming the Franchise Tax

Regardless of how the Court chooses to rule, there is increasing interest among legislators in rewriting the margin tax to eliminate some of its commonly-stated policy concerns. Unfortunately, as one reform button is pushed, two more pop up—especially if such reforms are revenue neutral, in which case some taxpayers will have to pay for the benefits afforded to others.

Other discussions have centered on adjusting the tax to meet its original revenue expectations—a "reform" that could only serve to make an unpopular tax even bigger. Relative to lower business taxes in other states, the higher Texas margin tax could become a "sore thumb" in trying to attract new investment to the state.

Ultimately reforms could take one of two diametrically opposed approaches:

1. simplify the tax by reducing deductions, in which case the tax becomes more directly a **gross receipts tax**, or
2. ease policy concerns by allowing more deductions, in which case the tax becomes more directly a tax on **net income**.

Converting the tax to one on gross receipts would greatly simplify the tax and make it more stable, but would exacerbate the pyramiding of the tax. A single rate tax would also create a substantial shift by increasing the burden on capital intensive, goods-producing industries while perhaps lowering the tax on services-providing businesses—a reversal of one of the key 2006 policy goals. Among other states, Ohio does levy a flat rate gross receipts tax, while Washington levies a gross receipts tax with different rates for different industries. Neither tax is popular.

Shifting to a tax based more on net income would allow the legislature to eliminate some of the more unpopular policy aspects of the tax, but would most certainly require a higher tax rate if the changes are to be revenue neutral. Though the term "net income tax" is viewed as pejorative by many, it essentially describes the pre-margin franchise tax. While this may be politically unpopular, it may be more acceptable to many taxpayers, who would no longer owe tax if they failed to make a profit. It would, however, make the tax a more volatile revenue source for the state.

Unfortunately, there are no easy solutions, a lesson lawmakers learned in 2006 when they considered a number of different business tax proposals—taxes on income, taxes on gross receipts, taxes on payroll, etc.—and ruled them out. The margin tax ultimately proved to be acceptable, not so much for the tax it was, but because of the tax it wasn't.

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