issue

State Franchise Tax

In 2006, Texas faced a court mandate to boost education spending from a source other than local property taxes. Taking the opportunity to replace the corporate income tax (known in Texas as the franchise tax) with a tax that reached pass-through entities such as limited-liability corporations and partnerships, the state enacted a tax on business "margin," a modified gross receipts tax defined with some complexity. In 2006, Texas officials projected the tax would raise $5.9 billion per year (with some suggesting as much as $12 billion per year), but information obtained from prior year tax reports suggested it would raise barely $5 billion. In 2008, the tax raised just $4.45 billion, just under $4 billion in 2009, $3 billion in 2010[1] and $3.1 billion in 2011[2]. Far from solving the problems of the previous corporate franchise tax, the margin tax seems to have only aggravated them.

The tax was designed to reach businesses not reached by the franchise tax based upon net income, including partnerships, unprofitable businesses, and small businesses. In a survey done by the NFIB (National Federation of Independent Business), 84 percent of Texas small business owners reported a franchise tax increase of over 100 percent while over 40 percent of the respondents reported a tax increase over 500 percent. At the same time, over 18,000 taxpayers that had paid franchise tax reported no liability under the new tax. It appears that taxpayer confusion, increased compliance costs, and a lack of guidance for the peculiar definitions and rules under what is essentially a brand new type of tax is resulting in the margin tax's shortfall in collections[3].

The Bay Area Houston Economic Partnership and the National Federation of Independent Businesses of Texas have previously supported the following additional reforms, which would be in addition to those previously stated or alone should other reform efforts fail:

Recommendations for Tax Reform:

1. Allow deduction for cost of compliance for companies under $20 million.
2. Make permanent the $1 million small-business exemption.
3. Require a super-majority vote of the legislature before the tax rate can be increased.
4. Allow increased deductions and tax incentives for employers providing benefits.
5. Lower the tax rate by 50 percent for businesses with under $20 million in gross receipts.

Taxpayers have long complained about the margin tax's confusing nature and general unfairness. The Supreme Court decision gives the Texas Legislature the freedom and certainty it needs to fairly reform the margin tax. We urge the legislature to consider supporting these reforms in this legislative session.

1. 2010 Annual Financial Report , Comptroller of Public Accounts, 2. 2011 Annual Financial Report , Comptroller of Public Accounts, 3. Texas Tax Federation " Texas Margin Tax Experiment Failing Due to Collection Shortfalls, Perceived Unfairness for Taxing Unprofitable and Small Businesses, and Confusing Rules" August 17, 2011

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