HOUSE
RESEARCH
ORGANIZATION bill analysis 5/1/2007

HB 3928
Keffer, et al.
(CSHB 3928 by Ritter)

SUBJECT: Correcting and revising the revised franchise tax

COMMITTEE: Ways and Means — committee substitute recommended

VOTE: 8 ayes — Keffer, Ritter, Otto, Bonnen, Flores, Paxton, Pena, Pitts

1 present not voting — Y. Davis

0 nays

WITNESSES: For — Dale Craymer, Texas Taxpayers and Research Association; (*Registered, but did not testify*: Greg Herzog, Texas Medical Association; James LeBas, Association of Electric Companies of Texas/Texas Oil and Gas Association; Karen Reagan, Texas Retailers Association; Tony Reinhart, Ford Motor Company; Chris Shields, Toyota - Toyota Financial Services)

Against — None

On — Karey Barton, Texas Association of Manufacturers; Jeffrey Clark, American Electronics Association; Elizabeth Claude, Enbridge Energy Company Inc.; David Colmenero, Meadows Collier Reed Cousins and Blau; Jim Humrichouse, Texas Association of Personnel Consultants; Randy Lee, Stewart Information Services Corporation; Michael McDougal, Texas Apartment Association; Jerry Oxford, Comptroller's Office; Keith Strama, American Association of Travel Agents; Matt Woodruff, Texas Waterway Operators Association; Fred Heldenfels IV; (*Registered, but did not testify*: John Heleman and Jerry Oxford, Comptroller's Office)

BACKGROUND: In 2006, the 79th Legislature during its third called session enacted HB 3 by Keffer which established the "revised franchise tax." The revised franchise tax establishes a new mechanism for calculating the business franchise tax and revises the base of entities subject to the tax. The revised tax will take effect January 1, 2008.

Under HB 3, which dealt with Tax Code, ch. 171, the base of taxable entities subject to the revised franchise tax includes businesses in Texas that enjoy state liability protection, including corporations and limited

liability partnerships. The tax excludes sole proprietorships, general partnerships that are directly owned by individual persons, certain unincorporated passive entities, and non-profit organizations. Businesses with no more than $300,000 in total revenue, indexed for inflation, are exempt, as are businesses that owe less than $1,000 under the tax.

The tax is computed by determining a taxable entity's total revenue. From this amount, the entity may deduct either its cost of goods sold or total compensation — up to $300,000 per employee indexed to inflation — plus benefits. If the entity's margin after making its deduction is more than 70 percent of its total revenue, the business is taxed on only 70 percent of its total revenue. The business then must apportion to the state the amount of revenue from business done in Texas and subtract certain allowable exemptions to determine the entity's taxable margin.

Once the entity's taxable margin is determined, a rate of 1 percent is applied to that margin for an entity that is not engaged in retail or wholesale trade. For a taxable entity that is engaged primarily in retail or wholesale trade, a rate of one-half of 1 percent is applied to the entity's taxable margin.

Apportionment of a taxable entity's margin. A taxable entity's proportion of business performed in Texas is apportioned to the state to determine the entity's tax liability.

Under sec. 171.106(a), a taxable entity's margin is apportioned to Texas for the purposes of determining the amount of the entity's tax. This apportionment is performed by multiplying an entity's margin by a ratio determined by the following fraction:

- the taxable entity's gross receipts from business done in Texas;

divided by:

- the taxable entity's gross receipts from its entire business.

Under sec. 171.1055, for the purposes of apportioning a taxable entity's margin, receipts excluded from a taxable entity's total revenue may not be included in the entity's gross receipts from business done in Texas or from its entire business.

Under sec. 171.1011(g-2), a taxable entity must exclude from its total revenue the tax basis of securities and loans sold.

Transitioning credits. HB 3 contained provisions to transition taxpayers of the former franchise tax to the revised franchise tax. An entity receiving credit on net taxable earned surplus under the old franchise tax may carry forward credits on taxes due under the revised franchise tax.

DIGEST: CSHB 3928 would make numerous changes to the revised franchise tax.

Small business exemption. The bill would increase from $300,000 to $600,000 the size of the total revenue threshold below which an entity would owe no tax. Under CSHB 3928, businesses with no more than $600,000 in total revenue in a given tax year, indexed for inflation, would be exempt from the tax in that tax year.

Treatment of rental income for partnerships. In determining total revenue, the bill would require partnerships to include gross rental income as reported on IRS form 8825 instead of net rental income.

Apportionment of securities income. The bill would revise the manner in which a taxable entity's revenue from the sale of securities was apportioned to Texas. Under the bill, if a loan or security was treated as a seller's "inventory" for federal income tax purposes, the gross proceeds from the sale of a loan or security would be considered gross receipts for apportionment purposes.

Business loss carryforwards. On a taxable entity's first report due after the revised franchise tax takes effect, that entity would have to notify the comptroller in writing if it intended to take a credit on its taxable margin.

The credit would be computed by determining the amount of the taxable entity's business loss carryforwards that had not been exhausted under the old franchise tax. The entity's business loss carryforwards then would be multiplied by either:

- 2.25 percent for reports due on or after January 1, 2008, and before January 1, 2018; or
- 7.75 percent for reports due on or after January 1, 2018, and before September 1, 2027.

This amount would be multiplied by 4.5 percent.

The amount of credit claimed could not exceed the amount of tax due for a report. Unused credits could not be carried beyond September 1, 2027.

A taxable entity could not claim the credit unless the entity had been subject to the old franchise tax as of May 1, 2006. A combined group could claim the credit for each member entity that was subject to the old franchise tax as of May 1, 2006. An entity would lose its right to claim the credit if it changed combined groups after June 30, 2007.

The bill would require an entity to file a report and pay tax on its taxable margin for the period that the entity did business in the state between June 30, 2007, and January 1, 2008, if the entity:

- was not doing business in the state on January 1, 2008,
- would have been subject to the revised franchise tax if it had been doing business on January 1, 2008; and
- would not have been subject to the old franchise tax;

These provisions would take immediate effect if finally passed by a two-thirds record vote of the membership of each house. Otherwise, they would take effect September 1, 2007.

Elimination of reporting requirements for certain entities. The bill would repeal a requirement that an entity with more than 100,000 employees in the state file an annual informational report with the comptroller. Current law (HB 3) requires such an entity to file a report stating the number of its employees that receive assistance for the employee or the employee's family under Medicaid or the Children's Health Insurance Program.

Indexing the compensation deduction to inflation. The bill would push back the date at which the compensation deduction would begin to be indexed to the consumer price index (CPI) from January 1, 2009, to January 1, 2010. Beginning on that date and in every even-numbered year following, the compensation deduction would be increased or decreased by the percent increase or decrease in the CPI in the preceding state fiscal biennium and rounded to the nearest $10,000.

Other provisions. The bill would clarify that the definition of "controlling interest" would include, for a limited liability company, either at least 80 percent, owned directly or indirectly, of the total membership interest of the total membership interest or of the beneficial ownership interest in the membership interest of the company.

The bill would define "natural person" as a human being or a human being's estate, clarify the definition of "lending institution", and define "security" based on definitions in the Internal Revenue Code.

The bill would exclude from the definition of "taxable entity" a general partnership whose liability was not limited under a statute of Texas or another state.

The bill would delete references to "family limited partnerships" and clarify that non-profit self insurance trusts and certain other trusts were not taxable entities.

The bill would specify that holding a seat on the board of directors of an entity would not by itself constitute conduct of an active trade or business.

The comptroller could require an entity to file information to verify that the entity was not subject to the revised franchise tax.

The bill would specify, for a taxable entity that elected to expense a cost of goods sold and later elected to capitalize that cost of goods sold, that a cost expensed on a previous report could not be capitalized.

The bill would specify that net distributive income to a natural person from a limited liability company that was treated as a sole proprietorship for federal income tax purposes would be included in the definition of the deduction for wages and compensation.

The taxable margin of a combined group could not exceed 70 percent of the group's total revenue from its entire business. One member of a combined group could not claim as cost of goods sold if the goods for which the costs were incurred were owned by another member of the combined group. Each taxable entity that was a part of a combined group would have to include its activities for the same period as the combined group, for determining margin and apportionment.

The bill would delete certain references to "upper tier partnership," replacing them with "lower tier partnership," in a section dealing with reporting for certain partnerships in a tiered partnership arrangement.

The bill would take effect January 1, 2008.

SUPPORTERS SAY:

CSHB 3928 would retain the essential characteristics of the revised franchise tax that the 79th Legislature enacted overwhelmingly in its third called session in 2006. CSHB 3928 is a revenue neutral clean-up bill that would make numerous corrections to clarify the existing tax and improve its administration. The bill would make several changes to ensure that all taxable entities were treated similarly and fairly, leading to a modest increase in revenue that the tax would generate. This revenue increase would be offset by a technical correction in the apportionment of securities income and by doubling the exemption for small businesses so that no entity with less than $600,000 in annual gross revenue would be liable for the tax.

Small business exemption. CSHB 3928 would double the size of the small business exemption, ensuring that approximately 60,000 additional small businesses would not be required to pay any tax. Because HB 3 closed loopholes in the former franchise tax and brought in several new classes of businesses that had not paid the old tax, it is important to ensure that only large businesses that can afford the tax are required to pay it. An exemption of $600,000 would be generous and would allow CSHB 3928 to retain its fiscal neutrality.

An exemption with a threshold would be more beneficial to more businesses than an across-the-board allowable deduction. First, an exemption would be less costly, as it only would apply to entities whose total revenue fell below the $600,000 threshold amount. A deduction would have to be significantly smaller, because all companies would be able to claim it. Under a deduction, a small business would deduct the same set amount from its taxable margin as a large corporation, even though the deduction could have a nearly unnoticeable effect on the tax liability of the large corporation. A small business likely would know whether it fell under the $600,000 threshold of the exemption in CSHB 3928 and would not have to hire an accountant to determine whether the business owed a tax liability.

Rental income for partnerships. CSHB 3928 would correct an oversight in HB 3 that inappropriately included net rental income in a partnership's definition of total revenue instead of gross rental income. This purely was an accidental consequence of pulling the wrong line from a federal income tax form. CSHB 3928 would correct this problem, ensuring in the process that corporations and partnerships were treated equally under the revised franchise tax.

Apportionment of securities income. The intent of HB 3 was to retain the apportionment rules of the old franchise tax. However, a technical problem in the drafting of the bill led to improper application of apportionment rules to securities income. CSHB 3928 would correct this problem, ensuring that securities income was treated the same as all other income.

Temporary credit carryforward. The bill would correct a problem in the carryforward of business operating losses that were allowed to be taken as a credit under the old franchise tax. While this carryforward no longer would be allowed under the revised franchise tax, it is important that companies with these credits already on their books be allowed to use the credits as they transition to the new tax.

Other issues. It is important that CSHB 3928 retain the essential characteristics of the revised franchise tax that was enacted under HB 3. The bill can not eliminate the possibility that an unprofitable business might be taxed under the revised franchise tax, because to do so would establish a de facto unconstitutional state income tax. Courts have considered the potential of a business to owe taxes in a year in which it lost money as an essential test in determining whether a tax is a personal income tax. Further, a reduction in the rate of the tax would undermine the amount of funds flowing into the property tax relief fund, to which all revenues from the revised franchise tax are dedicated. This fund is essential to ensuring the constitutionality of the state's school finance system and to provide businesses and homeowners with an on-going source of relief from excessively high property taxes.

OPPONENTS SAY:

CSHB 3928 would miss an opportunity to improve a deeply flawed business tax that will have a disproportionately negative effect on small and marginally profitable businesses. This bill would not alter the revised franchise tax's characteristics as a modified gross receipts tax. The central problem would remain that that a business could be required to owe taxes

in a year in which it lost money. The bill should incorporate an exemption so that a business's tax liability would be removed if it had negative or only slightly positive net income in a particular tax year. It is unfair to require a business owner to render to the state taxes when his or her entity operated at a loss in a tax year, a scenario that very likely could occur under the revised franchise tax with CSHB 3928.

The $600,000 small business exemption included under CSHB 3928 still would be too insignificant to benefit many small business owners in Texas. This exemption should be raised at least to $1 million, if not higher. Small businesses are the backbone of Texas's dynamic economy, and CSHB 3928 still would subject many small business owners to this onerous and unfair tax. The approximate cost of raising the small business exemption to $1 million would be $125 million annually, an amount that easily could covered by under the current budget surplus.

CSHB 3928 also would fail to take advantage of a record state surplus to reduce the rate that businesses would have to pay under the revised franchise tax. A 50 percent reduction in the twin tax rates of the revised franchise tax easily could be absorbed in the state budget by either a modest increase in the sales-and-use-tax or by dedicating a portion of Texas' current budget surplus. Further, the Legislature should amend the tax to ensure that no business would be subject to any greater than a 100 percent increase in its tax liability under the revised tax. This would ensure that a business was not severely affected with a tripling of its tax liability or worse.

CSHB 3928 should not remove the requirement that businesses employing more than 100,000 people file an informational report on the number of its employees that receive health care from state-funded programs. This information is crucial to determining whether any large businesses, such as Wal-Mart, are under-compensating their employees while forcing taxpayers to pay for health insurance for those individuals. This report simply is informational in nature, but would help policymakers determine what future action should be taken to ensure that these large, profitable corporations do the right thing by their employees.

OTHER OPPONENTS SAY:

CSHB 3928 should amend the revised franchise tax to require a "super majority" of two-thirds or four-fifths of the members of both houses of the Legislature to approve any increase in the tax. While property and sales taxes apply to individuals who are readily able to resist increases in those

taxes at the ballot box, Texas businesses do not get a vote. Thus, in order to protect against a shifting of the state tax burden onto Texas businesses, the Legislature should take steps to prevent such an occurrence. The requirement of a super-majority would ensure that any increase in the amount of money that the revised franchise tax could raise enjoyed broad support among the Legislature.

NOTES: According to the Legislative Budget Board, CSHB 3928 would have no net impact to general revenue-related funds in fiscal 2008-09. From the property tax relief fund, the bill would have a net positive impact of $93,000 in fiscal 2008-09. This is because the provisions in the bill that would increase or expend funds largely would offset one another. Those provisions are itemized as follows:

- **treatment of rental income for partnerships.** A revenue increase of $402.7 million in fiscal 2008-09.
- **changing CPI date.** A revenue increase of $10 million in fiscal 2008-09.
- **increasing the small business exemption.** A cost of $146.2 million in fiscal 2008-09.
- **apportionment of securities income.** A cost of $266.4 million in fiscal 2008-09.