

SUBJECT: Revisions to the franchise tax

COMMITTEE: Ways and Means — committee substitute recommended

VOTE: 6 ayes — Hilderbran, Otto, Bohac, Button, N. Gonzalez, Ritter
0 nays
3 absent — Eiland, Martinez Fischer, Strama

WITNESSES: *(On introduced version:)*
For — Kathy Barber, NFIB; *(Registered, but did not testify: George Allen, Texas Apartment Association; Les Findeisen, Texas Motor Transportation Association; Robert Flores, Texas Citizen Action Network; Stephanie Gibson, Texas Retailers Association; Chris Shields, The Greater San Antonio Chamber of Commerce, Texas Agricultural Aviation Association)*

Against — None

On — *(Registered, but did not testify: Ed Warren, Comptroller of Public Accounts)*

BACKGROUND: The Texas franchise tax, or “margins” tax, applies to each taxable entity that does business or is organized in the state. The tax is calculated as 0.5 percent for taxable entities primarily engaged in retail or wholesale trade and 1 percent of taxable margin otherwise.

An entity’s taxable margin is the lesser of 70 percent of the entity’s total revenue, or an amount computed by either determining the entity’s total business revenue using a specific method or subtracting either cost of goods sold or compensation.

Businesses with annual revenue less than \$1 million currently are exempt from the franchise tax. This exemption will be lowered on January 1, 2014 to cover only those with less than \$600,000 in revenue.

DIGEST: CSHB 500 would make a variety of changes to the state franchise tax. The bill would make changes to exemptions and deductions under the tax and which entities qualify for a reduced-tax rate for retail trade. It further

would exclude a number of expenses from being counted as revenue and revise costs of goods sold deductions available to businesses.

The bill would take effect January 1, 2014, and would apply to a franchise tax report after its effective date.

(Note: Provisions from a number of bills under consideration in the 83rd Legislature appear in CSHB 500 and are labeled below.)

EXEMPTIONS AND DEDUCTIONS

Total revenue exemption of \$1 million for the franchise tax (HB 213 by Hilderbran). CSHB 500 would repeal a provision that otherwise would sunset the \$1 million small business franchise tax exemption on December 31, 2013. The bill would repeal provisions in session law governing the exemption scheduled to take effect in the 2014 tax year, which is set at \$600,000.

It also would repeal statutory language that establishes tax discounts for various levels of total revenue below \$1 million. Current law grants the graduated discounts to entities based on total revenue.

Margin base of 65 percent. Under the bill, a taxable entity that did not subtract cost of goods sold or compensation would compute its margin based on 65 percent of its total revenue, which would be 5 percentage points lower than the current law level of 70 percent.

DEFINITION OF RETAIL TRADE

Automotive repair shops (HB 71 by Fletcher et al.). The bill would add to the definition of “retail trade” industries that fall under Industry Group 753 of the 1987 Standard Industrial Classification Manual. These would include:

- top, body, and upholstery repair shops and paint shops;
- automotive exhaust system repair shops;
- tire retreading and repair shops;
- automotive glass replacement shops;
- automotive transmission repair shops;
- general automotive repair shops; and
- automotive repair shops, not elsewhere classified.

Rental-purchase activities (HB 317 by Otto). The bill would add to the definition of “retail trade” rental-purchase agreement activities regulated by Business and Commerce Code, ch. 92.

Classification of certain rental businesses as retail (HB 510 Murphy). The bill would exempt certain businesses that fall under Industry Group 735 from the requirement that more than 50 percent of total revenue from retail activities is necessary to qualify as a retail business for franchise tax purposes. Businesses that no longer would have to meet the 50 percent threshold to qualify would include:

- medical equipment rental and leasing;
- heavy construction equipment rental and leasing; and
- equipment rental and leasing, not elsewhere classified.

EXPENSES EXCLUDED FROM TOTAL REVENUE

Payments to subcontractors (HB 2766 by Hunter). The bill would add language to specifically exclude from total revenue any payments distributed to subcontractors.

Payments for businesses that transport aggregates (HB 1733 by Hilderbran). An entity primarily engaged in transporting aggregates would exclude from total revenue subcontracting payments to nonemployee agents for the performance of delivery services on behalf of the taxable entity.

Tenant payments for taxes (HB 2775 by Branch). A landlord of commercial property would exclude from total revenue interest and depreciation received from a tenant of the property for ad valorem taxes and any tax or excise imposed on rents.

Subcontracting payments for businesses transporting barite (HB 1596 by N. Gonzalez). An entity primarily engaged in transporting barite would exclude from total revenue subcontracting payments to nonemployee agents for the performance of transportation services on the entity’s behalf.

Subcontracting payments for landman services (HB 1475 by Hilderbran). An entity primarily engaged in performing landman services

would exclude from total revenue subcontracting payments to nonemployees for landman services on behalf of the taxable entity.

Physician payments for a vaccine (HB 1310 by Button). A physician's practice would exclude from total revenue the actual cost it paid for a vaccine.

Certain payments for transportation services (HB 1289 by Hilderbran). An entity engaged primarily in transporting commodities by waterways that did not subtract cost of goods sold would exclude from total revenue the cost of providing inbound or outbound transportation services by waterways to the extent that the entity would be able to subtract the costs of goods sold.

Costs to agricultural aircraft operations (HB 2451 by T. King). An agricultural aircraft operation (crop dusting) would exclude from its total revenue the cost of labor, equipment, fuel, and materials used in providing these services.

Motor carrier flow-through revenue (HB 1981 by Murphy). An entity registered as a motor carrier would exclude from its total revenue flow-through money derived from taxes and fees.

Apportionment for Internet hosting (HB 416 by Hilderbran). The bill would provide that a receipt from Internet hosting described by Tax Code, sec. 151.108 was a receipt from business done in the state only if the customer was located in the state.

COSTS OF GOODS SOLD DEDUCTIONS

Cost of goods sold for tree harvesting (HB 1432 by White). A business that primarily harvested trees for wood could subtract as cost of goods sold the direct costs of acquiring or producing the timber for the wood.

SUPPORTERS
SAY:

CSHB 500 would remedy a number of ills with the franchise or "margins" tax that have been plaguing businesses for years. The bill would address a number of equity issues with the tax that have been well known but that have been allowed to continue due to the fact that addressing them comes at a price.

While there would be a significant cost for adopting CSHB 500, the state

would pay an even greater toll if industries were to leave or fold due, in part, to inequitable and unfair tax policies. These issues must be addressed now, as they put Texas businesses at a competitive disadvantage and disrupt the state's equitable and supportive business climate.

There are some strong advocates for greater changes to the structure or very existence of the franchise tax, but changes of this magnitude do not appear to be a political possibility at this time. The Legislature should not allow the perfect to be the enemy of the good. CSHB 500 would be a clear improvement over current law and practice.

EXEMPTIONS AND DEDUCTIONS

CSHB 500 indefinitely would extend the \$1 million franchise tax exemption to small businesses that would be significantly impacted by a tax hike. The 81st Legislature in 2009 first temporarily adopted the \$1 million exemption limit, which it raised from an original exemption of \$300,000, and the 82nd Legislature in 2011 extended it through fiscal 2012-13. With the state in a fiscally stable position, the time is now to finally end the ad-hoc extensions of the small business tax exemption and set the \$1 million limit in statute.

A failure to extend the \$1 million exemption would be dangerous and counterproductive. Small business growth has been and continues to be a vital component of economic recovery, primarily through the generation of jobs. Small businesses also contribute directly to state coffers by paying property and sales taxes. Failing to extend the exemption would deal a major blow to small businesses that are still emerging from the recession economy. Subjecting small businesses to a higher burden would be counterproductive to goals of low unemployment, diverse economic growth, and diffused opportunity.

The bill would provide an important increase to the standard deduction (to 35 percent) that businesses can claim instead of itemizing costs of goods sold or compensation costs. This would help the large number of businesses whose operations do not fit nicely into the cost of goods sold or compensation deduction framework. Raising the standard deduction would help offset the disproportionate tax impact on businesses that fall into this category.

DEFINITION OF RETAIL TRADE

Retail trade businesses have a lower proportional burden under the franchise tax. Many businesses that are truly retail enterprises, however, are classified under a non-retail code in the 1987 Standard Industrial Classification Manual. This misclassification puts these businesses at a serious competitive disadvantage compared with competing businesses that are granted the reduced retail tax rate.

CShB 500 would correct three well-known instances of similar businesses being taxed at different rates due to a retail trade misclassification:

- independent automotive repair shops and body shops;
- rent-to-own businesses; and
- equipment rental and leasing.

Independent automotive repair shops are taxed at a higher rate (1 percent) than automotive repair shops attached to auto dealers (.5 percent). Similarly, the rent-to-own business model is fundamentally based on selling products through a trial renting period. The primary difference lies in how the customer pays for the products. Independent equipment rental businesses directly compete with other retail businesses with rental components, such as Home Depot and Lowe's, but have to pay a higher tax rate because they do not meet the 50 percent minimum requirement for retail trade.

In each of these cases, the current application of the franchise tax creates an uneven playing field for businesses with like pursuits. Taxes must be equal and uniform, and making these changes now would be a healthy stride in that direction.

EXPENSES EXCLUDED FROM TOTAL REVENUE

Another arena in which the franchise tax falls short is in taxing businesses for what are truly expenses. Some businesses receive a large number of payments that are simply "passed-through" to contractors, subcontractors, and to other entities working for that business. It is important to construct tax law to ensure that pass-through revenue is only taxed once, and at its final destination.

CShB 500 would make a number of amendments to the franchise tax to

ensure that businesses were not being taxed on pass-through revenue and that businesses in unique situations were not unduly burdened by tax rules. The bill would exclude from total revenue (and thus from taxation):

- payments distributed to subcontractors;
- subcontracting payments to nonemployee agents involved with transporting aggregates;
- payments from a tenant of a commercial landlord for property taxes and other taxes;
- subcontracting payments to nonemployees engaged in the transportation of barite;
- subcontracting payments to nonemployees performing landman services on behalf of an entity;
- the cost of providing inbound or outbound transportation services by waterways for commodities transporters that did not subtract cost of goods sold;
- the cost of labor, equipment, fuel, and materials used in providing crop dusting operations;
- the actual cost a physician's office paid for a vaccine; and
- money derived from taxes and fees paid to a motor carrier.

Providing for businesses in these unique situations that are disproportionately impacted by the tax would increase the overall equity and fairness of the franchise tax.

In addition, the bill would address the disproportionate tax burden on web-hosting businesses. Under the franchise tax, receipts from out-of-state customers paying for web storage in Texas are treated as business done in this state for the purposes of the apportionment formula. As such, web-hosting businesses have a higher percentage of their receipts subject to tax than other businesses with large out-of-state customer bases that are not taxed for those transactions. Exempting out-of-state customers from revenue calculations for web-hosting businesses would address this inequity.

COSTS OF GOODS SOLD DEDUCTIONS

CSHB 500 would address some issues that have arisen with the franchise tax due to the structure of the costs of goods sold deduction. The definition of costs of goods sold under the franchise tax is generally more strict than the definition used for IRS tax purposes.

The various shortcomings of the franchise tax's cost of goods definition create a disproportionate tax burden for certain industries in unique situations. CSHB 500 would correct one case in which legitimate expenses are not allowed under the cost of goods sold deduction. Specifically, the bill would allow such a deduction for the costs of acquiring or producing the timber used by a business that harvested trees for wood.

OPPONENTS
SAY:

CSHB 500, according to the Legislative Budget Board, would have a negative impact of almost \$400 million to the state for fiscal 2014-15. This would have a very significant, indirect impact on general revenue funds by reducing franchise tax funds flowing to the Property Tax Relief Fund, which was established by the Legislature in 2006 to offset reductions of school property taxes. Because revenue in the Property Tax Relief Fund is dedicated to public education, any reduction of revenue in the fund must be offset with general revenue funds.

The Legislature should not contemplate measures that drain funds available for public education without first restoring the deep cuts it made to schools in 2011. Until these cuts are restored, any proposal to reduce revenue to the state that is not absolutely necessary should be tabled.

This bill, along with the number of amendments that members have pre-filed for floor discussion, presents strong evidence that the franchise tax is deeply flawed and in desperate need of reform. As many have noted, under the current tax, businesses are taxed on expenses that should be exempt, others pay unequal rates for similar activities, and still others have to pay taxes for years in which they actually report a net loss of income.

CSHB 500 would put a dozen bandages on a patient without addressing the underlying ailment. There are at least two proposals for comprehensive reform of the franchise tax.

One proposal would be to add a wind-down provision to the franchise tax. HB 509 by Murphy and 607 by Scott Turner, for instance, would reduce the rate of the franchise tax each year from fiscal 2014 to 2016 and finally would eliminate the tax in fiscal 2017. While this would have a significant short-term negative impact to general revenue, the long-term net gain to the state by fostering a very attractive business environment would be soundly positive.

Another proposal would be to eliminate the current franchise tax and replace it with a business profits tax. The Supreme Court recently confirmed that a tax on business profits would not violate the so-called “Bullock Amendment,” which restricts taxes on a person’s share of partnership and unincorporated association income. A tax on business profits, or net income, could greatly simplify the franchise tax and would end various problems and inequities created by the differential tax structure in current law.

Whatever the ultimate choice, the Legislature should look toward enduring solutions to the numerous problems that have plagued the tax.

**OTHER
OPPONENTS
SAY:**

Continuing the \$1 million exemption would be problematic because it would create a sheer tax cliff at that amount: make \$999,999 and pay no taxes; make \$1,000,001 and pay the full percentage owed. A staggered approach with discounts for various ranges of revenue, as exists on paper in current law, would be preferable to a dollar-value cliff.

NOTES:

The Legislative Budget Board estimates that CSHB 500 would result in a loss of about \$396.8 million to the Property Tax Relief Fund for fiscal 2014-15. Any loss to this fund would have to be offset with an equal amount of general revenue to fund the Foundation School Program.

House members have pre-filed a total of 33 amendments on CSHB 500 for floor consideration today.