The Takeaway

Policy Briefs from the Mosbacher Institute for
Trade, Economics, and Public Policy

Giving an "F" to the Franchise Tax

The Texas Franchise Tax Fails to Fund

LORI L. TAYLOR, ERICA COTTINGHAM, AND ALLISON SHEA
Mosbacher Institute

In 2006, Texas faced a fiscal double whammy. Not only had the Texas Supreme Court ordered the state to pick up more of the tab for K-12 education, but the legislature promised voters significant property tax relief. To achieve both goals simultaneously, the Texas Legislature expanded the state's franchise tax (a form of corporate income tax) to include businesses other than corporations. A good idea in principle, but not in execution.

The Texas franchise tax is a business tax levied on a firm's "taxable margin." It applies to most Texas businesses, although very small firms (those with revenues less than $1.11 million per year), sole proprietorships, and general partnerships of natural persons (i.e., human beings) are tax exempt.

A key feature of the Texas franchise tax is that businesses choose how they are taxed. The three tax options are:

WHAT'S THE TAKEAWAY?

The Texas franchise tax burdens taxpayers without generating sufficient tax revenue.

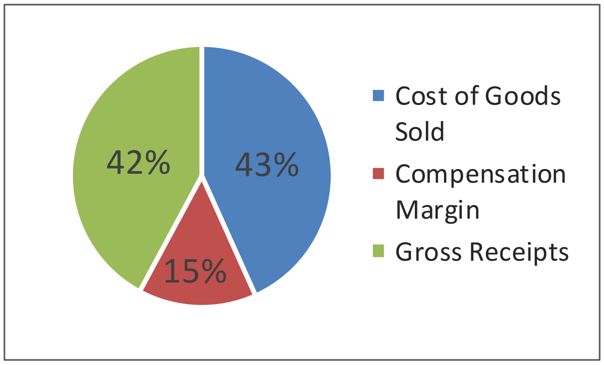
The tax is particularly hostile to smaller businesses and the business services industry.

Revenue would be better raised by replacing the franchise tax with either a value added tax (VAT) or a broader sales tax that includes consumer services.

VOLUME 7 | ISSUE 1 | 2016
http://bush.tamu.edu/mosbacher/takeaway
The Takeaway © Mosbacher Institute

1. **Cost of Goods Sold**- Firms are taxed on the difference between total revenue and the Texas definition of their cost of goods sold (COGS). The Texas COGS includes all expenses related to the acquisition and production of tangible property. However, expenses related to the distribution or sale of such property are not considered part of COGS. For example, the labor of a cook is part of a Texas restaurant's COGS, but the labor of a waitress is not. Expenses related to the production of intangibles (such as services) and the compensation of corporate officers are also not deductible.
2. **Compensation margin**- Firms are taxed on the difference between total revenue and total labor compensation. There is a $360,000 per person cap on the amount of compensation that can be subtracted.
3. **Gross Receipts**- Firms are taxed on 70% of their total revenue, which is equivalent to deducting expenses equal to 30% of total revenue. Firms with less than $20 million in annual revenues can choose the EZ Computation version of this option, which is equivalent to deducting expenses equal to 55.9% of total revenues.[1] All firms (except those that choose the EZ Computation option) are allowed a minimum deduction of $1 million.

Figure 1: Business Filers Using Each Option, 2015



Source: Texas Comptroller of Public Accounts

As Figure 1 illustrates, the 188,231 Texas firms filing for the franchise tax in 2015 chose the COGS option (which typically provides manufacturing firms the largest deduction possible) slightly more often than the gross receipts option (which includes the EZ Computation and the $1 million minimum deduction). Only 15% of filers chose to pay tax on their compensation margin.

THE FRANCHISE TAX FALLS SHORT

The key to understanding the flaws in the franchise tax is recognizing that—with a few notable exceptions—Texas firms are highly mobile. As a result, taxes that would otherwise fall on businesses are passed along to workers, customers, and landlords. Firms unable to pass on the excess costs of doing business in Texas will close up shop or move on down the road to another, friendlier state.

Allowing businesses to choose their tax base sounds business friendly, but it is not—because all of the choices are bad. In each case, firms pay a tax on their profits plus their non-deductible expenses, meaning that firms can owe tax even when they are losing money. Firms with a larger share of expenses that are not deductible pay higher effective tax rates than other firms, which distorts business decision-making and favors some industries over others.

Firms choosing option 1 are taxed on their profits, their costs of producing intangibles, their costs for distribution and sales, and some payroll. This option disproportionately burdens firms that both manufacture and distribute their products, and discourages the purchase of many business services, like those related to sales and advertising.

Firms choosing option 2 are taxed on their profits, their non-payroll costs of doing business, like rent or electricity, and some payroll. Firms producing services, such as airlines or accounting firms, tend to choose this option because they don't produce tangible property (so option 1 is off the table) and their labor costs exceed 30% of their revenues (so option 3 is less attractive). Under this option, employee labor is deductible but purchased services are not, so firms that employ accountants, lawyers, or computer programmers pay lower taxes than firms that hire accounting firms (or law firms, or freelancers), which again discourages the purchase of business services. So, even if a firm is too small to pay the franchise tax itself, it still can be adversely affected if it loses business because its customers decide, for tax reasons, to provide such services in-house.

Firms choosing option 3 are taxed on their gross receipts. This approach to taxation is particularly distortionary because every time a product changes hands, the entire value of the product is taxed. Consider, for example, a restaurant. It buys eggs from a local farmer, and a gross receipts tax is collected. When it sells omelets to a hungry crowd the gross receipts tax is collected again. The full value of the eggs is taxed twice, once at the farm level and again at the restaurant level. If the farmer had sold those eggs to a wholesaler rather than directly to the restaurant, the eggs would have been taxed three times. This "tax cascading" aspect of a gross receipts tax means that the effective tax rate can be many times higher than the statutory tax rate, compounding the distortionary effect of the tax.

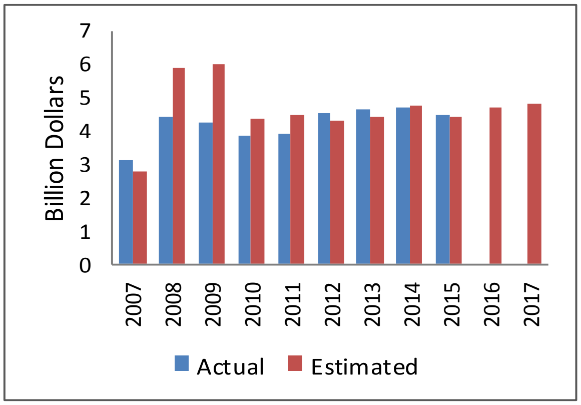
Tax cascading also means the effective tax rate depends on the number of times a product changes hands. Large, vertically integrated firms can complete all steps of the production process in-house and do not incur taxes until they sell their product to the final consumer. Smaller businesses create a taxable event every time they buy or sell, leading to higher effective tax rates on products produced by a series of smaller businesses than on products produced by a single, large firm. Simply put, a gross receipts tax is biased against smaller businesses.

> *Simply put, a gross receipts tax is biased against smaller businesses*

Economists evaluate the efficiency of a tax based on the economic distortion per dollar of revenue. By this criteria, the franchise tax is especially inefficient because it distorts firm behavior without raising enough revenue. Figure 2 depicts the estimated revenue projections of the franchise tax alongside the actual revenue raised since 2007. It shows that the state has received 25% less in tax revenue than was originally projected when the law was passed. The shortfalls were clear almost immediately with $2 billion less than expected being raised annually.

In May 2015, the Texas Legislature passed an across the board 25% cut to the franchise tax rate. Beginning in 2016, the tax rate was reduced to 0.75%, saving taxpayers roughly $1.3 billion per year.[2,3]

Figure 2: Actual and Estimated Revenue Raised by the Franchise Tax



Source: Texas Comptroller of Public Accounts

CONCLUSION

The franchise tax is inefficient due to its low revenue and distortionary effects. It is inequitable as it favors some industries over others and large firms over smaller businesses. The tax has also failed to meet predicted revenue estimates or adequately fund public education.

Replacing the franchise tax either with a value added tax (VAT) that taxes all businesses on the difference between their revenues and the total amounts they paid for inputs from other firms[4] or with a broader sales tax that includes consumer services—as was discussed in a previous *Takeaway*[5]—would be a more feasible, efficient, and equitable way to raise state revenues.

Lori L. Taylor, Director of the Mosbacher Institute, holds the Verlin and Howard Kruse '52 Founders Associate Professorship at the Bush School. She is an economist and the author of numerous articles on public finance.

Erica Cottingham and **Allison Shea** are Graduate Research Assistants at the Mosbacher Institute and recent graduates of the Bush School of Government with Master of Public Service & Administration degrees.

Notes:
For more information on the Texas franchise tax, see:

- Texas Taxpayers and Research Association (2011, October). *Understanding the Texas franchise-or "margins"-tax*. Retrieved from http://www.ttara.org/files/document/file-4ea5bda9239ef.pdf
- Seay, M. & Martens. J. (2010, Mar/Apr). A few quick answers about the Texas franchise (margin) tax. *Journal of State Taxation,* 28(3), 29-34.
- Texas Comptroller of Public Accounts. http://comptroller.texas.gov/taxinfo/franchise/

[1] Businesses that choose the EZ Computation pay a tax rate of 0.331% on 100% of their revenues rather than 0.75% on 70% of their revenues. A firm with $10 million in revenues would pay $33,100 under the EZ option. It would also pay $33,100 under the gross receipts option if it paid 0.75% on 44.1% of its revenues, implying a deduction of 55.9% .

[2] The franchise tax rate for firms primarily engaged in wholesale and retail trade, which is half the rate for other firms, was cut to 0.375%.

[3] Texas Legislative Guide, Budget & Taxes. (2015, May). Cutting margins taxes. Retrieved from http://txlege.texastribune.org/topics/budget-and-taxes/cutting-margins-taxes/

[4] Gruber, J. (2012) *Public Finance and Public Policy*, fourth edition.

[5] Taylor, L. (2011). Stop playing favorites with the tax code. *The Takeaway*, 1(2). http://bush.tamu.edu/mosbacher/takeaway/TakeAwayVol2Iss1.pdf

ABOUT THE MOSBACHER INSTITUTE

The Mosbacher Institute was founded in 2009 to honor Robert A. Mosbacher, Secretary of Commerce from 1989-1992 and key architect of the North American Free Trade Agreement. Through our three core programs–Integration of Global Markets, Energy in a Global Economy, and Governance and Public Services–our objective is to advance the design of policies for tomorrow's challenges.

Contact:
Cynthia Gause, Program Coordinator
Mosbacher Institute for Trade, Economics, and Public Policy
Bush School of Government and Public Service
4220 TAMU, Texas A&M University
College Station, Texas 77843-4220

Email: bushschoolmosbacher@tamu.edu
Website: http://bush.tamu.edu/mosbacher

To share your thoughts on *The Takeaway*, please visit http://bit.ly/1ABajdH

The views expressed here are those of the author(s) and not necessarily those of the Mosbacher Institute, a center for independent, nonpartisan academic and policy research, nor of the Bush School of Government and Public Service.