Policy Perspective
Texas Public Policy Foundation
March 2006

A Capital Defect in the Texas Franchise Tax

by Jennifer K. Patterson, J.D., LL.M.

Introduction

The Texas franchise tax, perhaps a capital idea 100 years ago, has degenerated to a capital problem for Texas taxpayers. The franchise tax is so easily circumvented by Texas businesses that it has become an oxymoron—an optional tax. Try as they might, the Legislature has failed to reform the franchise tax during the last several sessions. While that failure is largely attributable to an inability to close the existing loopholes in a politically palatable way, the recent focus on property tax relief and the Texas tax system's over-reliance on capital-intensive industries has brought to light another defect in the franchise tax, a capital defect.

The franchise tax has two components—taxable capital and taxable earned surplus. Taxable earned surplus is the company's[1] federal taxable income, with a few adjustments. Taxable capital is a company's net assets. Although the franchise tax is said to be the greater of .25 percent of taxable capital or 4.5 percent of taxable earned surplus, it really is a 4.5 percent surtax on taxable earned surplus for very profitable companies with a .25 percent of taxable capital minimum tax for all companies.[2] The capital component of the franchise tax is a minimum tax that all companies pay. However, the capital component has defects that call into question its fairness and usefulness as part of the franchise tax calculation.

Capital Tax as a Minimum Tax

Understanding the calculation of the tax on capital and its role as a minimum tax requires a knowledge of some complex statutes. The Texas Tax Code defines taxable capital as the sum of a company's stated capital and its surplus.[3] For a corporation, stated capital is the par value of all issued shares of stock, plus the consideration paid by shareholders for issued shares without par value, plus any other amounts transferred to stated capital.[4] Surplus is the net assets of the corporation minus its stated capital.[5] For a limited liability company, stated capital is the total of the members' actual and pledged contributions of cash and the agreed value of property and services.[6] Surplus means net assets of the limited liability company minus its members' contributions.[7]

CONTINUED ON NEXT PAGE

[1]The term "company" will be used throughout as a collective reference to entities subject franchise tax. The franchise tax is imposed on corporations and limited liability companies that do business or are chartered or authorized to do business in Texas. Tex. Tax. Code § 171.001(a).

[2]The franchise tax calculation is actually based upon *net* taxable capital and *net* taxable earned surplus. Tex. Tax Code § 171.002. Taxable capital and taxable earned surplus are apportioned to Texas to determine net taxable capital and net taxable earned surplus. Tex. Tax. Code §§ 171.101, 171.110. Because apportionment does not change the analysis, this paper will continue to refer to taxable capital and taxable earned surplus, or capital and earned surplus, as if those items were the basis of the franchise tax calculation.

[3]Tex. Tax Code § 171.101(a)(1).

[4]*Id.*, Tex. Bus. Corp. Act art. 1.02(24), 2.15.

[5]Tex. Tax Code § 171.109(a)(1).

[6]Tex. Tax Code § 171.101(b)(1); 34 Tex. Admin. Code § 3.562(c).

[7]Tex. Tax Code § 171.109(a)(1).

From these complicated definitions, the calculation of taxable capital boils down to this:

Stated Capital + Net Assets – Stated Capital = Taxable Capital

Simply put, for either a corporation or a limited liability company (LLC), taxable capital is equivalent to a company's net assets.

The computation of a company's franchise tax liability involves both taxable capital and taxable earned surplus, and more statutory gymnastics. Technically, a company's franchise tax liability is .25 percent of capital, plus the excess of 4.5 percent of earned surplus over .25 percent of capital.[8] Any negative amount, which could be negative assets on the capital side or a loss on the earned surplus side, is treated as zero.[9] The treatment of negative amounts as zero causes *all* companies to pay franchise tax based on taxable capital, but causes *only* companies that make a healthy profit to pay an additional tax on earned surplus.[10] However, because the result of the franchise tax computation is always the greater of .25 percent of taxable capital or 4.5 percent of earned surplus, taxpayers think of the franchise tax as a tax on either capital or earned surplus.

The reality is that all companies pay the tax on capital and only very profitable companies pay a surtax on earned surplus. The next step, then, is to determine what it means to be very profitable. The answer is revealed by the relationship between taxable capital and earned surplus. Taxable capital, actually net assets, represents the amount of capital employed in a business. Earned surplus, approximately net income, represents the profit earned on that capital. At .25 percent and 4.5 percent respectively, the tax on capital and the tax on earned surplus are equivalent when a company earns a 5.56 percent annual return on investment.

For example, if Company A has $100,000 in taxable capital and $5,555.65 in earned surplus, that represents a 5.56 percent return on investment.

Profit		Investment		Return on Investment
$5,555.65	÷	$100,000	=	5.56%

For Company A, the capital and earned surplus components of the franchise tax would be equivalent.

$100,000 in capital	x	.25%	=	$250.00
$5,555.65 in earned surplus	x	4.5%	=	$250.00

Following the machinations of the franchise tax calculation, Company A would pay only the capital component of the franchise tax, and its franchise tax liability would be $250.

Tax on capital		$250.00
Excess of tax on earned surplus over tax on capital	+	0.00
Franchise tax		$250.00

If a company's annual return on investment is greater than 5.56 percent, then the company must pay a surtax on earned surplus. For example, if Company B has $100,000 in capital and $5,570.00 in earned surplus, that represents a 5.57 percent return on investment.

Profit		Investment		Return on Investment
$5,570.00	÷	$100,000	=	5.57%

For Company B, the earned surplus component of the franchise tax is greater than the capital component.

$100,000 in capital	x	.25%	=	$250.00
$5,570.00 in earned surplus	x	4.5%	=	$250.65

Applying the franchise tax calculation, Company B would pay a surtax on earned surplus, and its franchise tax liability would be $250.65.

Tax on capital		$250.00
Excess of tax on earned surplus over tax on capital	+	0.65
Franchise tax		$250.65

[8]Tex. Tax Code § 171.002(a)-(b).
[9]Tex. Tax Code § 171.002(c)
[10]The exception is companies that have negative taxable capital, or negative assets. Such companies would pay franchise tax on the first dollar of earned surplus.

However, if a company's annual return on investment is less than 5.56 percent, it pays the same amount of franchise tax that it would if it had realized that level of return. For example, Company C has $100,000 in capital and $5,550.00 in earned surplus, which represents a 5.55 percent return on investment.

Profit		Investment		Return on Investment
$5,555.00	÷	$100,000	=	5.55%

For Company C, the earned surplus component of the franchise tax is less than the capital component.

$100,000 in capital	x	.25%	=	$250.00
$5,555.00 in earned surplus	x	4.5%	=	$249.75

Applying the franchise tax calculation, Company C would pay no surtax on earned surplus, and its franchise tax liability would be $250.00, the same as the tax on capital.

Tax on capital		$250.00
Excess of tax on earned surplus over tax on capital	+	0.00
Franchise tax		$250.00

Even if a company's return on investment is zero, it pays the same amount of franchise tax that it would if it had realized a 5.56 percent return. For example, Company D has $100,000 in capital and zero earned surplus. Its return on investment is zero.

Profit		Investment		Return on Investment
$0	÷	$100,000	=	0%

For Company D, the tax on capital is still $250, and its tax on earned surplus is zero.

$100,000 in capital	x	.25%	=	$250.00
$0 in earned surplus	x	4.5%	=	$0

Applying the franchise tax calculation, Company D's franchise tax liability would be $250.

Tax on capital		$250.00
Excess of tax on earned surplus over tax on capital	+	0.00
Franchise tax		$250.00

The franchise tax liability of Company A, Company C, and Company D is the same, even though C was less profitable than A, and D was not profitable at all. This is because the peculiar calculation of the franchise tax, coupled with the relative rates of the capital tax and the earned surplus tax, cause all companies to pay a minimum franchise tax at the level of a company that realized a 5.56 percent return on investment. Each of Company A, Company C, and Company D had a return on investment of 5.56 percent or less. Only Company B's franchise tax liability differed. Company B's annual return on investment was greater than 5.56 percent, and it paid a surtax on its additional profit in the form of the tax on earned surplus.

Defects in the Capital Tax

The taxable capital component of the franchise tax thus operates as a minimum tax that all companies pay, while the earned surplus component operates as an excess profits tax. However, the capital component has several undesirable characteristics that call into question its fairness and efficiency as a minimum tax applicable to all companies. First, to the extent a company's property is not debt-financed, the capital component is duplicative of the property tax. Second, by taxing only assets that are not acquired by borrowing, the capital component distorts the financing decisions of taxpayers. Third, the capital component pyramids capital within affiliated groups because it taxes capital invested through subsidiaries multiple times. Fourth, as a minimum tax, the capital component is not rational.

Duplicative of Property Tax. Real property and personal property owned by a business are subject to property tax in Texas. Property subject to the property tax also generates taxable capital for the company and

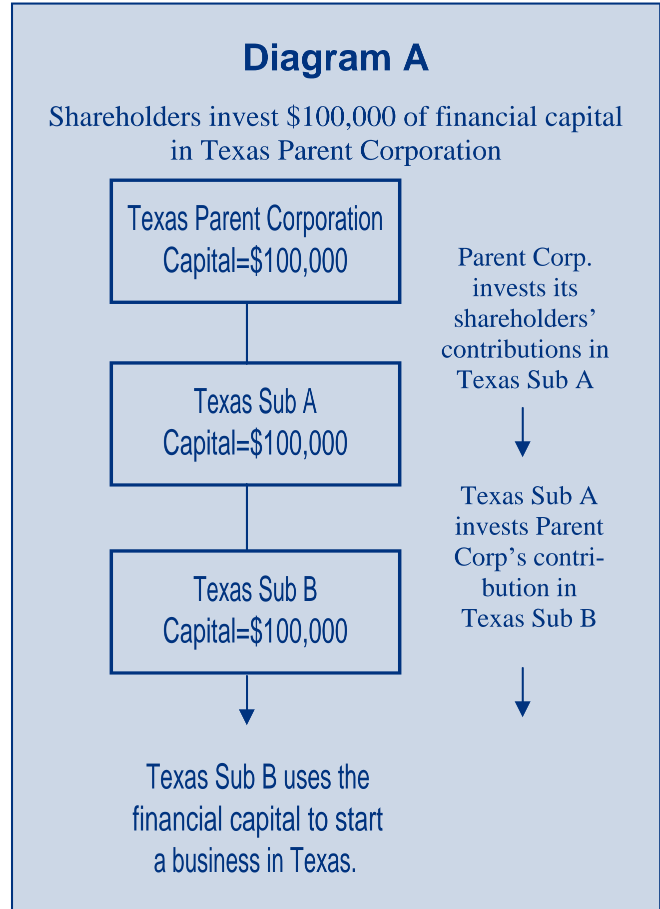
[11]The rate on taxable capital is 5.555% of the rate on taxable earned surplus. A change in either rate would cause the minimum tax to shift of a different level of annual return on investment.

increases its minimum franchise tax liability. For example, if a business purchases a new piece of equipment for cash, the book value of that equipment appears as an asset on its balance sheet. The equipment increases the company's net assets, which increases its taxable capital, which increases its minimum franchise tax liability. That piece of equipment is also subject to property tax. The property tax already falls more heavily on industries that use property instead of people, and the taxable capital component of the franchise tax exacerbates that effect. A distaste for the property tax, as a penalty on capital investment in Texas, should yield a similar distaste for the capital tax.

A distaste for the property tax, as a penalty on capital investment in Texas, should yield a similar distaste for the capital tax.

Distorts Purchasing Decisions. The capital tax, as a tax on net assets, also distorts investment decisions. If the company in the illustration above does not use available cash to buy the new equipment but borrows the purchase money instead, then the book value of the equipment still appears as an asset on its balance sheet, but the associated debt appears as a liability. The value of the asset and the purchase-money loan offset one another on the company's balance sheet. Net assets are not increased by the acquisition of the new equipment, the company's taxable capital is not increased, and its minimum franchise tax liability is not increased. Consequently, the capital component of the franchise tax encourages borrowing, even when otherwise unnecessary, because it reduces a company's minimum franchise tax liability and thus distorts the decision-making between acquiring new assets with debt or with equity.

Pyramids Capital. The capital component of the franchise tax pyramids taxable capital within groups of affiliated companies. Diagram A illustrates the pyramiding problem within an affiliated group.

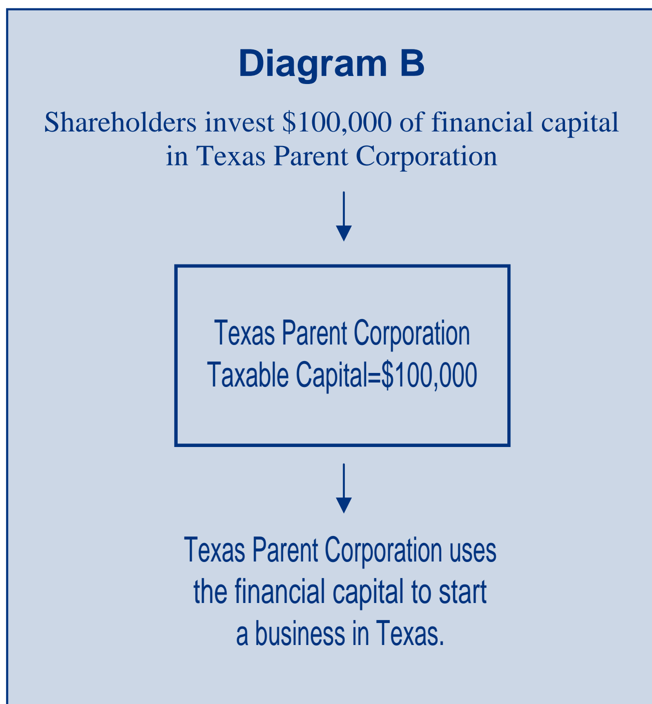


In Diagram A, the shareholders invested $100,000 in Texas Parent Corporation. Texas Parent Corporation invested that $100,000 in Texas Sub A, and Texas Sub A invested that $100,000 in Texas Sub B. Texas Sub B uses the $100,000 originally invested by the shareholders of Texas Parent Corporation to start and operate a business in Texas.

While the entire Texas affiliated group represents a single investment of $100,000 in financial capital in Texas, *each* Texas Parent Corporation, Texas Sub A, and Texas Sub B has net assets of $100,000 and, therefore, $100,000 in capital for franchise tax purposes. The result is that the minimum franchise tax associated with the Texas business is $750.00.

Parent Corporation	$100,000 in capital	x	.25%	=	$250.00
Sub A	$100,000 in capital	x	.25%	=	$250.00
Sub B	$100,000 in capital	x	.25%	=	$250.00
Minimum Franchise Tax Liability					$750.00

Contrast the tax liability associated with that $100,000 investment if Texas Parent Corporation operates the Texas business directly, rather than through subsidiaries.



In Diagram B, the total amount invested in a Texas business is $100,000, the same as Diagram A. However, the minimum franchise tax liability associated with the Texas business in Diagram B is only $250.00, one-third of that in Diagram B.

Parent Corporation	$100,000 in capital	x	.25% =	$250.00
Minimum Franchise Tax Liability				$250.00

The pyramiding illustrated in Diagram A results from the duplication of Texas Sub B's capital in that of Texas Sub A, and the duplication of Texas Sub A's capital in that of Texas Parent Corporation. In this way, the capital component of the franchise tax artificially triples the group's actual capital investment in Texas. Its minimum franchise tax liability is also tripled, even though the profit-making effort of the group is the same as that in Diagram B.

Pyramiding of taxable capital in the franchise tax system is inefficient because it treats the same financial investment differently, depending on the number of entities through which the capital is employed. Businesses operate in multi-entity, multi-layered structures for many different reasons. Government regulations, such as those that govern common carriers, require certain activities to be conducted in single-purpose entities. Financial reasons, such as the ability of one entity within an affiliated group to guarantee the debt of another entity, or the ability for a company to self-insure, require the creation of separate entities. The issuance of bonds, which requires a high level of financial stability, may necessitate the formation of a separate entity in order to protect bond investors. Following a merger, separate entities may be necessary to retain brand identity or to carry out the terms of the merger. In each case, the decision to form and operate an additional entity is motivated by business needs or government regulation, and the capital component of the franchise tax penalizes these efficient and necessary decisions.

Pyramiding of capital is poor economic policy because it fails to recognize the need of modern business to operate through more than one entity. The capital component of the franchise tax was first enacted in 1907,[12] and the intervening 99 years have seen dramatic changes in business and government. Specifically, an increase in government regulation, the globalization and increased complexity of our economy, and the maturation of our financial markets have given rise to multi-entity, multi-layered business structures. The taxable capital component of the franchise tax is antiquated and, because it does not accommodate the modern business norm, it penalizes sophisticated enterprises.

Not Rational. As a minimum tax, the capital component is not rational. Recall that a business must pay the capital tax whether or not it is profitable and that a business with zero (or even negative) earned surplus (net income) will have a franchise tax liability under the taxable capital component.[13] The justification for a minimum tax is that the State's obligation to build roads, to educate children, and to provide other ser-

[12]Act of May 16, 1907, 30th Legislature, 1st C.S., chapter 23, 1907 Tex. Gen. Laws 502.
[13]Again, the exception is a company with negative net assets and no earned surplus.

vices that support the business climate continues whether a business is profitable or not. By that justification, the capital component is an assessment in exchange for the provision of the services. However, as a minimum tax in exchange for state services, the taxable capital component is not rational because it bears no relationship to the quantity or value of government services utilized by a business.

It is not rational to impose a minimum tax in exchange for government services when the measure of that tax has no relationship to the value of government services utilized.

The capital component fails to relate to a business's consumption of government services in two ways at least. First, the capital component does not take into account the industry in which any particular business operates, and the amount of government resources devoted to supporting that industry. Second, while the size of a business operation might be an indicator of government services used, taxable capital does not necessarily relate to the size of a business operation. For any single business operation, taxable capital is reduced by borrowing and is increased through pyramiding. It is not rational to impose a minimum tax in exchange for government services when the measure of that tax has no relationship to the value of government services utilized.

Conclusion

The review of the state and local tax system currently underway in Texas represents an opportune time to examine, in general, the rationale for a minimum tax on business and, in particular, the efficacy of the capital component of the franchise tax as that minimum tax. The problem of pyramiding taxable capital can be resolved simply by allowing a business to deduct its investment in other entities or by allowing affiliated entities to calculate their minimum franchise tax on a combined basis. However, the capital component's duplication of property tax, distortion of purchasing decisions, and irrationality cannot be resolved so easily. Those problems can likely be solved only by repealing the capital component.

Even if the capital component of the franchise tax could be repaired, which the author believes it cannot, a fundamental question remains. Is it desirable to impose a minimum tax on business at all? While it is true that state obligations to build roads and to educate children continue whether a business is profitable or not, a minimum tax on all business misses an important distinction between profitable and unprofitable businesses. All businesses do use some state services, even if minimal, to operate. However, a profitable business uses state services *to its pecuniary advantage*, while an unprofitable business does not. The Legislature can reasonably draw this important distinction within the framework of the franchise tax by repealing the capital component. The remaining earned surplus component will effectively require only those businesses that profit from the use of state services to pay for them. The ability of businesses to "zero-out" their earned surplus liability through artificial means is generally a concern about the earned surplus component of the franchise tax. However, it would be better to address that concern directly—through mechanisms such as the existing add-back for officer and director compensation—than to rely on the duplicative, distortive, pyramiding, and irrational tax on capital for that purpose.

If the Legislature seeks to foster a healthy business climate in Texas...it should begin by eliminating the tax on the fundamental driver of business—capital.

[14]The ability of businesses to "zero-out" their earned surplus liability through artificial means is generally a concern about the earned surplus component of the franchise tax. However, it would be better to address that concern directly—through mechanisms such as the existing add-back for officer and director compensation—than to rely on the duplicative, distortive, pyramiding, and irrational tax on capital for that purpose.

If a business tax is a desirable or necessary means for funding state government—a point the author does not concede, but instead refers the reader to the accompanying side-bar by Byron Schlomach—that business tax should, fundamentally, distinguish between profitable and unprofitable businesses. Engaging in business carries financial and personal risks that return rewards not only to the entrepreneur but also to the employees and customers of that business Public policy ought to support those who are willing to undertake those risks in exchange for the greater reward, and not pile on the risk of owing a tax in unprofitable years. In doing so, the minimum tax discourages entrepreneurship, the bedrock of our economy. The minimum tax is also poor economic policy because that additional risk necessarily raises the cost of capital. If the Legislature seeks to foster a healthy business climate in Texas, which will return jobs and profits to Texans, it should begin by eliminating the tax on the fundamental driver of business—capital.

Jennifer Patterson is an attorney of counsel with the law firm McGinnis, Lochridge & Kilgore LLP, where she concentrates her practice in state and local tax and government relations. She holds a B.A in Government and a J.D. from The University of Texas at Austin and a Master of Laws in Taxation from Southern Methodist University School of Law. Ms. Patterson has practiced state and local tax law since 1997 and served as Tax Policy Director for the Texas Comptroller of Public Accounts in 2000.

Sidebar

Business taxes are undesirable for several reasons:

- They "pyramid"—i.e., build upon themselves through different stages of production thereby distorting final product prices;
- They hide the true cost of government from taxpayers since only people pay taxes through lost income from fewer jobs and lower wages, lower profits, and higher product prices;
- They grow government when its cost is hidden;
- They encourage "rent seeking"—the pursuit of special privileges from government—by creating another opportunity for lobbying for special interests;
- They directly tax work, innovation, investment, and job creation, meaning that business taxes directly reduce job availability; and
- Their complexity distorts the economy by requiring more resources be used merely in tax compliance.

—Byron Schlomach, chief economist at the Texas Public Policy Foundation

We Need Your Help

The Texas Public Policy Foundation is a non-profit, non-partisan research institute guided by the principles of limited government, free enterprise, private property rights, and individual responsibility. We seek to improve Texas government by producing academically sound research on important issues offered to policymakers, opinion leaders, the media, and general public.

We do not accept government funding or sell research outcomes; therefore, we rely solely on the generous contributions of individuals, foundations, and civic-minded corporations.

If you believe studies like this are important for Texas, won't you consider a financial gift to support the Foundation and our mission?

Give generously today by visiting us online at:

www.TexasPolicy.com

Log on to Learn More

All of the Foundation's research and reports are available online at www.TexasPolicy.com.

When there, be sure to sign up for the *Texas Public Policy News (TPPN).* This free e-newsletter is published every other Thursday and includes information about current policy issues, upcoming events, and publications.

Don't miss a single issue. Sign up today!