

“Fixing” the Texas Margin Tax

by The Honorable Talmadge Heflin, The Honorable Chuck DeVore, and James Quintero

Key Points

- Texas has a spending problem, not a revenue problem. “Fixing” the margin tax by increasing the revenue it produces will not solve anything.
- The margin tax presents both a financial and a compliance burden on small businesses and the Texas economy. To remedy this, the Legislature should phase out the tax over the next several years.

A History of State Revenue from the Margin Tax

In 2006, as part of an effort to reduce Texas’ high property tax burden, the business franchise tax was substantially revised to apply to the taxable margin of most businesses, including unincorporated businesses with liability protection.¹

The revisions were intended to replace a portion of the tax revenue lost by cutting property taxes, undertaken as part of a wider effort to correct a constitutional challenge to the school finance system. The changes were also expected to more evenly distribute the tax burden among economic sectors. The new margin tax went into effect on January 1, 2008.

After a few years of operation, we can now measure the effects of the tax law changes.

The high point for collections with this tax occurred in its first year of enactment, in 2008, when it generated \$4.45 billion, up from \$3.1 billion in 2007, the last year of collections before the tax was broadened. However, the official revenue estimate for 2008 was \$5.9 billion, so revenue was \$1.4 billion below estimates in the tax’s first year of operation.²

By fiscal year 2010, the tax was \$2.5 billion shy of initial estimates, of which \$1 billion was attributed to the recession.³ In fiscal year 2011, the franchise tax produced \$3.93 billion, up from \$3.86 billion the year before but still \$500 million below initial projections.⁴

Finally in 2012, the margin tax produced more than was expected. For the year, tax collections totaled \$4.3 billion, about \$300 million more than was initially projected.⁵

The Texas Comptroller of Public Accounts figures that “... the effects of the recession played a significant part in the poor performance of the tax and likely accounted for virtually all of the decline in tax collections from fiscal 2008 to fiscal 2010,” estimating that, had the tax not been broadened, it would have produced \$2.6 billion in 2010, some \$1.3 billion less than actually collected.⁶

Of course, the margin tax was not alone when it came to underperforming expectations during this period. The sales tax, for example, responsible for generating 57 percent of state revenue, was also impacted by the recession, coming in \$1.5 billion short of projections for the year by mid-2010.

Today, however, overall tax revenues are increasing in Texas. After a noticeable downturn in collections for fiscal years 2008 and 2009, largely attributable to the national recession, state revenues have greatly improved. In fiscal year 2010, Texas took \$55.8 billion in taxes, fees and lottery sales (this excludes federal funds, bond sales, land sales and contributions to employee benefits), rising \$5.5 billion to \$61.3 billion in 2011, a gain of 9.8 percent. Sales tax revenue, the largest component of state revenue at \$21.5 billion in 2011, ran 12.1 percent ahead of 2011’s pace in fiscal year 2012.

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Does the Margin Tax Need Fixing?

The underperformance of the margin tax has fed fuel to the fire from some quarters claiming a need to fix the Texas tax system because it doesn't produce enough revenue.⁷ However, despite the margin tax's underperformance compared to expectations, Texas was only one of eight states to see their business tax revenues increase as a percentage of total taxes collected from fiscal year 2007 to fiscal year 2009. In fact, Texas joined Michigan as the states with the largest increases.⁸

Further, when including property taxes and sales taxes that Texas businesses pay,* the tax burden on Texas business increased from \$47.9 billion in fiscal 2007 to \$53.8 billion in fiscal 2009, an increase of \$5.9 billion.⁹ The share of taxes paid by Texas businesses ranked 29th of the 50 states, according to Ernst & Young, with business taxes paid amounting to 4.9 percent of the economy in fiscal 2009, 0.2 percent above the all-state average.¹⁰

With tax revenues increasing and an expected \$8.1 billion in the Economic Stabilization Fund (the "rainy day" account), a discussion of "fixing" the franchise tax ought not to be a code word for increasing taxes. Instead, reforming the tax code to encourage job creation and boost economic prosperity ought to be the order of the day.

One Solution: Improving the Margin Tax

Kathy Barber, the Texas Legislative Director of the National Federation of Independent Business (NFIB) testified before the House Ways & Means Committee (August 17, 2010) with observations and recommendations to revise the franchise tax. She testified:

The margins tax is a gross receipts tax, so regardless of whether a business makes a profit, they still can owe taxes. One of our members experienced a \$250,000 loss in 2009. He was forced to lay off 5 employees and, after taking all the deductions allowable, he still paid \$12,000 in tax this past May.

Not only are small businesses paying more—members we surveyed showed doubling, tripling and higher in their liability—the tax is complicated to calculate, requiring small businesses to revise their accounting systems, increase their record keeping and have their CPA determine their tax burden using the different calculations. This has to be done each year.

A member recently reported under the old tax it cost approximately \$400 to comply with the tax. This year they will pay \$2500 to their CPA. This is a very common complaint among Texas small business owners. NFIB will be asking legislators to provide a deduction for cost of compliance to businesses grossing under \$20 million.

In addition to other reforms, we would also be interested in exploring a bifurcated system where small firms under \$20 million in gross receipts could opt to pay under a version of the old franchise tax. Our surveying results have shown that 75% of our members would prefer to pay a tax similar to the old franchise tax than the current tax.

As seen above, a lack of revenue is not the problem with the margin tax. Instead, its problem is that it is a highly complex tax with high administrative costs that contributes to the high tax burden on Texas businesses. Thus, for those that want to "fix" the margin tax, we offer these five recommendations:

Fix #1: Permanently extend the small business tax exemption and increase the amount of total revenue below which a taxable entity would owe no tax to \$10 million.

Fix #2: Allow unprofitable businesses to deduct a portion of their margin tax liability.[†]

Fix #3: Require any increase in the margin tax rate to be approved by two-thirds of all Members of each house of the legislature.

Fix #4: Allow deductions for cost of employment for all contract labor used by Texas firms.

Fix #5: Simplify the tax by reducing the number of moving parts.

The Best Solution: Eliminate the Margin Tax

While improving the margin tax is a step in the right direction, it still doesn't address the underlying problem of the heavy tax burden on Texas businesses. A previous Foundation study has documented the margin tax's contribution to this burden and the subsequent negative impact it has had on the state's economy.

* Although one can safely assert that businesses don't pay taxes at all; rather, taxes are borne by consumers, employees, and/or shareholders.

† The Texas Comptroller estimates that this reform might reduce tax revenue by \$1 billion. This amount might be mitigated by ensuring losses aren't used as a means of tax planning or tax avoidance.

Analyses from three entities—the Tax Foundation, the American Legislative Exchange Council (ALEC), and the State Business Tax Advisory Committee (SBTAC)—all point to a detrimental impact on the Texas economy from the imposition of the margin tax. In the Tax Foundation's *State Business Tax Climate Index*—a national ranking of state business climates—the ranking of Texas' relatively business-friendly climate declined after the margin tax was adopted. In ALEC's *Economic Outlook Rankings*—a national ranking of states based on certain policy positions—the Lone Star State is depicted as having a subpar economic outlook, stemming in part from its uncompetitive corporate tax structure. Finally, the SBTAC's biennial report suggests that the state's margin tax is contributing to a growing state and local business tax burden, which, when calculated as a percentage of Gross State Product, ranks the state higher than the national average and near the middle of the pack in an all-state comparison.¹¹

Texas missed a golden opportunity in 2006. The old franchise tax was a relatively minor portion of the state's overall revenue. With the state in the mood for tax reform, that would have been the time to make Texas the only major U.S. state to not have a dedicated business tax.

By eliminating the margin tax, Texas will vastly improve its business climate and improve upon its already strong economic growth.

Yet there is still opportunity. The margin tax accounts for only 6.4 percent of the state's revenue from taxes, fees and lottery sales. Phasing out the margin tax would provide the state the opportunity to adjust to the change in revenue. Plus, it is highly likely that any revenue shortfalls would be short lived with the increased economic growth from Texas being the only major state without income or business taxes.

Therefore, the Texas Public Policy Foundation recommends that the margin tax be phased out completely by extending and increasing the amount of total revenue below which a taxable entity would owe no tax up to \$10 million in 2013 and \$50 million in 2015, and then eliminating the tax altogether after 2017. By eliminating the margin tax, Texas will vastly improve its business climate and improve upon its already strong economic growth. ★

Endnotes

- ¹ Susan Combs, Texas Comptroller of Public Accounts, "The Business Tax Advisory Committee, Report to the 82nd Legislature" (Dec. 2010) 1.
- ² Texas Comptroller of Public Accounts, "The 2012-13 Certification Revenue Estimate" (Dec. 2011) 4.
- ³ *Ibid.*, 14.
- ⁴ Online query from "Where the Money Comes From" (accessed 17 Apr. 2012).
- ⁵ Texas Comptroller of Public Accounts, "The 2012-13 Certification Revenue Estimate" (Dec. 2011) 33.
- ⁶ Susan Combs, Texas Comptroller of Public Accounts, "The Business Tax Advisory Committee, Report to the 82nd Legislature" (Dec. 2010) 14.
- ⁷ "Talk of Tax Fixes," *Quorum Report* (6 Apr. 2011).
- ⁸ Susan Combs, Texas Comptroller of Public Accounts, "The Business Tax Advisory Committee, Report to the 82nd Legislature" (Dec. 2010) 9.
- ⁹ *Ibid.*
- ¹⁰ *Ibid.*, 10.
- ¹¹ Talmadge Heflin, James Quintero, and Robert McDowell, *The Texas Margin Tax & Its Impact on the State's Economic Competitiveness*, Texas Public Policy Foundation (Sept. 2012).

About the Authors

The Honorable Talmadge Heflin is the Director of the Texas Public Policy Foundation's Center for Fiscal Policy. For 11 terms, Heflin served the people of Harris County as a state representative. Well regarded as a legislative leader on budget and tax issues by Democratic and Republican speakers alike, he for several terms was the only House member to serve on both the Ways and Means and Appropriations committees. In the 78th Session, Heflin served as chairman of the House Committee on Appropriations. He navigated a \$10 billion state budget shortfall through targeted spending cuts that allowed Texans to avoid a tax increase.

The Honorable Chuck DeVore is Vice President of Communications and Senior Fellow for Fiscal Policy at the Texas Public Policy Foundation. From 2004 to 2010, DeVore represented almost 500,000 people in the California State Assembly. He was the Vice Chairman of the Assembly Committee on Revenue and Taxation and served on the Budget Committee as well. DeVore worked in the aerospace industry for 13 years as an executive. DeVore served as a Reagan White House appointee in the Pentagon from 1986 to 1988 as Special Assistant for Foreign Affairs. DeVore is a Lieutenant Colonel in the U.S. Army (retired) Reserve where he serves as an intelligence officer.

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