Texas: Lawmakers advancing legislation to phase out the franchise tax

David M. Kall | Thursday, May 4, 2017

Texas imposes a franchise tax on firms organized or doing business there, for the privilege of doing so. The rate is 3.75 percent for retailers and wholesalers, and 0.75 percent for others. The minimum threshold to trigger franchise tax liability is $1.11 million in gross receipts, and the deduction limit is $360,000.

Each taxable entity formed in Texas or doing business in Texas must pay it, but there are exceptions, like sole proprietorships and general partnerships.

A short history of the franchise tax

In January 2017, the Texas Comptroller of Public Accounts released a Sources of Revenue publication subtitled *A History of State Taxes and Fees in Texas, 1972 to 2016*). It revealed that for fiscal year 2016, the three largest sources of tax revenue were the sales tax, at 58.3 percent; the motor vehicle sales/rental taxes, at 9.5 percent; and the franchise tax, at 8 percent. Because the state does not have a corporate income tax, the franchise tax is the principal tax on business.

The publication acknowledges that over the years, revenue from the franchise tax has fluctuated, due to court challenges, base erosion, and tax planning opportunities. In 2006, because the schools were in need of additional funding, the legislature made a substantial change that expanded the types of business entities subject to it. In 2008, the franchise tax generated $4.5 billion in revenue, and in 2016, that amount was $3.88 billion. Between 1972 through 2016, the average annual growth rate of the tax rate itself, across the several tax bases and multiple rates, was 8 percent.

A new direction?

Now, in both the House and Senate, Lone Star State lawmakers are putting forth measures that would phase out, and ultimately eliminate, the franchise tax under certain conditions. In late March, the Senate passed their version, SB 17, and sent it to the House. Then, on April 28, the House version, by way of HB 28, passed by a vote of 96 to 39. This comes just two years after lawmakers imposed a franchise tax decrease that saved taxpayers about $2.6 billion during the current budget period, according to a *Texas Tribune* analysis titled “How current Texas lawmakers can boss future lawmakers around.”

The analysis points out that the franchise tax brings in about $7.6 billion each biennium, so continues to be a significant source of revenue for necessities like public education. Although its elimination would increase pressure on lawmakers to find money elsewhere, including the possibility of increasing property taxes, many support the legislation. They reason that limiting income and forcing spending cuts will result in smaller government.

But the analysis disparages lawmakers’ support for this particular revenue-reducing measure on the grounds that “the current officeholders get the party, and the next bunch gets to clean up… This set of politicians isn’t cutting spending…but their successors are either going to have to raise or create new taxes or make the spending cuts this Legislature doesn’t want to make.”

Similarly, the Center for Public Policy Priorities actively opposes the effort. In late March, in *SB 17: A time bomb that could blow up future state budgets*, the center explained the conditions that would trigger the revenue reduction: when the “comptroller’s biennial revenue estimate showed that general revenue related funds (available for certifying the budget) would grow by more than five percent in the next biennium. The tax rate would be cut by the amount needed to cut in half any revenue growth above the five percent cutoff.”

One problem with the plan is reducing revenue before spending needs are determined. The center discussed this issue as follows:

> Along with the “available revenue” limit, the budget is already constrained by a constitutional limit that caps growth in spending from undedicated tax revenue. The limit is linked to the growth in personal income in the state. Since 2001, personal income has grown by more than 11 percent each biennium. SB 17 would choke off state revenue if the Comptroller estimated it would grow less than half as fast.

In addition, “SB 17 would light the fuse on the tax cut before knowing how much damage it would cause.” This is so because

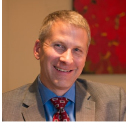
> the rate cut ‘bomb’ would be triggered by the Biennial Revenue Estimate in January, before the Legislative Budget Board presents a proposed budget, before the Appropriations and Finance Committees make any decisions about the need for state spending, and almost one full year before the new rate would take effect.

As the center observes, a future legislature would be unable to “defuse the time bomb before it automatically blows up that state budget.”

The House version, HB 28, is no better, declared the center in a late April piece. It contends that HB 28 could reduce state revenue by up to $3.5 billion in the 2020-21 and beyond.

On the other hand, the Texas Public Policy Foundation supports elimination of the franchise tax and testified about its flaws in a late February appearance before the Senate Finance Committee. In support of different legislation, SB 142, that would simplify the franchise tax calculation, the group stressed the “onerous” tax’s

complexity, substantial cost of compliance, and potential for litigation, forcing businesses to "spend more on the resources needed to comply with it than on their tax liability."



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Team member bio