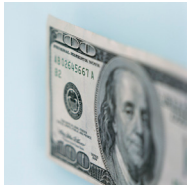


Texas Public Policy Foundation

The Margin Tax

Legislator's Guide to the Issues 2015-16

The Margin Tax



The Issue

In 2006, the Texas Legislature—under pressure from a Texas Supreme Court ruling declaring the state's school finance system unconstitutional—overhauled the state's corporate franchise tax and created the revised franchise tax, or "margin tax." While every tax comes with a cost, Texas' margin tax causes the most harm for each dollar raised and should be phased out and ultimately eliminated.

This new margin tax expanded the tax base to include all businesses enjoying state liability protection. It also introduced an entirely new method for calculating an entity's tax liability based on an entity's "taxable margin," calculated as the lowest of revenue minus the cost of goods sold, revenue minus compensation, or revenue times 70%.

Under these reforms, wholesalers and retailers, businesses that typically operate on a low profit margin, are subject to a rate half that of other businesses' 1% rate. This picks winners and losers through the tax code and it also creates tax "pyramiding"—business receipts taxed multiple times as they move through the economic chain—making the margin tax a very complex system.

In addition, the margin tax is a form of a gross receipts tax, meaning the tax is levied regardless of profitability such that business owners must still pay taxes even if they lose money. For obvious reasons, this can have a particularly damaging effect on small businesses.

Overall, the state's newly revised franchise tax is a poor and inefficient mechanism for generating state revenues and represents a tremendous burden for entrepreneurs and small businesses.

From these costly effects, the margin tax has not fulfilled its expectation among business and lawmakers to boost state revenues by about \$3 billion per year, create a simpler tax, and deliver meaningful property tax relief. This tax accounts for less than 10% of total state revenue yet has done untold economic damage by making it harder to run a business and more expensive once they are successful.

Studies modelling the dynamic fiscal and economic effects of repealing the margin tax find substantial economic benefits. These include tens of thousands of net new jobs created, billions in net new investment and personal income across Texas, increasing sales tax revenue that will more than make up the revenue loss from eliminating the margin tax.

Last session legislators took a good first step by passing HB 500 that provided about \$714 million in tax relief by making the \$1 million exemption for small businesses permanent and phasing in temporary cuts to the rates that expire in 2016.

Voters say legislators should do more. On the primary election ballot in March 2014, Proposition 3 asked voters whether legislators should "abolish the franchise tax to encourage business growth." Voters supported this measure by 9 to 1.

The margin tax is an inefficient form of taxation that presents both a financial and compliance burden on small businesses and the Texas economy. To further get the government off the backs of business and provide pro-growth measures, legislators should acknowledge this overwhelming voter approval and eliminate the margin tax.

The Facts

- Texas' margin tax is complex, costly, and difficult to comply with, giving rise to a less competitive business climate in the state.
- The margin tax has consistently underperformed. Collections have fallen below expectations in most years since its inception, partially resulting from legal tax avoidance strategies, a common issue with complex tax schemes.
- Texas does not have a revenue problem. From the 2004-05 to the 2014-15 biennia, the state's estimated total revenue growth is 71%, much faster than the 50% growth rate of population and inflation.

Recommendation

- Use the budget surplus to quickly buy down and eliminate the margin tax.

Resources

Conservative Coalition Letter to Governor Perry by Conservative Coalition, Texas Public Policy Foundation (May 2013).

The Texas Margin Tax & Its Impact on the State's Economic Competitiveness by Talmadge Heflin, James Quintero, and Robert McDowall, Texas Public Policy Foundation (Sept. 2012).

"Fixing" the Texas Margin Tax by Talmadge Heflin and Chuck DeVore, Texas Public Policy Foundation (Oct. 2012).

The Margin Tax Debunked: Dispelling Three Common Myths About Texas' Restructured Business Tax by Talmadge Heflin, James Quintero, and Lauron Fischer, Texas Public Policy Foundation (Nov. 2011).

