Texas Public Policy Foundation

Keeping Texas Competitive

A Legislator's Guide to the Issues 2013-2014

The Margin Tax ★Keeping Texas Competitive Priority

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."

Under this new taxing scheme, the base was expanded to include a greater number of Texas businesses enjoying state liability protection and an entirely new method for calculating an entity's tax liability was introduced, one based on the concept of an entity's "taxable margin."

Initially, it was hoped that these sweeping reforms would boost state revenues while also providing a mechanism to deliver meaningful property tax relief to businesses and homeowners. But in the few short years that the tax has been in place, it's failed to meet expectations.

In terms of performance, the tax has consistently failed to meet expectations. In fiscal 2008—the tax's first full year of collections—the margin tax generated $1.4 billion less than expected. In fiscal 2009, the revenue shortfall grew to $1.6 billion. And in both fiscal years 2010 and 2011, collections fell short of projections by $500 million annually.

For fiscal year 2012, collections exceeded expectations for the first time because of the improving economy.

Beyond its performance issues, the idea of a franchise tax is contradictory with the concept of a limited liability entity. Essentially, business owners are being punished for forming a limited liability entity—an option that encourages entrepreneurs to take necessary business risks.

In addition, the margin tax is a form of a gross receipts tax, so the tax is applicable regardless of the profitability of a business. For obvious reasons, this can have a particularly damaging effect on small businesses.

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

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. With the exception of the current fiscal year, collections have fallen below expectations every year since its inception, partially resulting from legal tax avoidance strategies, a common issue with complex tax schemes.
- The state's business tax is contradictory to the idea of a limited liability entity.

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- The margin tax is collected irrespective of a business' profitability.

- Texas does not have a revenue problem. From fiscal 1990 to fiscal 2010, the state's total revenue grew by 270.3%, much faster than inflation increases, 66.8%, or population growth, 48%, over the same period.

Recommendations

- Phase out the margin tax by 2018 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;

- Require any increase in the margin tax rate to be approved by two-thirds of all members of each house of the Legislature.

Resources

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

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

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