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Texas Margin Tax Experiment Failing Due to Collection Shortfalls, Perceived Unfairness for Taxing Unprofitable and Small Businesses, and Confusing Rules

By
Joseph Henchman

Texas's tax system has many notable aspects. The state imposes no individual income tax and no corporate income tax. Texans pay just 7.9 percent of their income in state-local taxes, 45th highest nationally and below the national average of 9.78 percent.[1] Their tax structure is the 13th most business-friendly in the country, according to our most recent *State Business Tax Climate Index*[2]. Texas's Tax Freedom Day[3]—the day of the year when Texans have paid all their federal, state, and local taxes—came on April 7, five days before the national Tax Freedom Day. Between 2000 and 2008 (the last year data is available), Texas faced a net inbound migration[4] of 586,000 individuals representing $12 billion worth of income.

One aspect of Texas's tax system faces strong criticism, however. In 2006, Texas faced a court mandate to boost education spending from a source other than local property taxes.[5] Taking the opportunity to replace the corporate income tax (known in Texas as the franchise tax) with a tax that reached pass-through entities such as limited-liability corporations and partnerships, the state enacted a tax on business "margin," a modified gross receipts tax and corporate income tax defined with some complexity as follows:

- Business taxpayers can choose one of three options for a tax base:
    - Total revenue minus cost of goods sold; or
    - Total revenue minus wages (limited to $300,000 per person) and benefits; or
    - 70% of total revenue.
- "Cost of goods sold" is specially defined by statute: excludes services, selling costs, distribution costs, advertising, taxes, and compensation
- Tax is 1%, with a special rate of 0.5% for retailers and wholesalers. (The unequal rate, intended to reduce the negative effects of tax pyramiding, may be challenged in court.)

Joseph Henchman is Vice President of State & Legal Projects at the Tax Foundation.

[1] http://www.taxfoundation.org/research/show/22320.html

[2] http://www.taxfoundation.org/taxdata/show/22661.html

[3] http://www.taxfoundation.org/taxfreedomday/

[4] http://interactive.taxfoundation.org/migration/

[5] *See* Chris Atkins, "Appropriation by Litigation: Estimating the Cost of Judicial Mandates for State and Local Education Spending," *Tax Foundation Background Paper No. 55* (Jul. 2007), at http://www.taxfoundation.org/files/bp55.pdf.

- Initially, the state had a discounted tax schedule for certain businesses:
  - Total revenue of less than $300,000: no tax liability.
  - Revenue between $300,000 and $400,000: pay 20% of tax liability.
  - Revenue between $400,000 and $500,000: pay 40% of tax liability.
  - Revenue between $500,000 and $700,000: pay 60% of tax liability.
  - Revenue between $700,000 and $900,000: pay 80% of tax liability.
- After an initial outcry from small business, all businesses with revenue of less than $1 million are exempt from the tax. Beginning in fiscal 2012, the exemption falls to $600,000, but extension of the existing exemption is likely.
- Taxable entities with less than $10 million can instead elect to pay 0.575% of total revenue multiplied by Texas's apportionment factors.
- No tax liability if tax due is less than $1,000.
- Tax owed on the Texas apportioned share of combined reported profits from all related business entities.

While it was enacted in 2006, officials proceeded cautiously with the untried tax. Large businesses were required to file informational returns as if they were paying the tax; the tax took effect in full beginning in 2008. Texas officials projected the tax would raise $5.9 billion per year (with some suggesting as much as $12 billion per year), but the 2006 information returns suggested it would raise barely $5 billion.[6] In 2008, the tax raised just $4.45 billion, and collections fell under $4 billion in 2009.[7] The eliminated corporate income tax raised $2.5 billion per year.[8]

Far from solving the problems of the previous corporate franchise tax, the margin tax seems to have only aggravated them. The tax was designed to reach businesses not reached by the corporate income tax, including partnerships, unprofitable businesses, and small businesses. As the tax was enacted, however, legislators expanded exclusions in the face of arguments that hefty tax compliance costs on small businesses were disproportionate.[9] Calls for additional exclusions, such as on unprofitable businesses, continue, and the state may well end up with something resembling its old corporate franchise tax but with added complexity. At the same time, over 18,000 taxpayers that had paid franchise tax reported no liability under the new tax.[10] In 2009, the Texas House Ways and Means Committee struggled with over 100 proposals to modify the tax, greatly increasing legislative workloads for a session that lasts only five months every other year.[11] These ongoing changes result in taxpayer confusion and aggravate the margin tax's shortfall in collections.

Significant wrangling has occurred over the vague definition of "cost of goods sold." Associate Deputy Comptroller Mike Reissig points to this as the main reason for the tax's underperformance.[12] Texas permits numerous items as "cost of goods sold" that differ from federal tax rules, many of which were directly added when the legislation was enacted. Reissig reported that tens of thousands of taxpayers have taken "cost of goods sold" deductions they were not eligible for, under state law.[13]

Other issues have included taxpayer confusion, increased compliance costs, and a lack of guidance for the peculiar definitions and rules under what is essentially a brand new type of tax. Jon Hoke, of the Texas chapter of the National Federation of Independent Business (NFIB), seeks the margin tax's repeal because in the group's view it is "crippling the small and mid-sized businesses without bringing in what [legislators] thought."[14] The NFIB is also concerned that the 1 percent tax rate will rise

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[6] *See* Billy Hamilton, "The Texas Margin Tax Falls Short of Projections," *State Tax Notes* (Dec. 22, 2008).
[7] Billy Hamilton, "The Tax That Fell to Earth: Lessons From the Texas Margin Tax's Launch," *State Tax Notes* (Sep. 6, 2010) at 671.
[8] *See* David Bowser, "New tax for businesses called 'taxpayer's nightmare,'" *Pampa News* (Oct. 17, 2006).
[9] Billy Hamilton, "Cosmetic Surgery for the Texas Margin Tax," *State Tax Notes* (Apr. 27, 2009), at 327.
[10] *See* Hamilton, "The Tax That Fell to Earth: Lessons From the Texas Margin Tax's Launch," *State Tax Notes*.
[11] Hamilton, "Cosmetic Surgery for the Texas Margin Tax," *State Tax Notes*, at 327.
[12] Hamilton, "The Tax That Fell to Earth: Lessons From the Texas Margin Tax's Launch," *State Tax Notes*, at 673.
[13] *Id.* at 674.
[14] Paul Wiseman, "NFIB Calls Texas' Business Margin Tax a 'Lose-Lose' Situation," *Midland Reporter-Telegram* (Apr. 6, 2011).

due to the collections shortfall, as is the Texas Retail Association (whose members pay 0.5 percent).[15] Dale Craymer of the Texas Taxpayers and Research Association has said that "[f]rom a taxpayer standpoint, it isn't as simple as it was conceived, and from an economic standpoint, it's controversial."[16]

Noted tax academic John Mikesell has referred to the Texas margin tax as a "badly designed business profits tax…combin[ing] all the problems of minimum income taxation in general—excess compliance and administrative cost, penalization of the unsuccessful business, undesirable incentive impacts, doubtful equity basis—with those of taxation according to gross receipts."[17]

With the Texas margin tax collecting far less in revenue than expected, causing significant confusion and compliance costs, resulting in significant litigation and controversy over "cost of goods sold" definitions, and facing calls for substantial overhaul and even repeal, it should not be used as a model tax reform for any other state.

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National Press Building
529 14th Street, N.W., Suite 420
Washington, DC 20045
202.464.6200
www.TaxFoundation.org

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[15] Samantha Stone, "Word From Texas: Margin Tax is a Work in Progress, Not Meeting Projections, Likely Headed for Major Reform," Nevada News Channel (May 6, 2011).

[16] *Ibid.*

[17] John L. Mikesell, "Gross Receipts Taxes in State Government Finances: A Review of Their History and Performance," *Tax Foundation & Council on State Taxation Background Paper No. 53* (Jan. 2007), at 4 n.6, http://www.taxfoundation.org/research/show/2180.html.