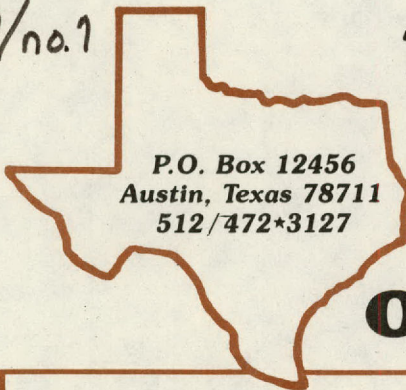


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# TEXAS RESEARCH LEAGUE

# BULLETIN

## on Texas State Finance

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— Jared E. Hazleton, President

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### RESTRUCTURING THE FRANCHISE TAX

The keystones of Comptroller Bob Bullock's revised plan for restructuring the Texas tax system are (1) broadening the sales tax base to include personal, business and professional services, and (2) restructuring the corporation franchise tax. This Bulletin will be devoted to a description of the major elements of the franchise tax proposal; a subsequent Bulletin will discuss the sales tax plan.

#### BACKGROUND

The franchise tax, which is paid by corporations for the privilege of doing business in Texas, has remained essentially unchanged, except for rate increases, since first enacted 80 years ago. Currently it is based on a rate of \$5.25 per \$1,000 of capital and surplus allocated to Texas.

Since it is based entirely on capital investment, the major burden of the tax, as illustrated below, falls on capital intensive industries such as oil and gas, manufacturing and utilities. The burden on these industries is disproportionately higher than their corresponding share of total corporate receipts in Texas.

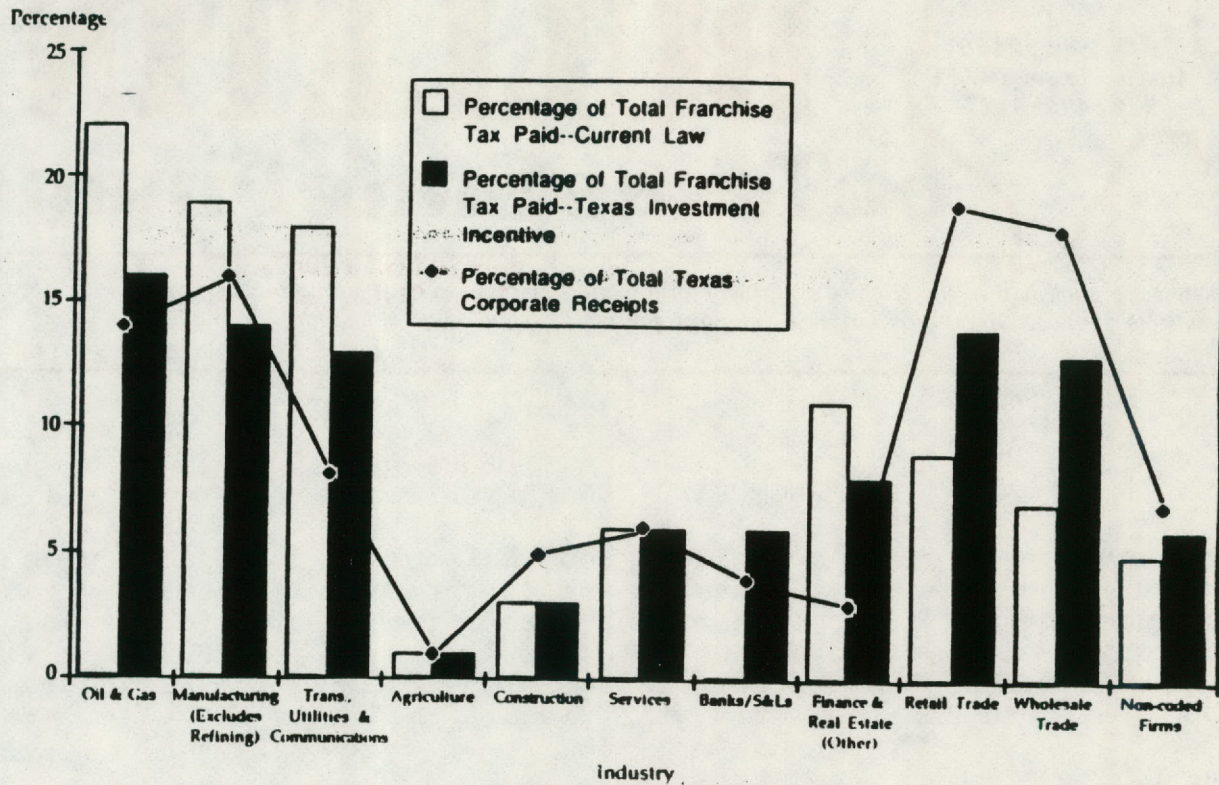
In contrast, the portion of franchise taxes paid by less capitalized businesses, such as those in the retail and wholesale sectors, is substantially below their percentage share of total corporate receipts.

The major thrust of the Comptroller's franchise tax proposal, which he calls the Texas Investment Incentive, would be to spread the total franchise tax burden among all industries in a manner which more closely matches their relative share of Texas corporate receipts. This shift in overall tax burden would be accomplished by making gross receipts a part of the tax liability calculation. A before and after comparison of franchise tax burden by industry is shown in the chart on page 2.



# Comparison of Franchise Tax Paid by Industry

## Texas Corporate Receipts vs. Franchise Tax Burden



SOURCE: Bob Bullock, Comptroller of Public Accounts

### TAX RATE

The basic franchise tax rate of \$5.25 per \$1,000 of capital and surplus would remain unchanged. However, each corporation's total tax rate would be determined by multiplying the basic rate by a tax rate multiplier based upon the relationship between Texas gross receipts and capital investment.

The first step would be to determine a ratio according to the following formula:

$$\frac{A}{B + 2C} = \text{RATIO}$$

A = gross receipts from business done in Texas  
 B = taxable capital allocated to Texas  
 C = annual capital equipment purchases for use in Texas

The procedure for determining Texas gross receipts and allocating taxable capital to Texas would be the same as under current law. Capital equipment purchases in the relevant accounting year would include tangible personal property used for more than six months and improvements to real property that are depreciable for federal income tax purposes.



The resulting ratio then would be found in a tax rate multiplier table to determine the figure to be multiplied by the basic rate. Any ratio of 5.6 or less would result in a multiplier of 1.0 and produce no increase in the basic \$5.25 tax rate. Ratios above 5.6 would result in progressively higher multipliers up to a 10.0 maximum for ratios of 12.0 or more -- thereby producing a maximum tax rate of \$52.50.

Thus, the new tax rate formula would lessen the reliance on capital investment in the calculation of franchise tax liability by giving greater weight to sales in Texas. It also would reward firms that make new or additional capital investments in Texas.

The overall effect of the new tax formula would be to shift a greater portion of the total franchise tax burden to less capital intensive businesses. As a corporation's gross receipts relative to capital investment increases, its franchise tax liability grows. (The box below shows the tax calculation for two example corporations.)

The Comptroller reports that, instead of being based entirely on capital investment, the proposed franchise tax in total would be based about 70% on capital and 30% on gross receipts. This distribution of the tax would vary considerably for individual corporations, of course, depending on the relationship between their capital and gross receipts.

The proposal also would eliminate the current \$68 minimum tax provision, and no taxes would be due if a corporation's calculated tax liability is less than \$68. Thus, over 90,000 firms (those with less than \$13,000 of taxable capital) who now pay the minimum would be relieved of any tax liability.

\*\*\*\*\* FRANCHISE TAX CALCULATION FOR TWO EXAMPLE CORPORATIONS \*\*\*\*\*

CORPORATION A: Manufacturer

Sales (100% in-state)	= \$100 million			
Capital & Surplus	= \$ 20 million	Ratio =	$\frac{\$100M}{\$20M + 2 (\$5M)}$	= 3.33
New Capital Investment	= \$ 5 million			

Multiplier for Ratio of 3.33 (from table) = 1.0  
 Tax Rate = 5.25 X 1 = \$5.25 per \$1,000 of capital & surplus  
 Taxes Due = 5.25 X 20,000 = \$105,000 (same as under current law)

CORPORATION B: Retailer

Sales (100% in-state)	= \$100 million			
Capital & Surplus	= \$ 8 million	Ratio =	$\frac{\$100M}{\$8M + 2 (\$1M)}$	= 10.0
New Capital Investment	= \$ 1 million			

Multiplier for Ratio of 10.0 (from table) = 4.75  
 Adjusted Tax Rate = \$5.25 X 4.75 = \$24.94 per \$1,000 of capital & surplus  
 Taxes Due = 24.94 X 8,000 = \$199,520 (\$42,000 under current law)



## BANK FRANCHISE TAX

Prior to 1985 banks were exempt from the franchise tax and bank stock was subject to property taxation by local governments. Bank stock was virtually the only intangible property in Texas subject to property taxation. - In response to a U.S. Supreme Court decision invalidating the method used to value bank stock because it did not allow for the exclusion of tax exempt federal securities in the valuation process, legislation was adopted eliminating property taxes on bank stock. To replace the lost property tax revenue, banks were made subject to the franchise tax and bank franchise tax receipts were allocated back to local governments based on their relative property tax rates.

Under the proposed plan, the allocation of bank franchise taxes to local governments would be eliminated; the state would retain such receipts. To replace the resulting revenue lost by local governments, the property taxation of bank stock would be reinstated.

The valuation of bank stock would be made to comply with federal law by prescribing the use of a proportionate method of deduction for exempt U.S. government obligations -- a method which has been validated by the Supreme Court. The amount of the deduction would be determined by multiplying the value of the bank stock by a ratio derived by dividing the total amount of federal obligations by the bank's total assets. The resulting amount plus the market value of the bank's real property would be subtracted from the actual cash value of the bank's stock to arrive at the taxable value of bank shares.

## GAAP REPORTING

The calculation of a corporation's surplus would be required to be made in accordance with Generally Accepted Accounting Principles (GAAP) whenever possible. Where GAAP is silent, the Comptroller would specify the reporting method to be used. Corporations with less than \$1 million in surplus would be allowed to use the method of accounting used for federal income tax purposes. Certain other reporting requirements would be mandated, including the use of the successful efforts or full cost method of accounting for reporting oil and gas exploration and production activities.

## REPEALERS

A number of current franchise tax provisions which provide deductions, special rates or exemptions for certain types of corporations would be eliminated. Among the exemptions removed would be those for savings and loan associations, railway terminal corporations and solar energy corporations.