LEGISLATIVE BUDGET BOARD
Austin, Texas

FISCAL NOTE, 79TH LEGISLATURE 3rd CALLED SESSION - 2006

April 20, 2006

TO: Honorable Jim Keffer, Chair, House Committee on Ways & Means

FROM: John S. O'Brien, Deputy Director, Legislative Budget Board

IN RE: **HB3** by Keffer, Jim (Relating to the franchise tax; making an appropriation; providing penalties.), **As Introduced**

Estimated Two-year Net Impact to General Revenue Related Funds for HB3, As Introduced: a negative impact of ($2,000,000) through the biennium ending August 31, 2007.

Appropriations:

Fiscal Year	Appropriation out of *GENERAL REVENUE FUND* 1
2006	$0
2007	$2,000,000

General Revenue-Related Funds, Five-Year Impact:

Fiscal Year	Probable Net Positive/(Negative) Impact to General Revenue Related Funds
2007	($2,000,000)
2008	$3,441,457,421
2009	$3,509,252,314
2010	$3,777,544,314
2011	$4,025,851,877

All Funds, Five-Year Impact:

Fiscal Year	Probable Revenue Gain/(Loss) from *GENERAL REVENUE FUND* 1	Probable Savings/(Cost) from *GENERAL REVENUE FUND* 1	Change in Number of State Employees from FY 2005
2007	$0	($2,000,000)	22.3
2008	$3,445,209,000	($3,751,579)	55.8
2009	$3,512,933,000	($3,680,686)	55.8
2010	$3,781,225,000	($3,680,686)	55.8
2011	$4,029,050,000	($3,198,123)	55.8

Fiscal Analysis

The bill would amend Chapter 171 of the Tax Code to modify the franchise tax rate and base. In addition, the bill would make an appropriation.

The bill would extend tax responsibility to certain types of partnerships and other business entities that

are not currently subject to the tax. However, sole proprietorships and general partnerships directly owned by natural persons only would remain exempt from the tax. In addition, the term "taxable entity" would exclude businesses meeting the bill's definition of a passive entity or those currently exempt under Subchapter B of Chapter 171. An entity currently subject to the franchise tax that would become exempt under this bill because it is a passive entity would not owe the additional tax imposed by Section 171.0011. A taxable entity with total gross receipts of less than $300,000, or an annual tax liability of less than $100, would owe no tax.

The bill would replace the current franchise tax base of taxable capital and taxable earned surplus with a new base, called "taxable margin." To arrive at its taxable margin, a firm would first have to calculate its "total margin" as the minimum of three values: 1) 70 percent of total revenue, 2) total revenue minus cost of goods sold, and 3) total revenue minus total compensation and benefits. "Taxable margin" would be total margin apportioned to Texas using a gross receipts ratio similar to the current franchise tax plus any margin allocated to this state.

The tax rate on taxable margin would be 1.0 percent for taxable entities not primarily engaged in wholesale or retail trade, as defined in the bill. For taxable entities primarily engaged in wholesale or retail trade, the tax rate would be 0.5 percent.

Taxable entities that qualified as "health care providers," other than "health care institutions" under this bill would be allowed to deduct from total revenue all payments received from certain health insurance programs, plus their actual costs of uncompensated care. Those taxable entities that qualified as "health care institutions" under the bill would be allowed to deduct 50 percent of their payments from qualifying health insurance program payments and uncompensated care costs. The health insurance program payments that could be deducted would include those from Medicare, Medicaid, the Children's Health Insurance Program, workers' compensation, and the TRICARE military system.

The bill contains a section, titled "Determination of Cost of Goods Sold", with definitions of certain terms, including "goods," "production," and "tangible personal property." This section would identify certain costs that would be included in the cost of goods sold and other costs that would not be included in cost of goods sold.

The bill contains a section, titled "Determination of Compensation," defining "wages and cash compensation" to include net distributive income from certain types of entities distributed to natural persons and stock awards expensed for federal income tax purposes and stock options exercised during the tax year. A taxable entity electing to deduct compensation would be allowed to deduct wages and cash compensation and the cost of all benefits provided to employees, officers, and owners, to the extent deductible for federal income tax purposes. The amount of compensation that could be deducted for any person could not exceed $300,000.

The bill would instruct the Comptroller to use the consumer price index to adjust the $300,000 limits for compensation deductions and gross receipts taxability at the beginning of each odd-numbered year, beginning in 2009.

The bill would alter the manner in which certain members of an affiliated group must report franchise tax. Under current law, all taxable entities report on a stand-alone basis, with no combining of revenue or expenses with other taxable entities. Under this bill, a group of two or more taxpayers would have to report as a single taxable entity if two conditions applied: 1) the entities were in an affiliated group defined by a common ownership test, and 2) the entities were engaged in a unitary business, as defined in the bill. The bill specifies the methods such a taxable entity would employ to calculate total revenue, cost of goods sold, and total compensation. The bill would allow a combined group to include an exempt entity in the group report if the entity would have been in the combined group were it not exempt.

The apportionment of taxable margin for a combined group would include in the factor for gross receipts in Texas the gross receipts of each entity that was a member of the group and that had nexus with Texas. The factor for gross receipts everywhere would include the gross receipts of all members of the combined group without regard for whether the entity had nexus with Texas. In addition,

transactions among members of the combined group eliminated in the calculation of total revenue, cost of goods sold, and compensation would be eliminated from the numerator and denominator of the apportionment ratio. An exception to the exclusion of receipts from transactions among members of the combined group would occur if the transaction involved tangible personal property and one party to the transaction had nexus with Texas, but the other party did not have nexus.

The bill would transition existing franchise taxpayers to the new base and tax rates beginning with the franchise tax report due in May 2008. A taxpayer's liability would be based on the taxpayer's taxable margin during the accounting year that ended in calendar 2007.

Taxpayers becoming subject to the franchise tax because of this bill would have to file an initial information report. Such an entity doing business in Texas before January 1, 2008 would have to file an annual report on May 15, 2008, based on a period specified in the bill.

Taxpayers subject to the franchise tax in its current form at any time after December 31, 2006, but not subject to the franchise tax on January 1, 2008, would have to file a final report based on a period specified in the bill.

The franchise tax credits existing under current law would be repealed. Franchise tax credits that had been earned but not used by the effective date of the bill could be used to reduce franchise tax liability after the effective date if the credits earned had carry-forward provisions in existing law and the carry-forward period were still open for the taxpayer who earned the credits.

The bill would direct the Comptroller to require specified entities to file an information report by February 15, 2007, with no possibility of extension. The information report would contain the information the entity would have provided on its 2006 report if the provisions of this bill had been in effect for the period covered by the 2006 report. The entities that would have to file the information report would include: the 1,000 entities with the largest franchise tax liability for the reporting period ending December 31, 2005; the 1,000 entities with the largest amount of total gross receipts; and the 1,000 entities doing business in this state with the greatest number of employees.

The bill would provide that a lawsuit by an entity subject to the tax contending that the imposition of the tax on the entity was unconstitutional be brought in a district court in Travis County. The bill would provide that the decision could be reviewed only by direct appeal to the Supreme Court.

The bill would appropriate $2 million to the Comptroller's Office for the biennium ending August 31, 2007, for implementation of this bill and for audit and enforcement purposes.

The bill would take effect January 1, 2008; and its provisions would apply to reports due on or after that date. The sections of the bill relating to information reports, the venue of a law suit, and the appropriation of funds to the Comptroller would take effect June 1, 2006, if the bill received two-thirds votes of all members in each house. Otherwise, those sections would take effect September 1, 2006.

Methodology

The estimate was based on data from the Internal Revenue Service's Statistics of Income publications and from information in the Comptroller's franchise tax data files.

The administrative cost estimate for fiscal 2007 reflects the funds that would be necessary for initial implementation of this bill and for audit and enforcement purposes. The estimates for the subsequent years reflect the funds that would be necessary to handle the additional workload due to the expansion of the tax base.

It is anticipated that the overall fiscal impact on the Secretary of State (SOS) will be minimal. Although a reduction in the number of Public Information Report transactions processed annually will result in some savings to the SOS each year the bill is in effect, these savings will be offset by the additional costs incurred by the anticipated increase in the number of involuntary termination/revocation transactions that will required of the SOS each year the bill is in effect.

The bill would create additional workload demands on the Office of Attorney General's (OAG) Taxation division because it changes the franchise tax base and imposes the new tax on most business entities. The current franchise tax is imposed only on corporations and limited liability companies.

The future case load resulting from the passage of this legislation is unknown and difficult to predict. The OAG anticipates any additional legal work in 2006 resulting from the passage of this bill could be reasonably absorbed with current resources. However, the OAG may request additional resources for 2007-2010 through the regular budget process as workload trends mature as a result of the passage of this bill.

This analysis assumes the bill will be effective 90 days after passage.

Technology

There would be a technology cost to the Comptroller’s Office of $786,554 in fiscal 2007 for programming changes and computer costs. In fiscal 2008, $709,773; fiscal 2009-10, $707,273; and fiscal 2011, $224,720 would be necessary for computer costs.

Local Government Impact

No fiscal implication to units of local government is anticipated.

Source Agencies: 302 Office of the Attorney General, 304 Comptroller of Public Accounts, 307 Secretary of State

LBB Staff: JOB, SD, SM