

SUBJECT: Constitutional amendment limiting the rate of the franchise tax

COMMITTEE: Ways and Means — committee substitute recommended

VOTE: 8 ayes — Craddick, Finnell, Heflin, Holzheuser, Horn, T. Hunter, Marchant, Place

2 nays — Oliveira, Romo

1 absent — Wolens

WITNESSES: For — Robert Howden, National Federation of Independent Business of Texas

Against — Charles Holt, Common Cause

BACKGROUND: The franchise tax is a privilege tax, paid by corporations in exchange for specific privileges granted by the state. These privileges include access to the state's legal system, treatment as a legal "person" and limitation of personal financial liability for officers of the corporation.

Adopted in 1907, the franchise tax is one of Texas' oldest revenue sources. Corporations, including closely held corporations, banks and limited liability companies doing business in Texas pay the tax, but non-corporate business entities such as partnerships, associations and proprietorships do not.

Franchise tax gross collections have risen steadily in the past several years, totaling \$1.48 billion in 1994, \$1.38 billion in 1993 and \$1.24 billion in 1992. The franchise tax represents approximately 7 percent of the state's total tax receipts.

In 1993, the last complete year of reporting, approximately 313,000 firms were subject to the tax. More than one-half of these firms had no tax liability. A relatively small number of large firms pay the bulk of the total tax burden. The top 10 percent of taxpaying firms pay about 90 percent of the total tax levy.

HB 11 by Hury, enacted during the 72nd Legislature's first special session, made the franchise tax applicable to the earned surplus (income) of corporations. Instead of being levied solely on net capital assets, the franchise tax is now levied either on capital assets or income, depending upon which yields the greatest tax liability.

The tax burden on capital assets was reduced by more than half when the tax rate applicable to net taxable capital was cut from 0.525 percent to 0.25 percent, and the tax on income was set at 4.5 percent. Corporations with less than \$100 in tax liability owe no taxes, but still must file a report.

DIGEST:

CSHJR 36 would amend Article 8 of the Texas Constitution by adding sec. 25 to limit the franchise tax rate to 4.5 percent on income, and 0.25 percent on capital assets.

The limit, which would apply to any tax on the privilege to operate as a legal entity that has a component determine by income or stated capital or assets, would cap the rate on the utility gross receipts tax, the oil well servicing tax and the gas utilities administration tax.

The proposal would be presented to voters at an election on November 7, 1995. The ballot proposal would read: "The constitutional amendment to limit the tax rate on the income and stated capital or asset components of the franchise tax."

**SUPPORTERS
SAY:**

HJR 20 would cap the income and capital assets components on the franchise tax at their current level: 4.5 percent on income and .025 percent on capital assets. These rates are a result of the franchise tax reform measures of 1991. The effect of the revisions has been increased revenues, a stabilized tax base, and a more even distribution of the tax burden.

Constitutionally freezing the franchise tax rate would reassure the business community that it could plan for the future with a stable tax rate. Any future attempt to raise the franchise tax rate would require a two-thirds vote from both houses of the Legislature and voter approval.

Revenues to the state from the franchise tax have been steadily increasing; no decrease in revenue from the tax is expected in the foreseeable future.

The people of the state have sent a message to the Legislature to demonstrate discipline and to operate within present revenues. Now is the time to cap the franchise tax rate.

Capping the franchise tax rate would by no means increase the chances for a state personal income tax. The franchise tax represents only 7 percent of the total tax receipts for the state. Economic growth, significant increases in federal receipts, tax collections, and lottery proceeds continue to help boost state finances. The Legislature did not raise taxes two years ago and will not do so this session either. The decision to adopt a personal income tax involves different economic factors unrelated to the corporate franchise tax.

The Legislature would retain the flexibility to raise additional revenue from the franchise tax by redefining the tax base. But the business community would know that, however broadly the income or assets base may be defined, the tax rate will be capped.

A floor amendment will be offered that would make the proposal revenue neutral. The amendment would specify that the constitutional provision would not affect any existing temporary credit that might produce an effective rate higher than the rate cap.

**OPPONENTS
SAY:**

This proposal would impose an inflexible constitutional cap on the franchise tax rate. Capping the rate on one particular tax would only increase the pressure on other taxes to generate necessary revenue, possibly increasing the chances of a state personal income tax.

It does not make financial sense to put specific tax rates into the Constitution. Legislators are elected to make difficult budgetary decisions and to set tax rates sufficient to fund the needs of the people of the state. Putting a specific tax rate in the Constitution would tie the hands of future legislatures and greatly reduce the flexibility needed to fund needed programs.

While the gross tax revenues have recently been increasing, just a few years ago the franchise tax revenues were declining. The tax is by no means stable and is susceptible to large fluctuations in revenue to the state.

This proposal is being presented as a way to help small businesses, but the numbers show that one-half of corporations pay no franchise tax, and that 10 percent of taxpaying firms pay about 90 percent of the total tax levy. This proposal would only help big businesses by limiting their tax responsibility.

The 73rd Legislature enacted and the voters approved Proposition 4, which requires that at least two-thirds of the money from a state personal income tax would go to reduce property taxes. But over 60 percent of the money from a reduction in property taxes would go to corporations. With Proposition 4, and the cap on the corporate franchise tax, corporations stand to reap tremendous tax subsidies paid for by working Texans.

The fiscal note raises the possibility that the tax cap in CSHJR 20 could be interpreted as applying to oil and gas production taxes, which could produce a significant revenue loss.

NOTES:

The original version of HJR 20 capped only the income component of the franchise tax.

A revised fiscal note estimated revenue loss from CSHJR 20 at \$3 million to \$51.5 million a year due to a tax credit that involves payment of a 0.45 percent tax on assets, which is 0.2 percent higher than the maximum rate in the proposal. Rep. Corte said he planned to offer a floor amendment that would eliminate any loss of tax revenue.

HJR 36 by Corte, which would have limited the income component of the franchise tax to 4.5 percent, passed the House during the 1993 regular session of the 73rd Legislature but died in the Senate Finance Committee.