THE TEXAS MARGIN TAX; LOOKING FORWARD

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FUTURE OF STATE BUSINESS TAX REFORMS

CHICAGO, ILLINOIS

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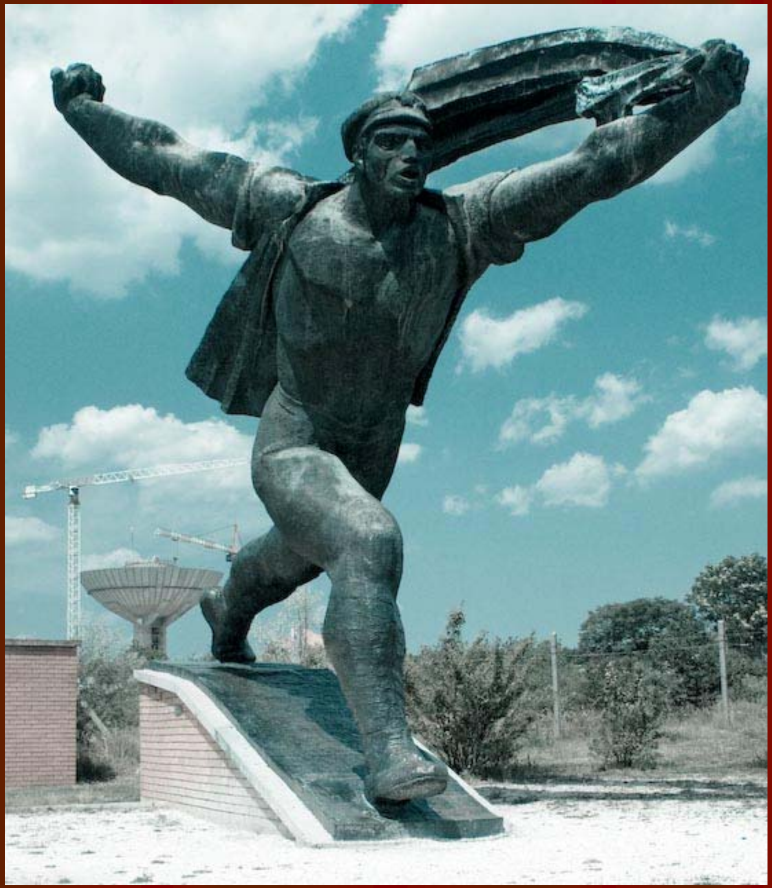

"THIS TAX IS . . .
MORE A BADLY DESIGNED BUSINESS PROFITS TAX, LIKE THOSE THAT EMERGED IN THE NEWLY INDEPENDENT STATES OF THE FORMER SOVIET UNION, THAN EITHER TRADITIONAL OR NEWER GROSS RECEIPTS TAXES."

– JOHN MIKESELL

HOW THE MARGIN TAX CAME TO BE

- Proposed reform and stalemate
- The Sharp Commission
- The Proposal: A weird three-legged stool—the margin tax, the cigarette tax and the “liar’s affidavit”

KEY GOALS

- Reduce local school property taxes.
- Eliminate franchise tax planning opportunities by reaching more forms of business and requiring combined reporting.
- To provide a "choice" of tax bases.

THE CHANGE

- The current franchise tax is repealed after this year.
- It will be replaced by the new franchise or margin tax starting in 2008.
- The tax base changes from "earned surplus" to net margin.
- Rate reduced to either 0.5% (retailers and wholesalers) or 1%--everyone else, although the effective maximum rate is 0.7%.

OVERVIEW OF THE TAX

- The Margin Tax is a broad-based, “low-rate” business privilege tax measured by a business’ net margin.
- Tax is imposed on all “persons,” which includes businesses large and small, however organized, and whether engaged in manufacturing, retail, services or other industries.

WHO PAYS

- Corporations (including banking corporations)
- Limited liability companies
- Partnerships
- Limited & Limited Liability Partnerships
- Professional Associations
- Savings & Loan Associations
- Joint Ventures/Joint Stock Companies
- Holding Companies

WHO DOESN'T PAY

- Sole proprietorships
- General partnerships owned entirely by natural persons
- Entities exempt under Subchapter B of Chapter 171 of the tax code (insurance companies, nonprofits)
- Certain unincorporated passive entities
- Grantor trusts, estates of natural persons, escrows
- Passive investment partnerships
- Certain family limited partnerships
- REITs & REMICs (real estate mortgage investment conduits)
- Certain non-business passive entity trusts

TAX BASE

<u>Lesser</u> of the following:

- 70% of Total Revenue OR
- Total revenue minus costs of goods sold
- **OR** total revenue minus compensation (wages and benefits)
- Taxable entity has choice of COGS or compensation
- Same election (i.e., COGS or compensation) applies to all members of combined group

TAX RATE

- 0.5% for entities *primarily* engaged in wholesale and retail trades and under Major Group 58 (eating and drinking places)
- 1% for all other entities subject to tax
- *NEW*: Businesses with less than $10 million in receipts may opt to pay a simpler 0.575% gross receipts tax.
- Majority voter approval via statewide referendum required for any increase to rate.

SMALL BUSINESS

- No tax on sole proprietors.
- No tax due if tax due is less than $1,000.
- Businesses with under $300,000 in revenues pay nothing regardless of form.
- Businesses with from $300,000 to $900,000 in receipts will get a discounted margin tax:
  - $300K-400K—80%
  - $400K-500K—60%
  - $500K-700K—40%
  - $700K-900K—20%

COMBINED REPORTING

- Combined reporting is new for Texas
- Taxable businesses that are part of an *affiliated group* must combine
- An affiliated group is:
  - A group of one or more businesses
  - With *more than 50%* controlling interest, either corporate or non-corporate, or by one or more of the member businesses
  - Tax is calculated as though it were a single, unitary business
  - Receipts from transactions among members are excluded

LOOKING AHEAD

- The tax is projected to raise just under $6 billion the first year, increasing thereafter.
- This is more than double current tax collections.
- Different effects on different industries.
- Some industries, with the new tax and the property tax reductions, will see reductions. Others—huge increases—services.
- Businesses will pay tax <u>regardless</u> of profitability.
- The change adds 200,000 new filers.

CHALLENGES TO THE FIVE-YEAR PLAN

- Plan didn’t adequately finance property tax cuts—up to **$25 billion** short over 5 years.
- Future depends on savings, economic growth and underestimates of tax gains.
- Margin tax gains have been reduced once already with another reduction possible based on taxpayer surveys.
- School property tax problems.

THANK YOU