Presentation to the

Senate Finance Subcommittee on Public Education Funding

Franchise Tax Overview

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Franchise Tax Overview

Franchise Tax Revenue

($billions)

Fiscal Year	Revenue ($Bill)	Tax as Pct of GSP	Percent of All Taxes	
2005	$2.17	.23%	7.3%	Earned Surplus/ Tax Cap
2006	$2.61	.25%	7.8%	
2007	$3.14	.28%	8.5%	
2008	$4.45	.37%	10.8%	Margin
2009	$4.25	.35%	11.2%	
2010	$3.86	.31%	10.9%	

Source: Comptroller of Public Accounts 2010 Annual Cash Report

Franchise Tax Overview

Franchise Tax Margin Base

Report Years 2008 and 2009 Results-Detailed Analysis

Expected				Unexpected			
	Estimate	Actual 2008	Actual 2009		Estimate	Actual 2008	Actual 2009
Apportionment Ratio	6.52%	6.62%	NA*	Percentage of Texas Revenue Reported using COGS ($1,844 billion Est.) ($2,098 billion Actual)	80%	85%	86%
Texas Revenue ($ Bill)	1,844	$2,098	$2,405	Deduction Share for COGS Deductors	68%	82%	84%
Overall Tax Rate	0.89%	0.89%	0.89%	Deduction Share for Compensation Deductors	45%	55%	55%
Credits/Discounts	$380 mil.	$370 mil.	$285 mil.	Annual Cost of Temp Credit	$40 mil.	$80 mil.	$80 mil.
* Updated federal data needed for 2009 calculation.							

Franchise Tax Overview

Fiscal 2009 Franchise Tax Paid
by deduction type ($mil.)

Deduction	Tax Paid*	Deduction as Percent of Total Revenue
COGS	$2,667	84%
70%	749	30%
Compensation	682	55%
EZ	239	43%**
Total	$4,337	

*Does not include effects of refunds and other adjustments. (Slide 2 is net.)

**Percent equivalent deduction at one percent tax rate.

Franchise Tax Overview

Why was COGS unexpectedly large?

- Statutory definition of COGS in Tax Code 171.1012(c) includes very broad language such as "all direct cost of acquiring or producing the goods" and is expanded in other sections of the code.
- Broad definitions for not only COGS but also tangible personal property (goods) means that costs for certain industries that don't usually calculate COGS may qualify for COGS deduction. However, these same industries may not calculate COGS in any other context, thereby creating no data for revenue estimation.
- Examples of COGS that are allowed for deduction under the franchise tax that are not allowed as COGS under the Internal Revenue Code (IRC) are:
    - Current year expensing of certain business assets (IRC Section 179 expenses)
    - Research and development costs
    - Geological and geophysical costs incurred to locate property that has potential to produce minerals
    - Intangible drilling costs and dry hole costs

Franchise Tax Overview

Phases of Franchise Tax Administration

- 2006 to 2008—Initial Rule Development, Frequently Asked Questions, Form Development, System Development, Webinars and Live Training.
- 2008 to Present—Enforcement actions that have produced $440 million of revenue in excess of that originally remitted through voluntary compliance.
- 2009 to Present—Audit coverage (see later slides).
- 2011—System enhancements to improve electronic filing opportunities.

Franchise Tax Overview

Resources Devoted to Audit Coverage

- Franchise Tax Auditors
  - 18 Fulltime field auditors
  - 8 Fulltime desk auditors
  - 28 part time out-of-state auditors
  - 227 part time single entity auditors
- Audits Complete and in Progress
  - 1,907 Field audits complete
  - 4,487 Desk audit complete
  - 6,394 Total audits complete
  - 360 Desk audits in progress
  - 2,471 Field audits in progress
  - 2,831 Total audits in progress

Franchise Tax Overview

Audit Issues and Assessments

The current audit effort is a two-pronged approach between near-term desk audits that are mostly on an issue by issue basis and long-term full audits of large taxpayers. Thus far, these audits have generated over $86 million in assessments. Desk audits for the latest full report year show under compliance in four areas:

- 1,130 taxpayers appear to have inappropriately taken the half percent tax rate in addition to the eligible 38,628 retailers, wholesalers and restaurants who paid at the half percent rate;
- 22,816 taxpayers in certain service industries appear to have taken the cost of goods sold (COGS) deduction that they may not be eligible for. Of the total: 3,500 are classified under transportation while 15,631 are in professional services, 241 in warehouses, and 3,444 in information services.
- 12,794 taxpayers appear to have taken excessive revenue deductions while calculating their liability under the EZ option because they reported deductions equal to or greater than 20 percent of their total revenue.
- 18,011 taxpayers paying $119 million under the old tax, but reported no liability under margin.

Franchise Tax Overview

Future of the Tax

- Priority-one audits will cover 2,050 reporting entities with over 100,000 affiliates. These audits will uncover issues currently not contemplated. These taxpayers are on a four-year audit cycle and many are still being audited for old tax.

- Long-term impact of audit may not exceed more than $300 million per year in additional revenue to the tax over current collections.

- Combination of audit and economic recovery will not likely combine to boost revenue from the tax to more than $5 billion per year within five years.

Questions?

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