Forms of Business and Business Taxes

Senate Select Committee on Education Reform and Public School Finance

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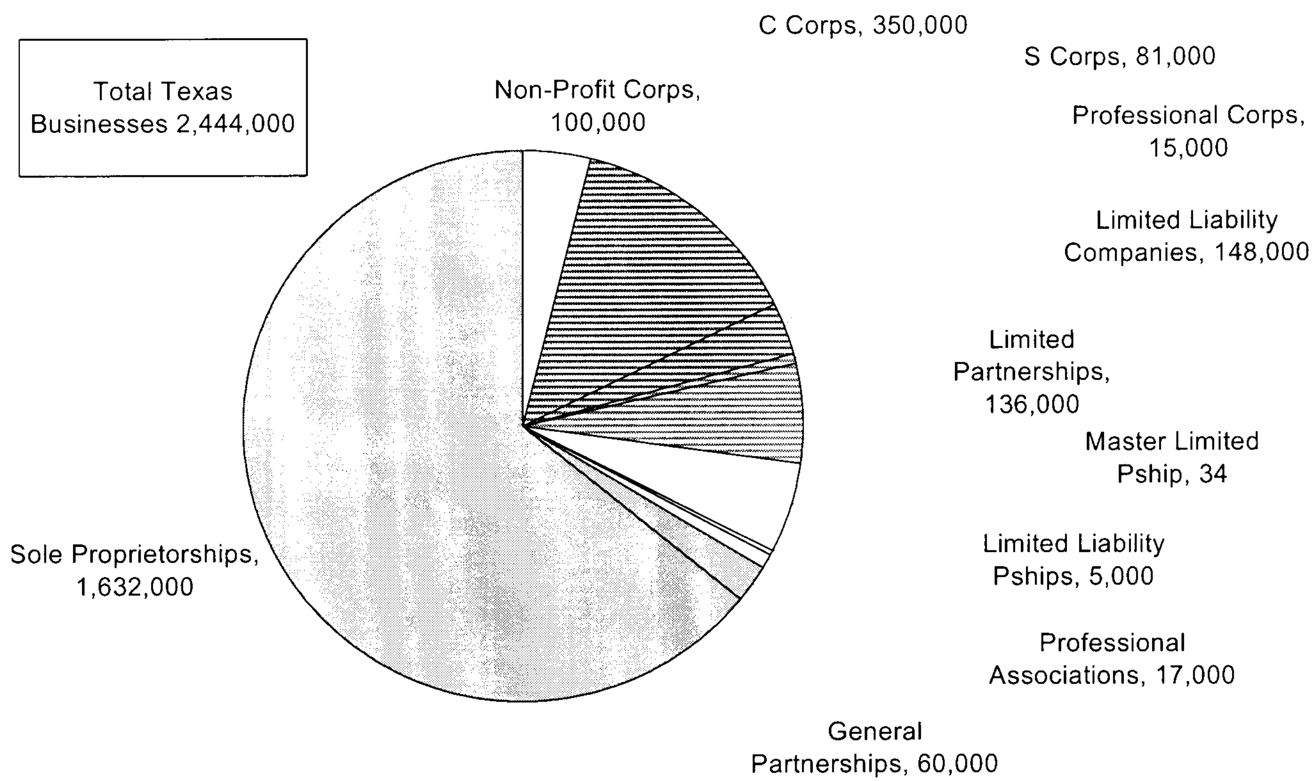
General Characteristics of Various Business Forms

Type of Business	Administrative Complexity	Liability Protections	Tax Treatment		
			Federal	Most states	Texas
Sole Proprietorship	Simple. No registration requirements.	None. The Individual owner is personally liable for all obligations	Income taxed on proprietor's personal income tax return		Income not taxed
Partnerships					
General	Simple. No specific registration requirements.	None. The general partners are personally liable for all obligations.	Pass-through; taxed on partner's personal income tax return		Income not taxed
Limited (LP)	Must register with state. Partners may or may not have formal legal agreement.	Passive investors (limited partners are not personally liable for business obligations); general partners are personally liable.	Pass-through; taxed on partner's personal income tax return		Income not taxed
Master Limited (MLP)	Must register with state and have formal legal agreement with defined organizational structure.		Pass-through; taxed on partner's personal income tax return		Income not taxed
Limited Liability (LLP)	Must be registered with state. Partnership must have formal legal agreement.	Limited partners not personally liable; general partners liable only for own errors, negligence, incompetence or malfeasance.	Pass-through; taxed on partner's personal income tax return		Income not taxed
Corporation					
Ordinary (typically a C Corporation)	Must register with state. Must have bylaws, board of directors and named officers. No restriction on owners (i.e. stockholders).	Corporation is responsible for its own debts, not the corporate owners (i.e. stockholders); stockholders are not personally liable for the corporation's obligations	Corporation's net income subject to special corporate tax; owner's income from dividends and capital gains are taxed on personal income tax return		Subject to franchise tax
Close (typically an S Corporation)	Must register with state. Simpler structure than C; board not required. Owners (stock holders must be individuals.		Pass-through; taxed on partner's personal income tax return		Subject to franchise tax, except that officers and director compensation excluded.[1]
Professional (PC; may be either a C or S)	Must register with state. Relatively simple structure, but form and ownership limited to named professionals (excluding medical practitioners).		Generally, most professional corporations qualify for S Corporation tax treatment		
Other					
Limited Liability Company (LLC)	Must register with the state and have formal articles of organization. Simple structure; few restrictions on owners (members).	LLC is responsible for its own debts, not the LLC owners (i.e. members); members are not personally liable for the corporation's obligations	Pass-through; taxed on member's personal income tax return		Subject to franchise tax
Professional Association (PA)	Must register with state and have articles of association. Relatively simple structure, but form and ownership limited to named professionals.	Each professional is liable with the association for his own acts; members are not personally liable for actions of other members.	Pass-through; taxed on professional's personal income tax return		Income not taxed.

[1] Officer director compensation is excluded from the calculation of earned surplus if a corporation is a registered close corporation or if it is a federal subchapter S Corporation. If a professional corporation does not qualify for Subchapter S, officer/director compensation is not excluded.

Numbers of Businesses in Texas

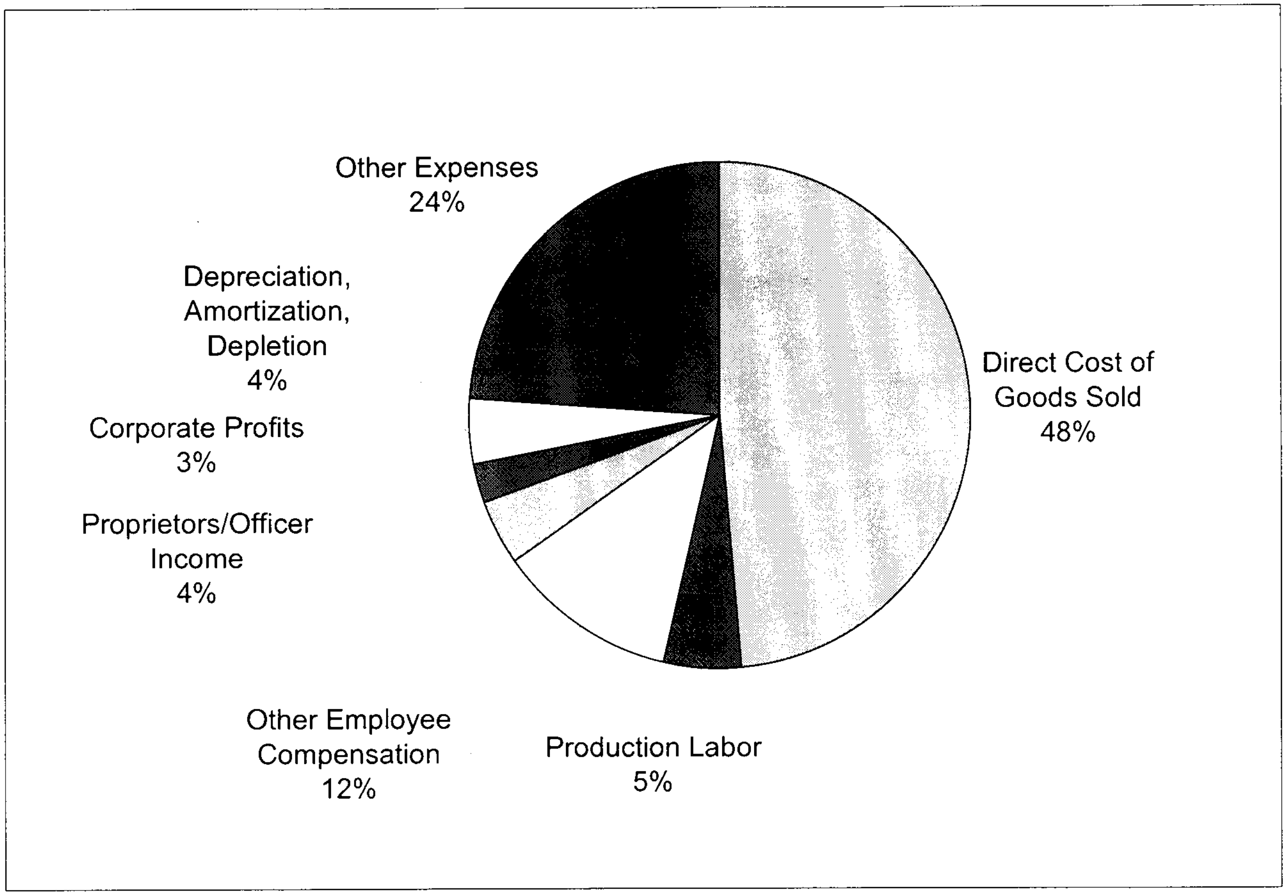


Shaded pieces represent businesses operating without liability protection granted by the state and not currently subject to the franchise tax. White pieces represent businesses currently liability-protected entities that are exempt or not subject to the franchise tax. Striped businesses represent the roughly 600,000 businesses subject to the franchise tax—of which only $150,000 incur actual tax liability.

Source: Data are derived from 2005 Comptroller data, 2004 Secretary of State Data and 2002 Internal Revenue Service data.

Components of Business Receipts

United States Total, 2002



Notes: Data is combined for corporations, partnerships, and sole proprietorships as reported by the Internal Revenue Service for 2002. Production labor is included in "cost of goods sold" in IRS data, and is estimated separately here. Other employee compensation is for other employees. Proprietors/officer income includes partner income and sole proprietor's income and makes not distinction between "compensation" or "profit".

Direct Taxes on Business Activity Across the States

Tax	Description	Tax Rates
Typical of Most States		
Corporate Income Tax	C Corporations pay tax on their net income. S Corporations, limited liability companies, partnerships and trusts are typically not taxed directly, but "pass-through" their income to their *owners*. These owners report the income from these pass-through businesses on their returns (be it a corporate income tax return or an individual tax return)	• 30 states have flat rates, ranging from Colorado's 4.63% to Pennsylvania's 9.99% • 12 states have graduated rates up to a high of Iowa's 12% (on net income above $250,000) • Several states have separate provisions for banks and insurance companies • 8 states have no broad-based corporate income tax
Personal Income Tax	Natural persons owning interests in S Corporations, partnerships, limited liability companies, sole proprietorships and other pass-through entities pay tax on their business earnings on their individual income tax returns	• 35 states have graduated rates on a broad base (Vermont's high at 9.5%) • 6 states have flat rates on a broad base ranging from Illinois's 3.0 percent to Massachusetts's 5.3% • 2 states only tax dividends and interest • 7 states have no tax
Unique States		
Texas Franchise Tax	C Corporations pay the tax, as well as S Corporations and Limited Liability companies (entities typically treated as pass-through entities in other states). Tax is on "earned surplus," defined as the the sum of profits plus officer/director compensation (S-Corporations exclude O/D compensation) or capital (assets less debt), whichever tax is higher. Insurance companies are exempt, but pay a much higher premiums tax.	• Earned Surplus: 4.5% • Capital: 0.25% Note: Compared to other states, Texas' "profits" tax rate is low, but that is mitigated by high capital tax and very unfavorable net operating loss provisions.

Tax	Description	Tax Rates
Unique States, *continued*		
Illinois Business Replacement Tax	C Corporations (in addition to the net income tax of 4.8%), S Corporations and partnerships must pay a business replacement tax based on their net income (pass-through entities are allowed a deduction for the labor value contributed by an owner)	• Corporations: 2.5% • Sole Proprietorships, Partnerships, and other pass-through entities: 1.5%
Michigan Single Business Tax	All businesses (sole proprietorships, partnerships, and corporations) pay a tax on the sum of profit, compensation, and depreciation. Companies with less than $350,000 in receipts are exempt. Limitations: tax base cannot be more than 50% of total gross receipts nor can compensation be more than 63% of the tax base.	• 1.9 % (scheduled to phased out should state revenues allow)
New Hampshire Business Enterprise Tax and Business Profits Tax	All businesses with more than $150,000 in gross receipts pay a 0.75% tax on the "enterprise value tax base" (the sum of all compensation paid or accrued, interest paid or accrued, and dividends paid by the business enterprise. All businesses with more than $50,000 in receipts pay a business profits tax of 8.5% (partnerships and sole proprietorships are allowed to deduct the labor value contributed by an owner).	• BET: 0.75% • PPT: 8.5% • Note: Business enterprise tax paid is allowed as a deduction against the profits tax.
Ohio Commercial Activity Tax (described after full phase-in)	Generally all businesses (sole proprietorships, partnerships, and corporations) pay a tax on gross receipts from sales of goods (if delivered or received in Ohio) and services (in proportion to the purchaser's benefit received in Ohio) and rent; interest and dividends are excluded; tax return filed on consolidated basis, which effectively excludes intra-group transactions.	• $0 - $150 th: no tax • $150 th - $1 ml: $150 • Over $1 ml: 0.26%
Washington Business Occupation Tax	All businesses with over $12,000 a year in receipts pay a business and occupation tax on their gross receipts. Businesses with gross receipts of less than $1,000 per month are exempt, as are receipts from farming and from the sale or rental of real estate. Businesses engaged in multiple lines of business pay on each line, but may take a multiple activities credit to mitigate double taxation.	• Retailing: 0.471% • Manufacturing and Wholesaling: 0.484% • Other Business: 1.5%

Recent Texas Discussions on Direct Taxes on Business Activity

Proposal	Summary	Concerns	Attributes
One Size Fits All			
Close "Loopholes"	1) Changes franchise tax law so that a limited partnership interest creates nexus in Texas, closing the "Delaware Sub" loophole, and 2) Requires a company to "add-back" amounts for royalties, interest, and trademarks paid to an affiliated entity (to the extent they exceed an "arms-length" rate), closing the "Geoffrey's Sub" loophole	• Fails to capture growing amounts of business activity done by partnerships • It has proven difficult to craft narrow language without unintended consequences	• Additional taxes are limited to only those corporations engaged in "tax planning"
Expand "fixed" franchise tax to liability-protected entities	In addition to the above changes, the franchise tax is extended to all forms of business (perhaps excluding non-liability protected entities such as sole proprietorships and general partnerships)	• *May* violate "Bullock amendment • Would require definition of "profit" for partnerships	• Does not penalize current franchise taxpayers with higher taxes (only new taxpayers) • Levels playing field (provided partnerships taxed appropriately)
Business Activity Tax	Extend the franchise tax to additional forms of business; the earned surplus and capital tax calculations are replaced with a single calculation based on the sum of profits and compensation	• Money-losing entities could have sizeable tax bill • Payroll overwhelms profits as part of tax base • Similar to unpopular Michigan tax	• Does not discriminate between compensation and profit • Grows with economy • More stable than profits tax • Shift to labor intensive bus.
Payroll Tax	Franchise tax is replaced with a flat rate payroll tax, applying to all businesses with employees (a partner's income is not considered payroll). Amount of tax may be "capped" per employee.	• Taxes "jobs" • Increases tax on labor intensive businesses • Does not capture partner compensation	• Simple, easy to calculate and administer • Lessens tax on capital intensive businesses
Business Tax Choice			
Choice of Tax Bases			
"Basket" Tax	Franchise tax is expanded to all forms of business (perhaps excluding non-liability protected entities such as sole proprietorships and general partnerships); business may choose to pay either	• Gross receipts tax as floor • Bullock amendment?	• Choice of tax base mitigates unusual industry impacts

Proposal	Summary	Concerns	Attributes
	franchise tax (a later version used a business activity tax) or payroll tax, with a minimum tax based on gross receipts.		
House "Choice"	Franchise tax is expanded to all forms of liability-protected businesses. Businesses may opt to pay either franchise tax or payroll tax. Amount of tax chosen may not be less than half of tax not chosen (the "floor"). Businesses must file combined return and make one choice for entire business.	• Comptroller-required "floor" limits benefits of choice • Bullock amendment?	• Choice of tax base mitigates unusual industry impacts
Choice of Deductions			
Margin Tax	Franchise tax restructured to be a "margin" tax in which a business may choose to deduct either "cost of goods sold" or "compensation" from their gross receipts. Tax base may not be more than 70 percent of gross receipts.	• Money-losing businesses may have substantial tax bill • Some industries have little compensation or cost of goods sold	• No floor or alternative minimum tax • Choice of deductions mitigates unusual industry impacts
Other Approaches			
Services Sales Tax	Sales tax would be expanded to a broader array of services	• "Point of Sale" confusion • Advantage for vertically integrated companies • Shift in taxes to business (largest consumers of most services) • Not tied to ability to pay	• Public perception of sales tax as most "fair" tax
Services Gross Receipts Tax	A broad array of services providers would be subject to tax on their gross receipts from business done in the state	• Not tied to ability to pay • Bullock amendment?	• Simple to administer (generally)