

Texas Gross Receipts Tax: A Back Door Tax on Advertising

HB 3, a bill introduced in the Texas House of Representatives by Rep. Jim Keffer, would propose enactment of a state gross receipts tax to replace the state's franchise tax on businesses. The task is challenging, because HB 3 represents an effort to tax part of corporate income without having the revenue raising mechanism labeled an "income tax." An income tax is prohibited under the Texas state constitution without a vote of the people.

This bill discriminates against business advertising costs. It has some characteristics of an income tax because it begins with all a company's income and receipts and reduces them by either its total compensation payments or its cost of goods sold. The first is intended to appeal to businesses that don't manufacture products but largely are service businesses with higher personnel costs. The second appeals to manufacturers. However, the bill specifically excludes advertising and marketing costs from reducing the amount of income to be taxed, so that a company with large expenditures for advertising relative to other corporate expenses, could pay a disproportionately high level of taxes. A net income treats service businesses and companies with large ad expenses more fairly because advertising and similar operating costs can be deducted. While this may not be as significant at a 1 percent rate, when that rate is increased it could be a costly difference. It should be noted that many other business groups appear to have obtained exclusions for their unique types of income or expenses.

A corporate income tax typically identifies all of the revenue streams coming to a business and then deducts from the total any operating costs or other ordinary and necessary business expenses. The "net" income left over is then subject to a tax. HB 3 modifies the federal Tax Code definition of business gross receipts shown in IRS Form 1120. The purpose of Form 1120 is to permit a business to calculate net income subject to the federal corporate tax. It begins with gross receipts and first deducts cost of goods sold to get the "gross profit." That prevents the company from paying any tax on the cost of producing the products it manufactures. Then the form adds in dividends, interest, rents, royalties and capital gains to determine "total income."

Here is where the federal corporate income tax and the proposed Texas gross receipts tax depart. The federal tax goes on to permit the deduction of compensation of officers, salaries and wages, repairs and maintenance, rent expense, **advertising** and other business expenses in order to determine net taxable income. That net income is taxed at a maximum rate of 35 percent.

The drafters of the Texas bill clearly do not want to tax all gross receipts, but they are very arbitrary in what is included or excluded. First they reduce the total "income" subject to tax by 30 percent, leaving the remaining 70 percent subject to the tax. Then the remaining 70 percent is further reduced by either the total compensation (salaries except for officers) paid by the business or the cost of goods sold (COGS) of the business. By allowing the deduction of COGS, the company can reduce its tax exposure by the amount it pays for raw materials going into its products as well as labor allocated to their manufacture – but not by amounts paid for advertising or many other ordinary and necessary business expenses.

Most businesses then would pay 1 percent of the so-called gross receipts, but retail and wholesale businesses are only required to pay 0.5 percent. The different rates may be another means by which the bill tries to appeal to retail businesses with high advertising costs.

Nevertheless, this is a back door tax on advertising. The tax would be even greater for businesses required to advertise more as a percentage of their gross income in order to reach their potential customers.