

CURRENT TEXAS TAX ISSUES AFFECTING BUSINESSES

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SEPTEMBER 22-23, 2005
SEPTEMBER 29-30, 2005**

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CURRENT TEXAS TAX ISSUES AFFECTING BUSINESSES

I. SCOPE OF ARTICLE

This purpose of this article is to discuss recent legislative changes and important administrative hearings decisions and cases in the areas of Texas state taxation, with a specific focus on franchise tax and sales tax. The author has also included a review and update concerning the status of the national Streamlined Sales Tax Project and Texas' participation in it. This paper also contains a brief analysis of the Texas Legislature's proposed changes to the Texas tax system that were not enacted in the 2005 regular or special sessions, but which may be considered again in future legislative sessions. A brief review of Texas franchise tax planning strategies for start-up and existing businesses concludes this paper.

Please note that a review of current issues and legislative changes in the areas of real and personal property ad valorem taxes is outside the scope of this article.

II. 2005 LEGISLATIVE CHANGES AFFECTING TEXAS TAXES

Although the recently ended legislative session, which included two special sessions, promised to be very active in the area of state taxes, the hype did not live up to the billing. The legislative actions described in this section make few changes that will affect everyday operations of Texas businesses.

A. Legislation Affecting All State Taxes

S.B. 1570. Senate Bill 1570, which became effective September 1, 2005, may have made the most significant change in the Texas tax area. The law amended Tax Code § 111.064 to place a limitation on the interest rate that the Comptroller is required to pay on tax refunds. Prior to the amendment, taxpayers received interest on refunded amounts at the rate of prime plus one percent. After the amendment, the interest rate is the lower of (i) prime plus one percent or (ii) "the annual rate of interest earned on deposits in the state treasury during December of the previous calendar year, as determined by the comptroller." Part of the rationale of this bill was to discourage taxpayers from intentionally overpaying tax. The rate charged against taxpayers on tax deficiencies remains prime plus one percent.

S.B. 263. This act, which became Tax Code § 111.0075 (a new section of the code) effective September 1, 2005, makes it illegal for anyone who uses an open records act request to identify taxpayers that will be audited from contacting the taxpayers until six days after receiving the information. Under the new law, a party who is not the taxpayer to whom the information relates may not "use the information for the direct solicitation of business or employment for pecuniary gain." Civil fines of \$500 for the first violation, \$1,000 for the second violation, and \$3,000 for every subsequent violation are included in the act. One of the stated purposes of the law is to prevent tax consultants from contacting taxpayers before the taxpayers even become aware of their audit.

Expiration of 2003's H.B. 1. H.B. 1 enacted in 2003 required the legislature to approve all payments to taxpayers exceeding \$250,000 for the biennium beginning on September 1, 2003, and ending on August 31, 2005.¹ This restriction applied to refund claims, final judgments, and settlements and included statutory interest, costs, and attorneys' fees awarded to a taxpayer in the \$250,000 limit.² Under the law, all of a taxpayers' tax claims were aggregated to determine if they exceeded the \$250,000 maximum.³ This law expired on August 31, 2005, and was not renewed by the 79th Legislature.

B. Franchise Tax Legislation

H.B. 2201. Tax Code § 171.108, which was added by this act to be effective September 1, 2005, allows corporations to take certain franchise tax deductions for clean coal projects. "Clean coal project" is defined in Water Code § 5.0001. The act allows a deduction from the corporation's apportioned taxable capital in an amount equal to the amortized cost of qualifying equipment or a deduction from the corporation's apportioned earned surplus in an amount equal to ten percent of the amortized cost of qualifying equipment.

C. Sales Tax Legislation

H.B. 135. Effective September 1, 2005, the Comptroller will increase her regulation of health spas. Health spas are currently required to register with the Secretary of State and post a bond in order to obtain a certificate of registration.⁴ In order for a health spa to obtain a sales tax permit after September 1, 2005, it must include a copy of its certificate of registration with its sales tax application. In addition, the act requires the Comptroller to provide the Secretary of State with the names of current sales tax permit holders that may be providing services that require a certificate of registration.

H.B. 1531. This law, which became effective September 1, 2005, exempts companies that provide "telematics services" from the requirement to be licensed by the state as an investigation company. Based on this exemption, charges for telematics services will no longer be taxed as security services under Texas sales tax laws. "Telematics services" are defined as services provided "to owners, operators, and occupants of consumer vehicles or commercial fleet vehicles through the remote access of in-vehicle data that may rely on global positioning system satellite data to fix the exact location of the vehicle," including an enumerated list of specific services. The bill is codified in Occupations Code § 1702.331.

H.B. 3140. Effective September 1, 2005, this law exempts certain alarm-type services from the definition of "alarm systems" that require a license under Occupations Code § 1702.002. Based on this exemption, charges for these services will not be subject to Texas

¹ Act of 2003, 78th Leg., R.S., H.B. 1, Rider 11.

² *Id.*

³ *Id.*

⁴ Tex. Occ. Code §§ 702.101, 702.151 (Vernon 2005).

sales tax. The new exempt services include “a telephone entry system, an operator for opening or closing a residential or commercial gate or door, or an accessory used only to activate a gate or door, if the system, operator, or accessory is not connected to an alarm system.”

S.B. 568. This act, effective September 1, 2005, created a new service under § 1702.331 of the Occupations Code called “personal emergency response systems.” “Personal emergency response system” includes “an alarm system that is: (1) installed in the residence of a person; (2) monitored by an alarm systems company; (3) designed only to permit the person to signal the occurrence of a medical or personal emergency on the part of the person so that the company may dispatch appropriate aid; and (4) not part of a combination of alarm systems that includes a burglar alarm or fire alarm.” Charges for these services are not subject to Texas sales tax.

S.B. 877. This new law amends certain provisions of the Alcoholic Beverage Code related to out-of-state wineries. Out-of-state wineries are permitted to make a limited number of deliveries to end-user consumers in Texas so long as the deliveries meet certain packaging requirements, strict delivery and acceptance procedures are followed, and a special permit is obtained. In order to obtain the permit, the winery must comply with federal laws, have a Texas sales permit, submit to personal jurisdiction in Texas state and federal courts and venue in Travis County, and must not directly or indirectly have a financial interest in a Texas wholesaler or retailer. All wine sales consummated by the out-of-state winery are deemed to have been made in Texas for delivery in Texas. The winery must pay applicable Texas excise taxes and sales and use taxes as if it were a Texas winery. Criminal penalties are authorized by the statute.

S.B. 1253. This act adopts new Chapter 398 of the Government Code that allows certain cities and counties to receive back from the Comptroller a portion of the sales and use taxes derived from hosting a special event in their community. The taxes refunded by the Comptroller may be used to pay for the cost of hosting the event.

D. Miscellaneous State Tax Legislation

S.B. 1863, Telecommunications Infrastructure Fund. This law extends the sunset provisions of the telecommunications infrastructure fund, or “TIF.” The TIF assessment must be paid by providers of telecommunications services that are subject to Texas sales tax; the rate of the assessment is equal to 1.25% of the retailer’s receipts from its sales of taxable telecommunications services.⁵

One provision that was removed from this bill prior to its enrollment for the Governor’s signature would have moved all administrative hearings concerning state taxes from the Comptroller’s office to the Office of Administrative Hearings.

H.B. 2418, Motor Vehicle Sales and Use Tax. This act extends the Texas Emissions Reduction Plan surcharge on certain diesel-powered vehicles until 2010; the surcharge was scheduled to expire in 2008. The law also extended the surcharge on certain off-road diesel-powered equipment that is subject to Texas sales tax. The surcharge is equal to (i) one percent of the sales price for 1997 and later models and (ii) 2.5% on models older than 1997.

⁵ See Tex. Util. Code §§ 57.041 *et seq.*

S.B. 867, Motor Vehicle Sales and Use Tax. Effective September 1, 2005, the purchase (or first use) of a recreational motor vehicle in Texas will not be subject to the Texas Emissions Reduction Plan surcharge.

III. RECENT TEXAS TAX CASES AND COMPTROLLER DECISIONS

This section of the article summarizes recent Texas cases and administrative hearings that have had a significant impact in the area of state taxation.

A. Texas Franchise Tax

1. Recent Cases

INOVA Diagnostics, Inc. v. Strayhorn, 166 S.W.3d 394 (Tex. App.—Austin 2005, pet. filed July 11, 2005). On May 26, 2005, the Third Court of Appeals affirmed Judge Darlene Byrne's judgment against INOVA in this case. INOVA sued the Comptroller for a refund of franchise taxes paid under protest. The suit involves report years 1999-2003. INOVA contended that Public Law 86-272 exempts it from the taxable capital component of the franchise tax because INOVA does business in Texas only by soliciting orders for its products, sending the orders outside Texas for fulfillment in California, and then shipping the products to Texas customers by common carrier. Public Law 86-272 exempts taxpayers from a state tax "imposed on, or measured by, income" when they conduct only these types of solicitation activities.

The court did not agree with INOVA's argument that the taxable capital component is imposed on or measured by net income because INOVA's net income is included in its retained earnings which form a part of its taxable surplus under the taxable capital component. The court held that the taxable capital component taxes a corporation's assets or capital and not net income. The court also ruled that INOVA had substantial nexus in the state under the U.S. Constitution even though INOVA's solicitor-employee was present in Texas only a few days out of each month.

INOVA has filed a Petition for Review with the Texas Supreme Court.

Home Interiors & Gifts, Inc. v. Strayhorn, No. 03-04-00660-CV, 2005 Tex. App. LEXIS 5908 (Austin July 28, 2005, mot. for reh'g filed Aug. 15, 2005). In this case, the Third Court of Appeals held that the Texas throwback provision, which is part of the earned surplus calculation of the franchise tax, is unconstitutional in circumstances where a Texas-based taxpayer is protected from taxation in other states by Public Law 86-272. The court held that, in this situation, the throwback provision of the Texas franchise tax violates the commerce clause of the U.S. Constitution.

The throwback rule is an apportionment provision that plays a role in determining what percentage of a corporation's earned surplus will be taxed in Texas. The apportionment fraction is calculated by dividing a corporation's Texas gross receipts by its total gross receipts; therefore, a corporation pays less tax when its Texas gross receipts are less than its total gross receipts. As a general rule, sales of tangible personal property are apportioned to the state where

the delivery of the product is made (the “destination state”). The throwback rule is an exception to this general rule. Under the throwback rule, if the taxpayer does not have sufficient contact with the destination state to require it to pay taxes in the destination state, gross receipts that would otherwise be apportioned to the destination state are “thrownback” to Texas.

In *Home Interiors*, Home Interiors was located in Texas and did not have sufficient contact to pay net income taxes in any other state. But, Home Interiors made sales into and delivered its products into other states because its solicitation activities in the other states were protected under Public Law 86-272. The Comptroller applied the throwback rule to these sales, thus causing an increase in Home Interior’s apportionment fraction and total franchise tax due. Home Interiors argued that applying the throwback rule to it violated the commerce clause of the U.S. Constitution.

The Third Court of Appeals reversed the trial court’s granting of the Comptroller’s motion for summary judgment and rendered judgment for Home Interiors. The court held that the application of the throwback rule to Home Interiors violated the commerce clause’s internal consistency test. When analyzing a tax statute under the internal consistency test, the court must suppose a hypothetical world in which all fifty states have a tax system identical to Texas’ and judge whether or not interstate commerce would be discriminated against in favor of intrastate commerce in this hypothetical world. If interstate commerce is discriminated against, then the state tax system violates the commerce clause.

When applying the internal consistency test, the court determined that, because of Public Law 86-272, Home Interiors, as an interstate seller, would be subject to higher cumulative state taxes than would a fictional taxpayer that made sales to only Texas customers (an “intrastate seller”). The intrastate seller in the hypothetical would owe Texas franchise tax on 100% of its earned surplus, but would not owe taxes to any other state.

The interstate seller, on the other hand, would owe Texas franchise tax on 100% of its earned surplus but would also owe franchise tax based on its taxable capital in any state where it had sufficient connection to create an obligation to pay the taxable capital component of the franchise tax. The court cited the holding in *INOVA Diagnostics, Inc. v. Strayhorn* for the proposition that Public Law 86-272 does not protect a taxpayer from taxation based on taxable capital. The court’s ultimate conclusion was that the interstate seller would owe a greater aggregate tax than the intrastate seller. This result causes the throwback rule to fail the commerce clause’s internal consistency test, thus rendering the throwback provision, as applied in the facts of this case, unconstitutional.

The Comptroller has not yet filed a Petition for Review with the Texas Supreme Court in this case, but the Comptroller is expected to do so. As a result of the holding in this case, many Texas taxpayers with operations similar to Home Interiors may be entitled to a refund of franchise taxes. These taxpayers should take appropriate action under Texas law to prevent their refunds from being time-barred under the four-year statute of limitations that apply to tax refunds.

Anderson-Clayton Bros. Funeral Home, Inc. v. Strayhorn, 149 S.W.3d 166 (Tex. App.—Austin 2004, pet. filed Jan. 24, 2005). This case arises from Anderson-Clayton’s franchise tax treatment of investment earnings on its prepaid funeral benefits trusts during the 1993-96 tax years. Throughout this period, Anderson-Clayton deposited proceeds from its sales of prepaid funeral benefits contracts into Texas trusts, in accordance with Texas Finance Code section 154.253(a)(3). These trusts, in turn, invested those funds in accordance with Texas Finance Code section 154.258 and accumulated investment earnings. It is undisputed that, at all relevant times, the investment earnings on Anderson-Clayton’s prepaid funeral benefits were paid by out-of-state corporations. The issue in this case is whether, under the Comptroller’s “location of payor” rule, the earnings on the taxpayer’s trust accounts, which was maintained in Texas trusts, but which consisted of payments from non-Texas companies, were Texas gross receipts.

The general franchise tax rule apportions investment earnings to the state where the payor of the earnings is located. Anderson-Clayton argued that the earnings were not a Texas gross receipts because the income was earned from investments in out-of-state corporations. Anderson-Clayton essentially wanted the Comptroller to look through the trusts and source the receipts based on the actual investments by the trusts in the out-of-state corporations. The Comptroller argued that the location of payor rule should be applied to the trusts, and if the trusts are Texas trusts, then the receipts from those trusts would be Texas gross receipts.

The trial court granted the State’s motion for summary judgment, and the Third Court of Appeals upheld the trial court’s judgment and agreed with the Comptroller’s argument that the subject receipts were gross receipts from business done in Texas. The court reasoned that under longstanding Texas law, trusts are considered separate entities, even where they may not be subject to federal income tax or the franchise tax. And because it is ultimately the trusts that pay income to the funeral homes earned from their investments, the Comptroller’s determination that the trusts are the payors is reasonable.

Dillard Department Stores, Inc. v. Strayhorn, et al., Cause No. GN300878, Travis County District Court. The main issue in this case is whether the requirement of the franchise tax’s earned surplus component to add-back officer and director compensation to the tax base is an unconstitutional tax on the income of natural persons under the Texas Constitution. Another issue in the case is whether the less than 36 shareholder statutory limit for the officer and director compensation add-back is arbitrary, unreasonable, and discriminatory. The State’s answer has been filed and discovery is proceeding in the lawsuit.

2. Recent Comptroller Hearings

Comptroller Hearing No. 43,518. In this hearing, the administrative law judge upheld the Comptroller’s administrative interpretation of the officer and director compensation add-back requirement. The version of Tax Code § 171.110(c) that was in effect during the audit period stated that subsidiary corporations are allowed to avoid the add-back requirement only if their “parent” also qualifies to avoid the add-back requirement. Comptroller Rule (34 Tex. Admin. Code) § 3.558(h) interpreted the statute to mean a subsidiary only avoided the add-back requirement if its “ultimate parent” also qualified to avoid the add-back. Under the Comptroller’s policy, a “corporation qualifies as a parent if it ultimately controls the subsidiary even though the control may

arise through any series or group of other subsidiaries or entities.” The taxpayer argued that the Comptroller Rule misapplied the statute, which was only meant to refer to immediate parents.

Tax practitioners should note that Tax Code § 171.110(c) was amended in 2003 to codify the Comptroller’s administrative interpretation.

Comptroller Hearing No. 40,352. In this dispute, the Comptroller held that under Comptroller Rule (34 Tex. Admin. Code) § 3.558(c), the amount of the compensation for a corporation’s officers that is required to be added back to the computation of earned surplus is limited to compensation paid while they served as designated officers. Certain of the taxpayer’s officers surrendered their officer positions during the audit period. The persons who were no longer officers remained as employees of the taxpayer and provided their services in that capacity. Because they were no longer designated as officers by the board of directors, Rule 3.558(c) allows their compensation to be excluded from earned surplus if that compensation was paid after they ceased being officers. The Comptroller also held that the auditor could not reallocate officer compensation to the taxpayer under Rule 3.558(f) because the reason for the reduction in the number of corporate officers was to “reduce the number of people who had authorization to contractually bind the Petitioner.” This was a legitimate business reason for reducing the number of officers, as opposed to merely avoiding franchise tax, a factor that must be shown by the Comptroller in order to invoke the reallocation provisions of Rule 3.558(f).

Comptroller Hearing No. 43,749. In this hearing, the taxpayer transferred certain raw materials to another company, which then used the materials to manufacture the taxpayer’s products. In connection with the transfer, the taxpayer charged the service provider an amount equal to its cost of the raw materials. The taxpayer argued that a charge “at cost” should not be considered a gross receipt for Texas franchise tax apportionment purposes. The judge disagreed, holding that no matter what amount is charged, a charge for the sale of items of tangible personal property to a third party is a gross receipt.

B. Texas Sales Tax

1. Recent Cases

Site Work Group, Inc. v. Chemical Lime, Ltd., No. 10-05-0081-CV, 2005 Tex. App. LEXIS 5922 (Waco July 27, 2005, no pet. h.). In this case between two private litigants, Site Work Group failed to pay Chemical Lime for certain construction-related materials that it purchased. Even though Site Work Group orally notified Chemical Lime that the materials were exempt from sales tax, it failed to give Chemical Lime an exemption certificate. The trial court granted Chemical Lime’s motion for summary judgment to recover the amounts owed because, since it failed to deliver an exemption certificate, Site Work Group could not raise a genuine issue of material fact as to whether or not the materials were subject to sales tax. The court of appeals affirmed the trial court in a split decision.

May Department Stores Company v. Strayhorn, No. 03-03-00729-CV, 2004 Tex. App. LEXIS 7681 (Austin August 26, 2004, pet. denied) (unpublished opinion). In this case, the taxpayer argued that charges for printing performed outside Texas were not subject to Texas tax

even though the printed materials were mailed to Texas customers. The taxpayer contended that out-of-state printing is equivalent to manufacturing that is completed outside the state. The Comptroller argued that the tax is owed on out-of-state printing when the printed advertising materials are mailed into Texas either (1) directly to prospective customers, (2) to a mailing company that mails the advertisements to Texas customers, or (3) to the taxpayer's stores or offices. The court of appeals held for the Comptroller because May's use of the printing services that produced the materials is the "exercise of a right or power incident to the ownership of tangible personal property over [such] property."

Alpine Industries, Inc. v. Strayhorn, No. 03-03-00643-CV, 2004 Tex. App. LEXIS 6242 (Austin July 15, 2004, pet. denied) (unpublished opinion). Alpine Industries, Inc. manufactures air purification equipment. Alpine used a force of independent salespersons to make sales into all fifty states; 20,000 of these salespersons were registered in Texas. In this case, Alpine argued that it did not have sufficient contact with Texas to be required to collect Texas sales tax on its sales to Texas customers. The Comptroller exercised its power under Tax Code § 151.024 to "regard a salesman, representative, peddler, or canvasser as the agent of a dealer, distributor, supervisor, or employer . . . [and] to regard the dealer, distributor, supervisor, or employer as a retailer or seller" if necessary for the efficient administration of the sales tax. The appellate court agreed with the Comptroller and held that Alpine had nexus with Texas under the U.S. Constitution and that administrative convenience provided a rational basis for the Comptroller's classification of Alpine as a Texas retailer and for the imposition of the tax.

2. Recent Comptroller Hearings

Comptroller Hearing No. 44,295. In this hearing, the taxpayer argued that its installation of synthetic turf for putting greens was the performance of a taxable landscaping service which allowed it to purchase its materials tax-free with a resale certificate. The Comptroller argued that the taxpayer's jobs were "hardscaping," a nontaxable improvement to realty. The administrative law judge agreed with the Comptroller. Under the ruling, the taxpayer was held to be performing lump-sum contracts in which it was the consumer of all of the materials. The taxpayer was not entitled to purchase its materials tax-free, and therefore owed tax on its purchases of materials. The taxpayer was also not entitled to offset tax it collected in error from its customers against its own tax deficiency.

Comptroller Hearing No. 42,587. The Comptroller argued in this hearing that the taxpayer owed use tax on installation services it purchased in connection with the acquisition of a new computer. The lease of the new computers involved multiple parties—one company ordered the computers, another company paid for the computers, and the companies where the computers were to be delivered, which included the taxpayer, paid for the installation services. Installation services are not taxable unless they are provided incident to the purchase of a taxable item. The Comptroller argued that the fact that one company paid for the item while another paid for the installation services was irrelevant because the purchases were connected. The administrative law judge disagreed and sided with the taxpayer, ruling that the sales of the item and the nontaxable services must be to the same customer in order for the nontaxable services to become part of the taxable sales price of the item.

Comptroller Hearing No. 39,547. The taxpayer in this hearing was in the business of providing local telephone service. The taxpayer argued that certain equipment that it purchased qualified for the manufacturing exemption because it “processed” and converted the customer’s voice into an electronic signal. The manufacturing exemption is limited to equipment that produces tangible personal property for ultimate sale. The taxpayer argued unsuccessfully that the customer’s voice signals were tangible personal property. The administrative law judge ruled that the taxpayer was selling a taxable telecommunications service, not tangible personal property.

Comptroller Hearing No. 39,444. In this hearing, the taxpayer, a newspaper publisher, purchased certain equipment to be used in the pagination process for the production of daily newspapers—this equipment was not subject to sales tax. But, the taxpayer was required to pay sales tax on equipment that, although it claimed was used in the pagination process, was ultimately used for internal advertising, warehouse purposes, and other purposes not related to manufacturing. The taxpayer was also required to pay sales tax on toner because it could have been used for printing not related to the manufacturing process.

Comptroller Hearing No. 44,050. The decision in this hearing clarifies that the fact that a taxpayer has collected but not remitted a large amount of sales tax does not automatically justify the application of the 50% fraud penalty. The taxpayer in this hearing presented evidence of a good faith (although significant) error in the way the taxpayer’s accounted for sales tax. The taxpayer took immediate steps to correct the error once it was discovered. The administrative law judge disagreed with the Comptroller’s argument that a significant amount of tax collected but not remitted, by itself, justifies application of the fraud penalty. The fraud penalty is appropriate only when the taxpayer has no plausible explanation for its gross error.

Comptroller Hearing No. 39,311. This hearing demonstrates once again the Comptroller’s policy of enforcing Texas sales tax laws to the full limits of the U.S. Constitution. The taxpayer in this hearing was a commercial flooring contractor that used subcontractors to install, repair, and maintain flooring in Texas. The taxpayer’s use of subcontractors created nexus with Texas under the U.S. Supreme Court’s holdings in *Scripto, Inc. v. Carson*, 362 U.S. 207 (1960) and *Quill Corp. v. North Dakota*, 504 U.S.298 (1992). Because it had nexus with the state, the taxpayer was required to collect sales taxes on its sales to Texas customers.

Comptroller Hearing No. 43,925. The taxpayer in this case sold clothing products, many of which were exported. In compliance with sales tax laws, the taxpayer collected sales tax on the export sales, and then upon receiving proof of export, refunded the sales tax to the customer. But, the taxpayer deducted and retained an administrative fee from the refunded sales tax. The administrative law judge determined that no authority exists to support the retention of such an administrative fee and ruled that the retained amounts constituted tax collected in error.

Comptroller Hearing No. 44,195. The decision in this hearing should make some corporate officers and directors sleep better at night. In this case, the taxpayer was found to have collected sales tax without remitting it, which normally creates personal liability for the corporation’s officers and directors. The taxpayer never filed sales tax returns; the failure to file returns tolls the normal four0year statute of limitations. The Comptroller’s assessment for these

taxes, however, occurred after the expiration of the four-year statute of limitations. The administrative law judge held that although Tax Code § 111.205(a)(2) is an exception to the statute of limitations that allows the Comptroller to pursue the taxpayer for the taxes because it never filed sales tax returns, the taxpayer's failure to file returns did not prevent the four-year statute of limitations from barring the Comptroller's personal liability claim against the taxpayer's officers and directors.

IV. THE STREAMLINED SALES TAX PROJECT—AN UPDATE

The Streamlines Sales Tax Project (SSTP) was organized in March 2000 to combat states' losses of sales tax revenue to online internet sales. Under current U.S. Supreme Court holding in *Quill Corp. v. North Dakota*, 504 U.S. 298 (1992), online sellers who lack a physical location in a state are not required to collect the state's sales or use taxes. The stated goal of the SSTP is to simplify sales tax administration by creating uniform sales tax laws among all fifty states. Supporters of the SSTP believe that uniformity would greatly reduce the burden on sellers and purchasers of complying with different states' sales and use tax laws in the hope that online sellers will voluntarily collect and remit state taxes. The SSTP's primary goal is to allow states to reach across state lines and tax sales that are completed in other states when the ultimate use will take place in the taxing state, thus eliminating the need for state use taxes; the achievement of this goal will require congressional action.

In a perfect SSTP world, all states would tax the same transactions at the same rate. The legislature passed legislation in 2003 authorizing the Comptroller to adopt rules to achieve the objectives of the SSTP and to allow the Comptroller to enter into Streamlined Sales and Use Tax Agreement (SSTP Agreement) if the Governor, Lieutenant Governor, Speaker of the House of Representatives, and Comptroller unanimously agree that it would be in the state's best interest.⁶ The result of this legislation was to make Texas one of the thirty-four SSTP "implementing states."

As an implementing state, Texas must achieve substantial compliance under the SSTP Agreement by amending nonconforming state laws. The Agreement will only be effective if at least ten states comprising at least twenty percent of total population of all states imposing a sales tax have been found to be substantially in compliance before the end of 2005.⁷ In 2003, the legislature brought portions of Texas' statutes regarding local sales taxes and taxable food into compliance with SSTP guidelines.

Under prior law, sellers were only required to collect local sales taxes if they had nexus with the locality to which the tax was due. If the seller did not have nexus with that particular taxing jurisdiction, the seller was not required to collect the tax due; instead, the purchaser was required to accrue the tax as a use tax and remit it to the appropriate jurisdiction. Under the new law, sellers are required to "collect any applicable local use tax that is due from a purchaser even

⁶ Act of 2003, 78th Leg., R.S., H.B. 2425, §§ 94-95.

⁷ State Tax Review, June 10, 2003, p. 24.

if the retailer is not engaged in business in the local jurisdiction into which the table item is shipped or delivered.”⁸

The Legislature also enacted some changes with regard to which local sales tax rates apply. Under pre-2003 law, the determination of which local sales tax rate applies to a sale of taxable services depends upon which taxable service is the subject of the transaction—different services had different rules. And, the pre-2003 default rule was that the local sales tax rate of the place of business of the service provider would apply. The 2003 legislation unified the rule for all services and stated that effective July 1, 2004, a sale of taxable services is deemed to occur where the service is performed or delivered, and the taxing rate of that jurisdiction will apply.⁹ This law turned the Texas default rule on its head in order to conform to SSTP guidelines.

Prior to the effectiveness of this statute concerning the application of local sales tax rates, the Comptroller issued a statement delaying the effectiveness of the statute and allowing taxpayers to continue to follow the pre-2003 law because “several members of the Texas Legislature as well as many business owners around the state have raised concerns about the significant and far-reaching effects of these changes.”¹⁰ The Comptroller was expecting the legislature to provide further guidance on this issue during the 2005 session. During the 2005 session, the legislature included a provision in H.B. 2234 that would have reversed the 2003 legislation and reinstated the “old” local tax sourcing rules, but this bill was not passed by the House of Representatives. As of the date of this paper, the Comptroller’s website continues to indicate that the Comptroller is delaying implementation of the 2003 legislation.

The legislature’s final 2003 change with regard to local taxation granted the Comptroller the power to override a taxpayer’s effort to establish its place of business for local taxation. Most local tax analyses stem from the seller’s “place of business,” which is a physical location that is required to have a sales tax permit. The new 2003 law allows the Comptroller to declare a location to not be a place of business if she determines that the location is not required to maintain a sales tax permit and maintains the permit purely for the purpose of avoiding local tax liability.¹¹ The statute also grants the Comptroller the authority to establish a seller’s place of business in certain situations. When a seller claims to have no place of business but contracts with another business to process invoices or orders, the Comptroller may determine that the seller’s sales are consummated at the place where the goods originated as if they were resold to the contracted business.¹²

⁸ Act of 2003, 78th Leg., R.S., H.B. 2425, § 100, 102 (amending Tex. Tax Code § 151.103, 151.202).

⁹ Act of 2003, 78th Leg., R.S., H.B. 2425, § 115 (amending Tex. Tax. Code § 321.203).

¹⁰ *Delay in Implementation of Changes to Local Sales and Use Taxes*, available on the website of the Texas Comptroller of Public Accounts, http://www.cpa.state.tx.us/taxinfo/sales/localtax_change.html.

¹¹ Act of 2003, 78th Leg., R.S., H.B. 3534, § 1 (amending Tex. Tax. Code § 321.002).

¹² Act of 2003, 78th Leg., R.S., H.B. 3534, § 2 (amending Tex. Tax. Code § 321.203).

The legislature also made several changes in 2003 to the way the state taxes sales of food in order to comply with the SSTP. Before the changes, sales of food were taxable only if the food item being sold was served, prepared, or sold ready for immediate consumption in or by restaurants, lunch counters, cafeterias, vending machines, hotels, or similar places of business.¹³ The SSTP calls for taxing more food items than the previous statute, so the legislature expanded the definition of taxable food.

Under these new statutes, which became effective October 1, 2003, sales of the following items are also taxable: (1) “food sold in a heated state or heated by the seller” and (2) “two or more food ingredients mixed or combined by the seller for sale as a single item, including items that are sold in an unheated state by weight or volume as a single item, but not including food that is only cut, repackaged, or pasteurized by the seller.”¹⁴ This expansion may affect some grocery stores that combine one or more food ingredients and sell them as a single item, such as a quart of potato salad or a frozen lasagna. These items are now be taxed when they were not taxed under prior statutes because they were not sold by a restaurant in a state fit for immediate consumption. The 2003 statutes also codify Comptroller rules concerning bakery items by providing that items sold by bakeries without plates or utensils are exempt from taxation.¹⁵

The amended definition of taxable food was incorporated into the exemption for certain sales of gas and electricity in Tax Code § 151.317. Before the 2003 amendments, gas and electricity related to food preparation was exempt unless it was used by a restaurant or other commercial operation to prepare food for immediate consumption.¹⁶ The amended § 151.317 states that gas and electricity are exempt to prepare food other than food that is taxable under (amended) § 151.314.¹⁷ Therefore, sellers whose food items are newly taxed under the amended § 151.314 have probably also lost an exemption for their purchases of gas and electricity to prepare the food under amended § 151.317.

Even with the SSTP-related changes in 2003, Texas probably does not substantially comply with the SSTP Agreement. Some areas of sales tax law that may be ripe for amendment in future sessions include repealing the partial exemptions for data processing services,¹⁸ information services,¹⁹ and internet access services²⁰ because the SSTP Agreement does not

¹³ Tex. Tax Code § 151.314 (prior to 2003 amendments).

¹⁴ Act of 2003, 78th Leg., R.S., H.B. 2425, § 103 (amending Tex. Tax Code § 151.314).

¹⁵ *Id.*

¹⁶ Tex. Tax Code § 151.317 (prior to 2003 amendments).

¹⁷ Act of 2003, 78th Leg., R.S., H.B. 2425, § 102 (amending Tex. Tax Code § 151.317)

¹⁸ Texas Tax Code § 151.351 provides that the first 20% of the sales price of data processing services is exempt from tax.

¹⁹ Texas Tax Code § 151.351 provides that the first 20% of the sales price of information services is exempt from tax.

allow for partial exemptions from tax. The Texas sales tax also does not comply with the SSTP Agreement's provisions regarding the situs of sales of tangible personal property.²¹

Despite Texas' somewhat confusing status under the SSTP, the SSTP Agreement was enacted by the required number of member states and will become effective October 1, 2005.²² The initial governing board consists of eighteen states—Arkansas, Indiana, Iowa, Kansas, Kentucky, Michigan, Minnesota, Nebraska, New Jersey, North Carolina, North Dakota, Ohio, Oklahoma, South Dakota, Tennessee, Utah, West Virginia, and Wyoming.²³ Texas continues to be an implementing state, but is not a full member state or associate member state because its sales and use tax laws do not adequately conform to the SSTP agreement.²⁴

Member states continue to debate issues concerning state-specific exemptions allowed under the SSTP, as well as other matters. But, at this time, it appears that the member states are committed to the ideals and promotion of the SSTP. One of the first actions of the governing board of the SSTP will be to research and approve service providers for new technology to simplify collection and remittance of tax under the SSTP.²⁵ The new technology should allow sellers to use a centralized online registration system for all SSTP states and accurately calculate the tax due in all member states.²⁶

At this time, it is difficult to predict the amount of success the SSTP will have in convincing online retailers to voluntarily collect tax for destination states. In one Associated Press article, a tax officer of Amazon.com, Inc. stated, "Certainly at Amazon, we have no plans to volunteer."²⁷ The same article indicated that the Direct Marketing Association, a trade group comprised of many online retailers, believed the SSTP is "far too complex to work."²⁸ SSTP states have offered an incentive of sorts to online retailers to encourage their voluntary compliance with the new system—any retailer that does voluntarily comply and begins

²⁰ Texas Tax Code § 151.325 provides that the first \$25 of the sales price of internet access services is exempt from tax.

²¹ State Tax Review, June 10, 2003, p. 24.

²² State Tax Review, July 12, 2005, p. 1. The SSTP requirements for effectiveness were achieved as a result of a bit of maneuvering. Upon realizing that the required number of member states would not be obtained, the implementing states amended the SSTP agreement to create a new category of "associate member states" that would be counted along with full members for purposes of meeting enactment thresholds. *Id.* at 2.

²³ *Id.* at 1.

²⁴ *Id.* at 3.

²⁵ *Id.* at 4.

²⁶ *Id.*

²⁷ Robert Tanner, *States Expanding Push for Internet Taxes*, Aug. 31, 2005, appearing at http://news.yahoo.com/s/ap/20050831/ap-on-hi-te/internet_taxes.

²⁸ *Id.*

collecting taxes in SSTP members states in 2005 is given amnesty by all member states for taxes that may have been owed on prior online sales.²⁹

V. STATE TAX CHANGES PROPOSED IN THE 79TH LEGISLATURE

During the 79th Legislature's regular session, both the House of Representatives and Senate made proposals for sweeping changes to Texas taxes. Below is a summary of each legislative body's regular session proposals.³⁰

House of Representatives. The House of Representative's version of H.B. 3 included the following:

- The maximum real property ad valorem tax rates would have been reduced from about \$1.50 per \$100 of appraised value to \$1.15 (and later to \$1.10).
- The franchise tax would have offered taxpayer's a choice. Taxpayer's could pay either (i) the existing franchise tax or (ii) a 1.15% payroll tax. The taxpayer's election would have been binding for three years. The category of taxable entities would have been expanded to include any business with employees, with some exclusions.
- The state sales tax rate would have increased from 6.25% to 7.25%, and the sales tax would have been extended to include bottled water, billboard advertising, motor vehicle repair and washing, and elective cosmetic surgery.
- Other state taxes, such as cigarette taxes, tobacco taxes, and taxes on the sales of boats and motor vehicles would have been increased. The House also considered a 3% snack tax.

Senate: The Senate's proposals for H.B. 3 included:

- Reducing real property ad valorem taxes in approximately the same amounts as the House's proposal.
- The franchise tax would have been extended to most for-profit entities and also provided taxpayers a choice. Under alternative one, the taxpayer would pay 2.5% of the sum of its net income and employee wages, adjusted by subtracting the lesser of 50% of the wages or \$30,000 per employee. Alternative two would require taxpayers to pay a 1.75% payroll tax, capped at \$1,500 per employee. All taxpayers would be required to pay a minimum tax equal to 0.25% of its gross receipts plus allocable income.
- The state sales tax rate would have increased from 6.25% to 6.75%; the tax base remained largely unchanged.
- Other state taxes, such as cigarette taxes, tobacco taxes, taxes on the sales of boats and motor vehicles, alcohol excise taxes, and mixed beverage gross receipts taxes would have been increased.

²⁹ *Id.*

³⁰ The legislature's proposals changes numerous times. The summaries that follow highlight provisions that were included in the final forms of the bills.

These proposals were debated, amended, and amended further but ultimately failed to garner enough support in the regular session for passage. After the governor vetoed the public school spending bill, the legislature was forced into the first of two special sessions. In the first special session, the House of Representatives passed a bill that would have enacted limited changes to the franchise tax. Among the changes included in this bill were (1) changing the nexus rules to close the so-called “Delaware Sub” loophole so that limited partners in Texas limited partnerships would be required to pay the franchise tax if they owned a controlling interest in the partnership and (2) closing the so-called “Geoffrey’s” loophole by requiring Texas taxpayers to add-back into their franchise tax calculations certain royalty and interest payments and management fees paid to out-of-state related parties. The first special session ended before the legislative bodies could agree on the final version of the bill. A second legislative session commenced but ended without any action being taken.

VI. TEXAS FRANCHISE TAX PLANNING—THE SAME OLD ADVICE

Franchise tax planning options for new businesses and existing businesses remain unchanged after the 2005 legislative session. This section of the paper contains a brief discussion of planning strategies for Texas companies.

A. New Business Planning

One of the first choices new start-up businesses usually face is which entity form to use. Texas franchise tax considerations often tip the scale towards using either a corporation, limited liability company, or limited partnership. Under current Texas law, all state law corporations, including subchapter “S” corporations, and limited liability companies must pay the Texas franchise tax unless an exemption applies.³¹ Partnerships, including limited partnerships, do not pay the franchise tax. This fact leads many new business owners to form their business as a limited partnership.

Limited partnerships are required to have at least one general partner that will be individually liable for all of the partnership’s obligations. Because the general partner(s) of the limited partnership will be jointly and severally liable for all of the obligations of the partnership, most owners will choose to form one or more limited liability entities to act as the general partner(s). These entities are usually “S” corporations or LLCs which must pay Texas franchise tax. In either instance, the general partners typically own only a very small percentage of the limited partnership interests—usually only an aggregate 1% or less. Therefore, so long as the limited partners are all individuals, using the limited partnership structure exposes only 1% or less of the entity’s income to Texas franchise tax.

New business owners may choose to form a limited liability company or a subchapter “S” corporation if the gross receipts of the business are expected to be less than \$150,000 per year during the first few years of the business’s operation. For any year during which the business’s gross receipts are less than \$150,000, the Small Corporation Exemption in Tax Code

³¹ Texas Tax Code § 171.001.

§ 171.002(d)(2) gives the business a complete exemption from the franchise tax. A start-up business could initially form an LLC or subchapter “S” corporation, which generally have lower formation and operating costs than a limited partnership with an LLC or subchapter “S” corporation general partner, and utilize the Small Corporation Exemption to eliminate franchise tax liability. The owners could then implement one of the planning strategies outlined in Section VI-B below when the business’s gross receipts exceed the \$150,000 threshold.

B. Existing Businesses Planning

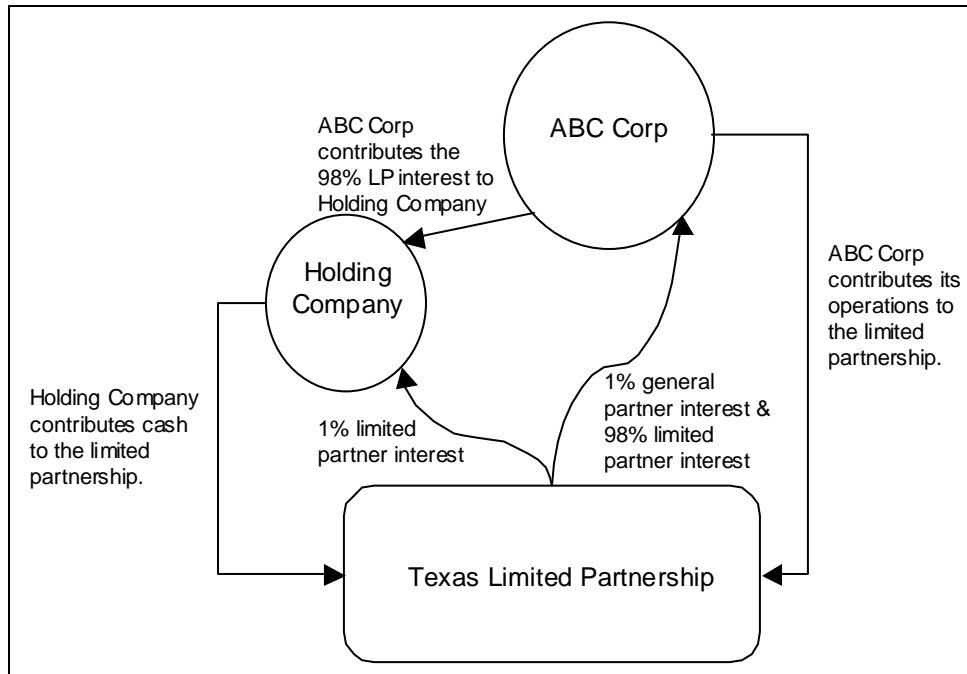
Existing Texas corporations and LLCs may find it financially beneficial to restructure into a partnership form that does not pay the Texas franchise tax. The fact that partnerships do not pay franchise taxes has spawned the creation of many restructuring techniques, all of which are designed to be federal tax neutral. This Part B of Section VI analyzes two of the most common restructuring strategies—the asset drop-down and the conversion. This Part also discusses the variations on the conversion planning strategy for LLCs and “S” corporations. ABC Corp, a hypothetical Texas “C” corporation, is used as a case study to analyze these restructuring techniques.

1. Asset Drop-Down Strategy

Asset drop-down restructuring involves transferring ABC Corp’s operations to a Texas limited partnership. The planning technique is fairly straightforward:

- ABC Corp will form a wholly owned non-Texas subsidiary (“Holding Company”) with cash. Holding Company is usually formed in Nevada or Delaware because of favorable state tax laws. Holding Company must use an out-of-state service provider to act as its official registered agent for service of process in the foreign state so that it does not do any business in the State of Texas. If Holding Company inadvertently creates tax nexus with the State of Texas, the benefit of the asset drop-down planning will be lost. Holding Company should be a corporation so that it may utilize favorable Texas apportionment rules.
- ABC Corp and Holding Company will form a Texas limited partnership. ABC Corp contributes the company’s operations to the limited partnership in exchange for a 1% general partnership interest and a 98% limited partner interest. Holding Company contributes cash equal to 1% of the value of ABC Corp’s operations to the limited partnership and receives a 1% limited partner interest in exchange for its contribution.
- Simultaneous with the contributions described above, ABC Corp contributes the 98% limited partnership interest to Holding Company. After the contribution, Holding Company will be a 99% limited partner in the partnership, and ABC Corp will be a 1% general partner in the partnership.

[diagram follows]



In the end, the Texas limited partnership will own and operate the company's business. This entity does not pay franchise tax. One percent of the profits and losses from the partnership flows to ABC Corp, which pays franchise tax on this 1%. Ninety-nine percent of the profits and losses from the operations will flow to Holding Company. The Texas Comptroller Rules state that owning a limited partner interest in a Texas limited partnership does not create nexus with the state for franchise tax purposes.³² The version of H.B. 3 passed by the House of Representatives in the first 2005 special session would have changed this rule and prevented taxpayers from using this restructuring strategy. But, under current law, as long as Holding Company performs no activities in Texas that would create nexus under the tax statutes or Comptroller Rules, Holding Company will not pay franchise tax on its 99% of the partnership income.

When Holding Company dividends its 99% of the partnership income to ABC Corp, the dividend will not be apportioned to Texas because of the location of payor rule. The location of payor rule prevents ABC Corp from paying taxes on the dividend to the State of Texas. The end result is that 99% of the profit and loss of the limited partnership will flow to the owners and escape Texas franchise taxation.³³

³² Comptroller Rule (34 TAC) 3.546(12)(B). The same Comptroller Rule provides that acting as a general partner in a Texas limited partnership does create nexus with the State of Texas for franchise tax purposes. The version of H.B. 3 passed by the House of Representatives in the first 2005 special session would have changed this rule and prevented taxpayers from using this restructuring strategy.

³³ The Texas Comptroller has issued numerous letters approving this structure. One such letter can be found on the Comptroller's Star System at Document Number 9903584L. A copy of this ruling is attached to this paper as Appendix A.

The main disadvantages of the asset drop-down approach are that (1) it is expensive to employ and (2) its purpose is destroyed if Holding Company inadvertently creates nexus with the State of Texas for franchise tax purposes. The costs will include forming two new entities and maintaining them on an ongoing basis. Holding Company's out-of-state service provider will also charge an annual fee for the services that it provides. In addition, all of the assets of ABC Corp must be transferred to the limited partnership, and titled assets must be retitled in the limited partnership's name.

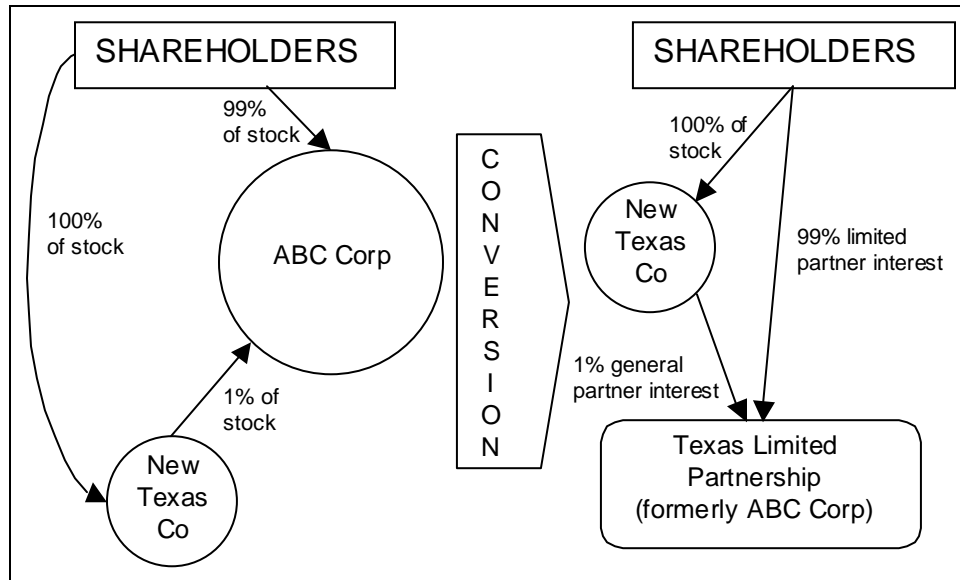
As a continuing matter, Holding Company must take special care not to conduct any activity that might be considered "doing business" in Texas under the Comptroller's Rules. At a minimum, Holding Company should maintain bank accounts in its state of formation, maintain an address in its state of formation, hold meetings in its state of formation, and conduct all formal business from its location in its state of formation. Failure to avoid creating nexus with Texas will make Holding Company's 99% distributions from the Texas limited partnership subject to the Texas franchise tax.

2. Conversion Strategy

Another restructuring strategy that ABC Corp could employ is a conversion strategy. The goal of this strategy is to convert ABC Corp into a Texas limited partnership using a state law conversion without creating additional federal tax obligations. The steps for implementing this strategy are described below.

- The shareholders of ABC Corp form another Texas corporation or LLC ("New Texas Co") and contribute an aggregate 1% of the ABC Corp stock to New Texas Co.
- ABC Corp performs a state law conversion into a Texas limited partnership by filing Articles of Conversion with the Texas Secretary of State. The owners' aggregate 99% of the ABC Corp stock will be converted into an aggregate 99% limited partnership interest in the new limited partnership. New Texas Co's 1% of ABC Corp stock will be converted into a 1% general partnership interest. The Texas limited partnership will elect to continue to be taxed as a corporation for federal tax purposes.

[diagram follows]



This restructuring strategy accomplishes the same result as the asset drop-down strategy. The limited partnership now operates the business, and it does not pay franchise tax. One percent of the profits and losses are owned by a general partner entity that will be subject to franchise tax. The ninety-nine percent limited partnership interests are owned directly by the individuals who were the former shareholders of the former ABC Corp, who do not pay franchise tax.

The conversion should qualify as a tax-free reorganization for federal tax purposes. The IRS has ruled that a state law conversion of a “C” corporation into a limited partnership accompanied by an election of the limited partnership to continue paying tax as a corporation will qualify as an F reorganization under IRC § 368(a)(1)(F).³⁴ The conversion statute in Texas has the added benefit of not requiring ABC Corp to transfer or retitle any of its property after the conversion.³⁵

One disadvantage of the conversion strategy is that the entity will be liable for the exit tax upon its conversion. Because ABC Corp will no longer be subject to the earned surplus component of the franchise tax by virtue of its conversion into a nontaxable limited partnership, it must pay 4.5% of its net taxable earned surplus for the period beginning on the day after the last day of its preceding full accounting year and continuing through the date of its exit.³⁶

a. Implementing Conversions for LLCs

The conversion strategy will work for LLCs in the same way that it worked for ABC Corp. The LLC members should form another LLC or a corporation that will become a 1%

³⁴ See PLR 199942009 (July 16, 1999). A copy of PLR 199942009 is attached to this paper as Appendix B.

³⁵ Tex. Bus. Corp. Act. § 5.20(A)(2).

³⁶ Tex. Tax Code § 171.0011.

member of the original LLC. The original LLC will convert into a limited partnership with the new entity as the 1% general partner and the other members of the original LLC as the limited partners. The owners of the LLC will achieve the same franchise tax result as ABC Corp. No federal “check-the-box” tax election will be necessary if the original LLC was previously being taxed as a partnership. If the original LLC was previously being taxed as an “S” corporation, see the next subpart for some specific caveats about implementing conversions for “S” corporations.

b. Implementing Conversions for “S” Corporations

The conversion strategy should not be implemented by an “S” corporation without caution. The fear is that the conversion may create two classes of stock in violation of the IRS rules. The IRS initially ruled that an “S” corporation could convert into a state law limited partnership, elect to be taxed as a corporation, and still retain its subchapter “S” election.³⁷ According to the facts of PLR 199942009, the partnership agreement of the resulting entity in the conversion provided for “equal allocations of profits, distributions of cash from operations, and distributions upon dissolution.”³⁸ Shortly after it issued this favorable ruling, however, the IRS announced that it would no longer issue rulings on whether conversions into limited partnerships created two classes of stock under federal law. Maintaining two classes of stock would violate the requirements for qualifying to make a subchapter “S” election.

The “test” for whether an entity has two classes of stock is if “all outstanding shares of stock of the corporation confer identical rights to distribution and liquidation proceeds.” The partnership agreement in PLR 199942009 met this test. Some writers believe that the stated result in PLR 199942009 is correct and that limited partnerships with partnership agreements that provide for equal allocations, distributions of cash, and liquidating distributions should be able to maintain subchapter “S” status.³⁹ Other writers believe that the fact that general partners are liable for partnership obligations under state law confers an “unequal” benefit (and possible unequal allocations or distributions) to limited partners, and that, therefore, state partnership law creates two classes of stock for limited partnerships.⁴⁰ The IRS’s reluctance to respond to this question leaves an open issue for conversions by “S” corporations.

Attorneys representing “S” corporations should consider employing one of two possible methods for avoiding the multiple classes of stock issue. First, the limited partnership in the conversion strategy outlined above could elect to be treated as a state law registered limited liability partnership, or RLLP.⁴¹ An RLLP treats all partners equally from a liability perspective, thus possibly avoiding the multiple classes of stock issue. A fair reading of the Texas statute

³⁷ PLR 199942009 (July 16, 1999).

³⁸ *Id.*

³⁹ See Bryan W. Lee, Changing Form of Entity, University of Texas School of Law 49th Annual Taxation Conference, October 24, 2001, Austin, Texas.

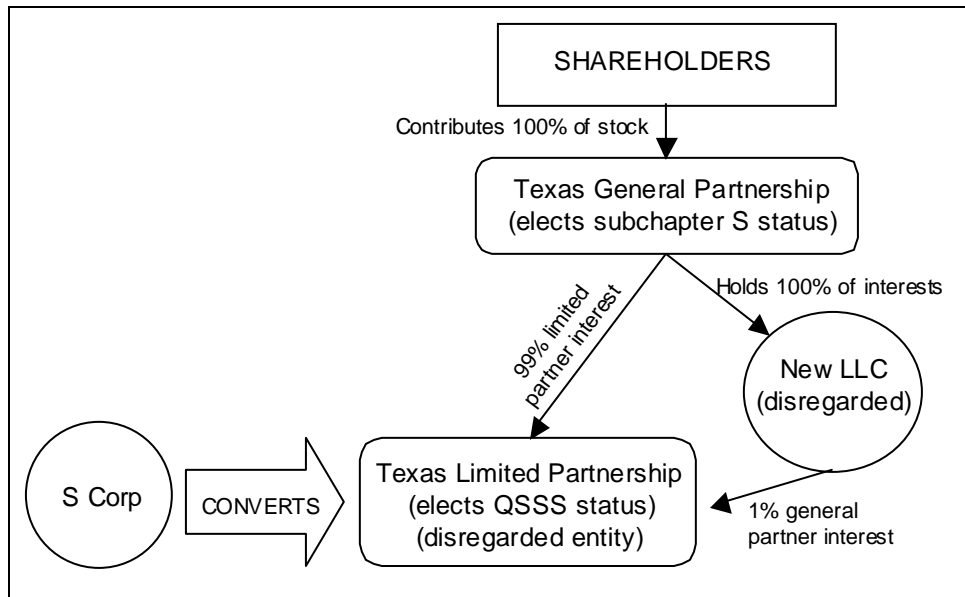
⁴⁰ See Daniel G. Baucum, Avoiding Texas Franchise Taxes Through Conversions, State Bar of Texas Advanced Tax Law Course, September 20-21, 2001, Dallas, Texas.

⁴¹ See Section 3.08 of the Texas Revised Partnership Act for provisions regarding RLLPs.

governing RLLPs seems to provide the same liability protection to the partners of the RLLP that the Texas Revised Limited Partnership Act provides to limited partners of a limited partnership, but the liability protections of RLLPs have not been thoroughly tested in Texas courts. The main difference between the liability shields provided a limited partnership and an RLLP is that in an RLLP, partners may continue to be liable for their own negligence. Clients electing to rely on the liability protections provided to partners in an RLLP will run the risk of Texas courts interpreting the statute more narrowly and being held personally liable for their own negligence if they take an active role in the business.

As a second alternative, the shareholders of the subchapter “S” corporation could add an additional entity layer to the restructuring in the following manner:

- The shareholders contribute their stock in the “S” corporation to a new general partnership that treats all partners equally. This new general partnership elects to be taxed as a subchapter “S” corporation for federal tax purposes.
- The general partnership forms a new single-member LLC with itself as the only member.
- The original “S” corporation converts into a Texas limited partnership with the single-member LLC as the 1% general partner and the general partnership as the 99% limited partner. The converted limited partnership elects to be taxed as a qualified subchapter “S” subsidiary, or QSSS.



In this final structure, the single-member LLC is disregarded for federal tax purposes, thus causing the converted limited partnership to be disregarded for lack of two partners.⁴² The general partnership will maintain its subchapter “S” election because it does not have more than

⁴² See PLR 200008015.

one class of stock. The converted limited partnership and single-member LLC will provide limited liability protection to the shareholders of the original “S” corporation.

VII. CONCLUSION

After the legislature’s failure to enact sweeping changes to the Texas tax system in 2005, the tax planning techniques utilized by attorneys and accountants and their clients remain largely unchanged. Tax professionals will (and should) continue to advise clients that state tax laws may change in the future to nullify the advantages of the carefully structured business arrangements, but the debates that took place during the 2005 legislative session indicate just how difficult it will be to change the state’s tax system.

APPENDIX A

Texas Comptroller of Public Accounts

STAR System - 9903584L

9903584L

March 24, 1999

Dear Mr. *****:

Thank you for your letter concerning the nexus of a newly formed entity.

You stated in your letter that a Texas Corporation (Parent) will form a wholly owned Nevada Subsidiary (Nevada Sub) and will transfer cash to Nevada Sub. Parent and Nevada Sub will then create a Texas Limited Partnership (PNLP). Parent will contribute its Texas based assets to PNLP for a 1% general partnership interest and a 98% limited partnership interest in PNLP. Parent will contribute its 98% limited partnership interest in PLNP to Nevada Sub as a capital contribution. The end result will be that Parent will own a 1% general partnership interest in PNLP and Nevada Sub will own a 99% limited partnership interest in PNLP.

Nevada Sub will hold its annual meeting of its board of directors outside of Texas. Nevada Sub will primarily be a passive holding company. The legal documents to incorporate Nevada Sub will be prepared in Texas by a Texas attorney.

Based on the information provided, the Nevada Sub will not have nexus in Texas for either component of the Texas franchise tax. If the Texas attorney continues to perform work on behalf of Nevada Sub subsequent to its incorporation, however, it may become subject to the franchise tax.

This response is based on current law and the facts presented. If there are different or additional facts, the response may change.

If you have any questions about this or any other franchise tax matter, please call me at 1-800-531-5441, extension 34612. My direct number is (512) 463-4612. You may write me at Tax Policy Division, Comptroller of Public Accounts, Austin, Texas 78774.

Sincerely,

Janet Spies
Tax Policy Division

ACCESSION NUMBER: 9903584L
SUPERSEDED: N
DOCUMENT TYPE: L
DATE: 03/24/1999
TAX TYPE: FRANCHISE

APPENDIX B

PLR 199942009, 10/25/1999 -- IRC Sec. 1362

October 25, 1999

Code sec.1362

Uil no. 7701.02-00

Headnote

The Service has ruled that a company's conversion to a state limited partnership and its concurrent election to continue to be an association taxable as a corporation will not terminate the company's S election under section 1362(a).

Full Text

Release Date: 10/22/1999

Date: July 16, 1999

Refer Reply To: CC:DOM:P&SI:3 PLR-105915-99

LEGEND:

Company A =* * *

Company B =* * *

Company C =* * *

Shareholder =* * *

State =* * *

State Law =* * *

Provision 1 =* * *

Provision 2 =* * *

Provision 3 =* * *

Provision 4 =* * *

a =* * *

b =* * *

c =* * *

Dear* * *

This letter responds to a letter from your authorized representatives dated March 12, 1999, submitted on behalf of Company A, requesting various rulings relating to Company A's contemplated conversion under State Law from a corporation to a limited partnership. Company represents the following facts.

Company A was incorporated in State on a and elected under section 1362(a) to be an S corporation that same date. Shareholder owns 100 percent of Company A's stock.

Company A intends to become a limited partnership under State Law, which permits a change in the type of entity without a disruption or interruption of the entity's existence. The intent of State Law, as represented by Company, is to allow entities to use a conversion transaction as an alternative to a merger.

Before the conversion, Shareholder will form Company B, a State limited liability company. Company B will contribute cash or other assets to Company A in exchange for a b percent interest in Company A. Company A then will become a State limited partnership (Company C) by filing articles of conversion with State pursuant to Provisions 1-4 (State Law). Company B will be the general partner, with a b percent interest in Company C, and Shareholder will be the limited partner, with a c percent interest.

On the date of conversion, Company C (Company A prior to conversion) will elect under section 301.7701-3 of the Procedure and Administration Regulations and section 301.7701-3T of the Temporary Regulations (the "check-the-box" regulations) to continue to be classified as an association taxable as a corporation for federal tax purposes. Company intends the conversion transaction to be a section 368(a)(1)(F) reorganization. See Rev. Rul. 64-250, 1964-2 C.B. 333, which provides that a reorganization under section 368(a)(1)(F) does not terminate a company=s S corporation election.

Section 1361(a) of the Internal Revenue Code provides that the term "S corporation" means, with respect to any tax year, a small business corporation for which an election under section 1362(a) is in effect for that year.

Section 1361(b)(1) provides that, for purposes of subchapter S, the term "small business corporation" means a domestic corporation which is not an ineligible corporation and which does not, among other things, (B) have as a shareholder a person (other than an

estate, a trust described in section 1361(c)(2), or an organization described in section 1361(c)(6), who is not an individual; and (D) have more than one class of stock.

Except as provided in section 301.7701-3(b)(3) [regarding eligible entities in existence before January 1, 1997], section 301.7701-3(b)(1) provides that, unless the entity elects otherwise, a domestic eligible entity is (i) a partnership if it has two or more members; or (ii) disregarded as an entity separate from its owner if it has a single owner. Section 301.7701-3T(a) of the Temporary Regulations defines an eligible entity as a business entity that is not classified as a corporation under section 301.7701-2(b)(1), (3), (4), (5), (6), (7), or (8) (a per se corporation).

Company B is a State limited liability company with a single owner. It is not a per se corporation. Thus, Company B is disregarded as an entity separate from its owner, Shareholder, who is treated as owning Company B's assets directly. The b percent interest in Company A owned by Company B is treated as being owned directly by Shareholder.

Section 1.1361-1(l)(1) provides that, except as provided in section 1.1361-1(l)(4) (relating to instruments, obligations, or arrangements treated as a second class of stock), a corporation is treated as having only one class of stock if all outstanding shares of stock of the corporation confer identical rights to distribution and liquidation proceeds. Differences in voting rights among shares of stock of a corporation are disregarded in determining whether a corporation has more than one class of stock.

Section 1.1361-1(l)(2) provides that the determination of whether all outstanding shares of stock confer identical rights to distribution and liquidation proceeds is made based on the corporate charter, articles of incorporation, bylaws, applicable state law, and binding agreements relating to distribution and liquidation proceeds (collectively, the governing provisions). Although a corporation is not treated as having more than one class of stock so long as the governing provisions provide for identical distribution and liquidation rights, any distributions (including actual, constructive, or deemed distributions) that differ in timing or amount are to be given appropriate tax effect in accordance with the facts and circumstances.

The partnership agreement provides for equal allocations of profits, distributions of cash from operations, and distributions upon dissolution. The main differences between the respective interests of the partners relate to management and liability:

a) Under the partnership agreement, Company B has voting rights and all rights and powers necessary to manage Company C, whereas Shareholder, with some exceptions, has no rights or powers to participate in Company C's management and control.

b) Under the State limited partnership statute, Company B can be made liable for claims against Company C, whereas Shareholder is not liable for Company C's obligations unless it participates in control of the business.

c) Under the partnership agreement, Company B shall be indemnified for claims made against it by third parties relating to any liability or damage incurred because of the performance or omission of any authorized act by Company B relating to the business of Company C.

d) Under the partnership agreement, Company B may be removed as general partner of Company C by a vote of 90 percent of the partners' sharing ratio.

Both partners of Company C will have identical rights to partnership distributions and liquidation proceeds under the partnership agreement. Thus, the two different interests in Company C (general and limited) will not constitute more than one class of stock for purposes of section 1361(b)(1)(D).

Section 301.7701-3T(a) provides that a business entity that is not classified as a corporation under section 301.7701- 2(b)(1), (3), (4), (5), (6), (7), or (8) (an eligible entity) can elect its classification for federal tax purposes as provided in this section. An eligible entity with at least two members can elect to be classified as either an association (and thus a corporation under section 301.7701-2(b)(2)) or a partnership, and an eligible entity with a single owner can elect to be classified as an association or to be disregarded as an entity separate from its owner.

Under State Law, a State corporation may convert to any other type of entity, including a limited partnership. Provision 1. The conversion is effective when State issues a certificate of conversion. Provision 3. Upon issuance of the certificate, the converting entity continues to exist, without interruption, but in the organizational form of the converted entity rather than in its prior organizational form. Provision 4. All rights, title, and interests in property owned by the converting entity continue to be owned by the converted entity without reversion or impairment, and without any transfer or assignment having occurred. Id. All liabilities and obligations of the converting entity continue to be liabilities and obligations of the converted entity without impairment or diminution. Id.

Based solely on the facts as presented in this ruling request, and viewed in light of the applicable law and regulations, we rule that Company A's conversion under State Law to Company C, and the concurrent election by Company C to continue to be classified as an association taxable as a corporation for federal tax purposes, will not terminate Company C's election under section 1362(a) to be an S corporation.

Except for the specific ruling above, no opinion is expressed or implied concerning the federal tax consequences of the facts of this case under any other provision of the Code. Specifically, no opinion is expressed regarding Company A's eligibility under section 1361 to be an S corporation, as well as the validity of its election under section 1362(a).

In accordance with the power of attorney on file with this office, we are sending you the original of this letter and a copy to your authorized representative.

This ruling is directed only to the taxpayer who requested it. According to section 6110(k)(3), this ruling may not be used or cited as precedent.

Sincerely,

WILLIAM P. O'SHEA

Chief, Branch 3

Office of Assistant

Chief Counsel

(Passthroughs and

Special Industries)

encl: copy for 6110 purposes

cc:* * *