# SUMMARY OF THE REVISED TEXAS FRANCHISE TAX (AFTER 2007 LEGISLATIVE CHANGES)

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## I. TEXAS FRANCHISE TAX

The Texas Legislature enacted House Bill 3, a significant revision to the Texas franchise tax, in a special session in the summer of 2006. The revised Texas franchise tax, sometimes called the "Margin Tax," goes into effect January 1, 2008, but the 2008 tax report will be based on 2007 financial activity. The new tax contains provisions that may render ineffective some tax planning measures implemented during the 2007 calendar year. Business owners should contact their accountant, attorney, or other tax professional as soon as possible to discuss any available planning opportunities under the new tax for their businesses.

During the 2007 legislative session, the Texas Legislature passed one significant bill, House Bill 3928, to correct, clarify, and refine the new margin tax. Other bills affecting the tax were also enacted. This section of the Texas tax update provides a complete overview of the margin tax. 2007 legislative changes are italicized for emphasis.

**IMPORTANT UPDATES SINCE OCTOBER 2007:** In the past six months, some important transitional steps have been completed as the Comptroller and taxpayers prepare for the filing of the first margin tax reports in 2008.

1. Fifteen new Comptroller administrative rules were adopted effective December 11, 2007. The new rules are:

   3.581 – Margin: Taxable and Nontaxable Entities
   3.582 – Margin: Passive Entities
   3.583 – Margin: Exemptions
   3.584 – Margin: Reports and Payments
   3.585 – Margin: Annual Report Extensions
   3.586 – Margin: Nexus
   3.587 – Margin: Total Revenue
   3.588 – Margin: Cost of Goods Sold
   3.589 – Margin: Compensation
   3.590 – Margin: Combined Reporting
   3.591 – Margin: Apportionment

3.592 – Margin: Additional Tax
3.593 – Margin: Franchise Tax Credits
3.594 – Margin: Temporary Credit and Business Loss Carryforwards
3.595 – Margin: Transition

2. 2008 Franchise Tax Report forms became available for download on the Comptroller's website in March 2008.

3. The Comptroller released a series of answers to Frequently Asked Questions on her website. The "FAQs" are updated continuously and are represent the Comptroller's most up-to-date statement of policy positions on various aspects of the margin tax. The FAQs may be accessed at the following website: http://www.cpa.state.tx.us/taxinfo/franchise/faq_questions.html

4. On April 22, 2008, the Comptroller released an announcement that all Texas taxpayers who are unable to meet the May 15, 2008, due date for their franchise tax reports will have an additional 30 days to submit their returns or file an extension without penalty.

The standard formula for calculating the margin tax is set forth below:

Lesser of:

(A) 70% of Total Revenue from Entire Business or

(B) Total Revenue from Entire Business

- Deduction equal to the greater of:

(i) Compensation and Benefits; or

(ii) Cost of Goods Sold

Unapportioned Taxable Margin

x Texas Apportionment Factor

Apportioned Taxable Margin

- Deductions for Solar Energy/Clean Coal

x Tax Rate (either 1% or 0.5%)

Franchise Tax Due Before Credits

- Applicable Credits

Final Franchise Tax Liability (for non-small business)

x Applicable Small Business Discount (for small businesses)

Final Franchise Tax Liability (for small businesses)

The addition of an optional E-Z Computation for businesses with less than $10 million in total revenue was added during the 2007 legislative session. The formula for the E-Z Computation is set forth below:

Total Revenue from Entire Business

x Texas Apportionment Factor

Apportioned Total Revenue

x Tax Rate of 0.575%

Final Franchise Tax Liability (for non-small business)

x Applicable Small Business Discount (for small businesses)

Final Franchise Tax Liability (for small businesses)

Some important aspects of the Margin Tax and the various components of the Margin Tax formula are briefly described in this outline.

*2007 Legislative Change: House Bill 3928 added the concept of a Small Business Discount. The applicable percentage discount is applied to the franchise tax liability determined after applying the applicable tax rate and subtracting any applicable credits. The following discounts will apply:*

*A taxable entity with Total Revenue from Entire Business greater than $300,000 but less than $400,000 will receive a discount of 80%.*

*A taxable entity with Total Revenue from Entire Business equal to or greater than $400,000 but less than $500,000 will receive a discount of 60%.*

*A taxable entity with Total Revenue from Entire Business equal to or greater than $500,000 but less than $700,000 will receive a discount of 40%.*

*A taxable entity with Total Revenue from Entire Business equal to or greater than $700,000 but less than $900,000 will receive a discount of 20%.*

*The amounts listed above will be adjusted based on CPI on January 1 of every even-numbered year beginning in 2010.*

## TAXABLE ENTITIES

Only corporations and limited liability companies must pay the franchise tax in its pre-2008 form. Under the revised tax, all entities with limited liability under state law (with the exception of "passive entities," as explained below) will be taxed. This includes partnerships, limited liability partnerships, corporations, banking corporations, savings and loan associations, limited liability companies, business trusts, professional associations, business associations, joint ventures, joint stock companies, holding companies, and other legal entities. Sole proprietorships and general partnerships comprised of only natural persons will ***not*** be subject to

the revised tax. For the first time under the Texas franchise tax, some entities will be required to file combined tax returns (see discussion below).

> *2007 Legislative Change: House Bill 3928 added limited liability partnerships to the list of taxable entities. The statute also clarified that the following types of trusts are <u>not</u> taxable entities: (i) grantor trusts taxable under Section 671 and IRC § 7701(a)(30)(E), not taxable as a business entity pursuant to Treasury Regulation Section 301.7701-4(b), and in which all of the grantors and beneficiaries are natural persons or charitable entities as defined in IRC § 501(c)(3); (ii) nonprofit self-insurance trusts for health care liability claims; (iii) trusts that are part of an employer's stock bonus, pension, or profit-sharing plan; and (iv) trusts that are voluntary employees' beneficiary associations.*
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> *2007 Legislative Change: House Bill 3928 amended the definition of "natural person" to include the estate of a natural person.*

The revised tax contains an exemption for certain "passive entities." An entity qualifies as a passive entity if: (1) the entity is a general or limited partnership or a trust, other than a business trust; (2) during the period on which margin is based, the entity's federal gross income consists of at least 90% of the following income: dividends, interest, foreign currency exchange gain, periodic and nonperiodic payments with respect to notional principal contracts, option premiums, cash settlement or termination payments with respect to a financial instrument, and income from a limited liability company; distributive shares of partnership income to the extent that those distributive shares of income are greater than zero; capital gains from the sale of real property, commodities traded on a commodities exchange, and securities; and royalties, bonuses, or delay rental income from mineral properties and income from other nonoperating mineral interests; and (3) the entity does not receive more than 10% of its federal gross income from conducting an active trade or business.

> *2007 Legislative Change: House Bill 3928 modified the inclusion of "gains from the sale of real property" as qualifying passive income so that the provision now reads "<u>capital</u> gains from the sale of real property." The statute also removed superfluous provisions addressing passive family limited partnerships, investment partnerships, and other specific passive entities.*

A taxable entity will not owe any tax if the calculated tax is less than $1,000. A taxable entity will not owe tax if its "revenue from entire business" is less than or equal to $300,000; this $300,000 amount will be indexed based on CPI on January 1 of every even-numbered year beginning in 2010.

The Comptroller recognizes in her FAQs that the margin tax statutes allow taxpayers to combine the E-Z Computation, Small Business Discount, and $1,000 baseline exemption. Based on the combination of these statutory provisions, a taxpayer may have up to $434,782 in Total Revenue on its 2008 Franchise Tax Report and owe no tax.

## <u>TOTAL REVENUE FROM ENTIRE BUSINESS</u>

Revenue is defined by references to federal income tax forms.

The total revenue of a taxable entity treated for federal income tax purposes as a corporation is an amount computed by adding the following: (a) the amount entered on line 1c, Internal Revenue Service Form 1120; (b) the amounts entered on lines 4 through 10, Internal Revenue Service Form 1120; and (c) any total revenue reported by a lower tier entity as includable in the taxable entity's total revenue. The following are then subtracted from such sum: (a) bad debt that corresponds to the computed revenue; (b) to the extent included in revenue, foreign royalties and foreign dividends, including amounts determined under IRC § 78 or IRC § 951 through IRC § 964; (c) to the extent included in revenue, net distributive income from partnerships and from trusts and limited liability companies treated as partnerships for federal income tax purposes and net distributive income from limited liability companies and corporations treated as S corporations for federal income tax purposes; (d) allowable deductions from Internal Revenue Service Form 1120, Schedule C, to the extent the related dividend income is included in total revenue; and (e) to the extent included in revenue, items of income attributable to an entity that is a disregarded entity for federal income tax purposes.

The total revenue of a taxable entity treated for federal income tax purposes as a partnership is an amount computed by adding the following: (a) the amount entered on line 1c, Internal Revenue Service Form 1065; (b) the amounts entered on lines 4, 6, and 7, Internal Revenue Service Form 1065; (c) the amounts entered on lines 3a and 5 through 11, Internal Revenue Service Form 1065, Schedule K; (d) the amounts on Form 8825, line 17; and (e) any total revenue reported by a lower tier entity as includable in the taxable entity's total revenue. The following are then subtracted from such sum: (a) bad debt that corresponds to the computed revenue; (b) to the extent included in revenue, foreign royalties and foreign dividends, including amounts determined under IRC § 78 or IRC § 951 through IRC § 964; (c) to the extent included in revenue, net distributive income from partnerships and from trusts and limited liability companies treated as partnerships for federal income tax purposes and net distributive income from limited liability companies and corporations treated as S corporations for federal income tax purposes; and (d) to the extent included in revenue, items of income attributable to an entity that is a disregarded entity for federal income tax purposes.

> *2007 Legislative Change: As expected, House Bill 3928 cleaned up some of the confusion surrounding which entries on a partnership's federal tax forms would be included in revenue. A double-inclusion of guaranteed payments was deleted, and the line for <u>gross</u> rental income on Form 8825 was substituted for the line for <u>net</u> rental income on Form 1065, Schedule K.*

The total revenue of a taxable entity other than a taxable entity treated for federal income tax purposes as a corporation or partnership is computed in a substantially equivalent manner.

> *2007 Legislative Change: House Bill 3928 requires that the amounts entered on federal income tax forms used to calculate total revenue must comply with federal tax law. The definition of total revenue was also modified by stating that the revenue that a lower-tier entity reports as includable by an upper-tier entity is treated as revenue by the upper-tier entity.*

## DEDUCTIONS

Each taxable entity will be able to take the ***largest*** of three deductions—cost of goods sold, compensation and benefits, and what amounts to a 30% deduction (by paying tax based on 70% of total revenue instead of electing to deduct compensation or cost of goods sold).

### COST OF GOODS SOLD

Cost of goods sold is defined in the new statute; it does ***not*** follow the federal tax concept. A taxable entity's cost of goods sold is calculated by adding (i) the direct costs associated with acquiring or producing the goods, (ii) certain indirect costs associated with the goods, and (iii) certain administrative or overhead costs allocable to the acquisition or production of goods. Cost of goods sold includes only costs associated with real property or tangible personal property, not intangible property or services. The definition of cost of goods sold does include production, however. So, many construction and manufacturing expenses will qualify as deductible costs of goods sold. In addition, cost of goods sold for a particular good may only be included in the deduction if the taxpayer, or a member of its consolidated group, "owns" the goods based on "all of the facts and circumstances."

### COMPENSATION AND BENEFITS

Deductible compensation includes wages, tips, net distributive income from certain types of entities distributed to natural persons, and stock awards and stock options deducted for federal income tax purposes. A taxable entity electing to deduct compensation may deduct wages and cash compensation and the cost of all deductible benefits. The amount of compensation that may be deducted for any person cannot exceed $300,000. There is no limit on the amount of deductible benefits. Deductible benefits include the cost of all benefits the taxable entity provides to its officers, directors, owners, partners, and employees, including workers' compensation benefits, health care, employer contributions made to employees' health savings accounts, and retirement to the extent deductible for federal income tax purposes.

*2007 Legislative Change: House Bill 3928 clarified that net distributive income from a disregarded LLC is included in compensation if it is distributed to a natural person.*

*2007 Legislative Change: House Bill 3928 allows "Small employers," as that term is defined in Insurance Code § 1501.002, that have not provided health care benefits to any of their employees in the calendar year preceding the beginning date of a report period, but that (i) elect to begin providing health care benefits to all of their employees and (ii) elect to deduct compensation and benefits, to take bonus deductions. For the first 12-month period on which margin is based after which health benefits are provided to all employees, the taxable entity may deduct an additional 50% of the cost of the health care benefits. For the second 12-month period on which margin is based after which health*

*benefits are provided to all employees, the taxable entity may deduct an additional 25% of the cost of the health care benefits. Insurance Code § 1501.002 defines "small employer" to mean a person or entity "who employed an average of at least two employees but not more than 50 eligible employees on business days during the preceding calendar year and who employs at least two employees on the first day of the plan year."*

THIRTY PERCENT DEDUCTION (option to pay on 70% of Revenue)

The 30% deduction ensures that no more than 70% of a taxable entity's revenue will be taxed in any year. The 30% deduction is not actually described as a deduction in the statute. The technical calculation in the statute provides that taxable margin is equal the lesser of (i) total revenue minus the greater of cost of goods sold or compensation and benefits or (ii) 70% of total revenue.

## APPORTIONMENT

For the most part, apportionment rules have not changed for the new tax. A taxable entity's apportionment factor will be determined by dividing its gross receipts from business done in Texas by its total gross receipts. The comptroller has already adopted lengthy rules that describe when receipts are considered Texas receipts; the rules are expected to remain mostly unchanged for the revised tax.

## TAX RATE

For most taxpayers, the tax rate will be 1%. For taxpayers engaged primarily in retail or wholesale trade, the tax rate will be 0.5%. A taxable entity is engaged primarily in retail or wholesale trade only if: (a) the total revenue from its activities in retail or wholesale trade is greater than the total revenue from its activities in trades other than the retail and wholesale trades; (b) less than 50% of the total revenue from activities in retail or wholesale trade comes from the sale of products it produces or products produced by an entity that is part of an affiliated group to which the taxable entity also belongs (this does not apply to total revenue from activities in a retail trade described by Major Group 58 of the Standard Industrial Classification Manual published by the federal Office of Management and Budget); and (C) the taxable entity does not provide retail or wholesale utilities, including telecommunications services and electricity or gas. "Wholesale trade" means the activities described in Division F of the 1987 SIC Manual published by the federal Office of Management and Budget, and "retail trade" means the activities described in Division G of the 1987 SIC Manual.

*2007 Legislative Change: House Bill 3928 clarifies that "retail and wholesale utilities" includes "telecommunications services, electricity, or gas."*

## CREDITS

Most credits available under the current franchise tax are eliminated by the revised tax. Taxpayers are allowed to carryforward economic development credits and business losses

accruing under the current tax into the calculation of the revised tax, subject to certain limitations. The provisions of the revised tax related to the carryforward of business losses were clarified in House Bill 3928.

> *2007 Legislative Change: Under House Bill 3928, the temporary margin tax credit is calculated by (a) determining the entity's unused business loss carryforwards; (b) multiplying such amount by (i) 2.25% for the first 10 margin tax reports (to January 1, 2018) and (ii) 7.75% for the next 10 margin tax reports (to September 1, 2027); and (c) multiplying that amount by 4.5%. Under the statute, a taxpayer must notify the comptroller in writing of its intent to claim this credit on the first report due under the margin tax.*

Note that because the new tax is a tax on an entity's "margin" and not its net income, the concept of a business loss or net operating loss does not come into play (an entity may owe tax even if it has a net loss in a particular year).

In order to qualify for the credit, a taxpayer must file a form claiming the credit with the Comptroller on or before the due date of the taxpayer's franchise tax return.

## COMBINED REPORTING

The requirement to file combined reports may be the most complicated change in the franchise tax. Members of a "combined group" will be required to file combined franchise tax reports. Entities are members of a combined group if they are "affiliated" ***and*** if they are engaged in a "unitary business."

Members of a group are "affiliated" if a controlling fifty percent (50%) or greater interest is owned by a common owner or owners or by one or more members of the affiliated group. The definition includes both direct and indirect ownership.

> *2007 Legislative Change: House Bill 3928 changed the threshold for affiliation from 80% to 50%.*
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> *Important Note: Newly adopted Comptroller Rule 3.590 defines an "affiliated group" as a group where a Controlling Interest is owned by a common owner (excluding the statutory reference to "or owners"). The Comptroller Rule contains a number of examples showing how entity ownership in various tiered arrangements will be attributed to other entities. The Comptroller Rule does not contain any provisions concerning familial attribution, but the Comptroller FAQs do announce a policy of spousal attribution so that husbands and wives will be deemed a single owner for purposes of the affiliated group test. The Comptroller FAQ does not differentiate between community property and separate property.*

Members are conducting a "unitary business" if their business is a single economic enterprise that is made up of separate parts of a single entity or of a commonly controlled group of entities that are sufficiently interdependent, integrated, and interrelated through their activities so as to

provide a synergy and mutual benefit that produces a sharing or exchange of value among them and a significant flow of value to the separate parts. In determining whether a unitary business exists, the comptroller will consider three factors, including whether: the activities of the group members are in the same general line, such as manufacturing, wholesaling, retailing of tangible personal property, insurance, transportation, or finance, or are steps in a vertically structured enterprise or process, such as the steps involved in the production of natural resources, including exploration, mining, refining, and marketing; and the members are functionally integrated through the exercise of strong centralized management, such as authority over purchasing, financing, product line, personnel, and marketing.

The mechanics of combined reporting require each entity to calculate its total revenue separately. To determine the combined group's revenue, each revenue figure is added together, and intragroup revenue is subtracted. Each member of the combined group must elect the same deduction; the deductions are calculated separately and then added together to obtain the total deduction. The combined group's apportionment factor is determined by dividing the entities' aggregate Texas receipts by the entities' aggregate total receipts; intragroup receipts are ignored. Under the current version of the revised tax, the gross receipts of members of a combined group that do not have nexus with Texas will be treated as non-Texas gross receipts (and will be included in the bottom part of the fraction). The combined group's tax rate will be determined by applying the retail/wholesale classification to the entire group's receipts.

The margin tax includes a second type of combined reporting for tiered partnership arrangements. In a "tiered partnership arrangement," an "upper tier entity" *may* report its share of a "lower tier entity's" taxable margin, in which case, the lower tier entity is not required to pay tax on such portion of its taxable margin. The lower tier entity is required to file a report showing the amount of its taxable margin that each upper tier entity should include in its taxable margin. A "tiered partnership arrangement" means an ownership structure in which *any* of the interests in one taxable entity treated for federal income taxes as a partnership or as an S corporation (a "lower tier entity") are owned by one or more other taxable entities (an "upper tier entity"). A tiered partnership arrangement may have two or more tiers.

> *2007 Legislative Change: House Bill 3928 provides that in the case where an upper tier entity is not subject to the margin tax, the lower tier entity must report the share of its taxable margin that is attributed to the non-taxed upper tier entity. The statute also provides that an upper tier entity may not be exempt for having less than $300,000 in revenue or $1,000 in tax owed if, before the attribution of any total revenue by a lower tier entity to the upper tier entity, the lower tier entity is not exempt for having less than $300,000 in revenue or $1,000 in tax owed.*