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THE NEW TEXAS FRANCHISE TAX

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Recent legislation enacted as a result of the Texas school finance crisis has replaced the more or less voluntary Texas franchise tax with a radically expanded business tax, labeled by its critics as the largest tax increase in Texas history.

Background

Last November, the Texas Supreme Court ruled that the state's current school finance system was unconstitutional. The Court set a June 1, 2006 deadline for the Texas Legislature to correct the constitutional deficiencies. In anticipation of the Court's ruling, Governor Rick Perry called a 30-day special session that began on April 17, 2006 to address the school finance problem. After 29 days of arm-twisting, negotiation and several near meltdowns, the Legislature adjourned the special session on school finance on Monday, May 15, after passing five bills addressing this issue, and the Governor signed all into law.

HB 3 establishes a new mechanism for the calculation of a modified franchise tax, referred to as the new "margin tax," and expands the taxpayer base to include Texas businesses that currently enjoy state liability protection. The revised tax bill takes effect January 1, 2008, and applies to reports due on or after that date. In addition, the bill appropriates \$2 million in general revenue to the Comptroller for fiscal years 2006-2007 for audit and enforcement activities.

Summary of the Current Franchise Tax

Under Tax Code, ch. 171, the state levies the corporate franchise tax, Texas' primary business tax, in exchange for granting the privilege (franchise) of doing business in Texas. The tax applies only to for-profit corporations and, since 1991, to limited liability companies (LLCs) chartered or organized in Texas, as well as to foreign corporations and LLCs based or doing business in the state. As such, franchise taxpayers include professional corporations, banks, savings and loan associations, state-limited banking associations, and professional LLCs, but not limited partnerships, sole proprietorships, or non-corporate associations. Insurance and open-end investment companies (e.g., mutual funds) and most non-profit corporations are exempted, as are corporations with gross receipts less than \$150,000 or owing less than \$100 in tax. Major exemptions and exclusions include interest earned on federal securities, business loss carryover, and officer/director compensation paid by companies with 35 or fewer shareholders.

A dual calculation method determines the amount of tax liability. Taxpayers pay the greater of a 0.25 percent tax on taxable capital (assets' net worth) or a 4.5 percent tax on earned surplus (modified net income). The income component generates the most revenue and is paid by about 75 percent of franchise taxpayers.

In recent years, some large Texas-based firms have reorganized as partnerships under state law. As such, they no longer pay franchise tax. Examples include Dell Computer and SBC Communications (now AT&T). Firms accomplish this by forming wholly owned out-of state subsidiaries, usually in tax-friendly states such as Delaware - hence, the resulting entity has been nicknamed "the Delaware sub." Typically, the subsidiaries enter into limited partnerships wherein the general corporate partner owns 0.1 percent of the operating assets in Texas and the limited partners own 99.9 percent. Under the Comptroller's administrative rules, foreign corporations acting as limited partners are not considered to be doing business in Texas for tax purposes and

thus are not subject to the franchise tax. The franchise tax liability of the general partner corporation typically is zero because its 0.1 percent interest fails to generate total receipts greater than the \$150,000 income threshold.

A second accounting method used by some large firms is termed the “Geoffrey” loophole, named after the Toys R Us Inc. giraffe mascot. Under this method, corporations establish a subsidiary in another state that charges the Texas operations a royalty for the use of its trademarks. This method diverts money out of the Texas operations, and the franchise tax applies only to what remains.

Overview of the Revised Franchise Tax -- Margin Tax

HB 3 establishes a new mechanism for calculating the franchise tax and expands the definition of taxable entity to include most Texas businesses that enjoy state liability protection. The revised tax takes effect January 1, 2008. Sole proprietorships, general partnerships owned directly by natural persons, certain unincorporated passive entities receiving limited amounts of active trade or business income, and entities such as non-profit organizations currently exempt from the franchise tax are excluded from the definition of taxable entity. Businesses with no more than \$300,000 in total revenue, indexed for inflation, are exempt from the tax, as are businesses that owe less than \$1000 in tax.

The revised franchise tax is computed by determining a taxable entity’s total revenue. From this amount the entity will choose to deduct either its cost of goods sold or total compensation, up to \$300,000 per employee, indexed for inflation. If the entity’s margin is greater than 70 percent of its total revenue, the business is taxed only on 70 percent of its total revenue. The business then will apportion to Texas the amount of revenue from business done in the state and will subtract any other allowable deductions to determine the entity’s taxable margin.

Once the business’s taxable margin is determined, a rate of 1 percent is applied to that margin for all taxable entities that are not statutory defined retailers or wholesalers. For a taxable entity that is a statutory defined retailer or wholesaler, a rate of 0.5 percent is applicable.

Basic Calculation. *In a nutshell, the new margin tax applies a tax rate of 1 percent (0.5 percent for retailers and wholesalers) to a taxable entity’s (or unitary group’s) total revenue less the greater of (x) compensation, (y) cost of goods sold, or (z) 30 percent of total revenue. An affiliated group must choose one type of deduction to apply to the entire group. The “tax base” is apportioned to Texas using a single-factor gross receipts apportionment formula - Texas gross receipts divided by aggregate gross receipts.*

Taxable Entities. A “taxable entity” subject to the margin tax is defined as a partnership, corporation, banking corporation, savings and loan corporation, limited liability company, business trust, professional association, joint venture, joint stock company, holding company, or other legal entity. Among the entities excluded from the definition are: sole proprietorships, natural person general partnerships, passive entity family limited partnerships at least 80 percent held, directly or indirectly, by members of the same family (includes a person’s ancestors, lineal descendants, spouse, and brothers and sisters (whole or half blood) and the estate of any of the described persons) or passive entities. Also excluded from the definition are premium tax paying insurance companies, nonprofits, some cooperatives, certain trusts, estates of natural persons, real estate

investment trusts (REITs) and real estate mortgage investment conduits (REMICs). In addition, the definition excludes an entity that was not a corporation but that would qualify for exemption under current law if it were a corporation, such as a nonprofit organization.

An otherwise taxable entity is exempt from the new tax if it owes less than \$1000 or its total revenue is not more than \$300,000. On January 1 of each odd-numbered year beginning in 2009, this \$300,000 threshold will be adjusted based on changes in the consumer price index.

Passive Entity Exemption. To qualify for the passive entity exemption, the entity must: (i) be a general or limited partnership or non-business trust, (ii) derive at least 90 percent of its income from passive investments (such as dividends, interest, income from limited liability companies; distributive shares of partnership income; capital gains including real property gains; and royalties, bonuses, or delay rental income from mineral properties and income from other non-operating mineral interests), and (iii) receive no more than 10 percent of its federal gross income from the conduct of an active business. Rents are not considered passive income. A royalty interest or non-operating working interest in a mineral right is not considered an “active trade or business.” Under the bill, a business is considered to be conducting an active trade or business if the entity’s activities include operations that earn income or profit and the entity performs active management and operational functions.

Total Revenue. A taxable entity’s “total revenue” is its total income as reported on IRS Form 1120 (for corporations) or IRS Form 1065 (for partnerships and other pass-through entities) plus dividends, interest, gross rents and royalties, capital gain, net income less bad debt, foreign royalties and dividends, and income from a related entity (to the extent already included). If a taxable entity has an interest in a passive entity, that taxable entity includes its share of income from the passive entity, but only to the extent that the passive entity’s net income is not generated by a separate taxable entity.

Exclusions. The bill enumerates several expenses and “flow-through funds,” or funds passed through a taxable entity to another entity, that are excluded from the total revenue of a taxable entity. This includes specific exclusions relevant to legal services entities and staff leasing entities. A taxable entity belonging to an affiliated group cannot exclude such payments if they are made to another member of that group. An amount excluded from total revenue cannot be deducted as cost of goods sold or compensation in a taxable entity’s determination of its taxable margin. Dividends from federal obligations and bonds are excluded from total revenue.

Health Care Deduction. Health care providers can exclude certain payments from total revenue. Providers can exempt payments from Medicaid, Medicare, the Children’s Health Insurance Program (CHIP), workers’ compensation, and the TRICARE military health system. In addition, the cost of uncompensated services, at rates set by the Comptroller, can be excluded from total revenue as long as audit requirements are met. Health care institutions, including hospitals, assisted living facilities, and others, can exempt 50 percent of those amounts.

Cost of Goods Sold. The cost of goods sold deduction is generally limited to taxpayers who sell goods in the ordinary course of business. Goods are defined as real or tangible personal property sold in the ordinary course of business by a taxable entity. The definition of tangible personal property excludes services and intangible property, but computer programs (canned and custom), films, recordings, videotapes and other similar property are included in the definition. The

deduction covers the direct costs associated with the acquisition or production of goods, including labor, materials expenses, handling costs, storage costs, equipment renting or leasing costs, depreciation associated with production of the goods, research and development, design, equipment maintenance, geological exploration costs, taxes stemming from the cost of production, and electricity costs. Indirect and administrative overhead costs are deducted if the costs are allocated to the production of the goods. Such deduction cannot exceed 4 percent of the entity's total indirect and administrative overhead costs. A lending institution is permitted to deduct interest expense as cost of goods sold.

A deduction is also permitted for a contribution to a partnership partially owned by a taxable entity for activities that otherwise are eligible for deduction as cost of goods sold. This provision applies only if those costs are related to goods obtained, rather than sold, by the taxable entity. Various other costs also are deductible, including deterioration and obsolescence of goods, certain preproduction costs, insurance costs related to the goods, utility costs used in production of the goods, quality control costs, and licensing costs. Several costs are not included in cost of goods sold, including officer compensation.

Compensation Deduction. The deduction for compensation includes all W-2 wages and cash compensation paid to officers, directors, owners, partners, and employees; and the cost of all benefits the entity provides to its officers, directors, owners, partners, and employees, including workers' compensation, health care, employer contributions to employees' health savings accounts and retirement to the extent deductible for federal income tax purposes. Stock awards and options also qualify for deduction as wages and cash compensation. Wages and cash compensation include not only the amount entered in the W-2 Medicare wages and tips box, but it also includes net distributive income accruing to a natural person from partnerships, trusts, limited liability corporations, and "S" corporations. An entity's deduction for wages and cash compensation is capped at \$300,000 for any person, subject to CPI adjustments beginning in 2009. Wages paid to undocumented workers may not be included in the compensation deduction. Special rules apply to staff leasing companies and management companies.

Margin. A taxable entity's gross margin is determined by deducting from total revenue either cost of goods sold or compensation. Once a year, an entity makes an election on its annual report to subtract either cost of goods sold or compensation. The election can be changed by filing an amended annual report. If the difference after deduction is less than 70 percent of the entity's total revenue, that amount is the entity's gross margin. If the difference is greater or equal to 70 percent of the entity's total revenue, the entity's gross margin is 70 percent of its total revenue.

Upon determining its gross margin, an entity determines its "apportioned margin" by apportioning to Texas the proportion of business it performs in the state, according to the bill's apportionment rules. From this amount, the entity subtracts any other allowable deductions. The result is the entity's "taxable margin."

Calculation of Tax. The revised franchise tax is computed by applying one of two rates to a taxable entity's taxable margin, depending on the type of business activity that the taxable entity primarily is engaged. If a taxable entity is engaged primarily in retail or wholesale trade, a rate of 0.5 percent is applied to the entity's taxable margin. If the entity is not engaged primarily in retail or wholesale trade, a rate of 1 percent is applied to the entity's taxable margin.

An entity is engaged primarily in retail or wholesale trade if:

- the total revenue from its retail and wholesale trade activities is greater than its total revenue from other activities;
- less than 50 percent of its total revenue in retail or wholesale trade comes from the sale of products it produces (excluding eating and drinking establishments); and
- the entity does not provide utilities, including telecommunications, electricity, or gas.

Combined Reporting. For the first time, a group of two or more taxable entities that are part of an affiliated group must file a combined group report in lieu of individual reports. An affiliated group is defined as a group of entities (including entities without Texas nexus) in which an 80 percent or more controlling interest is owned by a common owner and the group is engaged in a unitary business. A unitary business is defined as a single economic enterprise in which the entities are sufficiently interdependent, integrated and interrelated through their activities so as to provide a synergy and mutual benefit that produces a flow of value to the separate parts. The group does not include entities with 80 percent or more of their property and payroll outside of the United States. The affiliated group is a single taxable entity for purposes of filing the report and the report is designed to be the sum of the returns of the separate affiliates (netting out transactions between affiliated entities).

Apportionment. Like the old Texas franchise tax, the new margin tax is apportioned by using a single-factor gross receipt formula based on Texas receipts divided by total receipts. The group includes all affiliates with a common owner, as well as entities that have no nexus with Texas in total receipts. Texas receipts include only the gross receipts of entities with Texas nexus. In apportioning margin, exclusions taken by an entity when determining the entity's total revenue can not be included in the entity's Texas receipts. Texas receipts include receipts from the sale of tangible personal property delivered or shipped to a buyer in Texas, services performed in Texas, the use of a patent, copyright, trademark, franchise, or license in Texas, the sale of Texas real property (including royalties from minerals) and other business done in Texas.

Penalties. The Comptroller is authorized to forfeit a taxable entity's right to transact business in the Texas in the same manner that the Comptroller can forfeit a corporation's corporate privileges under current law.

Transition Provisions, Reporting, and Other Provisions. A taxable entity that owes franchise tax under the bill will have to file an initial informational report with the Comptroller and an annual report containing information necessary to compute the tax on the taxable entity.

The Comptroller will require an information report from each of the 1,000 entities that paid the most franchise tax in calendar year 2005 under the existing franchise tax, the 1,000 entities that had the greatest gross receipts in 2005, and the 1,000 entities with the most employees in the state in 2005. This information will be used by the Comptroller to report to the Governor, the Lieutenant Governor, and the Legislature the amount of revenue that would have been generated from the entities if the new franchise tax had been in effect on January 1, 2006. This report will be delivered by April 1, 2007.

The bill establishes provisions for the transition of existing franchise taxpayers to the new franchise tax established under the bill. Franchise tax credits existing under current law are repealed. Until September 1, 2026, a temporary margin tax credit is available to entities that notify the Comptroller of their intent to preserve the right to take the credit by March 1, 2007. An entity may elect to use the credit (based on the amount of its booked net operating losses) in an amount up to 10 percent of its apportioned net operating losses. Certain outstanding credits eligible to be carried forward under current law may be applied to an entity's tax burden under the bill, including those under a written agreement between a taxpayer and the Department of Economic Development.

Lawsuits contending that the new franchise tax is unconstitutional must be heard in Travis County district court. The bill specifies that the new franchise tax is not an income tax and federal law (Pub. L. No. 86-272) concerning state taxation of income from interstate commerce does not apply.

Revenue from the tax imposed under the bill goes into the state's general revenue fund. The bill appropriates \$2 million in general revenue to the Comptroller for fiscal years 2006-07 for audit and enforcement activities.

The tax imposed under the bill takes effect January 1, 2008, and would apply to reports due on or after that date.

Constitutional Questions. The Comptroller (running for Governor as an Independent in the November elections) believes the margin tax is an impermissible income tax that violates the Texas Constitution, and has requested a formal opinion from the Texas Attorney General on its constitutionality. She has also raised a question as to the constitutionality of the retailer and wholesaler reduced tax rate.

Impact. While it may be too early to state who the winners and losers are under the new legislation, businesses should run pro formas to determine how the legislation will affect their individual situation and should explore changes to their legal structures to minimize the new tax liability.

The taxpayer group that appears to bear the greatest burden of the tax changes is the service industry. The service industry, particularly the professions that were largely exempt from the old franchise tax because they tended to operate in partnership form, will now be subject to the tax. The tax will also be punishing to businesses that have significant costs that won't be deductible either as compensation or cost of goods sold such as transportation and rental businesses.

Oil and gas production companies will do particularly well since they are capital-intensive businesses, so they will benefit from the property tax reduction resulting from HB 1. The passive entity definition is also structured in such a way that oil and gas businesses are more likely to qualify - for instance, royalty interests and nonoperating working interests in mineral rights are not treated as active income.

Because of the broad definition of the cost of goods sold deduction, manufacturers are treated more favorably than service companies. The half-percent wholesalers and retailers rate is a significant tax break, since these companies also will take the cost of goods sold deduction. The justification for the lower rate is the very low margins at which wholesalers and retailers tend to operate. However, service companies often have low margins as well, and are not eligible for the

break. This disparate treatment may be challenged in the courts as an unconstitutional violation of equal protection and due process.

The new legislation may also impact the decision of whether to hire workers as employees, independent contractors or temporary workers. For businesses expected to take the compensation deduction, it may make more sense to hire workers as employees since their wages and benefits will be deductible. Payments to independent contractors and temporary staffing companies won't be deductible. This could make a difference to businesses where large numbers of workers are hired.

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