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SALT WATCH

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Texas Replaces Franchise Tax With New Margin Tax

Background and Impact on Texas Taxpayers

On May 18, 2006, Governor Perry signed into law H.B. 3, which replaces the current franchise tax with a gross receipts tax ("Texas Margin Tax"). The new Texas legislation follows a current trend among states that have replaced traditional franchise taxes with state gross receipts taxes, including Ohio's Commercial Activity Tax (a pure gross receipts tax) and Kentucky and New Jersey's alternative minimum taxes based on gross receipts/gross profits.

The Texas Margin Tax is effective January 1, 2008 and the first report will be due May 15, 2008, based upon the prior year's financial information. A seven month extension will be available. An information return will be required of certain larger taxpayers to be submitted with their 2007 franchise tax return. The reporting requirements under the Texas Margin Tax closely follow the existing requirements under the current Texas franchise tax. Taxable entities part of an affiliated group engaged in a unitary business (the test is an 80% controlling interest rather than the typical 50%) are required to file a combined group report. Tiered flow-through entities may choose the level at which they wish to pay the Texas Margin Tax.

For many corporate taxpayers who minimized their exposure for Texas franchise tax using a limited partnership structure, the Texas Margin Tax may trigger significant entity level liability. Under the current franchise tax rules, a corporation or LLC that is a limited partner in a limited partnership doing business in Texas is generally not subject to franchise tax if it has no other activities in Texas. The Texas Margin Tax legislation, however, expands the types of businesses subject to tax to include limited partnerships and thus effectively eliminates the planning opportunity that was previously available.

In addition to limited partnerships, the Texas Margin Tax applies to general partnerships, LLCs, and LLPs, corporations, business trusts, and joint ventures. The tax does not apply to the other entity types, such as sole proprietorships, general partnerships directly owned by natural persons, grantor trusts, real estate mortgage investment conduits (REMICS), certain real estate investment trusts (REITs), certain family limited partnerships, and certain passive entities.

A passive entity is defined in Texas Tax Code as a general or limited partnership or trust (other than a business trust) that does not receive more than 10 percent of its federal gross income from the conduct of an active trade or business. The code defines active trade or business generally to include the performance of management and operational functions. Although these rules appear to be straightforward, the application of them may prove to be complex. For example, an entity is deemed to be conducting an active trade or business if assets held by the entity (*e.g.*, royalties, patents, trademarks and other intangible assets) are used in the active trade or business of one or more related entities.

An otherwise taxable entity is not required to pay the Texas Margin Tax if the amount of tax due is less than $1,000 or if its total revenue is $300,000 or less. The $300,000 limitation does not apply to combined group reports. All taxable entities must file a return even though no tax is due.

The Texas Margin Tax is imposed on each taxable entity that does business in Texas or is chartered or organized in Texas. The Texas Comptroller takes the position that the Texas Margin Tax is an income tax, which suggests that taxpayers will be afforded P.L. 86-272 protections. Texas Tax Code expressly prohibits, however, P.L. 86-272 from applying to the Texas Margin Tax. The Comptroller is expected to promulgate nexus rules for

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the Texas Margin Tax, but it is not known whether or not those rules will apply P.L. 86-272.

The Texas Margin Tax is imposed on an entity's apportioned "taxable margin" at the rate of 1.00%, or in the case of entities engaged "primarily" in retail or wholesale trade at the rate of 0.50%. Taxable margin is generally apportioned to Texas in the same manner as under current law. Taxable margin is equal to the lesser of (1) 70% of an entity's "total revenue" from its entire business, (2) an entity's "total revenue" less a cost of goods sold ("COGS") deduction, or (3) an entity's "total revenue" less a compensation deduction. An entity may elect to use a COGS deduction or a compensation deduction in calculating the Texas Margin Tax. Total revenue is generally based on federal income tax reporting. Members of a combined group must use the same method to compute taxable margin.

The COGS deduction includes direct costs related to goods the taxpayer owns and transactions between related members if such transactions are made at arm's length, as well as certain non-direct costs. For purposes of the compensation deduction, compensation and benefits includes W-2 wages, cash compensation paid to officers, directors, owners, partners and employees (limited to $300,000 per person), as well as benefits provided to all personnel, including worker's compensation, health care and retirement benefits to the extent deductible for federal income tax purposes. Special rules apply to staff leasing companies and management companies.

Business losses for franchise tax cannot be carried forward to offset the Texas Margin Tax. Taxpayers are allowed, however, to make a one time electron to take a temporary credit essentially on its net deferred tax assets for the period. The taxpayer must notify the Comptroller by March 1, 2007 to preserve its right to claim the temporary credit. The temporary credit may be carried forward for 20 years. All other credits have been repealed but any unused credits may be used to offset the Texas Margin Tax.

The Comptroller is expected to provide additional guidance on various aspects of the Texas Margin Tax, including computation of the temporary credit. Current guidance on the credit is somewhat inconsistent with the language in Texas Tax Code. In addition, the definition of control for combined reporting purposes may be reduced to 50%.

Action Items

GBQ will continue to monitor this development, as necessary. GBQ SALT professionals are able to assist you with issues related to the new Texas Margin Tax.

FOR MORE INFORMATION, PLEASE CONTACT:

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