Document ID#: 547200610055

AMERICAN BAR ASSOCIATION -- SECTION OF TAXATION

2006 Joint Fall CLE Meeting

TITLE: The New Texas Margin Tax: (more than a marginal change to the Texas landscape)

AUTHOR: Ohlenforst, Cynthia M.

PANEL: State Tax Developments Affecting Partnerships & LLCs

DATE: 10/20/06 3:25p

COMMITTEE: Partnerships & LLCs

The New Texas Margin Tax:

(more than a marginal change to the Texas landscape)

State Tax Developments Affecting Partnerships & LLCs

October 20, 2006
Denver, Colorado

Sponsored by
ABA Section of Taxation
and
Section of Real Property, Probate and Trust Law

in cooperation with
2006 Joint Fall CLE Meeting

Cindy Ohlenforst
Hughes & Luce, LLP
1717 Main Street, Suite 2800
Dallas, Texas 75201
(214) 939-5512
cindy.ohlenforst@hughesluce.com

The New Texas Margin Tax:
(more than a marginal change to the Texas landscape)

Presented as Part of
ABA Section of Taxation and Section of Real Property, Probate and Trust Law
2006 Joint Fall CLE Meeting

State Tax Developments Affecting Partnership & LLCs

Background: In 2006, the Texas Legislature enacted sweeping changes to the long-standing Texas franchise tax. House Bill No. 3, passed by the Legislature and signed by Governor Rick Perry, has become law and is effective for reports filed on or after January 1, 2008. Like other taxes that are based on activity during a period prior to the report year, though, the tax reaches back to 2007 – and even earlier for some taxpayers.

The margin tax is part of a larger tax reform agenda designed to respond to the Texas Supreme Court's ruling in Neeley v. W. Orange-Cove Consol. Indep. Sch. Dist., 176 S.W.3d 746 (Tex. 2005) (related to school funding), to offer voters a property tax reduction, and to address certain school-related provisions. The legislation subjects additional businesses to the franchise tax and fundamentally changes the way the tax is calculated.

Current Franchise Tax: As in effect prior to the new margin tax, the franchise tax is imposed only on corporations (as defined in the Texas Tax Code) and limited liability companies, and is imposed on a separate entity basis. As a practical matter, that tax is the greater of 0.25 percent of an entity's adjusted (as required by the Texas Tax Code) GAAP net worth or 4.5 percent of adjusted (again, as required by the Texas Tax Code) federal taxable income plus officer and director compensation, in both cases as apportioned to Texas.

New Margin Tax: The margin tax statutory provisions, like the "old" franchise tax ones, comprise Chapter 171 of the Texas Tax Code.[1] While the new tax incorporates many provisions from the prior law, the margin tax differs from the "old" franchise tax in several material respects:

- it applies to additional businesses/entities;
- it has a different starting point (revenue);
- it requires combined reporting for many entities;
- it is imposed at a rate of 1.0 percent (0.5 percent for wholesale and retail sellers); and
- it allows deductions from revenue for either (a) cost of goods sold or (b) compensation, in both cases, as apportioned to Texas.

---

[1] Unless otherwise indicated, all chapter and section references are to TEX. TAX CODE ANN. (Vernon 2006).

"Big picture" computation

Starting Point:	Total Revenues
Minus:	Either: (a) Cost of Goods Sold, or (b) Total Cash Compensation ($300,000 per person limit) and Employee Benefits (Note: Election between cost of goods sold and compensation deduction may be changed on an annual basis and applies to all members of combined reporting group, each of which computes its revenue and deductions separately)
Equals:	Gross Margin (but not to exceed 70 Percent of Total Revenues)
Multiplied By:	Texas Apportionment Factor (Texas Gross Receipts divided by Total Gross Receipts—so retains the single-factor formula used for the old Texas franchise tax, but without throwback rule)
Equals:	Taxable Margin
Multiplied By:	One Percent Tax Rate (or 0.5 Percent Tax Rate, for Wholesalers and Retailers)
Equals:	Tax Payable (a) subject to special rules for smaller taxpayers/lower receipts: taxpayers with total revenue of less than or equal to $300,000 (with CPI adjustments for later years) or total tax liability of less than $1,000 are not required to pay the tax; and (b) the tax may be reduced by certain already-accrued but unused credits, and by a credit for certain losses.

A. What entities are subject to tax?

1. **Background:** While several proponents of the new tax describe the tax as one applicable to all entities that have limited liability under state law, the list of taxable entities is more specific than, and sometimes inconsistent with, that description. A significant change to the tax is its application, for the first time, to partnerships. Although not all partnerships are subject to tax, the legislature (finally) successfully extended the tax to most limited partnerships, which have been a key component of Texas franchise tax planning for years.

2. **The § 171.0002 definition of "Taxable Entities":** The "taxable entities" subject to the tax include all legal entities (including limited partnerships, which are not taxable under the current franchise tax) **other than**:

- sole proprietorships;

- general partnerships, the direct ownership of which is composed exclusively of natural persons;

► **NOTE: This characterization is one of several "cliff" rules: It appears that having even one non-natural person partner makes the partnership taxable. What happens if a partner dies and the partner's estate holds the partnership interest? The Comptroller's preliminary draft definition of "natural person" excludes estates and trusts from the definition, although legislators may consider changing the statute to avoid the harsh, unintended consequences that might otherwise result.**

Guidelines: On October 13, 2006 (Friday the 13th!), the Comptroller circulated draft "Instructions for Completing Texas Franchise Tax Information Report due February 15, 2007" together with several draft forms and additional instructions (collectively, "Draft Guidelines). These are only drafts and, in many areas, do not extend substantially beyond the statutory language, and this outline makes only brief mention of a few items from the Guidelines. It is important to remember, however, that both the current Texas Comptroller and the successor Comptroller (to be elected in November 2006) will play a major role in analyzing and interpreting the new margin tax.

► **NOTE: Because LLPs are general partnerships that elect LLP status (*see* TEX. BUS. ORG. CODE ANN. §§ 152.802-.804 (Vernon 2006)), taxpayers may point out that LLPs composed of natural persons should not be subject to the tax. Legislators appear poised to make changes to ensure that the tax applies to LLPs, which are among the entities targeted by many legislators.**

- "passive entities" (see below);

- certain entities exempt under Subchapter B of the Tax Code (note that a new section is added to Subchapter B to allow an exemption for a non-corporate entity that would qualify for one of the specific exemptions if it were a corporation);

- grantor trusts with natural persons or charitable entities as the sole beneficiaries;

► NOTE: Another cliff rule. What happens when a person dies or the charitable entity ceases to qualify as a charitable entity?

- estates of natural persons;

► NOTE: The legislature's intent not to tax estates of natural persons offers further support for treating partnerships of natural persons and estates as nontaxable.

<u>Guidelines:</u> The Draft Guidelines define a "natural person" as "a human being as distinguished from a purely legal entity given recognition as the possessor of rights, privileges, and responsibilities, such as a corporation, limited liability company, partnership, or trust."

- escrows;

- family partnerships that are passive entities;

- "passive investment partnerships" — limited or general partnerships that are passive entities;

<u>Guidelines:</u> The Draft Guidelines provide that a passive investment partnership is "a partnership established for investment purposes that meets the requirements of a passive entity."

- certain passive entity — trusts with natural persons or charitable entities as their sole beneficiaries; and

- REITs that do not directly own real property (other than real estate that the REIT occupies "for business purposes") and qualified REIT subsidiaries.

► NOTE: In many respects, real estate businesses fare relatively well under the new tax, although there remain unanswered questions concerning both computation and application of the tax to real estate enterprises. To the extent REIT partnership subsidiaries may be taxable, REITs may not benefit as much as expected by being excluded from the tax.

► NOTE: The standards used to determine what holdings are "direct" holdings and when real estate is used "for business purposes as opposed to holding interests in limited partnerships or other entities that directly hold the real estate" will likely trigger controversy – and perhaps Comptroller guideline discussion.

- REMICs.

► **NOTES ABOUT FEDERAL TAX CLASSIFICATIONS:**

(1) Section 171.0002(a) indicates that even limited liability companies that are disregarded and treated as sole proprietorships for federal tax purposes are not exempt sole proprietorships for margin tax purposes;

(2) The "old" franchise tax did not follow federal entity classification rules, e.g., state-law entities that are disregarded for federal tax purposes generally were treated as separate taxpayers for Texas franchise tax purposes; and

(3) Some provisions of the new margin tax suggest an intent similarly to apply the tax without regard to federal entity classification concepts, unless otherwise specified. However, the old franchise tax incorporated the federal Internal Revenue Code and Treasury regulations in effect for the federal tax years beginning before January 1, 1997, prior to the effective date of the federal "check-the-box" entity classification rules. The margin tax, by contrast, incorporates the Internal Revenue Code and Treasury Regulations in effect for the federal tax year beginning on January 1, 2006, well after the effective date of the check-the-box regulations and other federal law relying on disregarded entity principles. (*Compare* § 171.001 (Vernon 2005) ("Internal Revenue Code" means the Internal Revenue Code of 1986 in effect for the federal tax year beginning on or after January 1, 1996, and before January 1, 1997, and any regulations adopted under that code applicable to that period.) *with* § 171.0001 ("Internal Revenue Code" means the Internal Revenue Code of 1986 in effect for the federal tax year beginning on January 1, 2006, and any regulations adopted under that code applicable to that period.).)

Because the margin tax lacks a global provision specifying the tax effect of federal disregarded entity status, the margin tax's updating of the reference to federal tax law may create some confusion as to when and how federal disregarded entity principles affect margin tax computations. The current Texas policy of not following the federal disregarded entity rules is based only partially on the effective date of the federal entity classification regulations, and is based primarily on the Comptroller's conclusion that the Texas Tax Code's imposition of the tax on specified state law entities supersedes contrary federal law concepts (*See* X Tax Policy News 1, available at http://www.window.state.tx.us/taxinfo/taxpnw/tpn2000/tpn00501.html ("Whether an entity is subject to Texas franchise tax depends on the type of legal entity it is in its state of formation, and not on how it elects to be treated for federal income tax purposes.").)

3. **Special Rules for Passive Entities:** A "passive entity" excluded from the § 171.0002 definition of "taxable entity" is defined in § 171.0003 as a partnership or trust:

(1) with over 90 percent of its federal gross income from the following sources: 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; positive distributive shares of partnership income; 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 mineral interests not operated directly or by an affiliate. Rent is specifically excluded from passive sources; and

(2) with not more than 10 percent of its federal gross income from an active trade or business, where: (i) items of income in (1) are not from an active trade or business, (ii) "active trade or business" is defined in very general terms, and (iii) income from licensing intangibles to affiliates for use in their active trade or business is deemed active to the licensor.

► **NOTE:**

(1) It appears unclear under what circumstances a taxable entity could meet the 90 percent test in (1) above but fail the 10 percent test in (2) above. The apparently overlapping definitions result from combining multiple draft provisions without the time or redrafting that typically accompanies major tax legislation.

<u>**Guidelines:**</u> The Draft Guidelines refer to 90 percent of revenue from the passive categories "to the extent not earned from an active trade or business."

(2) Although a "passive entity" is by definition not subject to the tax, four of the listed categories refer to specific entities that are "passive entities" <u>and</u> meet other criteria, e.g., the § 171.0002(c)(4) "family limited partnership that is a passive entity [and meets several other requirements]." An entity that meets the "passive entity" aspect of the definitions would appear to be outside the tax without regard to the other requirements included in the definitions. It will be interesting to see how (if at all) administrative guidelines and rules will address these "extra" requirements, or whether a legislative clarification is in the offing.

(3) Passive entities are excluded from taxation only if they are partnerships or trusts. Thus, a distinction between the taxability of partnerships and that of corporations remains in this context.

B. What's the starting point for the tax base?

In § 171.1011, Total Revenues are defined by reference to specific line items of income reported by a taxable entity on its federal tax returns; Revenues begin with this number, from which certain specified items are subtracted.

Additions: The statute specifies two sets of particular federal tax return line items includible in income:

(1) one set for an entity "treated for federal income tax purposes as a corporation" (per § 171.1011(c)(1)(A), computed by adding IRS Form 1120, line 1c, to Form 1120, lines 4 through 10); and

(2) another set for an entity "treated for federal income tax purposes as a partnership" (per § 171.1011(c)(2)(A), computed by adding IRS Form 1065, line 1c, to Form 1065, lines 4 through 7, and Form 1065, Schedule K, lines 2 through 11).

What about other taxable entities? For these entities, § 171.1011(c)(3) directs the Comptroller to adopt rules for computing margin "in a manner substantially equivalent" to the above definitions.

The specified line items of federal income generally pick up items of gross income before deductions or offsets. However, as a result of what has been widely characterized as a drafting error, only net income from partnership real property rental activities is included in the calculation prescribed by § 171.1011(c)(2)(A) (because line 2 of Internal Revenue Service Form 1065, Schedule K references net rental real estate income). H.C.R. 51 expresses legislative intent to revise the definition of partnership revenue to include gross rents in the next regular session. Note also that guaranteed payments are apparently double counted in the tax base as a result of a drafting error. H.C.R. recognizes the need to correct this error.

Subtractions: Per § 171.1011(f) *et seq.*, a taxable entity may exclude or subtract, to the extent otherwise included in total revenues, specified items including:

(1) bad debt if expensed for federal tax purposes;

(2) distributive shares of income from pass-through entities, Schedule C deductions, and "items of income attributable to" disregarded entities (in all cases, other than any income from "passive entities");

► **NOTE: These subtractions generally are aimed at ensuring that taxable margin is taxed only at one level.**

(3) "flow-through" items that must be paid to third parties, including (limited to?) taxes collected and remitted; sales commissions to non-employees for real

estate sales and “sales of products”; the tax basis of underwritten securities; and payments to subcontractors for real property surveying, repair, or improvements;

► **NOTE: The scope of flow-through expenses triggered numerous discussions during the legislative session and continues to do so. Among the subjects of discussion: various commissions, payments to independent contractors for sales of services, payments for advertising and payments for other pass-through items.**

► **NOTE: Remember that, to the extent flow-through items are not included in revenue in the first place, no deduction is necessary to exclude the items from the tax base.**

(4) dividends and interest from federal obligations, including foreign royalties and dividends, such as amounts determined under Section 78 or Sections 951-964 of the I.R.C.;

(5) principal repayments received by lending institutions;

(6) the federal tax basis of securities and loans sold (recall that gains from the sale of securities are passive income for purposes of the seller’s qualification as a nontaxable passive entity);

(7) for lawyers, certain trust fund items and pro bono expenses;

► **NOTE: The pro bono exclusion from revenue for lawyers is limited to $500 “per case” and excludes only “actual out-of-pocket expenses.”**

(8) reimbursements received by a “management company” for specified costs, including labor costs (these costs are also treated as part of the managed company’s compensation or COGS deduction);

► **NOTE: “Management company” is defined as “a corporation, limited liability company, or other limited liability entity that conducts all or part of the active trade or business of another entity” in exchange for a management fee and reimbursement of specified costs. What, in this context, constitutes conducting part of the active business? What items qualify for reimbursement? What about allocated expenses? What if no management fee is paid?**

(9) certain types of elderly, indigent health care, and worker’s compensation governmental reimbursements and costs of uncompensated care, limited only to 50 percent of such amounts for “health care institutions” (as opposed, e.g., to physicians, who may deduct 100 percent); and

► **NOTE: Unlike the pro bono exclusion above, the exclusion for uncompensated health care is not subject to a dollar limit and excludes the "actual cost to the health care provider for any uncompensated care provided." How will the Comptroller implement these differing standards?**

(10) revenue from small-production oil and gas wells during periods of low prices (as certified by the Comptroller).

C. What's deducted from Revenues to determine the "Margin"? Some entitles will choose to deduct COGS, some will choose to deduct Compensation, and … some won't get a choice at all.

Section 171.101 provides that a taxable entity computes its "margin" by subtracting from total revenues its unilateral choice of either "cost of goods sold" or "compensation," although in either case the margin is capped at 70 percent of total revenue from the entire business.

1. **A Few Key Points:**

(a) **Annual Choice:** Section 171.101(d) allows the election between deducting either cost of goods sold ("COGS") or compensation to be changed annually, and the election may be changed after the fact for a given year by filing an amended return.

(b) **Goods means goods:** "Goods" is defined to mean real or tangible personal property sold in the ordinary course of business of a taxable entity, so an entity that doesn't sell goods doesn't have much of a choice. (More details below.)

(c) **Federal tax law relevance:** While federal income tax law addresses the cost of goods sold, and Form 1120 and Form 1065 each includes cost of goods sold (line 2 on both forms), the Texas definition does not match the federal concept. Nonetheless, several federal tax rules and authorities will be relevant. *See, e.g.*, I. R. C. §§ 263A (capitalization and inclusion in inventory costs of certain expenses), 460 (special rules for long-term contracts), and 471 (inventories).

(d) **Combined reporting (a first for Texas):** Certain entities are required to file as a combined group, and the new law provides that a combined group will make an election that applies to all of its members. So…not much of a choice for some of these companies either. (More details below.)

2. **Deduction for Cost of Goods Sold:** Cost of Goods Sold is defined at length in § 171.1012, rather than by directly incorporating federal tax or GAAP computations. Multiple industries have presented their concerns and suggestions concerning COGS to the Comptroller since the end of the legislative session, and many people (including in the Comptroller's office) initially expected that informal Comptroller guidance would provide significant guidance to address some of the concerns in guidelines to be issued in connection with forms and advice being prepared for the "practice returns" due (pursuant to H.B. No. 3 § 23) from the state's

largest 1000 taxpayers in February 2007. However, the draft guidelines circulated on October 13, 2006 do not significantly expand on the statutory language.

Cost of Goods Sold includes only costs associated with real or tangible personal property (such as software and certain films, recordings and books), and the statute explicitly provides in subsection (a)(3)(B) that tangible personal property does not include sales of services or intangible property.

► **NOTE: The definition of tangible personal property appears to have roots in both federal tax principles and Texas sales tax. See, e.g., Section 151.009 of the Texas Tax Code, which defines "tangible personal property" for sales tax purpose.**

The definition in revised Section 171.1012(a)(3)(A), unlike the sales tax statutory definition, does not specifically reference computer programs or telephone prepaid calling cards. However, subsequent margin tax subsections add specific references to films, sound recordings, etc. (and "other similar property…" and include the concept of "mass-distributed" media) and adopt the sales tax definition of "computer program" from Section 151.0031 of the Tax Code. The Comptroller's eagerly anticipated written guidelines do not include (at least in their draft form) many of the examples that some taxpayers had hoped for.

► **NOTE: "Direct"? Many aspects of the COGS definition turn on whether a particular cost is a "direct" cost of producing or acquiring goods (*see* § 171.1012(c)), but the statute does not explicitly provide a global standard for differentiating "direct" and "indirect" costs, or indicate whether interpretations developed for other Texas tax purposes (e.g., in the context of the sales tax manufacturing exemption) apply.**

► **NOTE: "Production"? In § 171.1012(a)(2), "production" is defined to include "construction, installation, manufacture, development, mining, extraction, improvement, creation, raising or growth." In reviewing the laundry list, notice that some, but not all, sections refer to both production and acquisition – another example of drafting issues that Comptroller guidelines will likely address.**

COGS includes: The § 171.1012(c) "direct" costs of producing or acquiring goods, including:

(1) labor;

► **NOTE: Payroll expenses? Labor cost appears to include wages and benefits, but questions exist concerning the employer's share of payroll expenses. The inclusion of labor in the COGS deduction means that sellers of goods electing a COGS rather than a compensation deduction are effectively entitled to a deduction for compensation costs. The COGS deduction may include some labor costs that are excluded from the compensation deduction, such as amounts paid to independent contractors, or salary and wage amounts in excess of $300,000 per person per year.**

(2) integrated materials;

► **NOTE: The statute refers in subsection (c)(2) to materials that are an "integral part" of specific property produced, but doesn't explicitly specify whether the integral-part standard is to be determined by reference to existing state tax law interpretations from other contexts (e.g., from sales tax construction concepts).**

(3) materials consumed in production processes;

► **NOTE: More definitional issues ("consumed in" and "production") where sales tax concepts may be useful.**

(4) packaging and handling and inbound transportation costs;

(5) storage costs;

(6) "depreciation, depletion, and amortization, to the extent associated with and necessary for the production of goods" (the amounts of depreciation, depletion and amortization generally are determined with respect to federal income tax principles,[2] but no explicit guidance is provided to determine whether a particular amount is "associated with and necessary for the production of goods");

► **NOTE: This provision is one of many that mixes federal tax concepts with state tax standards. In this mix, query whether standards like "necessary for the production" will look to general federal income tax principles or to state tax standards (e.g., the manufacturing rules for sales tax purposes)?**

This item is also one of several that illustrates well the difference between the deductions available to sellers of goods (e.g., a seller of desks may deduct depreciation for a computer that is associated with and necessary for the production of the desks) and sellers of services (e.g., a seller of design services may not deduct depreciation for a computer that is associated with and necessary for the production of desk designs).

(7) costs to rent or lease equipment, facilities, and real property directly used for production, including pollution control equipment and intangible drilling and dry hole costs;

---

[2] Recall that the Internal Revenue Code definition has been updated to the I.R.C. as in effect for the federal tax year beginning on January 1, 2006.

(8) costs of preparing and maintaining production equipment and facilities, including pollution control equipment;

(9) costs attributable to research, experimental, engineering, and design activities directly related to the production of goods, including Internal Revenue Code §174 R & D expenditures;

► **NOTE: The subsection (c)(9) R&D deduction applies to R&D expenditures "directly related to the production of goods"; query whether the Comptroller will assert that R&D costs attributable to products that never reach the market are not deductible. Contrast this R&D deduction language with the phrasing of the deduction for certain oil and gas exploration costs.**

(10) geological and geophysical costs incurred to locate property with "the potential to produce minerals";

(11) certain taxes related to direct production costs;

(12) cost of producing or acquiring electricity for sale; and

(13) contributions to a partnership in which the taxable entity owns an interest that is used to fund activities, the cost of which would otherwise be treated as the partnership's COGS (but only to the extent the costs are "related to" goods distributed to the taxable entity as goods in kind in the ordinary course of production activities).

<u>More COGS</u>: The costs above are listed in Section 171.1012(c). Subsection (d), which does not refer to "direct costs," provides that COGS also includes the following "in relation to the taxable entities' goods":

(1) deterioration of the goods;

(2) obsolescence of the goods;

(3) spoilage and abandonment, including rework labor, reclamation and scrap costs;

(4) certain direct pre-production costs;

(5) certain direct post-production costs;

(6) certain insurance costs (plant, facility, machinery, equipment or materials directly used in production);

(7) insurance on the produced goods;

(8) utilities, specifically including electricity, gas and water, directly used in production;

(9) quality control, including warranty replacement of defective components, inspection directly allocable to production, and repair and maintenance of the goods; and

(10) licensing or franchise costs, including fees incurred in securing contractual rights to use trademarks, manufacturing procedure or other listed rights directly associated with the goods.

Also:

(1) Section 171.1012(k), a separate "notwithstanding anything else" type provision, allows a lending institution that offers loans to the public and elects COGS to subtract as part of COGS an amount equal to interest expense.

(2) Also deductible under § 171.1012(f): "indirect or administrative or overhead costs" (e.g., security, legal, data processing, accounting, personnel, or financial), if "allocable" to the acquisition or production of goods, are also deductible, but capped at 4 percent of "total indirect or administrative overhead costs," and excluding any costs that are specifically excluded from the definition of COGS, as described below.

Not COGS: "Cost of goods" sold specifically excludes the following costs, listed in § 171.1012(e):

(1) costs of renting or leasing equipment, facilities or real property not used for production;

(2) "selling costs, including employee expenses related to sales";

(3) distribution costs, including outbound transportation;

(4) advertising;

(5) idle facility expense;

(6) rehandling costs;

(7) and (8) bidding costs, regardless of whether the bid leads to a contract;

(9) interest expense (other than for certain financial institutions, see above);

(10) income taxes, including local, state, federal and foreign income taxes and income-based franchise taxes;

► **NOTE: Speaking of income taxes … it appears that the margin tax will be considered an income tax that should be accounted for under FASB Statement No. 109 Accounting for Income Taxes.**

(11) strike expenses;

(12) officers' compensation; and

► **NOTE: The margin tax does not distinguish, as the current franchise tax does, between (a) officers for industries such as banks that designate many persons as officers and (b) officers for other industries.**

(13) compensation for undocumented workers used for the production of goods. For this purpose, "goods" specifically includes but is not limited to animal husbandry, crop growing and harvesting, and timber severance. The cost of benefits to such workers may be deductible as COGS, just as benefits are treated for purposes of the compensation deduction exclusion described below.

► **NOTE: Against the backdrop of the national debate on immigration law, this provision isn't particularly surprising. Nor is it surprising that employers have already begun to ask what steps they should take to determine whether labor costs are attributable to undocumented workers.**

<u>General Rule: No ownership, no deduction</u>: Section 171.1012(i) makes clear that, except for real property contractors and federal government contractors who pass title to goods to the government before production is complete, an entity is generally allowed a cost of goods sold deduction only for costs incurred with respect to goods that it owns.

Motor vehicle lessors and renters, heavy equipment leasing companies, and railroad rolling stock rental or leasing companies are specifically authorized in § 171.1012(k-1) to use a cost of goods sold deduction for items that they rent or lease.

► **NOTE: Do the provisions mean that a contract manufacturer cannot use the cost of goods sold deduction? It is unclear how strictly this provision will be interpreted.**

► **NOTE: The § 171.1012(a)(1) definition of "goods" for COGS purposes is "real or tangible personal property <u>sold</u> in the ordinary course of business of a taxable entity." Some will argue that the term "sold" suggests that renters or lessors generally cannot claim a COGS deduction, a possibility reinforced by (i) this special margin tax rule authorizing specific lessors and renters to take a COGS deduction and (ii) a proposed amendment that died in committee clarifying that "goods" for COGS purposes includes "real or tangible personal property <u>sold or rented</u> in the ordinary course of business of a taxable entity." However, note that in other tax contexts (e.g., sales tax), Texas law often treats leases and rentals as sales.**

<u>General rule: Arms length with affiliates</u>: Section 171.1012(l) makes payments to an affiliate that is not part of a taxable entity's combined group deductible only if the transaction is "at arm's length." Shades of I.R.C. § 482?

► NOTE: Although the Comptroller could argue that this provision disallows any deduction, rather than disallowing a deduction only for the portion of the payment in excess of arm's length, such an interpretation appears unduly harsh and inconsistent with prior sessions' legislative discussions.

3. **<u>Deduction for Compensation</u>:** Section 171.1013 deductible compensation includes:

(1) "Wages and cash compensation" paid to officers, directors, owners, partners, and employees, *but* the deduction is capped at $300,000 per person per year (indexed for inflation). Deductible "wages and cash compensation" consists of the following, enumerated in § 171.1013(a):

(a) wages and tips reported on Form W-2 for Medicare tax purposes (note W-2 wages do not include the employer's share of federal employment taxes);

► NOTE: What about payments to independent contractors that are reported on Form 1099 rather than W-2? If no deduction is allowed for 1099 payments, industries or businesses who use independent contractors for a significant part of their workforce may be materially disadvantaged, particularly if they do not qualify to take a COGS deduction or exclude commission payments from revenue.

(b) net distributive income to natural persons from partnerships and from trusts and LLCs treated as partnerships for federal income tax purposes, as well as net distributive income to natural persons from LLCs and corporations treated as S corporations for federal tax purposes; and

► NOTE: The treatment as compensation of net distributive shares of natural persons does not require that such "compensation" be related to labor performed by the recipient; this treatment appears to allow a pass-through entity a deduction for the distributive share of net income of any individual investor. This exclusion may be intended to avoid the constitutional concern that the margin tax violates the "Bullock amendment" to the Texas Constitution which requires voter approval of a tax on the income of natural persons, "including a person's share of partnership and unincorporated association income." However, because the deduction is capped at $300,000, some will argue that the margin tax still reaches individuals' shares of partnership net income.[3]

[3] Section 21 of H.B. No. 3 states explicitly that "[t]he franchise tax imposed by Chapter 171, Tax Code, as amended by this Act, is not an income tax, and Pub. L. No. 86-272 does not apply to the tax." There seems only a remote possibility that this section will deter constitutional challenges.

(c) stock awards and stock options deducted for federal income tax purposes.

(2) Per § 171.1013(b)(2), the cost of "all benefits" provided to officers, directors, owners, partners, and employees, is not included in the $300,000 per person deduction cap. "All benefits" is not defined, other than to state that it includes workers' compensation benefits, health care, contributions to employee health savings accounts, and deductible contributions to retirement plans.

► **NOTE: Because the $300,000 cap applies to wages and not benefits, it creates an incentive to shift compensation from wages to benefits for highly-compensated employees. This trend will be constrained to some extent by federal law restrictions on certain "top heavy" benefit plans, though nonqualified plans may have more flexibility.**

Guidelines: The Draft Guidelines refer to "the cost of benefits provided to officers, directors, owners, partners and employees, including workers' compensation, health care and retirement benefits."

► **NOTE: The drafters may have intended deductible benefits not to include the employer's portion of federal social security taxes, but that result arguably is not clear from the statutory language.**

Guidelines: The Draft Guidelines provide that "net distributive income for the calculation of compensation is the amount of guaranteed payments and distributions made during the accounting period; net distributive income paid to natural persons from limited liability companies and corporations treated as S corporations for federal income tax purposes. Net distributive income for the calculation of compensation is the amount of distributions made during the accounting period."

Section 171.1013 makes clear that no deduction is allowed for "wages and cash compensation" paid to undocumented workers, but the deduction is not disallowed for the cost of "all benefits" provided to undocumented workers.

Special provisions (§ 171.1013(d)-(f)) direct that compensation paid to persons employed by staff leasing companies or management companies will be deductible by the client company, not the staff leasing or management company. Generally, the thrust of the staff leasing and management company provisions sprinkled throughout the margin tax is to treat workers assigned to an operating business as if they were employed by that business for purposes of computing revenue and related deductions.

D. Combined Reporting Principles

Section 171.1014 provides that all taxable entities that are part of an "affiliated group" engaged in a "unitary business" must report on a combined basis.

(1) "Affiliated group" is defined in § 171.0001 as all entities in which a "controlling" 80 percent or greater interest is owned by a common owner or owners, or by one or more other members of the affiliated group. The 80 percent test for a corporation applies to "direct or indirect" ownership of total combined voting power of all classes of stock or the "beneficial ownership interest in the voting stock." The 80 percent test for other entities applies to direct or indirect ownership of "the capital, profits, or beneficial interest" in the entity.

The Texas affiliated group definition is freestanding; it does not directly incorporate or refer to any federal tax affiliated group classification or status.

<u>Guidelines:</u> The Draft Guidelines define "Reporting Entity" as "the principal Texas entity that is responsible for reporting on behalf of the combined group," and define "Principal Texas entity" as "an entity that is the parent entity unless the parent entity is not subject to tax in Texas; is not part of the unitary business; or there is no parent, in which case it means the entity that: (1) is included within the group; (2) is subject to Texas' taxing jurisdiction; and (3) has the greatest Texas business activity during the first year that a combined return is required to be filed, as measured by the total revenue for that year."

► **NOTE: Several aspects of the affiliated group definition are not entirely clear. The 80 percent test applies to voting <u>or</u> beneficial interests — but what if the same stock has different owners of voting rights and beneficial interests? Also, the definition applies to 80 percent ownership "by a common owner or owners, either corporate or noncorporate." This phrasing suggests that overlapping ownership of entities by natural persons could cause them to report on a combined basis, an unusual result.**

Moreover, the common ownership test does not discriminate based on relative ownership shares by the common owners, e.g., it suggests that a partnership owned 99 percent by person A and 1 percent by unrelated person B is part of an affiliated group with a partnership owned 1 percent by person A and 99 percent by person B.

Finally, the sheer potential breadth of the definition creates a concern that seemingly independent entities could be traced through to 80 percent common ownership — but what if several publicly held companies have 80 percent common ownership by mutual funds, retirement plans, investment vehicles, etc.?

The impact of this broad "affiliated group" definition is somewhat limited because a combined reporting group includes only entities that are both members of an affiliated group <u>and</u> engaged in a "unitary business." However, other special rules may apply to those members of a common "affiliated group" that are <u>not</u> engaged in a unitary business (the COGS transfer pricing rules) or without regard to whether they are engaged in a unitary business (e.g., see the test to qualify as a retailer or wholesaler subject to a reduced 0.5 percent tax rate).

(2) Per § 171.1014(a), a combined group excludes foreign affiliates meeting certain property and payroll tests (or a gross receipts test if the affiliate has no payroll or property) which establish that 80 percent of their operations are outside the United States ("water's edge reporting"). The tests for determining the location of a foreign affiliate's payroll and property are imported from the Multistate Tax Compact of Chapter 141 of the Tax Code, and are new concepts in Texas tax law.

(3) While many states use a "unitary business" method of reporting state income tax, Texas historically has not (although in limited circumstances Texas considers whether businesses are unitary). Texas' movement to a unitary system is significant from a tax administration perspective, and the new definition of "unitary business" in § 171.0001(17) is as follows, in full:

> "Unitary business" means 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 shall consider any relevant factor, including whether:
>
> (A) the activities of the group members:
>
> (i) are in the same general line, such as manufacturing, wholesaling, retailing of tangible personal property, insurance, transportation, or finance; or
>
> (ii) 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
>
> (B) the members are functionally integrated through the exercise of strong centralized management, such as authority over purchasing, financing, product line, personnel, and marketing."

(4) Note that a single affiliated group can include multiple combined groups and/or entities that report on a separate entity basis, depending on which groupings of entities are "unitary."

(5) Section 171.1014 specifies the mechanics for combined group reporting. Each member must first compute "total revenue" on a separate entity basis, then the members' separately computed revenues are added together, and any intra-group revenues are subtracted. All combined group members must make a uniform election to deduct either COGS or compensation, and the combined group's COGS or compensation deduction is

computed by determining deductible amounts (COGS or compensation) on a separate entity basis, adding together the separately computed amounts, and subtracting any intra-group payments. The difference between the combined group's revenues and the combined group's deduction is the group's margin, which is apportioned to Texas on a combined basis as described below.

► **NOTE: The § 171.1014(d) requirement of a <u>uniform election to use a COGS or a compensation deduction</u> may be quite harmful to combined groups that include members with divergent operations. The COGS versus compensation decision will be made based on which approach yields the lowest tax for the combined group, but may result in individual members receiving minimal offset for revenue. For example, if a group includes both a manufacturing entity and a services provider, it may be better off overall electing COGS — even though the services entity gets no COGS deduction and its entire total revenues go into gross margin. Moreover, if the cap on total revenues equal to 70 percent of total revenues applies at the combined group level, the cap would not mitigate this result by limiting the includible total revenues of a member forced to use a disadvantageous deduction method.**

► **NOTE: In two different places—§ 171.0002 (defining the term "taxable entity") and § 171.1014—the margin tax statute specifies that a "<u>combined group" is deemed a single "taxable entity</u>" for purposes of applying the tax. Among other things, this concept may mean that the combined group as a whole is subject to either the default 1 percent tax rate or the reduced 0.5 percent tax rate for manufacturers and wholesalers (see below), depending on whether the group's combined revenues meet the objective tests to qualify for the 0.5 percent rate. On the other hand, the mechanics for computing a combined group's taxable margin require that each member's "total revenue" and its deductible COGS or compensation must be computed "as if each member were an individual taxable entity." Therefore, other significant aspects of the margin tax computation may apply on a member-level rather than group-level basis.**

► **NOTE: The § 171.1014(c), (e), and (f) requirements that total revenues, COGS and compensation be computed for each group member "<u>as if the member were an individual taxable entity</u>," if applied literally, could lead to presumably unintended consequences where different facets of unitary business operations are performed by different group members, since certain margin tax computations depend on the nature of the business activities conducted by the taxable entity. Assume, for example, that one group member holds title to a manufacturing facility that it leases it to another group member, which uses the facility to produce a product for sale. Arguably, if COGS is computed for the first group member strictly "as if the member were an individual taxable entity," it would not qualify for any COGS deduction because it does not produce or sell goods. Moreover, the subsections (e) and (f) combined group adjustments to revenue and COGS for intercompany payments appear to restrict a combined group's ability to address**

these concerns by shifting costs to the production entity through intercompany charges.

(6) Under § 171.1014(g), a combined group may elect to include and treat as taxable an exempt entity that is otherwise part of its affiliated, unitary group.

► **NOTE: Presumably, a combined group would want to include an exempt entity with high non-Texas gross receipts and a low gross margin, which could reduce the combined group's taxable margin. The mere fact that an exempt entity has non-Texas receipts will not alone merit inclusion if it has a high gross margin relative to group members with Texas receipts, e.g., if it has proportionately smaller COGS or compensation such that its inclusion increases the group's gross margin more than it dilutes the apportionment factor.**

(7) The margin tax also contains a provision (§ 171.1015) apparently intended to allow an upper-tier entity to elect to report and pay the tax on the taxable margin of a pass-through entity in which it owns an interest but that is not part of its combined group.

► **NOTE: The tiered reporting provision generally does not appear to affect tax computations, but rather allows a partner to include its share of a pass-through entity's taxable margin (i.e., tax base after apportionment) on the owner's return. This election, however, might allow an owner to use its credits to offset tax liability arising from allocable taxable margin of the pass-through. The provision as enacted contains some confusing terminology that appears to need clarification.**

E. Apportionment Concepts

Section 171.106 largely imports the old Texas franchise tax concepts for apportioning the tax base, i.e., a single factor approach that multiplies the tax base by the ratio of an entity or group's Texas gross receipts to total gross receipts. "Gross receipts" generally are determined, pursuant to § 171.104, under federal tax gross income principles. The principles for determining whether a particular gross receipt is a "Texas gross receipt," under § 171.103, are unchanged from the old franchise tax except:

(1) while services generally continue to be sourced to Texas only if "performed in this state," receipts from servicing loans secured by real property are now sourced to Texas if the real property is located in Texas; and

(2) perhaps in light of a recent adverse court decision (Home Interiors & Gifts, Inc. v. Strayhorn, 175 S.W.3d 856 (Tex. App.–Austin 2005, pet. filed)), Texas has eliminated its long-standing "throwback rule" that sourced to Texas any receipts from sales of tangible property shipped from Texas into a state in which the seller has insufficient contact to be subject to state income tax.

For groups reporting on a combined basis, Texas has adopted the "*Joyce* rule" to apportion the gross margin of combined groups that contain members which lack tax nexus with Texas. Under

§ 171.103, any gross receipts from group members that do not have stand-alone tax nexus with Texas will not be treated as Texas gross receipts for apportionment purposes; but under § 171.105, such "no-nexus" group members' gross receipts are included in total gross receipts. In other words, gross receipts from no-nexus entities will be included in the denominator but not the numerator of the group's apportionment factor. Correspondingly, revenues and deductible cost of goods sold or compensation for any no-nexus entities are included in the computation of a combined group's margin.

► NOTE: The 2007 Texas legislature may give some consideration to changing the apportionment rules for combined groups to the "Finnegan rule" under which Texas receipts of non-nexus combined group members would be included in the numerator of the group's apportionment factor — a decidedly less taxpayer-friendly approach, and one that might lead to a constitutional challenge.

"Gross receipts" for apportionment purposes are defined in § 171.1121 as "all revenues reportable by a taxable entity on its federal tax return, without deduction . . . unless otherwise specifically provided," though any receipts excluded from total revenues are also excluded from gross receipts. For combined groups, any intra-group revenues that are excluded from the computation of the combined group's total revenue are excluded from receipts for apportionment purposes. However, to prevent tax avoidance structures, § 171.1055 provides that if a non-nexus member of a combined group sells into Texas without modification any tangible property purchased from a member that has nexus, the non-nexus member's revenues are treated as Texas gross receipts.

► NOTE: "Gross receipts" for apportionment purposes are defined differently than "total revenues"; this difference may cause some amounts to be included in one but not the other. Although this possibility is reduced by excluding from gross receipts the amounts "excluded" from revenues, there may be instances in which amounts included in the definition of total revenues differ from amounts included in the definition of gross receipts. (However, at least some Comptroller representatives have indicated that gross receipts should equal gross revenues).

F. Tax Rates

Per § 171.002(a), the default rate is one percent of taxable margin, but the rate is reduced in subsection (b) to 0.5 percent if, pursuant to subsection (c), more than 50 percent of a taxable entity's total revenues are from "retail trade" or "wholesale trade" as defined by SIC Codes (though excluding any telecoms or utilities), *and* (other than for bars and restaurants) less than 50 percent of such retail/wholesale revenues derives from products that a taxable entity or its affiliate produces. Note that the tests are based on 1987 SIC classifications rather than the more recent SIC code. Section 171.003 provides that any rate increase requires voter approval, but some have questioned the constitutionality of this requirement.

► NOTE: Under § 171.002(c)(3), the 0.5 percent rate is not available to a taxable entity that "provide[s] retail or wholesale utilities, including telecommunications services and electricity or gas." This limit is again a "cliff," with perhaps unintended consequences:

Is a retailer that leases to a third party its excess telecommunications circuit capacity denied the 0.5 percent rate?

G. Margin Loss Carryforwards

Section 171.101, defining "taxable margin" (total revenues less deductions), includes a provision stating that "[i]n making a computation under this section, an amount that is zero or less is computed as zero," suggesting that a negative taxable margin is deemed a taxable margin of zero. Moreover, H.B. No. 3 repeals the business loss carryforward provisions of the current franchise tax, and does not enact any provision specifically addressing or allowing a carryforward of negative margin. These factors suggest that the margin tax does not allow any future benefit or deductions if a taxpayer has a negative taxable margin in a given year.

► **NOTE: Capital-intensive businesses may generate negative taxable margin due to accelerated depreciation deductions in years with heavy capital investment. Even though these depreciation deductions are a legitimate cost of goods produced and sold in future years, it's possible that the business may never be allowed any offset to the related future revenues.**

H. Credits

There is a short list of credits which are available to qualifying taxpayers under the margin tax. Under § 171.111, taxpayers that have "booked" net operating losses (NOLs) under the existing franchise tax at the end of the taxpayer's 2006 tax year are permitted to take a credit against the margin tax. The temporary NOL credit is calculated by multiplying the taxpayer's apportioned NOLs by the current franchise tax rate and then multiplying the sum by 10 percent. The credit can be taken over a 20 year period.

► **NOTE: The cite in this loss-credit provision (in § 171.111(b)(4)) is to the 4.5 percent rate appearing in current § 171.002 (the rate against which accrued Texas franchise tax business losses would be credited under pre-margin tax law). However, the Comptroller's office has indicated, including in the directions for its online franchise tax calculator, that the margin tax rate in new § 171.002 should apply. Questions also exist regarding the computation of the loss credit, and 2007 legislation will likely address this credit.**

► **NOTE: Section 171.111 refers to March 1, 2007 as the date by which a taxable entity is to notify the Comptroller of the taxpayer's intent to claim this credit. However, the Comptroller has circulated a draft rule that would require notice on or before September 1, 2007.**

Other credits permitted to be carried forward from the franchise tax to the margin tax are the Strategic Investment Area credits (R&D credit, job creation credit, and the capital investment credit taken under subchapters O, P, Q).

I. Effective Date and Transition Issues

Per H.B. No. 3 §22(a), the margin tax will be effective for reports due on or after January 1, 2008, but those reports will include revenues from earlier periods. For example, a calendar year taxpayer will file a report May 15, 2008, which will include a margin tax computed with respect to all revenues earned during calendar year 2007. For fiscal year taxpayers, H.B. No. 3 § 22(b) provides that the margin tax computations cannot apply to business activity before June 1, 2006. Transitional rules in H.B. No. 3 § 22(b) specify the accounting periods on which the tax is based for the first reports filed by entities made newly subject to tax by the margin tax (e.g., partnerships). Anti-tax avoidance provisions in H.B. No. 3 § 22(f) treat successor partnerships as "continuations" of predecessor partnerships for purposes of computing the initial report under the margin tax.

► **NOTE: While the various transition rules are reasonably clear as applied to individual entities, there is some ambiguity in applying these rules to a combined group, particularly if it contains some members subject to the existing franchise tax and other members who will be newly subject to the margin tax.**

As a planning and revenue projection tool for the State, certain large taxpayers will be required, pursuant to H.B. No. 3 § 23, to file information reports by February 15, 2007, to report the margin tax they would have paid based on 2005 activity.

Guidelines: The Draft Guidelines provide that "if the taxable year of a member differs from the taxable year of the group, the principal Texas entity may elect to determine the portion of that member's revenue and cost of goods sold or compensation amounts to be included in the report in one of the following ways: a separate income statement prepared from the books and records for the months included in the group's taxable year; or including all of the income for the year that ends during the group's taxable year."

The Draft Guidelines further state that the "same method must be used for each member with a different accounting period."

► **NOTE: Taxpayers now using a "Delaware sub" limited partnership structure to minimize liability under the current Texas franchise tax generally will continue to realize the tax savings of that structure through any accounting period that ends on or before December 31, 2007 (for example, through December 31, 2006 for calendar year taxpayers).**

► **NOTE: Many taxpayers also have in place a "Geoffrey's" or "passive investment company" multistate tax planning structure under which income is shifted to low- or no-tax states via intercompany payments for management fees, interest, or intangibles licensing. These structures are often effective to reduce franchise taxes under Texas' pre-margin tax system, but the consequences of these structures under the margin tax are unclear and will require a fact-specific analysis of particular taxpayers' intercompany arrangements to assess whether they are beneficial, harmful or neutral in computing a combined group's margin tax.**

J. Implementation and Comptroller Interpretation

The margin tax legislation explicitly and repeatedly delegates to the Comptroller the authority to enact administrative rules interpreting or implementing many facets of the new tax system. The Comptroller's staff is working to analyze the new law and provide guidance, and has already posted online the Comptroller's "Franchise Tax Calculator" (available at http://www.window.state.tx.us/taxinfo/franchise/calculator/). In addition, as noted above, on October 13, 2006, (Friday the 13th) the Comptroller released Draft Guidelines, the draft instructions for the information returns due from certain large taxpayers on February 15, 2007 (i.e., the practice returns that will provide revenue-estimating numbers) and draft forms. Because the margin tax system is unique among state tax systems, and because many of its principles are defined in the Texas Tax Code rather than by incorporating federal tax principles, these administrative rules will be critical. Interested taxpayers may have significant opportunities for meaningful input.

K. What comes next? Technical corrections, "clarifications" and policy changes?

During the 2006 Special Session, the Legislature considered several amendments to the margin tax bill as passed, but the principal vehicle — Senate Bill 6 — died in committee. It is likely that during the next regular session the Legislature will consider both substantive changes as well as technical or clean-up items.

A few lawyerly caveats:

Please consult your tax advisor on your specific facts, as this outline is not intended to offer legal advice. This outline is not intended or written to be used, and it cannot be used, by any taxpayer for the purpose of avoiding penalties that may be imposed on such taxpayer under United States federal tax laws. This outline does not constitute a tax opinion or other advice to which circular 230 is relevant in any way, shape, or form.

In fact, there's a lot of good Texas legislative stuff (including some fine gossip) that's not in the outline.. There's also a lot more in H.B. No. 3–which was 105 pages long–than in this outline.

AND….(the really big caveat): The next regular legislative session begins in January 2007!

**Special thanks to Sam Megally who worked with me on this version of the outline and to Geoff Polma who co-authored with me a prior presentation titled "On the Cutting Edge or on the Margin?" that served as the basis for much of this outline.* *I can be reached at 214-939-5512 or cindy.ohlenforst@hughesluce.com; Sam Megally can be reached at 214-939-5491 or sam.megally@hughesluce.com; and Geoff can be reached at 214-740-8644 or gpolma@lockeliddell.com.*