History

- The Texas franchise tax dates back to the early 1900s. The current version is the result of the work of the Texas Tax Reform Commission, which then Governor Rick Perry (R) established in 2005 to modernize the state tax system and resolve issues related to school funding, which the courts had declared unconstitutional. The Commission was led by former Texas Comptroller, John Sharp (D) and it resulted in a sweeping reform of the Texas franchise tax. Prior to this reform, the franchise tax was based on a two-factor formula effectively taxing the earned surplus or the capital of the taxable entity.

How does the Texas franchise tax work?

- Who must pay the tax? – “Taxable entities” must pay the tax. Generally, these are legal entities such as corporations or limited liability companies. However, there are many exceptions to this rule, for example, sole proprietorships, partnerships that are exclusively owned by natural persons, and grantor trusts are all not taxable entities. There are thirteen exemptions found in the definition of taxable entity, one of which is a reference to a Subchapter that contains 34 exemptions, for a total of 46 different exemptions.

- What is it? – The Texas franchise tax is neither a net income tax, nor it is a gross receipts tax, although it does share some similarities between those types of taxes. Similar to both a net income tax and a gross receipts tax, calculating the Texas franchise tax liability begins with the gross revenue of the taxable entity. Unlike a net income tax, not all ordinary and necessary business expenses may be deducted, but unlike a gross receipts tax, there are several large deductions available. This results in a tax on “margin” rather than on income or receipts.

- What is taxable? – The Texas franchise tax is imposed on taxable margin, which is based on the result of four different possible calculations. All of these calculations start with the taxable entity’s total revenue. Under this system, taxable margin is equal to the lesser of:

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1 See Texas Tax Code § 171.0002 (Definition of Taxable Entity).
2 See Texas Tax Code § 171.101 (Determination of Taxable Margin).
70% of total revenue; total revenue less compensation; total revenue less cost of goods sold; or total revenue less $1,000,000. Each of these deductions benefit different types of taxpayers. The compensation deduction tends to benefit service providers, such as lawyers and accountants, while the cost of goods sold deduction tends to benefit manufacturers and retailers. The $1,000,000 exemption helps protect small businesses. The 70% calculation benefits service industries that tend to hire independent contractors.

- **What is the tax rate?** – The base tax rate is 0.75 percent and there is a reduced tax rate available for retailers and wholesalers. Also, there is no tax due if the total tax due is less than $1,000, or the total revenue of the taxable entity is less than or equal to $1,000,000, adjusted for inflation.4

**Traps for the Unwary**

- **Single Member LLCs** – Single member LLCs that are disregarded for federal tax purposes are NOT disregarded for the Texas Franchise Tax. This can lead to significant complications in certain situations because the calculation of total revenue is based on certain line items from the taxable entities’ federal income tax returns. For single member LLCs owned by an individual, this has been addressed by rule to base total revenue on Schedule C and other federal tax forms.5 For single member LLCs owned by other types of entities, the result is less clear. For example, a recent private letter ruling from the Texas Comptroller determined that single member LLCs owned by an IRC § 401 (a) trust must report and pay franchise tax based on the unrelated business income reported by the trust on its form 990-T.6 This was a case where the statute and the rule did not clearly identify a federal tax return from which to take revenue information, so a catch-all “substantially equivalent” rule applied.

- **Public Law 86-272** – By legislative declaration, Public Law 86-272 does not apply to the Texas franchise tax because it is not a net income tax.7

**Recent Trends**

- **Legislation** – Industries continue to lobby for special treatment, particularly with respect to the Cost of Goods Sold deduction and the Reduced Tax Rate.

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3 Texas Franchise Tax “Cost of Goods Sold” is not equivalent to a taxpayer’s “Cost of Goods Sold” for federal income tax purposes.

4 See Texas Tax Code § 171.002 (Rates; Computation of Tax). The $1,000,000 figure in Texas Tax Code § 171.002 is adjusted for inflation by Texas Tax Code § 171.006 (Adjustment of Eligibility for No Tax Due, Discounts, and Compensation Deduction.) The amount for the 2019 report year is $1,130,000.

5 See 34 Tex. Admin. Code § 3.587 (d)(5)


7 See 34 Tex. Admin. Code § 3.586 (e).
Enacted bills from the most recent legislative session\(^8\) include:

- HB 2126 – Clarified that sellers of prepaid telephone cards are not selling telecommunications services, and therefore they are eligible for the reduced retail rate.
- HB 3992 – Added an exemption for certain farmers’ cooperatives.

Upcoming proposed legislation for the 2019 legislative session:

- HB 52 – Pilot program to provide franchise tax credit for employer contributions to an employee’s dependent care flexible spending account.
- HB 276 – Additional deduction for costs related to the sale of goods to the federal government.
- SB 66 – Would reduce the tax rate for the franchise tax using a formula based on available revenue and would repeal the franchise tax once that rate reaches 0%.

**Nexus Issues** –

- A recent private letter ruling from the Comptroller’s office indicates that Texas will continue to apply a physical presence test to franchise tax nexus requirements.\(^9\) But, given *Wayfair*, it is possible that this could change, either via legislation or administrative action.
- The Comptroller’s Business Activities Research Team (BART) is actively looking for businesses that may have nexus with Texas.

**Recent Litigation**

- *Graphic Packaging Corporation v. Hegar*, 538 S.W.3d 89
  - Texas Supreme Court opinion issued December 22, 2017.
  - This case involved the application of the Multistate Tax Compact (MTC) to the Texas Franchise Tax. The taxpayer, Graphic Packaging, claimed that the three-factor income apportionment election under the MTC\(^{10}\)

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\(^8\) 85th Regular Session of the Texas Legislature (2017).
\(^{10}\) The MTC was adopted in Texas as Texas Tax Code, Chapter 141.
applied to the Texas Franchise Tax because the Texas Franchise Tax satisfies the MTC definition of “income tax.” The Comptroller responded that the single factor apportionment under the franchise tax statutes was the exclusive method for apportionment. 11

• Interestingly, the Texas Supreme Court did not decide the case on the “income tax” issue, leaving open the question of whether the Texas Franchise Tax is truly an income tax or not. 12 Rather, the Court decided the issue using general principals of statutory construction.
• The Court found that allowing the MTC election would have created an irreconcilable conflict with the Franchise Tax statutes. The Court resolved the conflict in favor of the single-factor apportionment statute because the single-factor apportionment statute was adopted after the MTC, and was more specific than the MTC.

○ Lockheed Martin Corp v Hegar, 550 S.W.3d 855
  • The Texas Third Court of Appeals issued an opinion June 8, 2018. The case is currently on appeal to the Texas Supreme Court.
  • This case involves the sale and export of military aircraft manufactured by Lockheed. The aircraft were sold by Lockheed to the US Government as “Foreign Military Sales” (FMS). The US Government took delivery of the aircraft in Texas before delivering the aircraft to the ultimate purchaser, a foreign nation.
  • Lockheed claimed the ultimate destination of the products should control the sourcing of receipts for apportionment purposes. The Comptroller takes the position that the location of delivery controls the sourcing of the receipts.
  • The district court held in favor of the Comptroller, which was affirmed by the appeals court. As a threshold matter, the appeals court determined that Lockheed sold the aircraft to the U.S. Government, rather than the foreign governments involved. This was based on the terms of the FMS, as well as several federal cases involving similar issues. The Court decided the case on this threshold matter, because the U.S. Government was considered the ultimate purchaser, so the distinction between the place of delivery and location of the ultimate consumer did not need to be addressed.


11 See Texas Tax Code, Section 171.106.
12 “Even were we to agree with Graphic that its franchise tax for the years in question amounted to the same thing as chapter 141’s income tax (an issue we do not decide), Graphic must still establish that the Legislature did not, or could not, make chapter 171’s single-factor apportionment formula the exclusive means for apportioning the Texas franchise tax.” Graphic Packaging at 96.
The Texas Third Court of Appeals issued an opinion on January 6, 2017. The case is currently on appeal to the Texas Supreme Court.

This case involves the Cost of Goods Sold deduction, specifically whether the sale of a movie ticket is the sale of a good. Am. Mult. Cinema (AMC) took the position that when it sold movie tickets, it was selling tangible personal property because the movie was either perceptible to the senses, or was a “film” under the relevant Cost of Goods Sold statutes. The Comptroller took the position that AMC sold the right to view the movie, rather than the movie itself.

The Court of Appeals first issued an opinion on April 30, 2015 which held for AMC on the “perceptible to the senses” issue. That opinion was withdrawn and substituted with an opinion that held for AMC on the definition of “film” and did not decide the “perceptible to the senses” issue.

Going forward, the Cost of Goods Sold deduction has been amended by the legislature to allow for the costs at issue in this case.\(^\text{13}\)

Sirius XM Satellite Radio v. Hegar

A district court decision has been issued, and the Comptroller appealed the case to the Third Court of Appeals. This case involves the sourcing of receipts from the sale of satellite radio services for franchise tax purposes.

\(^\text{13}\) See Texas Tax Code § 171.1012 (t)