NEWS ALERT

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Summary of the Revised Texas Franchise Tax

The Texas "Margin Tax"

The State of Texas has been imposing a state franchise tax which applied to for-profit corporations and to limited liability companies (LLCs) chartered or organized in Texas, as well as to foreign corporations and LLCs doing business in the state. Franchise taxpayers also have included professional corporations, and banks and savings-and-loan associations, but previously did not include general or limited partnerships, sole proprietorships, or non-corporate associations. However, a recently enacted Texas law has replaced the franchise tax with a revised business franchise tax — the so-called "margin" tax. The margin tax applies much more broadly than the previous franchise tax because the base of entities subject to the tax has been expanded, and there is a new mechanism for calculating the tax. The margin tax takes effect on January 1, 2008, and for calendar-year taxpayers, the margin tax will apply to entity income commencing January 1, 2007, and will be payable annually commencing May 1, 2008. The May 2007 franchise tax payment which was calculated on 2006 income or equity was based on the franchise tax as it existed prior to enactment of the new margin tax.

Tax Base and Determination of Total Revenue

The "margin tax" has been dubbed as such because it is based on the "margin" between total revenue and either employee compensation costs or the cost of goods sold (whichever is elected by the taxpayer). The election between costs of goods sold and the compensation deduction may be changed on an annual basis. A few deductions (e.g., bad debts and interest from the federal government) further reduce revenue. The margin tax for most businesses will be equal to 1% of the margin. However, taxable entities engaged primarily (generally more than 50% of revenues) in retail or wholesale trade will pay a reduced rate of 0.5%. (The previous franchise tax was based on 4.5% of net income or 0.25% of capital.) There is a cap on the amount that is taxable — if the entity's margin after making its deduction is greater than 70% of its total revenue, the business will be taxed only on 70% of its total revenue. Upon determining its margin, multi-state businesses will apportion to Texas the amount of margin taxable in Texas based on the source of gross receipts (see below). Taxable entities with up to $10 million in revenue may elect to pay margin tax on 0.575 percent of the total revenue apportioned to Texas (the so-called "EZ Computation").

Total Revenue. Total revenue generally is determined based on federal tax return references and concepts. In determining revenue from the sale of property (e.g., the sale of real estate or securities), only the gain from such sale is included in revenue, as opposed to the sales proceeds. Each entity may need to review its methods for accounting for receipts to make sure it is not including receipts that should not be treated as such entity's revenue (e.g., deposits, customer or tenant payments to be paid or forwarded to third party vendors, funds held in trust or escrow, etc.).

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Determination of Deductible Compensation. The margin tax basically allows the deduction of wages and cash compensation and benefits for each employee of the entity. The deduction for wages and cash compensation paid to employees is capped at $300,000 per employee per year and includes wages, salaries, stock grants and options, and net distributive income accruing to a natural person from entities treated as "pass-throughs" for federal income tax purposes, including partnerships, trusts, limited liability companies, and "S" corporations. (Wages and cash compensation means the amount entered in the Medicare wages and tip box in IRS Form W-2, subject to the $300,000 cap). Payments to independent contractors generally are not deductible under the statute, although payments of certain commissions (e.g. to co-brokers) and payments to certain subcontractors may be deducted. In addition to the wages and cash compensation deduction, an entity may deduct "all benefits" provided to its employees. "All benefits" is not defined, but the law does state that it includes workers' compensation benefits, health care, deductible contributions to retirement plans, and contributions to employer health savings account contributions. Unlike the wages and cash compensation deduction, the benefits deduction is not subject to the $300,000 cap.

Determination of Cost of Goods Sold. Cost of goods sold includes certain identified "direct costs" of acquiring or producing real or tangible personal property sold in a taxable entity's ordinary course of business, and certain other "related" costs. "Cost of Goods Sold" is defined in detail in the new law, rather than using federal tax or generally accepted accounting principles (GAAP) definitions of cost of goods sold. The law also provides a very detailed list of expenses that are specifically excluded.

Texas Apportionment. Multistate businesses will determine their Texas portion of the taxable margin using the same apportionment calculation used for the previous franchise tax. The apportionment calculation is the ratio of Texas gross receipts (the numerator) to total gross receipts from the entire business (the denominator). Receipts excluded from the total revenue may not be included in gross receipts used for apportionment. A change to be noted from the previous franchise tax is that while services continue to be sourced to Texas only if performed in Texas, receipts from servicing loans secured by real property are now sourced to Texas if the real property is located in Texas.

Taxable Entities

Under the new law, businesses subject to the margin tax are generally those with state law liability protection. As a result, the base of the entities subject to the margin tax is more expansive than those entities that were subject to the previous franchise tax. Subject to certain exceptions described below, entities taxable under the margin tax regime include corporations and limited liability companies subject to the previous franchise tax, and also include general partnerships and joint ventures which have at least one partner that is not a natural person, limited partnerships, limited liability partnerships, professional and business associations, joint stock companies, savings-and-loan associations, banking corporations, holding companies, and other legal entities.

Non-taxable Entities

The base of taxable entities subject to the margin tax excludes:

- sole proprietorships;
- “passive investment partnerships" — limited or general partnerships that are passive entities (discussed below);
- general partnerships and joint ventures that are owned solely by natural persons;
- escrows;
- grantor trusts with natural persons or charitable entities as the sole beneficiaries;
- certain trusts with natural persons or charitable entities as the sole beneficiaries that are passive entities;
- certain entities exempt from the previous franchise tax under Subchapter B of the Texas Tax Code (i.e., non-profit corporations, cooperatives, credit unions and insurance companies required to pay insurance premium taxes) (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 such as a non-profit organization);
- estates of natural persons;
- real estate investment trusts ("REITs"), but only if the REIT does not own real estate directly (other than real estate that the REIT occupies solely "for business purposes") and qualified REIT subsidiaries (as a practical matter, however, there really is very little exception for REITs); and
- real estate mortgage investment conduits ("REMICs").

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Combined Reporting

Taxable entities that are part of an "affiliated group" engaged in a "unitary business" must file a combined group report. "Affiliated group" is defined as a group of one or more entities in which a "controlling" 50% or greater interest is owned by a common owner or owners, either corporate or non-corporate, or by one or more other members of the affiliated group. The 50% "controlling" interest test for a corporation refers 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 50% test for other entities applies to direct or indirect ownership of "the capital, profits, or beneficial interest" in the entity. An affiliated group is in a "unitary business" if there is a single economic enterprise and the entities are sufficiently interdependent, integrated and interrelated to provide a synergy and mutual benefit that produces a sharing or exchange of value (e.g., common management and employees). The election to subtract cost of goods sold or employee compensation is made by the combined group and applies to all of its members.

Exceptions to the Margin Tax

Small Business Exception. Taxable entities with $300,000 or less in total annual revenue (indexed for inflation) or that owe less than $1,000 under the tax are not required to pay the tax. This doubles the small business exemption from the previous franchise tax for taxable entities with gross receipts of $150,000 or less in a given tax year. Taxable entities with total annual revenue between $300,000 and $900,000 are entitled to a “phasing in” of the tax for such year.

Passive Entities. "Passive entities" are excluded from the definition of "taxable entity." A passive entity is generally defined as a general or limited partnership or trust, other than a business trust, that both (i) derives at least 90% of its federal gross income from passive income, and (ii) does not receive more than 10% of its federal gross income from conducting an active trade or business. Importantly, a limited liability company does not fall under the definition of a passive entity.

Passive income includes, but is not limited to, dividends, interest, distributive shares of partnership income, capital gains from the sale of real property, and royalties. Passive income also includes royalties, bonuses or delay rental income from mineral properties and income from other mineral interests not operated directly or by an affiliate. Rent income is <u>not</u> considered passive income.

Generally, a business is considered to have conducted active business if the entity's activities include operations that earn income and if the entity performs active management and operational functions. A royalty interest or non-operating working interest in a mineral right is not considered "active business."

Choice of Entity

The enactment of the margin tax will change the analysis for choice of entity decisions. Under the previous franchise tax, limited partnerships were favorable entities because they were not subject to the franchise tax.

Limited Liability Company. Generally, subject to the comments below, the LLC will be the most attractive entity under the margin tax regime. Under the federal "Check the Box" regulations, it can be taxed for federal income tax purposes as a corporation or a partnership.

Limited Partnership. In certain situations however, limited partnerships may still be favorable. Entities that are engaged in "passive investment" income activities (see above) may still want to consider being organized as limited partnerships in order to qualify as an exempt "passive entity.” For example, an entity owning securities, mineral interests or real estate in Texas most often should be a limited partnership. Although rent is not passive income, the capital gain from the sale of real estate is passive income. Therefore, limited partnerships should continue to be the preferred vehicle for real estate ownership. From a planning standpoint, where real estate has been rented, the timing of a sale (or the timing of the gain from a sale via the use of the installment method) may be critical if it will cause the entity's income for a year to be 90% passive, and thus not taxable for the year.

General Partnership. A general partnership will also be an attractive entity in certain circumstances. General partnerships owned entirely by natural persons will not be subject to the margin tax. The margin tax will be imposed on a general partnership which has an entity as a partner. However, one major downside is that under common law, all partners in a general partnership generally have joint and several liability for all of the debts and obligations of the partnership.

Family Limited Partnership. Family limited partnerships that are passive investment partnerships are not taxable entities under the margin tax regime.