

The "New" Texas Franchise Tax: A Summary of HB 3*

As part of a comprehensive package of tax reform legislation, the Texas Legislature passed HB 3 (the "Act"), which Governor Rick Perry signed into law on May 18, 2006. The Act changes the manner in which business entities are taxed in Texas by (i) broadening the classes of business entities subject to the Texas franchise tax (the "Franchise Tax"), (ii) replacing the manner of calculating the tax base using taxable capital or earned surplus with a "taxable margin," and (iii) changing the rate applied to the tax base.

The following are the most significant changes made pursuant to the Act to the Franchise Tax scheme, Chapter 171 of the Texas Tax Code. The tax provisions of the Act will take effect on January 1, 2008, while some reporting and administrative provisions, and a provision giving exclusive jurisdiction to the Texas Supreme Court for any challenges to the constitutionality of the Act, will take effect on September 1, 2006.

1. **Taxable Margin; Tax Rates.** The Franchise Tax is no longer based on a taxable entity's net taxable capital or net taxable earned surplus, but rather on the taxable entity's "taxable margin." "Taxable margin" is calculated by determining a taxable entity's "margin," apportioning the margin to Texas, and then subtracting any permitted deductions. "Margin" is the lesser of (i) 70% of the taxable entity's total revenue on its entire business or (ii) the taxable entity's total revenue on its entire business minus either (a) its cost of goods sold or (b) its compensation. The election to subtract cost of goods sold or compensation is made by the taxable entity on its Franchise Tax report, and the election is valid for that report only. This approach allows the taxable entity to select the method that will produce a lower Franchise Tax liability.

The Franchise Tax is calculated by multiplying a taxable entity's taxable margin by the tax rate of 1%, or 0.5% for retailers and wholesalers. No tax is owed if the tax due is less than \$1,000 (raised from \$100) or if the taxable entity's total revenue from its entire business does not exceed \$300,000 (raised from \$150,000) subject to adjustment based on changes in the consumer price index.

Any increase in the tax rates must be approved by the voters in a referendum held specifically on the issue of raising the tax rates. The Legislature may decrease a tax rate without voter approval.

*This summary is intended to provide general information regarding the subject matter addressed. It is not legal advice and cannot be relied upon as such. For legal advice, please contact one of our firm's attorneys.

However, any increase in the rate thereafter—even a return to the original rate—must be approved by the voters in a referendum.

The Act applies to reports originally due on or after January 1, 2008. An entity not previously subject to the Franchise Tax that becomes subject under the Act must file an annual report on May 15, 2008. The reporting period will be based on the taxable entity's fiscal period.

2. **Business Entities Subject to and Excluded from Franchise Tax.** The entities that are subject to the Franchise Tax (each a "taxable entity") include partnerships, corporations, limited liability companies ("LLCs"), banking corporations, savings and loan associations, professional associations, business associations, business trusts, joint ventures, joint stock companies, holding companies and most other legal entities.

Entities excluded from the definition of "taxable entity" and not subject to the Franchise Tax include:

- a sole proprietorship (an entity that is treated as a sole proprietorship for federal tax purposes (e.g., a single-member LLC) is deemed a "taxable entity" if it is formed in a manner that limits the liability of the entity);
- a general partnership, if all ownership interests are directly held by natural persons;
- a passive entity;
- a tax-exempt entity;
- an estate of a natural person;
- an escrow;
- a real estate investment trust ("REIT"), with some exceptions;
- a real estate mortgage investment conduit ("REMIC");
- certain family limited partnerships that are passive entities;
- certain grantor trusts;
- certain kinds of trusts and passive investment partnerships; and
- a non-corporate entity that would qualify because of its activities as a tax-exempt entity if it were a corporation.

A "passive entity" is a general partnership, limited partnership or trust, other than a business trust, at least 90% of the income of which consists of passive income, including: dividends; interest; gains on foreign currency exchange; distributive shares of partnership or LLC income; gains from the sale of real property, exchange-traded commodities and securities; and royalties, bonuses and delay rental income from mineral properties. Passive income does not include rental income. Passive income also does not include income received by a non-operator from mineral properties under a joint operating agreement if the non-operator is a member of an affiliated group and another member of the affiliated group is the operator under that same joint operating agreement. A taxable entity that owns an interest in a passive entity that is not included in a combined group report must include the taxable entity's share of the net income of the passive entity to the extent that such net income was not generated by the margin of any other taxable entity.

Generally, an additional tax is imposed for the stub period where a taxable entity becomes no longer subject to the Franchise Tax. However, this additional tax is not imposed on a taxable entity where non-application of the Franchise Tax is due to such entity qualifying as a passive entity.

Under the Act, the definition of passive entity includes a limited partnership formed pursuant to the Texas Revised Limited Partnership Act. As of January 1, 2006, all new business entities formed in Texas are formed pursuant to the Texas Business Organizations Code ("TBOC"). A limited partnership that otherwise meets the definition of a passive entity under the Act but was formed pursuant to TBOC should be included within such definition. Based on the express language of the Act, however, it is unclear whether a limited partnership formed under TBOC will qualify as a passive entity.

3. **Total Revenue of a Taxable Entity.** Generally, a taxable entity's "total revenue from its entire business" is the amount of total income, excluding costs of goods sold, that is reported on the entity's federal income tax return, with some adjustments. Adjustments include: bad debt expense; foreign royalties and foreign dividends; net distributive income from entities treated as partnerships or S corporations for federal income tax purposes; income attributable to an entity disregarded for federal income tax purposes (*e.g.*, a single-member LLC); and certain deductions for corporations if dividend income is included in total revenue. A corporation that is part of a "federal consolidated group" must compute its total revenue as if it had filed a separate return for federal income tax purposes.

To the extent that certain items are included in initially calculating total revenue as described above, a taxable entity excludes such items from its total revenue. Several of these exclusion items are discussed below under subheadings relating to particular trades or businesses. Any amount excluded from total revenue may not be included in the determination of cost of goods sold or of compensation. A payment on an ordinary contract for the provision of services in the regular course of business may not be excluded, with some exceptions. Dividends and interest received from federal obligations, sales commissions to non-employees, and split-fee real estate commissions are excluded from calculation of total revenue. Flow-through funds that are required to be distributed to other entities, including taxes collected by a taxable entity from a third party and remitted to a taxing authority, are excluded from total revenue.

4. **Cost of Goods Sold.** "Cost of goods sold" includes the direct costs of acquiring or producing goods. Cost of goods sold generally must be determined in accordance with accounting methods and related rules prescribed under federal tax laws. The Act contains a list of expenses included in the determination of cost of goods sold where such items of cost are either directly or indirectly allocable to the production of good.

A taxable entity may include as cost of goods sold indirect or administrative overhead costs that it can demonstrate are allocable to the acquisition or production of goods. A taxable entity may include amounts in its cost of goods sold to the extent the taxable entity owns the goods acquired

or produced. Cost of goods sold does not include costs that are not directly or indirectly allocable to the production of goods, including costs of selling, distribution or advertising; interest payments, including interest on debt used to finance the production of goods; income taxes; compensation of officers; and compensation paid to an undocumented worker used for the production of goods. Partner contributions used to fund operations and deducted as otherwise permitted by the contributing partners may not be included in a taxable entity's cost of goods sold.

5. **Compensation.** "Compensation" includes all wages, cash compensation and benefits a taxable entity pays or provides to its officers, directors, owners, partners and employees. The term "wages and cash compensation" includes W2 wages, net distributive income from entities treated as partnerships or S corporations for federal tax purposes (but only if the recipient of distributions is a natural person) and stock awards and stock options deducted for federal income tax purposes.

A taxable entity may not include more than \$300,000 (subject to adjustment for changes in the consumer price index) paid by the taxable entity as wages and cash compensation to any one person. A taxable entity may not include in its compensation any wages or cash compensation paid to an undocumented worker.

6. **Apportionment to Texas.** The term "services" now includes receipts derived from servicing loans secured by real property if the real property is located in Texas. Any items of revenue excluded in the determination of total revenue (as reported on the taxable entity's federal tax return) are not taken into consideration for purposes of apportionment.

A combined group must include in its gross receipts the gross receipts of each member taxable entity with a nexus to Texas for taxation purposes. Receipts derived from transactions between members of a combined group that are excluded in determining the total revenue of the combined group may not be included in the receipts of a member from its business done in Texas. However, receipts from the sale of tangible personal property between members of a combined group will be included in the Texas receipts of the combined group to the extent a member not otherwise having a nexus to Texas resells the property without modification to a purchaser in Texas.

Despite the fact that the new Franchise Tax scheme is based on revenue and no longer requires capital based calculations, the Act explicitly declares that the Franchise Tax is not an income tax and the provisions of Public Law 86 272 do not apply. The prior Franchise Tax scheme included "throwback" provisions requiring the gross receipts from sales of tangible personal property shipped from Texas to a purchaser in another state to be added to the gross receipts of business done in Texas for purposes of apportionment. The throwback provisions are designed to capture and tax income that would otherwise go untaxed as a result of Public Law 86272. In *Home Interiors & Gifts, Inc. v. Strayhorn*, the throwback provisions were held to be internally inconsistent in violation of the relevant U.S. Supreme Court rulings. Given the ruling in *Home Interiors*, a conclusory statutory provision may not be sufficient to fend off similar constitutional attacks on the new Franchise Tax scheme.

7. **Many new provisions are specific to particular trades or industries.**

- A. Retail or Wholesale Trade. A taxable entity primarily engaged in the retail or wholesale trade is taxed at a rate of 0.5% of its taxable margin. A taxable entity is primarily engaged in the retail or wholesale trade if retail or wholesale revenues exceed revenues from other trades, less than 50% of its retail or wholesale revenues comes from other members of an affiliated group of which the taxable entity is a member (this limitation does not apply to the restaurant business), and the taxable entity does not provide utilities, including electricity, gas or telecommunications services. "Retail trade" and "wholesale trade" are each defined with respect to the Office of Management and Budget's 1987 Standard Industrial Classification ("SIC") Manual.
- B. Insurance Industry. Generally, an insurance organization, title insurance company or title insurance agent that is required to pay tax assessed on gross premiums is exempt from payment of Franchise Tax. Such an entity must, however, pay Franchise Tax for a tax year in any part of which such entity is in violation of a final or nonappealable order issued by the Texas Department of Insurance for the return of excessive premiums paid for personal auto or residential property insurance.
- C. Legal Profession. A taxable entity that provides legal services (a law firm) excludes from its total revenue: flow-through funds that are required to be distributed to a client by his attorney or to other entities by an attorney on behalf of his client; reimbursement of the law firm's expenses incurred in representing a client, but only those expenses specific to the matter and not general operating expenses; and up to \$500 per case of actual out-of-pocket expenses of an attorney for providing pro bono legal services, if the attorney maintains proper records.
- D. Lending Institutions. A lending institution excludes from its total revenue proceeds from repayment of principal of loans as well as the federal tax basis of loans sold. A lending institution that offers loans to the public and elects to subtract cost of goods sold may subtract its interest expense as a cost of goods sold.
- E. Securities Industry. A taxable entity excludes from its total revenue the federal tax basis of securities sold and of securities underwritten.
- F. Construction Industry. A taxable entity excludes from its total revenue subcontracting payments handled by the taxable entity to provide services, labor or materials in connection with the actual or proposed design, construction, remodeling or repair of improvements on real property or the location of the boundaries of real property.

- G. **Staff Leasing.** A staff leasing services company excludes from its total revenue, and may not include in its wages or cash compensation, payments received from a client company for wages, payroll taxes, employee benefits and workers' compensation benefits for the assigned employees of the client company. Compensation must be based on the staff leasing services company's own employees that are not assigned employees. A client of a staff leasing services company includes as wages or cash compensation payments it makes to the staff leasing services company for payment of wages and benefits of assigned employees, but may not include in compensation any administrative fee paid to the staff leasing services company or any other amount, including payroll taxes.
- H. **Management Companies.** A management company excludes from its total revenue reimbursements of specified costs incurred in its conduct of the active trade or business of a managed entity. A management company may not include as wages or cash compensation any amount reimbursed by the managed entity, while a managed entity includes such reimbursements as if the wages and compensation had been paid to employees of the managed company.
- I. **Health Care.** A "health care provider" is a taxable entity that participates in the Medicaid program, Medicare program, Children's Health Insurance Program ("CHIP"), state workers' compensation program, or TRICARE military health system as a provider of health care services. A health care provider excludes from its total revenue the amount of payments received under such programs as well as the amount of any uncompensated care provided. A health care provider that is a "health care institution", such as a hospital, nursing home, emergency medical services provider or pharmacy, excludes 50% of the amount that a health care provider excludes as described above.
- J. **Housing Industry.** A taxable entity excludes from its total revenue all revenue that is directly derived from operation of a facility that is on property owned or leased by the U.S. government and operated primarily to house members of the U.S. armed forces. A taxable entity may not include wages or cash compensation paid to an employee whose primary employment is directly associated with such a facility.
- K. **Certain Leasing Businesses.** A taxable entity in the business of leasing to others motor vehicles, heavy construction equipment or railcar rolling stock may include in its cost of goods sold costs with respect to tangible personal property that the entity leases in the ordinary course of business.
- L. **Oil and Gas.** A taxable entity excludes total revenue received from oil or gas produced from certain small wells during Comptroller-certified periods of low oil and gas prices.

Taxable entities that are part of an affiliated group engaged in a unitary business must file a "combined group" report instead of individual Franchise Tax reports. A "unitary business" is a single economic enterprise in which the members of the affiliated group are sufficiently interdependent and integrated through their activities that they produce a mutual benefit and a sharing of value among them and a significant flow of value to the separate parts.

A combined group is treated as a single taxable entity and makes the election to subtract cost of goods sold or compensation that applies to all members of the combined group. A combined group determines in similar manner its total revenues, cost of goods sold and compensation. First, the revenues, cost of goods sold and compensation, as applicable, of each member is determined as if such member were an individual taxable entity. Next, the amounts of all members are added together. Finally, any amount received or paid to a member of the combined group is subtracted. A payment from a member of an affiliated group to another member of the affiliated group that is not a member of the combined group may only be subtracted as a cost of goods sold if the payment is part of an arm's length transaction.

8. **Tax Credits.** The tax credits permitted under Subchapters L through U have been repealed. Any unused credits that accrued before and remain unused when the Act becomes effective may be claimed within a limited time period provided in the Act. Likewise, credits allowed under a written agreement effective before June 1, 2006 between a taxpayer and the Texas Department of Economic Development may still accrue and be claimed as provided in such agreement. The repealed provisions of the Franchise Tax scheme continue in effect for the purpose of determining the amount of credits the corporation may claim and the manner in which the corporation may claim such credits.

1. The Act is silent on whether the cost of benefits provided to an undocumented worker may be included in compensation (while their wages and cash compensation expressly may not be included). In statement of legislative intent, Rep. Rafael Anchía clarified that it was his intent that taxable entities that hire undocumented workers be ineligible for workers' compensation related deductions under the Act.

2. 15 U.S.C. §§ 381384.

3. 175 S.W.3d 856 (Tex. App.—Austin 2005, pet. filed).

4. See *Oklahoma Tax Commission v. Jefferson Lines, Inc.*, 514 U.S. 175 (1995) (holding that a state taxation scheme must be "internally consistent"), and *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274 (1977) (holding that state taxation of corporations in interstate commerce must be fairly apportioned).