

THE NEW AND EVOLVING TEXAS MARGIN TAX, PART I

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In 2006, the Texas Legislature passed and the Governor signed into law House Bill 3, which substantially revises the existing franchise tax by expanding the types of businesses that are subject to the tax, expanding the tax base, and eliminating a number of credit provisions previously included in Chapter 171 of the Texas Tax Code. Notably, HB 3 subjects partnerships to the new Texas franchise tax (a.k.a., the “margin tax”), exempts “passive” entities, and introduces combined reporting for certain affiliated entities. The new tax becomes effective in 2008, and the first returns will be based upon activity in 2007. The current franchise tax by comparison is imposed on corporations and limited liability companies and is the greater of .25% of an entity’s taxable capital (adjusted GAAP net worth) or 4.5% of taxable earned surplus (adjusted federal taxable income plus officer and director compensation).

The 2007 Texas Legislature recently passed a technical corrections bill, HB 3928, making a number of revisions to the new margin tax. HB 3928 has now been signed into law by Governor Perry. This paper summarizes the provisions of the new margin tax, as amended by HB 3928. The reader should note however that information included in this paper is intended to be general in nature and should not be relied upon without seeking individual legal advice.

The Texas Comptroller has also recently issued a draft of proposed rules construing the new margin tax (“Proposed Rules”). The Proposed Rules, which are not addressed in Part I of this paper, are expected to be adopted later this year as final rules after comments to the Proposed Rules are considered by the Texas Comptroller. The final rules will be discussed in Part II of this paper, which will be published in the fall/winter issue of this publication.

All references to “Code Section” are to Internal Revenue Code.¹

¹ References to the Internal Revenue Code under the margin tax means the Internal Revenue Code of 1986 in effect for the federal tax year beginning on January 1, 2007 and does not include any changes made by federal law after that date.

Imposition of Tax

Tax On Entity - Section 171.001

Tax is imposed on each “taxable entity” (defined below) that does business in Texas or that is chartered or organized in Texas. Section 171.001. The franchise tax extends to the limits of the United States Constitution and the federal law adopted under the United States Constitution.

Additional Tax – Section 171.0011

If a taxable entity ceases to be subject to the franchise tax, the margin tax is imposed on the portion of the year prior to the taxable entity ceasing to be subject to the franchise tax.

Taxable Entities

A “taxable entity” is defined in Section 171.002 to include the following:

- Partnership
- Limited liability partnership
- Corporation
- Banking Corporation
- Savings and loan association
- Limited liability company
- Business trust
- Professional association
- Business association
- Joint venture
- Joint stock company
- Holding company
- Other legal entities
- Combined group

A taxable entity does not include the following entities:

- Joint operating or co-ownership agreements meeting requirements of Treas. Reg. Section 1.761-2(a)(3) that elect out of federal partnership treatment under Code Section 761(a);
- Sole proprietorship. A sole proprietorship does not include an entity that can file as a sole proprietorship for federal tax purposes if the entity is formed in a manner under the statutes of this state, another state, or a foreign country that limit the liability of the entity;

- General partnership whose direct ownership is entirely composed of natural persons and whose liability is not limited under a statute of this state or another state, including by registration as a limited liability partnership;²
- A passive entity – defined under Section 171.0003;
- An entity that is exempt under Subchapter B of the franchise tax statute;
- Grantor trust under Code Section 671 if all of the grantors and beneficiaries are natural persons or Code Section 501(c)(3) charitable entities, excluding trusts taxable as a business entity under Treas. Reg. Sec. 301.7701-4(b) (business trust provisions);
- Estate of a natural person as defined under Code Section 7701(a)(30)(D), but excluding an estate taxable as a business entity pursuant to Treas. Reg. Section 301.7701-4(b)(business trust provisions);
- An escrow;
- Real estate investment trusts and their qualified REIT subsidiaries. A REIT with any amount of its assets in direct holdings of real estate, other than real estate occupied for business purposes, as opposed to holding interests in limited partnerships or other entities that directly hold the real estate, is a taxable entity. The limited partnership or other entity holding the real estate is not exempt;
- A real estate mortgage investment conduit (REMIC), as defined by Code Section 860D of the Internal Revenue Code;

² Natural person is defined as a human being or the estate of a human being. The term does not include a purely legal entity given recognition as the possessor of rights, privileges, or responsibilities, such as a corporation, limited liability company, partnership, or trust.

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- A nonprofit self-insurance trust created under Chapter 2212, Insurance Code, or a predecessor statute;
- A trust qualified under Section 401(a) of the Internal Revenue Code; or
- A trust or other entity that is exempt under Section 501(c)(9) of the Internal Revenue Code.

Passive Entity – Section 171.0003

An entity qualifies as a Passive Entity only if (a) the entity is a general or limited partnership or a trust, other than a business trust; and (b) during the period on which margin is based, the entity's federal *gross income* consists of at least 90 percent of the following income:

- Dividends, interest, foreign currency exchange gain, periodic and non-periodic 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;
- Distributive shares of partnership income to the extent that those distributive shares of income are greater than zero;
- Capital gains from the sale of real property, gains from the sale of commodities traded on a commodities exchange, and gains from the sale of securities; and
- Royalties, bonuses, or delay rental income from mineral properties and income from other non-operating mineral interests; and

(c) The entity does not receive more than 10 percent of its federal *gross income* from conducting an active trade or business.

Passive income does not include rent or income received by a nonoperator from mineral properties under a joint operating agreement if the nonoperator is a member of an affiliated group and another member of that group is the operator under the same joint operating agreement.

Active Trade or Business (Section 171.0004). For purposes of the Passive Entity provisions, the following definition of conducting an active trade or business applies:

Defined: An entity conducts an active trade or business if, (i) the activities being carried on by the entity include one or more active operations that form a part of the process of earning income or profit and (ii) the entity performs active management and operational functions.

Independent contractors: Activities performed by the entity include activities performed by persons outside the entity, including independent contractors, to the extent the persons perform services on behalf of the entity and those services constitute all or part of the entity's trade or business. Payment of compensation to employees or independent contractors for financial or legal services reasonably necessary for the operation of the entity does not constitute the conduct of an active trade or business.

Assets used by Related Entities: An entity conducts an active trade or business if assets, including royalties, patents, trademarks, and other intangible assets, held by the entity are used in the active trade or business of one or more related entities.

Mineral Interests: The ownership of a royalty interest or a non-operating working interest in mineral rights does not constitute conduct of an active trade or business.

Board of Directors: Holding a seat on the board of directors of an entity does not by itself constitute conduct of an active trade or business.

Exempt Entities – Section 171.088

An entity that is not a corporation but that, because of its activities, would qualify for a specific exemption under subchapter B of Chapter 171 (Franchise Tax) of the Tax Code if it were a corporation, qualifies for the exemption and is exempt from the tax in the same manner and under the same conditions as a corporation.

Tax Rates – Section 171.002

Tax Rates Applicable to Taxable Entities Other Than Retailers and Wholesalers

Subject to the elective reduced rate available to taxable entities with total revenue of less than 10 million under § 171.1016 of the Texas Tax Code and the reduced rate that applies to certain retailers and wholesalers, the new tax rate for taxable entities is one percent (1%) of taxable margin.

Retailers and Wholesalers

The tax rate is 0.5 percent of taxable margin for taxable entities primarily engaged in retail or wholesale trade. Retail Trade means activities described in Division G of the 1987 Standard Industrial Classification Manual (“SICM”) published by federal OMB and wholesale trade means activities described in Division F of SICM.

Primarily Engaged in Retail and Wholesale Trade

Primarily engaged in the retail and wholesale trade means (a) an entity’s total revenue from its activities in retail or wholesale trade must be greater than the total revenue from its activities in trades other than the retail and wholesale trades; (b) less than 50% of the total revenue from activities in retail or wholesale trade comes from the sale of products it produces or products produced by an entity that is part of an affiliated group to which the taxable entity also belongs (this second instance does not apply to SIC Major Group 58 [selling prepared food and drinks for consumption on the premises]); and (c) the taxable entity does not provide retail or wholesale utilities, including telecommunications services and electricity or gas.

Exclusions From Tax

A taxable entity is not required to pay any tax and is not considered to owe any tax for a period if:

- The amount of tax computed for the taxable entity is less than \$1000.00; or
- The amount of the taxable entity’s total revenue from its entire business is less than or equal to \$300,000 or the amount determined under Section 171.006 (CPI adjustments), per twelve-month period on which margin is based.

Discounts From Tax Liability for Small Businesses

A taxable entity is entitled to a discount of the tax imposed under this chapter that the taxable entity is required to pay after determining its taxable margin under Section 171.101, applying the appropriate rate of the tax under Section 171.002(a) or (b), and subtracting any other allowable credits as follows:

- (1) For a taxable entity for which the total revenue from its entire business is greater than \$300,000 but less than \$400,000, the taxable entity is entitled to a discount of 80 percent;
- (2) For a taxable entity for which the total revenue from its entire business is equal to or greater than \$400,000 but less than \$500,000, the taxable entity is entitled to a discount of 60 percent;
- (3) For a taxable entity for which the total revenue from its entire business is equal to or greater than \$500,000 but less than \$700,000, the taxable entity is entitled to a discount of 40 percent; and
- (4) For a taxable entity for which the total revenue from its entire business is equal to or greater than \$700,000 but less than \$900,000, the taxable entity is entitled to a discount of 20 percent.

The total revenue thresholds above are subject to adjustment according to changes in the consumer price index.

Rate Increases – Section 171.003

Rate increases must be approved by a majority of the registered voters voting in a statewide referendum. This section does not apply to rate decreases or any change in the manner the tax is computed (including determination of margin, taxable margin and deductions or credits, administrative or enforcement of tax or applicability of tax to certain entities).

Combined Groups

Combined groups are regarded as a single taxable entity for purposes of applying the margin tax, including Section 171.002(d) (pertaining to the exemption for taxable entities with a tax liability of less than \$1,000 or total revenue that is less than or equal to \$300,000).

Tax Base – Subchapter C

Taxable Margin – Section 171.101

The taxable margin of an entity is equal to the *lesser of*:

- (1) 70 percent of the taxable entity's total revenue from its entire business, as determined under Section 171.1011, or
- (2) An amount computed by determining the taxable entity's total revenue from its entire business under Section 171.1011 and *subtracting*, at the election of the taxable entity, either (a) cost of goods sold ("CGS"), as determined under Section 171.1012 or (b) compensation, as determined under Section 171.1013 (plus compensation paid to an active duty Texas member of the armed forces and the cost of training a replacement for the individual).

The taxable margin is then apportioned as provided in Section 171.106 and reduced by subtracting allowable deductions. Taxable margin cannot be less than zero.

Staff Leasing Services: A staff leasing services company may only subtract compensation as determined under section 171.1013.

Elections on Alternative Deductions: An election to deduct either cost of goods sold or compensation must be made by a taxable entity on its annual report and is effective only for that annual report. A taxable entity must notify the Comptroller of its election not later than the due date of the annual report.

Total Revenue From Entire Business – Section 171.1011

The total revenue from a taxable entity's entire business is computed as follows:

Corporations: The amount reportable as income on line 1c of IRS Form 1120 (gross receipts or sales, net of returns and allowances) *increased* by (1) the amounts reportable as income on lines 4 through 10 of the IRS Form 1120, and (2) any total revenue reported by a lower tier entity as includable in the taxable entity's total revenue under Section 171.1015(b) and *decreased* (a) by bad debt expensed for federal income tax purposes that corresponds to an amount of gross receipts reported on the return or in a past reporting period,

(b) foreign royalties and foreign dividends, (c) dividend related deductions from IRS Form 1120, Schedule C, (d) net distributive income from a taxable entity treated as a partnership or as an S corporation for federal income tax purposes, and (e) items of income from disregarded entities.

Partnerships: The amount reportable as income on Line 1c of IRS Form 1065 (gross receipts or sales net of returns and allowances) *increased* by the amounts reportable on lines 4, 6, and 7 of IRS Form 1065; the amounts reportable as income on lines 3a and 5 through 11 of IRS Form 1065, Schedule K; the amounts reportable as income on line 17, IRS Form 8825; the amounts reportable as income on line 11, plus line 2 of line 45 of IRS Form 1040, Schedule F; and any total revenue reported by a lower tier entity as includable in the taxable entity's total revenue under Section 171.1015(b), and *decreased* by (a) bad debt expensed for federal income tax purposes that corresponds to items of gross receipts reported on the return or in a past reporting period, (b) foreign royalties and foreign dividends, (c) dividend related deductions from IRS Form 1120, Schedule C, (d) net distributive income from a taxable entity treated as a partnership or as an S corporation for federal income tax purposes, and (e) items of income from disregarded entities.

Other Entities: For other entities, an amount determined in a manner substantially equivalent to the amounts determined above for corporations and partnerships as determined by rules that the Comptroller adopts.

Income From Passive Entities: A taxable entity that owns an interest in a passive entity must exclude from its total revenue its share of the net income of the passive entity, but only to the extent the net income of the passive entity was generated by the margin of any other taxable entity.

Amounts Reportable as Income: References to amounts "reportable as income" on specific line items of an Internal Revenue Service form refers to amounts entered on those line items to the extent the amounts entered comply with federal income tax law and include the corresponding amounts entered on a variant form, or a subsequent form, with different line numbers to the extent the amounts entered comply with federal income tax law.

Exclusions From Total Revenue

Exclusion for Lending Institutions: A taxable entity that is a lending institution may exclude from its total revenue, to the extent included, proceeds from the principal repayment of a loan. This does not apply to payments made to members of the taxable entity's affiliated group.

Securities and Loans Sold: A taxable entity may exclude from its total revenue, to the extent included, the tax basis as determined under the Internal Revenue Code of securities and loans sold. This does not apply to payments made to members of the taxable entity's affiliated group.³

Exclusion for Certain Flow-Through Funds: If included in revenue under the above provisions: (a) *By law or fiduciary duty:* Flow-through funds that are mandated by law or fiduciary duty to be distributed to other entities, including taxes collected from a third party by the taxable entity and remitted by the taxable entity to a taxing authority, are excluded from total revenue. This does not apply to payments made to members of the taxable entity's affiliated group; (b) *By contract:* Specific types of flow-through funds mandated by contract to be distributed to other entities are excluded from total revenue. These are limited to sales commissions to non-employees, including split-fee real estate commissions; the tax basis as determined under the Code of securities underwritten;⁴ and 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. This does not apply to payments made to members of the taxable entity's affiliated group.

Sales commission means (1) compensation paid to a person for an act for which a license is required by Chapter 1101 of the Occupation Code and (2) compensation paid to a sales representative based on amount or on level of orders for sales of the principal's product and the principal reports on IRS Form 1099 MISC. Principal means a person who (1) manufactures, produces, imports, distributes or acts as an independent agent for a product for sale; (2) uses sales representative to solicit orders; and (3) compensates sales representative in whole or in part by commissions.

³ For purposes of Sections 171.1011(g), 171.1011(g-2), and 171.106(f) only, "security" has the meaning assigned by Section 475(c)(2), Internal Revenue Code, and includes instruments described by Sections 475(e)(2)(B), (C), and (D) of that Code.

⁴ For purposes of Sections 171.1011(g), 171.1011(g-2), and 171.106(f) only, "security" has the meaning assigned by Section 475(c)(2), Internal Revenue Code, and includes instruments described by Sections 475(e)(2)(B), (C), and (D) of that Code.

Law Firms

Certain Flow-Through Funds Excluded: A taxable entity that provides legal services (“law firm”) must exclude from total revenue, to the extent included, flow-through funds that are mandated by law, contract or fiduciary duty to be distributed to the claimant or other entities on behalf of a claimant, limited to the following items: (a) damages due the claimant; (b) funds subject to a lien or other contractual obligation arising out of the representation, other than fees owed to the attorney; (c) funds subject to a subrogation interest or other third party contractual claim; and (d) fees paid an attorney who is not a member, partner, shareholder or employee of the taxable entity and certain amounts relating to reimbursement of the taxable entity’s expenses.

Reimbursed Expenses: A law firm shall also exclude from total revenue, to the extent included, reimbursement of expenses incurred in prosecuting a claimant’s matter that are specific to the matter and are not general operating expenses.

Certain Costs Relating to Pro-Bono Services Excluded: A law firm shall also exclude \$500 per pro bono services case handled by the attorney, but only if the attorney maintains records of the pro bono services for auditing purposes in the manner in which those services are reported to the State Bar of Texas. “Pro bono” services are defined as the direct provision of legal services to the poor, without an expectation of compensation.

Intercompany Payments Not Excluded: A law firm may not exclude payments made to members of the law firm’s affiliated group.

Pharmacy Cooperatives: A taxable entity that is a pharmacy cooperative shall exclude from its total revenue, to the extent included, flow-through funds from rebates from pharmacy wholesalers that are distributed to the pharmacy cooperative’s shareholders. If the taxable entity belongs to an affiliated group, it may not exclude payments made to entities that are members of the affiliated group.

Federal Obligations

Dividends and interest received from federal obligations are excluded from total revenue. Federal obligations are defined to include stocks and other direct obligations of, obligations unconditionally guaranteed by, the United States government and United States government agencies and direct obligations of a United States government-sponsored agency.

Management Companies

A taxable entity that is a management company excludes, to the extent included, from its total revenue reimbursements of specified costs incurred in its conduct of the active trade or business of a managed entity, including wages and compensation. A management company is a limited liability entity that conducts all or part of the active trade or business of another entity in exchange for fee and reimbursement for specified costs incurred in conduct of the active trade or business of the other entity.

Health Care Providers

A health care provider is defined as 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 taxable entity that is a health care provider, with the exception of health care institutions, shall exclude from its total revenue the total amount of payments received (1) under the Medicaid program, Medicare program, Indigent Health Care and Treatment Act (chapter 61, Health and Safety Code), and Children's Health Insurance Program (CHIP); (2) for professional services provided in relation to a workers' compensation claim under Title 5, Labor Code; and for professional services provided to a beneficiary rendered under the TRICARE military health system.

The provider shall also exclude actual cost of uncompensated care provided, but only if the provider maintains records of the uncompensated care for auditing purposes. If the provider later receives payment for all or part of that care, the provider must adjust the amount excluded for the tax year in which the payment is received. The Comptroller is directed to adopt rules governing the computation of the actual cost to a health care provider of any uncompensated care and the audit requirements related to the computation of those costs.

Health Care Institutions

A health care provider that is a health care institution shall exclude from its total revenue 50% of the same amounts that are excluded by other health care providers.

A health care institution is defined as:

- An ambulatory surgical center;
- An assisted living facility licensed under Chapter 247, Health and Safety Code;
- An emergency medical services provider;
- A home and community support services agency;
- A hospice;
- A hospital;
- A hospital system;
- An intermediate care facility for the mentally retarded or a home and community-based services waiver program for persons with mental retardation adopted in accordance with Section 1915(c) of the federal Social Security Act (42 U.S.C. 1396n);
- A birthing center;
- A nursing home;
- An end stage renal disease facility licensed under Section 251.011, Health and Safety Code; or
- A pharmacy.

Staff Leasing Services Company

A staff leasing services company shall exclude, to the extent included, from its total revenue payments received from a client company for wages, payroll taxes on those wages, employee benefits, and workers' compensation benefits for the assigned employees of the client company. A staff leasing services company refers to (1) a business entity that offers staff leasing services, as that term is defined by Section 91.001 of the Texas Labor Code or (2) a temporary employment service, as that term is defined by Section 93.001 of the Texas Labor Code. A client company carries a corresponding definition and includes (1) a person that contracts with a license holder under Chapter 91 of the Texas Labor Code and is assigned employees by the license holder under that contract or (2) a client of a temporary employment service, as that term is defined by Section 93.001(2) of the Texas Labor Code, to whom individuals are assigned for a purpose described by that subdivision.

Revenues From Housing for Armed Forces

A taxable entity shall exclude, to the extent included, from total revenue all revenue that is directly derived from the operation of a facility that is (1) located on property owned or leased by the federal government and (2) managed or operated primarily to house members of the armed forces of the United States.

Revenues From Certain Oil and Gas Well Production

A taxable entity shall exclude total revenue received from oil or gas produced during dates certified by the Comptroller from (1) an oil well designated by the Railroad Commission of Texas or similar authority of another state whose production averages less than 10 barrels a day over a 90-day period and (2) a gas well designated by the Railroad Commission of Texas or similar authority of another state whose production averages less than 250 mcf a day over a 90-day period.

The Comptroller is required to certify dates during which the monthly average closing price of West Texas Intermediate crude oil is below \$40 per barrel and the average closing price of gas is below \$5 per MMBtu, as recorded on the New York Mercantile Exchange (NYMEX).

No Double-Dipping

Amounts excluded under the above provisions may not be included in the determination of cost of goods sold or compensation deducted in arriving at taxable margin.

Members of Consolidated Group

Each member of a consolidated group for federal income tax purposes must compute its total revenue as if it had filed a separate return for federal income tax purposes.

Cost of Goods Sold – Section 171.1012

For a taxable entity that elects to subtract cost of goods sold for the purpose of computing taxable margin, the following rules apply.

Computation of Cost of Goods Sold

Direct costs: Includes all direct costs of acquiring or producing the goods sold, including:

- Labor costs;
- Cost of materials that are an integral part of specific property produced;
- Cost of materials that are consumed in the ordinary course of performing production activities;
- Handling costs, including costs attributable to processing, assembling, repackaging, and inbound transportation costs;
- Storage costs, including the costs of carrying, storing, or warehousing property;
- Depreciation, depletion, and amortization, reported on the federal income tax return on which the franchise tax report is based to the extent associated with and necessary for the production of goods, including recovery described by Code Section 197;
- The cost of renting or leasing equipment, facilities, or real property directly used for the production of the goods, including pollution control equipment and intangible drilling and dry hole costs;
- The cost of repairing and maintaining equipment, facilities, or real property directly used for the production of the goods, including pollution control devices;
- Costs attributable to research, experimental, engineering, and design activities directly related to the production of the goods, including all research or experimental, expenditures described by Code Section 174;
- Geological and geophysical costs incurred to identify and locate property that has the potential to produce minerals;
- Taxes paid in relation to acquiring or producing any material, or taxes paid in relation to services that are a direct cost of production;
- The cost of producing or acquiring electricity sold; and
- A contribution to a partnership in which the taxable entity owns an interest used to fund activities, the costs of which would be treated as cost of goods sold of the partnership, but only to the extent those costs are related to goods distributed to the taxable entity as goods-in-kind in the ordinary course of production activities rather than being sold.

Other Included Items

The following additional costs in relation to the goods are included:

- Deterioration of the goods;
- Obsolescence of the goods;
- Spoilage and abandonment, including the costs of rework labor, reclamation, and scrap;
- If the property is held for future production, preproduction direct costs allocable to the property, including costs of purchasing the goods and of storage and handling the goods;
- Postproduction direct costs allocable to the property, including storage and handling costs;
- The cost of insurance on a plant or a facility, machinery, equipment, or materials directly used in the production of the goods;
- The cost of insurance on the produced goods;
- The cost of utilities, including electricity, gas and water, directly used in the production of the goods;
- The costs of quality control, including replacement of defective components pursuant to standard warranty policies, inspection directly allocable to the production of the goods, and repairs and maintenance of goods; and
- Licensing or franchise costs, including fees incurred in securing contractual right to use a trademark, corporate plan, manufacturing procedure, special recipe, or other similar right directly associated with the goods produced.

Indirect Costs

Indirect or administrative overhead costs, including all mixed service costs, such as security services, legal services, data processing services, accounting services, personnel operations and general financial planning and financial management costs, that it can demonstrate are allocable to the acquisition or production of goods, except that the amount subtracted may not *exceed* four percent (4%) of the taxable entity's total indirect or administrative overhead costs, including all mixed service costs.

Costs That Are Specifically Excluded

The following costs in relation to the taxable entity's goods are excluded:

- The cost of renting or leasing equipment, facilities, or real property that is not used for the production of the goods;
- Selling costs, including employee expenses related to sales;
- Distribution costs, including outbound transportation costs;
- Advertising costs;
- Idle facility expense;
- Re-handling costs;
- Bidding costs, which are the costs incurred in the solicitation of contracts ultimately awarded to the taxable entity;
- Unsuccessful bidding costs, which are the costs incurred in the solicitation of contracts not awarded to the taxable entity;
- Interest, including interest on debt incurred or continued during the production period to finance the production of the goods;
- Income taxes, including local, state, federal, and foreign income taxes, and franchise taxes that are assessed on the taxable entity based on income;
- Strike expenses, including costs associated with hiring employees to replace striking personnel, but not including the wages of the replacement personnel, costs of security, and legal fees associated with settling strikes;
- Officers' compensation;
- Costs of operation of a facility that is (1) located on property owned or leased by the federal government and (2) managed or operated primarily to house members of the armed forces of the United States; and
- Any compensation paid to an undocumented worker used for the production of goods.

For purposes of this last exclusion, an "*undocumented worker*" means a person who is not lawfully entitled to be present and employed in the United States; and "*goods*" includes the husbandry of animals, the growing and harvesting of crops, and the severance of timber from realty.

Capitalized Costs

A taxable entity that is allowed a subtraction for a cost of goods sold and that is subject to Sections 263A, 460, or 471 of the Internal Revenue Code may capitalize that cost in the same manner and to the same extent that the taxable entity capitalized that cost on its federal tax return or may expense those costs.

If the taxable entity elects to capitalize costs, it must capitalize each cost allowed that it capitalized on its federal income tax return. If the taxable entity later elects to begin expensing a cost that may be allowed as a cost of goods sold, the entity may not deduct any cost in ending inventory from a previous report. If the taxable entity elects to expense a cost of goods sold that may be allowed, a cost incurred before the first day of the period on which the report is based may not be subtracted as a cost of goods sold. If the taxable entity elects to expense a cost of goods sold and later elects to capitalize that cost of goods sold, a cost expensed on a previous report may not be capitalized.

Television Production or Broadcasting

If a taxable entity, including a taxable entity with respect to which cost of goods sold is determined pursuant to Section 1014(e)(1)(cost of goods sold for combined groups), whose principal business activity is film or television production or broadcasting or the distribution of tangible personal property described by Subsection (a)(3)(A)(ii), or any combination of these activities, elects to subtract cost of goods sold, the cost of goods sold for the taxable entity are the costs described in Section 171.1012 (the cost of goods sold section) in relation to the property and include depreciation, amortization, and other expenses directly related to the acquisition, production, or use of the property, including expenses for the right to broadcast or use the property.

“Goods” Defined

For purposes of the cost of goods sold deduction, the term “goods” means real or tangible personal property sold in the ordinary course of business of a taxable entity.

Tangible personal property means (1) personal property that can be seen, weighed, measured, felt, or touched or that is perceptible to the senses in any other manner; (2) films, sound recordings, videotapes, live and prerecorded television and radio programs, books, and other similar property embodying words, ideas, concepts, images, or sound, without regard to the means or methods of distribution or the medium in which property is embodied for which, as costs are incurred in producing the property, it is intended or reasonably likely that any medium in which the property is embodied will be

mass-distributed by the creator or any one or more third parties in a form that is not substantially altered; and (3) a computer program, as defined by Section 151.0031. Tangible personal property does not include (1) intangible property or (2) services.

Ownership of Goods Required

A taxable entity is entitled to a cost of goods sold only if it owns the goods. A taxable entity engaged in the construction, improvement, remodeling, repair, or industrial maintenance of real property is considered to own the labor or materials that it furnishes as part of that project.

Solely for purposes of determining cost of goods sold, a taxable entity providing services under a contract with the federal government is treated as owner of goods manufactured or produced by the entity under the contract notwithstanding that the Federal Acquisition Regulation may require that title or risk of loss with respect to those goods be transferred to the federal government before the manufacture or production of those goods is complete.

A member of a combined group may claim as a cost of goods sold those costs that qualify under Section 171.1012 if the goods for which the costs are incurred are owned by another member of the combined group.

Federal Tax Method Required

A taxable entity is required to determine its cost of good sold, except as otherwise provided, in accordance with the methods used on the federal income tax return on which the report is based.

Lending Institutions

A taxable entity that is a lending institution, other than certain pawn shops, that offers loans to the public and elects to subtract cost of goods sold may subtract an amount equal to interest expense as part of its cost of goods sold.⁵

⁵ A Lending Institution is defined as an entity that makes loans and (1) is regulated by the Federal Reserve Board, the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation, the Commodity Futures Trading Commission, the Office of Thrift Supervision, the Texas Department of Banking, the Office of Consumer Credit Commissioner, the Credit Union Department, or any comparable regulatory body; (2) is licensed by, registered with, or otherwise regulated by the Department of Savings and Mortgage lending; (3) is a “broker” or “dealer” as defined by the Securities Exchange Act of 1934 at 15 U.S.C. Section 78C; or (iv) provides financing to unrelated parties solely for agricultural production.

Certain Entities Engaged in Leasing Activities

Certain taxable entities may subtract as cost of goods sold costs otherwise allowed in relation to tangible personal property that the entity rents or leases in the ordinary course of business. These entities are (1) a motor vehicle rental or leasing company that remits a tax on gross receipts imposed under Section 152.026; (2) a heavy construction equipment rental or leasing company; and (3) a railcar rolling stock rental or leasing company.

Intercompany Transactions

A payment made by one member of an affiliated group to another member of that affiliated group not included in the combined group may be subtracted as a cost of goods sold only if it is a transaction made at arms length. Arms length means the standard of conduct under which entities that are not related parties and that have substantially equal bargaining power, each acting in its own interest, would negotiate or carry out a particular transaction. Related parties are defined as entities in which the same persons or related persons indirectly or directly owns *or* controls a controlling interest.

Determination of Compensation – Section 171.1013***Deductible Amount***

A taxable entity that elects to subtract compensation for the purpose of computing its taxable margin may subtract an amount equal to (1) all wages and cash compensation paid by the taxable entity to its officers, directors, owners, partners, and employees, limited to \$300,000 per person; and (2) the cost of all benefits, to the extent deductible for federal income tax purposes, the taxable entity provides to the above persons, including workers' compensation benefits, health care, and employer contributions made to employees' health savings accounts and retirement.

Compensation Defined

Wages and cash compensation is defined to include amounts reported as Medicare wages and tips on IRS Form W-2. The term also includes:

- Net distributive income from a taxable entity treated as a partnership for federal income tax purposes, but only if the person receiving the distribution is a natural person;
- Net distributive income from limited liability companies and corporations treated as S corporations for federal income tax purposes, but only if the person receiving the distribution is a natural person;

- Stock awards and stock options deducted for federal income tax purposes; and
- Net distributive income from a limited liability company treated as a sole proprietorship for federal income tax purposes, but only if the person receiving the distribution is a natural person.

Additional Compensation Deduction for Small Employers

A taxable entity that is a small employer, as defined in Section 1501.002 of the Insurance Code, and has not provided health care benefits to any of its employees in the calendar year preceding the beginning date of its reporting period, and elects to deduct compensation in arriving at taxable margin, may deduct, in addition to other allowable compensation deduction amounts:

- For the first 12-month period on which margin is based and in which the taxable entity provides health care benefits to all of its employees, an additional amount equal to 50 percent of the cost of health care benefits provided to its employees for that period, and
- For the second 12-month period on which margin is based and in which the taxable entity provides health care benefits to all of its employees, an additional amount equal to 25 percent of the cost of health care benefits provided to its employees for that period.

Undocumented Workers

A taxable entity that elects to subtract compensation for the purpose of computing its taxable margin may not subtract any wages or cash compensation paid to an undocumented worker, defined as a person who is not lawfully entitled to be present and employed in the United States.

Staff Leasing Services

Staff Leasing Services Company

A staff leasing services company may not include as wages or cash compensation payments received from a client company for wages, payroll taxes on those wages, employee benefits, and workers' compensation benefits for the assigned employees of the client company.

Client Company of Staff Leasing Services Company

A taxable entity that is a client company that contracts with a staff leasing services company for assigned employees must include payments made to the

staff leasing services company for wages and benefits for the assigned employees as if the assigned employees were actual employees of the entity. In addition the client company may not include an administrative fee charged by the staff leasing services company for the provision of the assigned employees and may not include any other amount in relation to the assigned employees, including payroll taxes.

Management Services

Service Provider

A taxable entity that is a management company may not include as wages or cash compensation any amounts reimbursed by a managed entity and must determine compensation for only those wage and compensation payments that are not reimbursed by a managed entity.

Managed Entity

A taxable entity that is a managed entity must include reimbursements made to the management company for wages and compensation as if the reimbursed amounts had been paid to employees of the managed entity.

Compensation Relating to Operating Armed Forces Housing

A taxable entity that elects to subtract compensation may not include as wages or cash compensation amounts paid to an employee whose primary employment is directly associated with the operation of a facility that is located on property owned or leased by the federal government and managed or operated primarily to house members of the armed forces of the United States.

Combined Groups

If a person is paid by more than one entity of a combined group, the combined group may not subtract in relation to that person a total of more than \$300,000 in wage and cash compensation, or the amount determined under Section 171.006, per 12-month period on which margin is based. The combined group must make an election to subtract either cost of goods sold or compensation that applies to all of its members. Regardless of the election, the taxable margin of the combined group may not exceed 70 percent of the combined groups total revenue from its entire business. Each taxable entity that is part of a combined group, must, for purposes of determining margins and apportionment, include its activities for the same period used by the combined group. Each member of the combined group shall be jointly and severally liable for the tax of the combined group.

Staff Leasing Services Company

In calculating cost of goods sold or compensation, a taxable entity that is a client company of a staff leasing services company must rely on information provided by the staff leasing services company on a form promulgated by the comptroller or an invoice.

Apportionment

The margin of a taxable entity is apportioned by multiplying the margin by a fraction, the numerator of which is the taxable entity's gross receipts from business done in Texas (Section 171.103) and the denominator of which is the taxable entity's gross receipts from its entire business (Section 171.105). Section 171.106.

Gross Receipts From Business Done in Texas – Section 171.103.

General Rules: The gross receipts of a *taxable entity from its business done in Texas* is the sum of the taxable entity's receipts from:

- Each sale of tangible personal property if the property is delivered or shipped to a buyer in Texas regardless of the FOB point or other condition of the sale;
- Each service performed in Texas, except that receipts derived from servicing loans secured by real property are in Texas if the real property is located in Texas;
- Each rental of property situated in Texas;
- The use of a patent, copyright, trademark, franchise, or license in Texas;
- Each sale of real property located in Texas including royalties from oil, gas, or other mineral interests; and
- Other business done in Texas.

Combined Groups: A combined group is required to include the gross receipts of each taxable entity that is a member of the combined group that has a nexus with Texas for the purpose of taxation. Receipts derived from transactions between individual members of a combined group that are excluded for purposes of computing total revenue may not be included in the receipts of the taxable entity from its business done in Texas.

However, receipts that are ultimately derived from the sale of tangible personal property between individual members of a combined group, where one member party to the transaction does not have nexus with Texas, must be included in the receipts of the taxable entity from its business done in Texas to the extent that the member of the combined group without nexus resells the tangible personal property without substantial modification to a purchaser in Texas. Receipts are considered ultimately derived from a sale if they represent an amount paid for tangible personal property by the third party purchaser.

A taxable entity that is a combined group must include in its franchise tax report, for each member of the combined group that does not have nexus with Texas (1) gross receipts from business done in Texas and (2) gross receipts from business done in Texas that are subject to taxation in another state under a throw-back law or regulation. This information may be used for informational purposes only. The comptroller is required to adopt rules as necessary to enforce this reporting requirement.

The Throw-Back Rule is Eliminated: The throw-back rule in Sections 171.103(1) and 171.1032(a)(1), which was recently held unconstitutional, is eliminated.

Gross Receipts From Entire Business – Section 171.105

The gross receipts of a taxable entity from its entire business are the sum of the taxable entity's receipts from each sale of the taxable entity's tangible personal property; each service, rental, or royalty; and other business. If a taxable entity sells an investment or capital asset, the taxable entity's gross receipts from its entire business for taxable margin includes only the net gain from the sale.

A combined group must include in its gross receipts the gross receipts of each taxable entity that is a member of the combined group, without regard to whether that entity has a nexus with the state of Texas for purposes of taxation. Receipts derived from transactions between individual members of a combined group that are excluded for purposes of computing total revenue may not be included in the receipts of the taxable entity from its entire business. Section 171.105.

Receipts Excluded From Total Revenue

For apportionment purposes, receipts that are excluded from total revenue under Section 171.1011 may not be included in either the numerator or denominator of the apportionment fraction. Section 171.1055.

Gross Receipts Defined

For apportionment purposes, gross receipts means all revenues reportable by a taxable entity on its federal tax return, without deduction for the cost of property sold, materials used, labor performed, or other costs incurred, unless otherwise specifically provided in the Tax Code. Section 171.1121.

Accounting Method in Determining Gross Receipt

For purposes of apportioning margin, a taxable entity must use the same accounting method used in computing margin. An entity may not change its accounting methods used to calculate gross receipts more often than once every four years without the consent of the comptroller. A reduction in tax liability alone does not justify a change in accounting method. Section 171.1121.

Deductions for Taxable Margin

Items that were previously deductible from apportioned taxable capital and taxable earned surplus, including the cost of solar energy devices and the cost of clean coal project carry over to the new franchise tax and are deductible for purposes of computing an entity's taxable margin.

No Net Losses

Taxable margin may not be less than zero. This provision precludes taxable entities from reporting taxable margin at a net loss.

Tax Credits**Tax Credits Deleted**

All existing franchise tax credits are repealed. Those include Subchapter L, Subchapter M, Subchapter N, Subchapter O, Subchapter P, Subchapter Q, Subchapter R, Subchapter S, Subchapter T and Subchapter U. The repeal of these credits does not affect a credit that accrued before the effective date of House Bill 3. Subject to certain limitations, a corporation with unused credits may continue to use those credits even in later years.

Temporary Credit on Taxable Margin – Section 171.111

A taxable entity must notify the comptroller in writing of its intent to preserve its right to take a credit in an amount allowed under Section 171.111 on the tax due on taxable margin. The notification must be made on the first report originally due on or after January 1, 2008. The taxable entity may thereafter elect to claim the credit for not more than twenty consecutive

privilege periods beginning with the first report due after January 1, 2008. The Comptroller may request from the taxable entity information relating to the amount of the credit claimed by the taxable entity. The credit cannot be conveyed, assigned or transferred. The credit is lost if the taxable entity changes combined groups after June 30, 2007.

A taxable entity, other than a combined group, may not claim the credit unless the taxable entity was, on May 1, 2006, subject to the tax imposed by this chapter as it existed on May 1, 2006. If the taxable entity is a combined group, the credit can be claimed for each member entity that was, on May 1, 2006, subject to the tax imposed by this chapter as it existed on May 1, 2006. The amount of the credit, including any unused credit carried forward, may not exceed the amount of franchise tax due for the report. Unused credits may not be carried forward to reports originally due on or after September 1, 2027.

Calculation of Temporary Credit – Section 171.111(b)

The credit is based upon the amount of the taxable entity's business loss carryforwards under Section 171.110(e), as that section applied to annual reports originally due before January 1, 2008, and that were not exhausted on an annual report originally due before that date. The business loss carryforward is then multiplied by a stated percentage rate (see rates below) and the product of that calculation is then multiplied by 4.5%. The resulting number is the credit allowable for the particular year. The stated percentage rates are:

- 2.25% for annual reports originally due on or after January 1, 2008, and before September 1, 2018; and
- 7.75% for annual reports originally due on or after January 1, 2018, and before September 1, 2027.

Therefore, the formula for the credit is:

[business loss carryforward] times
 [applicable stated percentage rate] times 4.5%
 equals credit against margin tax.

Alternative Tax for Certain Small Business

A taxable entity whose total revenue from its entire business is not more than \$10 million may elect to pay the tax imposed under § 171.1016 of the Texas Tax Code rather than the amount computed and at the tax rate provided under § 171.002. The amount of the tax for which a taxable entity is liable under § 171.1016 is computed by (i) determining the taxable entity's total

revenue from its entire business, as determined under § 171.1011; (ii) apportioning this amount, as provided by § 171.106, to determine the taxable entity's apportioned total revenue; and (iii) multiplying the apportioned amount by the rate of .575 percent. A taxable entity that elects to pay the taxes provided in § 171.1016 may not take a credit, deduction, or other adjustment that is not specifically authorized in Section 171.1016. Section 171.0021 (the discounts available for small businesses) applies to a taxable entity that elects to pay the tax provided in § 171.1016.

Reporting – Section 171.1014

Combined Reporting

General Rule for Unitary Business

Taxable entities that are part of an affiliated group engaged in a unitary business (combined group – Section 171.0001(7)) shall file a combined group report in lieu of individual reports based on the combined group's business.

Affiliated Group

An affiliated group is defined as a group of one or more entities in which a controlling interest is owned by a common owner or owners, either corporate or non-corporate, or by one or more of the member entities. Section 171.0001(1).

Controlling Interest

A controlling interest is defined as follows:

- For a corporation, either more than 50 percent, owned directly or indirectly, of the total combined voting power of all classes of stock of the corporation, or more than 50 percent, owned directly or indirectly, of the beneficial ownership interest in the voting stock of the corporation;
- For a partnership, association, trust, or other entity, other than a limited liability company, more than 50 percent, owned directly or indirectly, of the capital, profits, or beneficial interest in the partnership, association, trust, or other entity; and

- For a limited liability company, either more than 50 percent, owned directly or indirectly, of the total membership interests of the limited liability company or more than 50 percent, owned directly or indirectly, of the beneficial ownership interest in the membership interest of the limited liability company. Section 171.0001(8).

Unitary Business

A unitary business is defined as a single economic enterprise that is made up of separate parts of a single entity or of a commonly controlled group of entities and 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 is directed to consider any relevant factor, including whether

- The activities of the group members are in the same general line, such as manufacturing, wholesaling, retailing of tangible personal property, insurance, transportation, or finance;
- The activities of the group members 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; or
- The members are functionally integrated through the exercise of strong centralized management, such as authority over purchasing, financing, product line, personnel, and marketing. Section 171.0001(17).

Water's Edge Only

The combined group may not include a taxable entity that conducts business outside the United States if 80 percent or more of the taxable entity's property and payroll, as determined by factoring under Chapter 141, are assigned to locations outside the United States. A taxable entity that conducts business outside the U.S. and has no property or payroll may not be included in the combined group if 80 percent or more of the taxable entity's gross receipts, as determined under Sections 171.103, 171.105 and 171.1055, are assigned to locations outside the U.S.

Computing Combined Amounts

Single Entity: A combined group is treated as a single taxable entity for purposes of determining the franchise tax and makes an election to subtract either cost of goods sold or compensation that applies to all of its members.

Computation: A combined group is required to determine its total revenue and cost of goods sold or compensation deduction by determining the respective amount for each of its members as if the member were an individual taxable entity, adding each respective amount computed for each member together, and subtracting intercompany amounts.

Tiered Partnerships – Section 171.1015

A taxable entity that is an upper tier entity may include, for purposes of calculating its own taxable margin, the total revenue of a lower tier partnership if the lower tier partnership submits a report to the comptroller showing the amount of total revenue that each upper tier entity that owns it should include within the upper tier entity's own taxable margin calculation, according to the ownership interest of the upper tier entity.

For these purposes, an upper tier partnership is a taxable entity treated as a partnership, or S corporation for federal income tax purposes, in which any of the interests are owned by one or more other taxable entities (an "upper tier entity"). In cases where the upper tier entity is not subject to the franchise tax, the lower tier partnership is liable for the tax on its taxable margin.

In addition, Section 171.002(d)(pertaining to the exemption for taxable entities with a tax liability of less than \$1,000 or total revenue that is less than or equal to \$300,000), does not apply to an upper tier entity if, before the attribution of any total revenue by a lower tier entity to an upper tier entity, the lower tier entity does not meet the criteria for exemption under either Section 171.002(d)(1) (\$1,000 tax) or (d)(2) (\$300,000 total revenue).

Other Reporting and Payment Provisions

Most of the reporting rules applicable to the reporting of earned surplus under current law carry over for purposes of reporting taxable margin. For example, the tax covering a regular annual period, other than a period included in an initial report, is based on business done by the taxable entity during the accounting period ending for federal income tax purposes in the year before the year in which the report was originally due. Annual reports are still due by May 15th of each year. The Comptroller and Secretary of State's authority to forfeit corporate privileges for reporting and payment violations is extended to authorize the forfeiture of a taxable entity's right to transact business in Texas.

Transition Rules and Effective Dates

The Act takes effect January 1, 2008 and applies to reports originally due on or after that date.

Entities Becoming Subject to Tax Under Act***No Pre-June 1, 2006 Margin or Gross Receipts***

Margin or gross receipts occurring before June 1, 2006 may not be considered for purposes of determining taxable margin or for apportionment purposes.

Annual Report Due May 15, 2008

An entity subject to the franchise tax on January 1, 2008, that was not previously subject to the tax and for which January 1, 2008 is not the beginning date, must file an annual report due May 15, 2008 based on the following periods:

Accounting Period Begins No Earlier Than June 1, 2006. If an entity has an accounting period that ends on or after January 1, 2007 and before June 1, 2007, the accounting period begins on the later of June 1, 2006 or the date the entity was organized in Texas or, if a foreign entity, the date it began doing business in Texas. On the other hand, if the entity has an accounting period that ends on or after June 1, 2007, and before December 31, 2007, the accounting period begins on the date that accounting period begins and ends on the date that accounting period ends in 2007.

Accounting Period Ends No Later Than December 31, 2006: If an entity has an accounting period that ends on December 31, 2007, or if the entity does not have an accounting period that ends in 2007, the accounting period begins on the later of January 1, 2007 or the date the entity was organized in Texas or, if a foreign entity, the date it began doing business in Texas, and ends on December 31, 2007.

Special Exit Tax For Entities Terminating in 2007

A special exit tax applies to certain taxable entities that were not previously subject to tax and that terminate their existence in 2007. Specifically, the exit tax applies to an entity that (1) is not doing business in Texas on January 1, 2008, (2) would be subject to the franchise tax as amended if it were doing business in Texas on or after January 1, 2008, but would not have been subject to the franchise tax as it existed before being amended House Bill 3 (2006); and (3) was doing business in Texas at any time after June 30, 2007 and before January 1, 2008. An entity that meets this criteria must file a report and pay an additional tax equal to appropriate rate under Section 171.002, as amended, based on the period *beginning* on the later of (1) January 1, 2007; or (2) the date the entity was organized in Texas or, if a foreign entity, the date it began doing business in Texas; and *ending* on the date the entity became no longer subject to the tax.

Appendix

Section by Section Comparison of HB 3928 to Prior Statute

§171.0001(6): Staff Leasing Services Companies: Client Company Definition

Current Law - Has meaning under § 91.001, Labor Code

Change

- (A) A person that contracts with a license holder under Chapter 91 of Labor Code and is assigned employees by license holder under that contract (§91.001(3)); or
- (B) A client of a temporary employment service defined by §93.001(2) of Labor Code to whom individuals are assigned for a purpose described by §93.001(2)

§171.0001(15) Staff Leasing Services Company Definition

Current Law - Meaning assigned by §91.001, Labor Code

Change

- (i) Business entity offers staff leasing services, as defined in §91.001, Labor Code; or
 - (ii) Temporary employment service, defined in §91.001, Labor Code
-

§171.0002 Taxable Entity – Definition**Current Law**

- (a) Lists many entities as covered
- (b) Excludes several entities, including general partnership entirely of natural persons and passive entity under §171.0003
- (c) Excludes several entities, including FLP, PIP, Passive Trust

Change

- Adds:**
- (a) Includes limited liability partnership
 - (b) General partnership of natural persons cannot have limited liability under any state statute

Removes:

- (c) FLP, PIP, Passive Trust (already included in passive entity exclusion)

Adds:

- (6) Non-profit self-insurance trust under §2212, Insurance Code
- (7) §401(a) trust
- (8) §501(c)(9) trust

§171.0001(11-a) Natural Person Definition**Current Law** - None**Change** - Human being or estate of human being; does not include legal entity

§171.0003(a) Passive Entities - Qualifying Passive Income**Current Law** 90% of entity's fed. gross income must consist of passive type income, which includes gains from the sale of real property, commodities and securities**Change** Gain from the sale of real property must be capital to qualify as passive income

§171.0004(e) Passive Entities - Definition of Conducting Active Trade or Business

Current Law Defines activities that constitute active trade or business for purposes of passive income 10% test

Change

- (e) Holding a seat on the board of directors of an entity not by itself constitute conduct of active trade or business

§171.0021 New Tax Discount for Small Businesses

Current Law - No provision

Change

- Taxable entity entitled to discount from margin tax using the following rates based on total revenue:

<u>Total Revenue</u>	<u>Discount</u>
\$300,000 to \$399,000	80%
\$400,000 to \$499,000	60%
\$500,000 to \$699,000	40%
\$700,000 to \$899,000	20%
\$900,000 – up	0%

- Indexed for inflation

§171.1016 - Alternate Tax For Small Businesses

Current Law No provision

Change

- Taxable entity with less than 10 million TR may elect to pay alternative tax in lieu of the tax imposed on taxable margin
 - Alternative tax is equal to apportioned total revenue x .575%
 - No deductions, credits or other adjustments allowed
 - Small business discount applies to alternate tax
-

§171.1011 Determination of Total Revenue from Entire Business

Current Law

(b) Based on amounts entered on specific line numbers of IRS forms

Change

(b) Based on amounts *reportable as income* on specific line numbers of IRS form to the extent the amounts entered comply with federal income tax law

§171.1011 Total Revenue from Entire Business

Current Law - (c)(1)(B)(iii) - corporation

Total revenue reduced by net distributive income from partnerships, trusts and LLCs treated as partnerships; S corporations

Change - (c)(1)(B)(iii) - corporation

Total revenue reduced by net distributive income from *taxable entity treated as a partnership or S corporation*

Same change for partnerships

§171.1011 Total Revenue from Entire Business: Farming Activities

Current Law - (c)(2)(A) - Net farm profit or loss is included in Total Revenue

Change

(c)(2)(A) - Cash basis farm income: Gross income plus cost of livestock is included in TR

Accrual basis farm income: Gross sales plus coop. dist; Ag program pymts; CCC loans; crop insurance proceeds; custom hire (mach. work) income; other income including fuel tax credits/refunds

§171.1011 Total Revenue from Entire Business: Rental Activities

Current Law

- Net Rental Real Estate Income (loss) included in TR
- Other Net Rental Income (loss) included in TR

Change

- Gross Rental Income (Line 17 of Form 8825) included in TR
- Other Gross Rental Income included in TR (Line 3a of Schedule K)

§171.1011 Total Revenue from Entire Business: Guaranteed Payments

Current Law Guaranteed Payments included twice in TR (Line 4 to 7 of IRS Form 1065 and Line 5 of Schedule K)

Change Double inclusion of Guaranteed Payments eliminated (ref. to Line 5 of Schedule K removed)

§171.1011 Total Revenue from Entire Business: Passive Entity Income & Pharmacy Coops

Current Law

(e) Taxable entity includes *net income* of passive entity if passive entity not included in a group report

Change

(e) Taxable entity may exclude net income of passive entity only if from another taxable entity

(g-4) & (h) Pharmacy cooperative excludes flow-through rebates from pharmacy wholesalers that are distributed to cooperative's non-affiliated shareholders

(t) Comptroller adopt rules to accomplish legislative intent

§171.101(d) Election to Deduct COGS or Compensation

Current Law Election to use COGS or compensation made on annual report and can be changed by filing amended report

Change Election made on annual report; notify comptroller of election not later than due date of annual report; cannot amend election

§171.1012 Determination of Cost of Goods Sold: Goods Defined**Current Law**

(a)(3)(A) Defines “tangible personal property”

(c)(6) Includes depreciation, depletion and amortization necessary for production of goods

Change

(A)(ii) **adds** “live and prerecorded television and radio programs” to definition of TPP regardless of dist. method

(c)(6) **limits** deduction for DD&A to *amounts reported on the federal income tax return* on which the report is based

§171.1012 Determination of Cost of Goods Sold: Capitalization Rules**Current Law** (continued)

(g) Taxable entity electing COGS and subject to capitalization rules under §263A, §460 and §471 of the Code must capitalize in same manner as required for federal tax purposes

Change

(g) Taxable entity may elect to capitalize costs as on federal return or may expense these costs. If elect to capitalize, must capitalize each cost allowed for margin purposes that is capitalized for federal tax purposes.

- If later elect to expense a cost, cannot deduct any cost in ending inventory from previous report
- If elect to expense a COGS, may not expense a cost incurred before first day of report period
- If later elect to capitalize CGS, cost expensed on previous report not capitalized

§171.1012 Determination of Cost of Goods Sold

Current Law (continued)

- (h) COGS determined in accordance with methods permitted for federal tax purposes
- (k) Entity that offers loan to public may include interest in CGS

Change

- (h) COGS determined in accordance with methods used in federal tax return
- (k) SIC 5932 entities (i.e., used merchandise stores) may not include interest in CGS; agricultural lenders may include interest in CGS.

§171.0001(10) Determination of Cost of Goods Sold: Lending Institution Definition

Current Law Entity makes loans and regulated by FRB, OCC, FDIC, Tx Dof B, OCC, Dept of S&ML, CUD or comparable regulatory body

Change

- Adds: CFTC, OTS;
- Deletes: Dept of S&ML
- Adds: Entity regulated by Dept of S&ML; is a broker or dealer under 34 Act §78(c), or provides financing to unrelated parties for agricultural production

§171.1013 Determination of Compensation: Owner Distributive Share of Income

Current Law

- (a)(1) Net distributive income from partnerships and from trusts and LLC treated as partnerships for federal tax purposes if person receiving distribution is natural person

Change

- (a)(1) Net distributive income from *taxable entity treated as partnership*
 - (a)(4) Net distributive income *from LLC treated as sole proprietorship* for federal tax purposes if person receiving distribution is a natural person
-

§171.1013 Determination of Compensation: Benefits**Current Law**

(b)(2) Cost of Benefits is included in compensation deduction

Change

(b)(2) Cost of Benefits is included to the extent deductible for FIT purposes

New

(b-1) Small Employer (def. in Ins. Code § 1501.002) that did not previously provide health care benefits to employees may include additional amount in comp. deduction as follows:

50% of health care cost for 1st 12 mo. paid on which margin based and in which health care benefit provided to all employees

25% of health care cost for 2nd 12 mo. period.

§171.1013 Determination of Compensation: Combined Groups**Current Law**

(c) Compensation deduction cannot exceed \$300,000 per 12 month period on which margin based

Change

(c) Combined group limited to \$300,000 per person

§171.1014 Combined Reporting**Current Law****Change**

- (b) Combined group treated as single entity in applying exemption for entities with less than 300K TR with 1K tax liability
- (d) Taxable margin of combined group limited to 70% of combined total revenue from entire business
- (d-1) Member of combined group can claim as CGS qualifying costs of goods owned by another member
- (h) Each member of combined group include activities for same period as combined group uses
- (i) Each member of combined group jointly and severally liable for tax

§171.0001(8) Combined Reporting - Controlling Interest Definition

Current Law

80% or more of (i) voting power of corporation; or (ii) capital, profits or beneficial interest in partnership, trust, association or other entity

Change

Reduced to more than 50%; includes membership interest or beneficial ownership interest in membership interest of LLC

§171.103 - Combined Reporting: Apportionment

Current Law

- (a) Texas receipts include receipts of combined group members with Texas nexus only (“Joyce” rule)

Change

- (a) No change
- (c) Combined group must file report that shows for each member of combined group that does not have Texas nexus:
 - (i) Texas receipts and
 - (ii) Texas receipts subject to taxation in another state under a throwback rule

§171.1015 Reporting for Certain Partnerships in Tiered Partnership Arrangement

Current Law

- (b) Owning partnership (upper tier) may pay tax on its share of owned partnership (lower tier) taxable margin *if all* lower tier interests are owned by one or more taxable entities

Change

- (b) Include in upper tier partnership share of lower tier partnership total revenue *if any* lower tier ownership interest is owned by taxable entity; lower tier must file report showing allocation of TR to upper tier
 - (d) Exemption for entities with less than 300K TR or 1K tax applies only if lower tier qualifies before attribution

(note that small business discount apparently not limited)
-

§171.111 - Temporary Credit on Taxable Margin

Current Law

- (a) Notice of Intent to claim credit due by March 1, 2007 (Comptroller extension to September 1, 2007)

Change

- (a) Notice of intent due on first report originally due on or after January 1, 2008.

§171.111 - Temporary Credit on Taxable Margin

Current Law

- (b)(1) Set forth formula for determining amount of credit

Change

- (b)(1) Amount of credit is the business loss carry forwards of taxable entity under (old) §171.110(e) to post-January 1, 2008 period
- (b)(2) Business loss is multiplied by 2.25% for first 10 years beginning January 1, 2008, then by 7.75% for next years through September 1, 2027, multiplied by 4.5%

§171.111 - Temporary Credit on Taxable Margin

Current Law

- (d) Credit cannot be transferred in a purchase transaction

Change

- (d) Credit cannot be transferred; credit lost if entity changes combined groups after June 30, 2007
 - (d-1) Taxable entity must have been subject to tax on May 1, 2006, to claim credit
 - (d-2) Credit cannot exceed tax due; unused credits expire September 1, 2027
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Exit Tax for Entities Terminating in 2007

Current Law

- Entities subject to franchise tax in 2007 and not subject to tax on 1/1/08 must file final report between 6/30/07 and 1/1/08
- Tax based on 2007 tax period.

Change

- Entity not doing business on 1/1/08 that would be subject to franchise tax on 1/1/08 but was not previously subject to tax (e.g., ltd. partnership) and that was doing business after 6/30/07 and before 1/1/08 is subject to exit tax
- Tax based on 2007 taxable margin

§171.3015 Forfeiture of Certificate of Registration of Taxable Entity

Current Law None

Change Comptroller can forfeit certificate of registration of a taxable entity for same reasons as for corporation

§171.356 Billing or Invoicing the Tax as a Fee, Charge, Reimbursement or Other Item

Current Law None

Change None