

**Texas CPA Tax Institute
Margin Tax Issues & Problems
Presentation Notes**

1. Introduction:

- This presentation to explain issues that have surfaced this year for the Comptroller and Legislature to consider.
- No legal challenges to the tax yet.
- Comptroller expecting to train 8-10 franchise tax auditors that will likely do desk audits.
- Comptroller has info sharing agreement with IRS that provides data. They'll also be cross-referencing data with Sec'y of State and Texas Employment Commission.

2. No Constitutional Challenge Based on Bullock Amendment.

- Explain Bullock Amendment. Is this a tax based on Net Income?
- Kansas yes; Virginia no.
- If Net Income Tax, is it imposed on a natural person's share of . . .
- Consider the possibility of the Texas Sup Ct. finding the tax is imposed on net income but not on a natural person's share thus not running afoul of the Bullock amendment.
- Implications: The Legislature would then be free to modify the tax to cure its current inequities. But then PL 86-272 would apply.

3. Passive Entities. Rental Income retaining its character.

- The Comptroller's present policy and proposed rule provides that taxpayers must retain the flow through character of rental income when making the passive income 90% test.
- TSCPA/SBOT letter expressing concerns about the lack of legislative authority to set such a policy.
- No apparent policy reason for the rule.
- Doesn't cure potential abuse.

4. Passive Entities. Non-controlling Interests.
 - In Rule 3.582.
 - Lack of Statutory Authority.
 - No similar federal distinction. (CGs rates still apply)
 - May cause entity to fail test (esp. passive holding companies).

5. Federal Gross Income Issue for Trusts.
 - A literal application of the IRC would make an otherwise passive trust taxable.
 - Discuss slide example.
 - Proposed changes to Rule 3.582 may correct this.
 - The new rule language says: as reportable on the entity's federal income tax return.
 - The federal income tax rules don't require the reporting of partnership flow-through gross income on a trust's return or on the partnership's return.

6. S Corp. Distributive Income Treated as Active to QSSTs.
 - The statute fails to treat the flow-through income from an S Corp. as passive income.
 - Normally income from S Corps flows through only to individuals, but in some cases to QSSTs.
 - Similar to flow-through and dividend income which are passive.
 - May cause passive QSST to be taxed.
 - While the revenue provisions exclude the flow-through income from S Corps, it may still create a difference in taxation.
 - Eg. QSST owns 25% S corp stock and receives a \$1mm flow-through distribution. The QSST also holds CDs that generate \$8mm in interest income. Since the S Corp flow-through is active income, the QSST fails the 90% passive income test and is therefore taxable. However, the otherwise passive interest is now taxed.

7. Passive Entities. Review Depreciation Recapture example in slides.

8. Passive Entities. Overreaching Anti-abuse (Geoffries) rule under 171.0004(d).

- The provision treats a taxpayer as active regardless of the amount of the income generated by an intangible asset.
- It appears to apply even if the operating company doesn't make payment to the other entity.
- Review slide example.

9. Tiered Reporting.

- Potential Cure for Clinic Structures
- Problem – very limited application (all or none)
- Legislature needs to correct provision to make it useful.
- Or allow PCs to qualify for the comp deduction for NDI.

10. Revenue: Gross v. Net Federal Reporting.

- Problem for Ad agencies, travel agencies and others who receive a substantial part of their gross receipts as reimbursement of customer expenditures
- They pay substantially more franchise tax depending upon whether they report their revenues gross or net.
- Cover materials in text.

11. Revenue Exclusions. Definition of Bad Debt.

- Unclear statutory definition.
- "Gross Receipts" (v. revenue)
- "Current or Past Reporting Period" Federal or Franchise (former and margin)

12. Revenue Exclusions. Flow-through payments.

- Unfair to Exclude Comp to Independent Contractors (eg. Trucking)
 - Real Estate Sub Payments. Fix "handles" language.
13. COGS - Officer/Manager Allocations.
- Production workers who also hold officer/director titles.
 - Policy tends to hurt the smaller businesses who must assign more than one job to a person.
14. COGS – Oil & Gas drillers.
- Beneficial Comptroller's policy - drillers are eligible for COGS.
15. COGS – retail stores – inventory ruling.
- Rent and utilities for inventory.
16. OOS Temp Staffing Firms.
- Meet conditions, client receives wage deduction.
 - OOS taxpayer that uses an OOSE temp agency.
 - Getting them to complete Form 05-176.
 - Reluctant to provide the data solicited on Form 05-176.
17. Compensation Deduction.
- The subtraction of negative NDI.
 - Include a discussion about the phenomenon of deducting profits.

- The SBOT and TSCPA have sent a letter to the Comptroller expressing their concerns about the lack of legislative authority to set such a policy.
- Example of anti-abuse problem likely contemplated by the Comptroller.

18. Common Owner(s).

- Statute v. Rule Language
- The Legislature needs to change to Common Owner
- Will doing so limit the Comptroller's ability to adopt attribution rules.
- Maybe change to Common Owner and legislate attribution rules.

19. Mandatory Water's Edge Reporting.

- Create a potential violation of the foreign commerce clause?
- Unitary concept is rooted in economic business concept that ignores legal and geographical lines.
- Mandatory water's edge reporting violates those principles and prefers domestic arrangements to foreign ones.

20. Handling Unitary Audits. Review Slides.