



2008 Texas Franchise Tax  
Hot Issues & Problems


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### Bullock Amendment

" . . . a tax on the net incomes of natural persons, including a person's share of partnership and unincorporated association income . . ." requires majority vote by citizens.

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### Audits & Legal Challenges



- Audit & Training
- No Lawsuits (yet)
- Net Income Tax Challenge

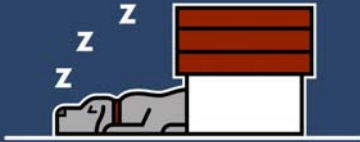
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### Public Law 86-272

- Enacted in 1959
- Only Affects Net Income Taxes
- Protects Solicitation
- Orders for Sale of Goods

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## Passive Entities



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## 90% Passive Income

- Interest & Dividends
- Flow-Through Income
- Net Capital Gains from Real Estate
- Net Gains from Securities
- Oil & Gas Income
- Other

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## Passive Entity Rules

### Requirements:

- Qualifying Entity
- 90% Passive Income
- 10% Active Income

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## Passive Entity Issues

### Flow-Through Rental Income:

- Comptroller Policy
- Effect on Classification
- Statutory Basis?
- No Applied to Other Items

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## Passive Entity Issues

### Non-Controlling Interests:

- Comptroller Policy
- Effect on Classification
- Statutory Basis?

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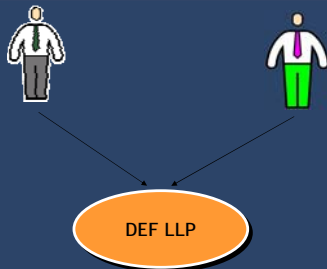
## Passive Income Issues

### Federal Gross Income Issue:

- IRC § 61 & Treas. Regs.
- Partnership Gross Income
- Unintended Results
- Corrected by Proposed Rule

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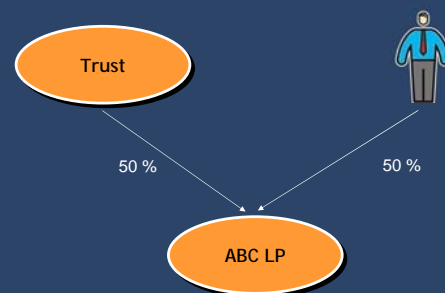
## Passive Entity - "Non-Controlling Interest"



51% Int: Software Co. Stock: \$100,000,000 Gain

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## Gross Income from Partnerships



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## Gross Income from Partnerships

### Trust Share:

Gross Income	\$5,000,000
Ordinary Income	\$1,000,000

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## Passive Income Issues

### S Corps & QSSTs:

- Flow-Through Income
- Active, Not Passive
- Compare Similar Categories
- Unintended Consequences

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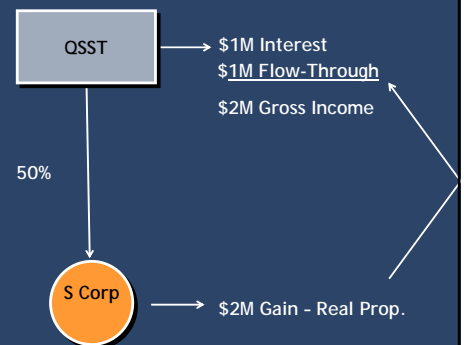
## Gross Income from Partnerships

$$\frac{1,000,000}{5,000,000} = 20\%$$

Fails 90% Test

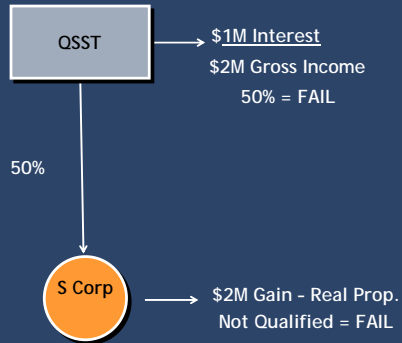
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## Passive Rules - QSSTs and S Corps



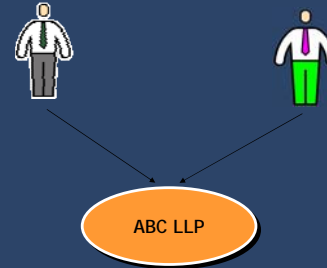
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## Passive Rules - QSSTs and S Corps



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## Passive Entity - Depreciation Recapture



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## Passive Income Issues

### Depreciation Recapture:

- Source of Issue
- Ordinary Income
- Capital Gains – Higher Rate

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## Passive Entity - Depreciation Recapture



Generates \$12 MM Gain

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## Passive Entity - Depreciation Recapture

Gross Rents	\$1,000,000
Gain on Sale of Real Property	
Long-Term §1231 Gain:	
Taxed at 15%	9,500,000
Taxed at 25%	500,000
Ordinary Income Recapture:	
Taxed at Ordinary Rates	0
Short-Term Gain	2,000,000
<hr/> Total Gross Receipts	<hr/> \$13,000,000

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## Anti-Abuse Rule

- Intangibles Used by Affiliate
- Automatically Active Affiliate
- *Geoffrey v. South Carolina*

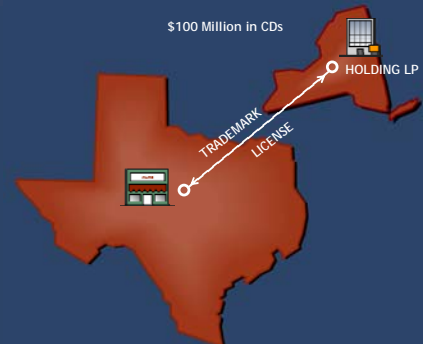
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## Active Income

- Active Business
- Rental Income
- Operator Working Interests
- Not Serving on Board of Directors

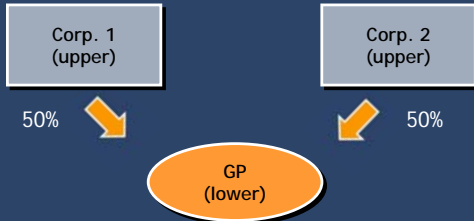
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## Anti-Abuse Rule Example



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## Tiered Partnerships



- Partners Report Revenue Share
- GP Files Information Report
- Limited Usefulness

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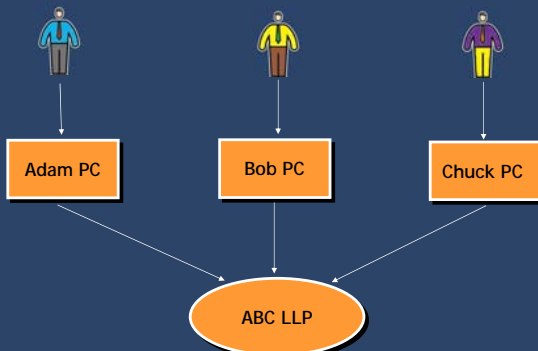
## Revenue - Federal Forms



Reported v. Reportable

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## Typical Clinic Structure



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## Form 1120

1120		U.S. Corporation Income Tax Return		OMB No. 1545-0123
Form 1120		For calendar year 2007 or tax year beginning _____, 2007, ending _____, 2007		2007
A Check # _____		Name _____	B Employer identification number _____	
1 Consolidated return (attach Form 951)		<input type="checkbox"/> Use IRS label	Number, street, and room or suite no. if a P.O. box, see instructions.	
2 Personal holding co. (attach Sch. PH)		<input type="checkbox"/> Otherwise, print or type	C Date incorporated _____	
3 Personal service corp. (see instructions)		<input type="checkbox"/> City or town, state, and ZIP code _____	D Total assets (see instructions) \$ _____	
4 S-corp M-3 required (attach Sch. M-3)		E Check # (1) Initial return (2) Final return (3) Name change (4) Address change		
1a Gross receipts or sales		b Less returns and advances		c Total
2 Cost of goods sold (Schedule A, line 8)				3
3 Gross profit: Subtract line 2 from line 1c				4
4 Dividends (Schedule C, line 10)				5
5 Interest				6
6 Gross rents				7
7 Gross royalties				8
8 Capital gain net income (attach Schedule D (Form 1120))				9
9 Net gain or (loss) from Form 4797, Part II, line 17 (attach Form 4797)				10
10 Other income (see instructions—attach schedule)				11
11 Total income. Add lines 3 through 10				12

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## Federal Gross Revenue

### Gross or Net?

- Reimbursed Client Expenses
- Agent Expenses
- Travel Agent Ruling

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## Reductions & Exclusions

### Bad Debt Expense:

- Claimed on Federal Return
- Correspond to Gross Receipts
  - Current Reporting Period
  - Past Reporting Period

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## Travel Agent Ruling

```
April 26, 2007
*****
*****
*****
Dear *****:

Thank you for your letter regarding House Bill 3 (HR 3) and the travel agent industry.

As you are aware, Section 171(e)(1) of the Internal Revenue Code (IRC) requires the taxpayer to report gross income for the purpose of determining special-use valuation. The purpose of this provision is to ensure that the taxpayer reports gross income on its Federal income tax return, as long as that methodology is appropriate under Federal income tax law.

You stated in your letter that Federal income tax law allows a taxpayer to report on the income lines of the Federal income tax return the amount which is the "gross" or "net" amount. "Gross" reporting includes items which are not considered gross income of the taxpayer under Federal income tax law. In contrast, "net" reporting excludes items that are not gross income of the taxpayer.

For example, if a $100 million ticket is booked for a customer and the travel agent's commission is $10, then the travel agent would be income to the extent the $10 amount on line 1 of the Internal Revenue Service (IRS) Form 1041. In other words, under the "net" method, the $10 and the entire $100 the customer paid for the ticket and commission, would be included in the travel agent's total amount for reporting tax purposes. Conversely, if $100 were included on line 1 of IRS Form 1041 under the "gross" method, then $110 would be included in the travel agent's total amount for reporting tax purposes.

If you need any additional information or have any questions, please contact me by e-mail at william.martens@taxes.com or by phone at (516) 470-0161.

Sincerely,

William Martens
Director of Tax Administration

MILLER/WHITMAN 20070426
*****
*****
DATE: 04/26/2007
THE FIRM: FRANKRINE
```

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## Reductions & Exclusions

### Certain Flow-Through Payments:

- Collected Taxes
- Real Estate Subcontractors
- Sales Commissions
- Claimant Damages Paid to Attorney
- Co-counsel Payments

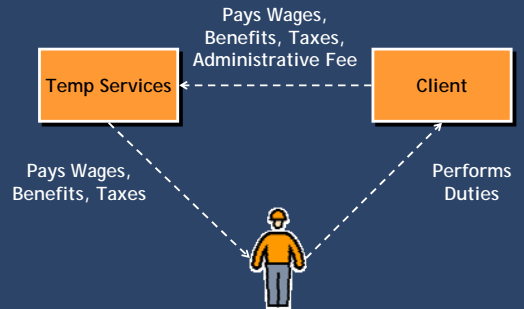
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## COGS Issues

- Officer/Manager Salary Allocations
- Oil & Gas Drillers
- Retail Stores - Rent & Utilities

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## Temporary Employment Services



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## Compensation Issues

- OOS Temporary Staffing Cos.
- Negative NDI

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## Temporary Staffing Report

The image shows a screenshot of a "REVISED TEXAS FRANCHISE TAX STAFF LEASING SERVICES COMPANY REPORT" form. The form includes fields for "Report Period", "Reporting Period", "Company Name", and "State". It also has a section for "Reporting Period" with checkboxes for "Calendar Year" and "Fiscal Year". The main body of the form is a table with columns for "Reporting Period", "Company Name", "State", "Reporting Period", "Company Name", and "State". The form is titled "REVISED TEXAS FRANCHISE TAX STAFF LEASING SERVICES COMPANY REPORT" and includes a "REVISED TEXAS FRANCHISE TAX" logo.

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## Compensation components

- Wages, Bonuses & Tips
- Fringe Benefits
- Education Expenses
- Employee's Share of Taxes
- Net Distributive Income

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## Net Distributive Income - 2008



Revenues	\$ 1,000,000
Rent & Supplies	(700,000)
Net Distr. Income	\$ 300,000

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## Net Distributive Income

- Must be Allocated to Natural Person
- Federal Tax Partnerships
- S Corporations
- Sole Member LLCs

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## Net Distributive Income - 2008



Revenues	\$ 1,000,000
Compensation Ded.	(300,000)
Margin	\$ 700,000

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## Net Distributive Income - 2009



CPA Firm LLP

Revenues	\$ 1,000,000
Rent & Supplies	(100,000)
<u>Net Distr. Income</u>	<u>\$ 900,000</u>

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## Negative NDI Issue

- Policy: Reduce Compensation
- Lack of Statutory Basis
- Inconsistent with Deduction Concept
- TSCPA/State Bar Letter
- Cures Potential Abuse Problem

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## Net Distributive Income - 2009

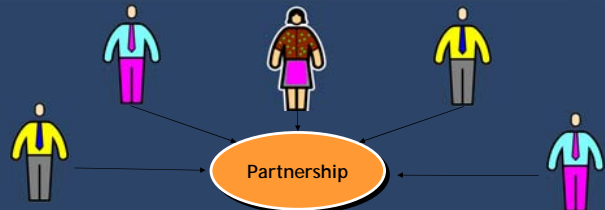


CPA Firm LLP

Revenues	\$ 1,000,000
Compensation Ded.	(900,000)
<u>Margin</u>	<u>\$ 100,000</u>

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## Net Distributive Income - No Planning

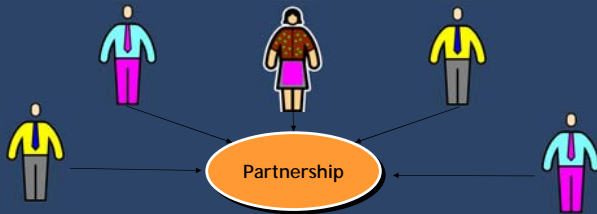


Partnership

Revenues	\$ 1,000,000
Partner Salary	(500,000)
Rent & Supplies	(500,000)
<u>Net Distr. Income</u>	<u>\$ 0</u>

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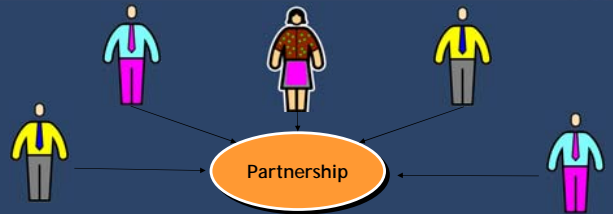
### Net Distributive Income - No Planning



Revenues	\$ 1,000,000
Partner Salary	(500,000)
Net Distr. Income	( 0)
<hr/>	
Margin	\$ 500,000

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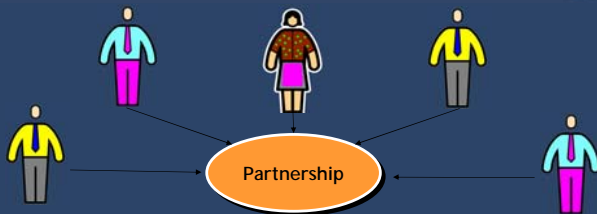
### Deduction Without Reduction



Revenues	\$ 1,000,000
Partner Salary	(1,500,000)
Net Distr. Income	( 0)
<hr/>	
Margin	\$ 0

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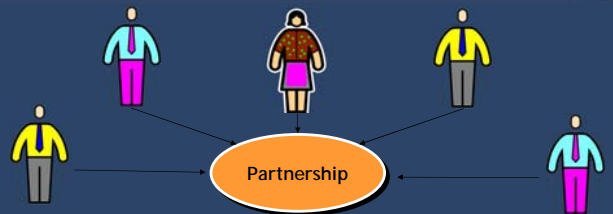
### Net Distributive Income - With Planning



Revenues	\$ 1,000,000
Partner Salary	(1,500,000)
Rent & Supplies	( 500,000)
Net Distr. Income	\$ (1,000,000)

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### Deduction With Reduction



Revenues	\$ 1,000,000
Partner Salary	(1,500,000)
Net Distr. Income	1,000,000.
<hr/>	
Margin	\$ 500,000

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## When to File Combined

- Affiliated Group
- Unitary Business

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## Unitary Audit Considerations

- Accounting
- Customers & Suppliers
- Research
- Advertising
- Employment Practices

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## Combined Reporting Issues

- Common Owner(s)
- Water's Edge Reporting
- Unitary Audits

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## Unitary Evidence

- Business Plans
- Organizational Charts
- Public Filings
- Board Minutes
- Licensing Agreements
- Company Manuals & Newsletters
- Website

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