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A Few Quick Answers
About the New Franchise (Margin) Tax

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On Thursday, May 18, Governor Perry signed into law an expanded business tax—a tax its opponents have labeled as the largest tax increase in Texas history. The bill replaces the ineffective and loophole-riddled franchise tax, and it's budgeted to bring in an additional $14.5 billion in taxes over the next five years. This money is meant to partially replace the tax revenue lost by the significant cut in state property taxes that the Legislature passed at the same time. Many businesses that paid no franchise tax should now expect to pay when the first returns are due, in May of 2008. The first taxable period generally begins on January 1, 2007, and businesses and their advisors should know what to expect before 2007 rolls around. This article will answer some general questions about the new margin tax, and explain how the new tax may influence other aspects of a taxpayer's business. Next week, we'll discuss some of the more technical aspects of the bill, point out some possible planning strategies, and pinpoint areas that are sure to be litigated if the Texas Legislature doesn't make some fixes to the tax in the 2007 regular session.

What types of companies must pay the new tax? What companies must pay the new tax that didn't pay the franchise tax?

For the most part, any legal entity that does business in Texas and enjoys some form of limited liability protection must pay the new tax. This includes corporations, limited partnerships (LPs), limited liability companies (LLCs), limited liability partnerships (LLPs), banking corporations, savings and loan associations, business associations, professional associations, and some joint ventures. About the only common entities that aren't taxed by the new law are sole proprietorships and general partnerships that only have natural persons as its partners. Entities that are disregarded for federal income tax purposes may still be taxed under the new Texas tax.

Some less common entities have been granted specific exemptions from the new tax. This list includes insurance companies, nonprofits, some cooperatives, certain trusts, estates of natural persons, some family limited partnerships, real estate investment trusts (REITs) and real estate mortgage investment conduits (REMICs).

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The law also excludes "passive entities." Passive entities must meet three requirements. The first is that the entity must be either a general or limited partnership, or a trust other than a business trust. Second, during the tax year, at least 90% of federal gross income must arise from a specific list of sources. This list includes interest, dividends, capital gains, distributive partnership income, and income from nonoperating mineral interests. Third, during the tax year, no more than 10% of the entity's federal gross income can be received from conducting an active trade or business. Generally, conducting an active trade or business means that the entity performs active management and operational functions.

Finally, smaller entities are also exempt. If an entity owes less than $1,000 in tax, or has $300,000 or less in total revenues, the entity doesn't have to pay the tax.

In a nutshell, how is this new tax calculated?

The tax is a tax on "taxable margin," which is a concept similar to taxable income. Generally, an entity's taxable margin is its revenue less either its cost of goods sold or its compensation expense, but not both. If 70% of the entity's revenue is less than either of these calculations, than 70% of revenue is the taxable margin. Taxable margin must then be apportioned to business done in Texas, measured by the ratio of gross receipts from business done in Texas to gross receipts from business done everywhere. The tax rate is then applied to the apportioned margin. A half percent rate is used for taxable entities primarily engaged in retail or wholesale trade, and a 1% rate is used for all other entities.

Revenue. An entity must look to its federal income tax return to determine its revenue. A corporation must add together the amounts on Line 1c and lines 4-10 on Form 1120 to determine revenue. This will include gross receipts (less returns and allowances,) dividends, interest, rents and royalties, capital gains, and other income. From this, a corporation is allowed to subtract bad debt expense, foreign royalties and dividends, partnership distributions, and dividends that qualify for the federal deduction for dividends received. A partnership will compute its taxable income in a similar way by referring to its Form 1065. Certain flow-through funds mandated by law, fiduciary duty, or contract are excluded for all taxable entities. Additionally, two professions get very specific exemptions of revenue: doctors and attorneys both get certain exemptions based on pro bono services they've provided, and doctors get to exempt all payments received from Medicaid, Medicare, and certain other governmental programs. Income received from certain low-volume oil and gas wells is also exempt. Dividends and interest received from federal obligations is exempt for everyone.

Compensation Deduction. Two types of expenses are deductible under the compensation election: "wages and cash compensation" and benefits. Wages and cash compensation covers most typical compensation expenses.

The law states the starting point is the "Medicare wages and tips" box on Federal Form W-2. An entity that is a partnership, LLC, S corporation, or other entity treated as a partnership for federal tax purposes can add to this number the net distributive income it paid to natural persons. Entities can also add to "wages and cash compensation" stock awards and options that were deducted for federal tax purposes. The "wages and cash compensation" amount is capped to $300,000 for any person. No deduction can be taken for payments to "undocumented workers," i.e. not lawfully present and employed in the United States. Benefits are also deductible to the extent they are deductible for federal income tax purposes, and the amount of benefits provided to any person is not subject to the $300,000 cap. Payroll taxes are not deductible under either category. Both wages and cash compensation and benefits are only deductible if they are paid to employees, officers, directors, owners, or partners. There are specific rules for staff leasing companies, management companies, and the customers of these companies.

Cost of Goods Sold Deduction. While the revenue and compensation deductions rely heavily on federal tax calculations, the cost of goods sold calculation depends entirely on Texas rules that are similar—but not identical—to the federal rules. The cost of goods sold deduction only includes costs required to produce or acquire a "good." A good only includes real or tangible personal property, but the definition of tangible personal property is somewhat broad—it includes the cost of developing films, sound recordings, or books if the tangible medium in which the property is embodied will be mass distributed. It also includes computer programs. It does not include intangible property (such as accounts receivable) or services (such as tax return preparation fees). The good must have been owned by the entity in order for its cost to be deducted. The "cost" of these goods includes all direct costs of acquiring or producing the goods. This includes inbound freight, storage, research and development, geological and geophysical costs, depreciation of equipment used to produce the goods, and other costs specifically listed. The cost also includes certain costs for goods that weren't actually sold: costs of deterioration, obsolescence, and spoilage of goods. There is a list of costs specifically excluded from cost of goods sold, including selling costs, outbound freight, idle facility expenses, bidding costs, interest costs, income taxes, officers' compensation, and compensation paid to undocumented workers. Up to 4% of indirect administrative costs can also be deducted, if the entity can demonstrate that the costs are allocable to the acquisition or production of goods. Lending institutions that offer loans to the public are allowed to deduct interest expense as cost of goods sold.

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If wholesalers and retailers only have to pay half the tax, what does it take to be considered a wholesaler or retailer?

The new law defines retail and wholesale trade by referring to the federal Office of Management and Budget's Standard Industrial Classification Manual. If the business activity has an SIC code numbered in the 5000's, it's a wholesaling or retailing activity. The categories include businesses traditionally thought of as wholesales and retailers, and also businesses such as bars and restaurants, car dealerships, gasoline service stations, mail-order houses, and vending machine operators.

The entity must also be "primarily" engaged in retail or wholesale trade. To make this hurdle, the entity must meet three requirements. The first is that the total revenue from activities classified as retail or wholesale trade must be greater than other types of revenue. The second is that at least half of the revenue from its wholesale or retail activities must not derive from the sale of goods produced by the entity or one of its affiliates (bars and restaurants are exempt from this requirement). The third is that the entity cannot provide retail or wholesale utilities, including telecommunication services, electricity, or gas.

The second requirement means that the entity must sell more of some other company's products than its own. Also, the third requirement can have harsh consequences in certain circumstances—it's possible that a retailer that earns an immaterial amount of revenue from selling "utilities" (perhaps by selling excess computer network capacity) could lose its wholesaler or retailer status.

What's all this about "combined groups," "unitary businesses" and "water's edge methods"?

A very significant change to the Texas business tax is the requirement that certain affiliated companies file a single return as a combined group. The law treats a "combined group" as the taxable entity instead of treating each of the individual legal entities as separate taxpayers. Two conditions must exist for entities to combine. The first is that the entities are in an "affiliated group." This generally means that each entity is owned at least 80% by a common owner, group of owners, or other member entity. The second requirement is that the entities are engaged in a "unitary business." This means that the entities are so interrelated and integrated that their activities together produce synergy, mutual benefit, and a sharing of the exchange of value. Many other states have adopted the unitary business concept, and in these states, the determination of whether a business is unitary is an extremely subjective and fact-intensive process.

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The Legislature has directed the Comptroller to specifically consider certain factors when determining if a group is unitary, including whether the activities of the group members are in the same general line of business or are different steps in a vertically structured process. Either of these conditions suggests a unitary business. Also, the Comptroller is directed to consider whether the members are functionally integrated through strong centralized management, including centralized authority over purchasing, financing, and other business functions.

Texas also follows the "water's edge" method. This generally means that entities that primarily conduct business outside of the United States must be excluded from the combined group, even if they are affiliates and are part of a unitary business. If 80% or more of the legal entity's property or payroll are located outside of the United States, the entity is considered past the "water's edge," and must be excluded from the combined group.

Once it is determined that a combined group exists, each individual legal entity in the group determines its revenue amount and amounts for deduction of compensation or cost of goods sold as if it were reporting separately. Each entity's amounts are then added to the other entities, and any intercompany transactions are eliminated. The combined entity, not the individual members, must make the election as to which deduction to take (30% of revenue, cost of goods sold, or compensation). This means that all of the group members must make the same deduction. The determination of the portion of the combined group's gross receipts performed in Texas is likewise computed for the group as a whole, after eliminating intercompany receipts. Members of the group that do not have a physical presence in Texas (i.e. do not have nexus) are not required to include their Texas gross receipts in the allocation formula, but they are permitted to include their gross receipts from total sales. Therefore, reporting as a combined group may be beneficial for certain entities, because the group members without nexus may reduce the margin apportioned to Texas more than they contribute in margin.

If a taxable entity meets the combined group requirements, it must be included in the combined group. However, it's the taxpayer's option whether to include exempt entities that otherwise meet the combined group requirements. If the taxpayer includes the exempt entity, it's treated as if it was taxable for purposes of determining the combined group's tax. For instance, if the same owner that owns the entities in a combined group also owns a passive entity, and both the combined-group entities and the passive entity are in the same unitary business, the owner doesn't have to include the passive entity in the combined group. However, the owner can elect to include the passive entity in the group if its inclusion would be beneficial.

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Which companies will be hit particularly hard by this new bill?

The taxpayer group that will bear the biggest burden of the change in tax is the service industry, particularly the professions that tended to be exempt under the franchise tax but are now taxed because of the expansion to partnerships. This group includes attorneys, architects, doctors, and CPAs, many of whom practice as LLPs. The medical profession has already been granted large exemptions, so the increase in tax on that group will likely be much less.

The tax will also be particularly punishing to businesses that have significant costs that won't be deductible either as compensation or cost of goods sold. In particular, this would include the transportation and rental industries.

Are any industries better off?

When combined with the significant property tax decreases that the Legislature passed at the same time it passed the new business tax, certain industries will likely receive a net decrease in total Texas tax. Oil and gas production companies will do particularly well.

They are capital-intensive businesses, so they will benefit significantly from the property tax reduction. The passive entity definition is also structured in such a way that oil and gas businesses are more likely to qualify—for instance, royalty interests and nonoperating working interests in mineral rights are not treated as active.

Because of the broadness of the cost of goods sold deduction, manufacturers will not be hit as hard as service companies. Finally, the half-percent cut in the tax rate for wholesalers and retailers is a very significant tax break, particularly since these companies will also be taking the cost of goods sold deduction. The lower rate was justified because wholesalers and retailers tend to operate on very low margins. However, service companies often have low margins as well, and were not given a break. It's possible that eventually this disparate treatment may be determined to be unconstitutional as a violation of equal protection and due process.

How might this tax change the way my company does business?

Lease Agreements: Many commercial lease agreements for real property provide that tenants must pay a pro-rata portion of the property tax on their leased space. The fact that property taxes have been partially replaced by a new business tax bodes well for tenants, and means bad news for landlords locked into long leases. Since most of a lessor's major expenses aren't deductible under the margin tax, landlords will be hit especially hard by this change. Landlords should start rewriting their leasing contracts for the future. Tenants should expect an increase in rent the next time they renew their lease, since their landlords will be attempting to recoup their increased taxes.

Hire, contract, or temp? Companies are often faced with the difficult decision of whether to hire workers as employees, contract with them as independent contractors, or hiring temporary workers. For companies that expect to take the compensation deduction, it now may make more sense to hire workers as employees. The wages and benefits paid to the employees will be deductible. Payments to independent contractors and temporary staffing companies won't be deductible. This could make a significant difference depending on the number of employees hired.

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Special Note: Martens & Associates, maintains a website which provides Texas tax information, links to all of the websites referenced in this manual and links to all available state revenue officers' websites. The site is located at:

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