

## More Answers About the New Franchise (Margin) Tax Part II

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***I've read that the new tax is unconstitutional because it's an income tax. Is it unconstitutional?***

The constitutionality of the new tax is an issue that is sure to be litigated. It's certainly too soon for anyone to draw conclusions about its constitutionality. The issue has been in the news primarily because of the actions of the state Comptroller, Carole Keeton Strayhorn. In a letter dated April 21, 2006, Ms. Strayhorn requested that the Attorney General issue a formal opinion addressing the constitutionality of the tax. She also included her own opinion stating why she thinks the tax was unconstitutional.

Article VIII, Sec. 24(a) of the Texas Constitution states that any "tax on the net incomes of natural persons, including a person's share of partnership and unincorporated association income" requires voter approval in a statewide referendum before enactment. The Texas courts have not yet had the opportunity to determine what this sentence actually means—but they will soon.

As we discussed last week, the margin tax does not tax individuals, sole-proprietor businesses, or general partnerships with natural-person partners. Therefore, no one claims that the margin tax is a "tax on the net incomes of natural persons." It's the second part of the amendment—the part taxing a person's share of partnership and unincorporated association income—that's causing the problem. The new bill did expand the franchise tax to cover some partnerships and unincorporated associations.

But is it an income tax on the natural person's share of income from the partnership (which is probably unconstitutional) or a tax on the partnership itself (which is probably not unconstitutional)? Strayhorn says that it's a tax on the natural person's share. The bill's supporters take the other side. It's an issue the courts will eventually have to sort out.

But it's not the only issue. The tax also has to be an "income tax" to be unconstitutional. Is the margin tax an income tax? Strayhorn claims that the fact that the margin tax allows deductions makes it so. Again, that will be for the courts to decide.

And when we say “courts,” we really mean “Court”—as in the Texas Supreme Court. The bill requires that constitutional challenges to the tax skip all of the lower courts and go straight to the Supreme Court. It also requires that the Supreme Court issue a decision within 120 days after the date the case is filed. So at least we’ll get answers about constitutionality in a hurry.

***I’ve also read that there was a drafting error in the tax bill that may cause the bill to be unconstitutional. Is this true?***

The statute does appear to contain an error that will makes it easier for the bill’s opponents to argue that it’s an income tax. This error, if it’s not fixed, will also give certain businesses an incredibly valuable loophole.

The error is in the subsection of the bill that calculates a partnership’s total revenue by referencing the entity’s federal Form 1065. The statute references the line for “net rental income (loss)” instead of the line for gross rental income. Limited partnerships that own rental real estate will get an unlimited deduction for their real estate activities, and may still take the compensation or cost of goods sold deduction if there’s anything remaining to deduct. Entities taxed by the IRS as corporations get no such deduction.

It’s unlikely that the Legislature intended to give partnerships such an important tax break. Also, because of the error, the statute is almost certainly an income tax on real estate partnerships—and therefore probably unconstitutional when applied to these entities.

However, don’t go reorganizing your real estate business just yet. The 79<sup>th</sup> Legislature appears to have spotted the error at the end of the Special Session, and has directed the 80<sup>th</sup> Legislature to fix the error when it convenes in 2007. On May 15, 2006, the Legislature adopted a concurrent resolution that requests that the 80<sup>th</sup> Legislature change the federal line numbers that the tax bill references to include *gross* rental income for partnerships, not *net* rental income. Watch the 80<sup>th</sup> Legislature carefully to see if the amendment is actually made.

***Do any other issues arise if the margin tax is an income tax?***

As we explain in the first question of this article, it’s possible that the Texas Supreme court may determine that the margin tax is an income tax, but that the tax is still constitutional because it’s a tax on business entities, not natural persons. However, the fact that the tax might be an income tax raises more issues than simply the tax’s constitutionality.

Public Law 86-272 is a federal law passed in 1959 that prevents states from enacting income tax laws that tax entities whose only activity in the state is soliciting orders for the sale of tangible personal property. The Texas margin tax does tax entities whose only activity in the state is soliciting orders – under Texas law, having salespeople in Texas is enough to establish “nexus” with the state. And if an entity has nexus with Texas, it can be taxed by Texas.

Public Law 86-272 only applies to income taxes, so the true nature of the new Texas tax is important. The Legislature has explicitly stated in the new tax bill that the tax is not an income tax, and that Public Law 86-272 does not apply. But under federal law, a state legislature isn’t allowed to make that decision. It will be up to the courts, and possibly even the federal courts, to determine whether the new margin tax is actually an income tax. If it is, then Public Law 86-272 will apply, no matter what the Texas Legislature says. If your business or your client’s business is an out-of-state company that’s only connection to Texas is salespeople that solicit orders within the state for tangible personal property, the question of whether the margin tax is an income tax or not will be critically important.

Comptroller Strayhorn’s written opinion that the Legislature enacted an income tax presents her with an interesting dilemma. Is this her agency’s policy? Or does her office now write a rule that says it’s not an income tax? Or may taxpayers take the position that Public Law 86-272 applies as a result of her written comments?

***The new tax makes limited partnerships taxable. Limited partnerships are often used in estate planning. What do estate planners need to watch out for?***

It doesn’t appear that entities used for estate planning were meant to be a target for the new tax. Most grantor trusts and estates of natural persons have been given specific exemptions. However, estate planners that use Family Limited Partnerships (FLPs) should be careful. Family Limited Partnerships are exempt, but only if they meet certain requirements. Most importantly, they must meet the definition of a “passive entity,” which we detailed in the last article. However, according to the statute, FLPs must meet two other requirements: they must be a limited partnership, and 80% of the partnership must be owned “by the same family.”

The problem is, passive entities are already exempt, without the additional two requirements imposed on an FLP. And to be an FLP, the entity must be a passive entity. So it’s unclear at this point if the additional requirements have to be met by FLPs, or not. It may be something that the Legislature decides to fix next session.

### ***What are some unanswered questions about the cost of goods sold deduction?***

There are several unanswered questions about the cost of good sold deduction. If one of these items pertains to your company or your clients, keep an eye out of for the Comptroller to issue rules for guidance:

- Direct labor is obviously included in cost of goods sold, but it's not defined by the statute. Does it include the labor of leased employees? It would seem so, but the compensation deduction made a specific allowance for leased employees. The cost of goods sold deduction does not. The statute also states that the direct labor cost of producing or *acquiring* goods sold is deductible. Does this mean that a portion of the wages paid to the purchasing department of a retailer is deductible as cost of goods sold? It's likely that the Comptroller will view these costs as administrative overhead (deductible, but capped at 4% of total overhead costs), but it may be arguable that the costs are direct labor and therefore fully deductible.
- The costs of deterioration, obsolescence, spoilage, and abandonment of goods are deductible, but these terms are also not defined by the statute. It remains to be seen how these costs will be measured. The spoilage and abandonment section of the statute lists examples like the cost of rework labor, reclamation, and scrap—all out-of-pocket costs. Does this indicate only out-of-pocket costs will be deductible? Or will the Comptroller's rules go so far as to allow a deduction for an allowance for obsolescence, for example?
- Up to four percent of an entity's indirect or administrative overhead costs are deductible as cost of goods sold. The statute states that these costs can include such items as legal services, data processing services, accounting services, and "general financial planning and financial management costs," but only if the entity can demonstrate that these costs are "allocable to the acquisition or production of goods." We don't know yet how an entity is supposed to demonstrate that such costs are allocable to the acquisition or production of goods. Because the percentage allowed is so low, we suspect that many entities will simply deduct four percent of total indirect and administrative overhead, and not worry if the costs are allocable to the acquisition or production of goods.

### ***What are some unanswered questions about the compensation deduction?***

There are some also quirky aspects of the compensation deduction. Again, it's likely that the business community will need guidance from either the Comptroller or the Legislature for these issues:

- If you recall from the last article, the compensation deduction actually consists of two separate deductions: a deduction for "wages and cash compensation" and a deduction for benefits. The statute often refers to "wages and cash compensation" when it

would make more sense to refer to total compensation (wages and benefits) as a whole. For instance, wages are capped to \$300,000, but benefits are completely uncapped. An entity can't deduct wages paid to an undocumented worker, but it can deduct benefits paid to an undocumented worker. It's unclear if this was a drafting error or if it was intentional.

- The term "benefits" is also undefined. The statute lists examples of items that should be considered benefits, but doesn't limit the term to just those examples. The drafters of the statute appear to have attempted to limit the benefits deduction only to benefits deductible for federal tax purposes, but it's arguable that the actual wording of the statute doesn't limit it in this way. There also may be overlap between certain payments included in "wages" and payments considered "benefits." If both wages and benefits are deductible, do you therefore get a double deduction for items that fit both categories? It's doubtful, but it's how the statute reads.

***The definition of a unitary business is very vague. How do I know if my affiliated group is unitary? How will the Comptroller know?***

As a recap, entities that are commonly-controlled by a single owner or group of owners are considered an affiliated group. If this group is also a "unitary business," the group must file a combined return. Generally, a business is unitary if it's characterized by a sharing or exchange of value between members of the group, and a "synergy and mutual benefit" all of the members of the group achieved by working together. In other words, separate parts coming together and achieving a more profitable whole.

Texas's definition of what it means to be a "unitary business" is quite vague, but so are the definitions that other unitary states have adopted. It's difficult to develop a bright-line rule when the law must deal with flighty concepts like "synergy." Close cases that end up in court will involve a very subjective and fact-intensive trial.

The Legislature has attempted to provide further guidance by directing the Comptroller to consider three areas when making a unitary determination:

1. Whether the activities are in the same general line of business (for instance, a group of entities that sell the same type of product, but in different states);
2. Whether the activities are steps in a vertically structured enterprise (like an oil exploration company, a refining company, and a gas station); and
3. Whether the members of the group are functionally integrated through the exercise of strong centralized management.

It's doubtful that an entity will automatically be considered unitary if it is described by one or more of these indicators. Several unitary states have similar statutes; and in some of these states the three indicators are used to shift the burden of proof. If none of the three indicators are applicable, then it's assumed that the group is not unitary.

The party claiming that the group is unitary has the burden of proving otherwise. If one or more of the indicators is met, the opposite is true—the party claiming that the group isn't unitary has the burden of proof.

If the Comptroller decides to investigate your business group's unitary position, look forward to the auditors asking for a sea of documents not usually seen in a tax audit—employee manuals and newsletters, board minutes, annual reports, marketing material, websites and more. The auditors must review non-financial information like this to get a general idea of how the group operates.

***I understand that passive entities are exempt under the new tax. However, I've heard that the margin of a passive entity may ultimately get taxed. How?***

The revenue calculation contains an often-overlooked provision that requires a taxable entity to include in margin its share of the net income of a passive entity that's not included in its combined group. The amount included is limited to "the extent the net income of the passive entity was not generated by the margin of any other taxable entity." It's unclear what that means. How would a taxable entity's margin generate net income for a passive entity? The limit seems to be attempting to avoid the double taxation of margin, but it's unclear how it will work in practice. Stay tuned to the Comptroller's rules and changes to the statute in 2007.

***I've organized my businesses using the Delaware Sub method to avoid paying the old franchise tax. How and when should my business report under the new tax?***

Business groups that organized under the traditional method to avoid the old franchise tax will likely report as a combined group beginning on margin generated in calendar year 2007. They will file the regular annual report and not an initial report—even if some of the group members have never before filed a franchise tax report.

***I understand that the margin tax handles reporting periods similar to the way the old franchise tax did—the margin period will match the federal tax year. However, my entities will report as a combined group, and some of the entities that must report together have different tax year-ends. What margin year do I use?***

The Legislature appears not to have taken this into account when they decided to keep a portion of the old franchise tax reporting rules—the old franchise tax did not have rules for combined groups. Regulations or further legislation will probably clarify this area, but it's most likely that this situation will be treated similar to how the IRS treats an individual that receives income from a partnership with a non-calendar fiscal year.

In other words, the combined report will be based upon the year-ends that fall before the close of the reporting entity's year-end.

***You've already discussed some changes the 80<sup>th</sup> Legislature is expected to make in 2007. What else is expected to be on their agenda?***

During the Special Session, there were several amendments proposed to the margin tax. Because these amendments came at the very end of the session, there was not time to put the amending bill up for vote. The following changes to the tax may resurface in 2007:

- Currently, if one owner or group of owners owns 80 percent or more of the voting rights or beneficial interests of an entity, that entity becomes part of an affiliated group (and may also have to be included in a combined report). An amendment was proposed to reduce the required ownership interest from 80 percent down to 50 percent.
- The tax bill as it stands is generous to combined groups that include entities without nexus with Texas. The current statute follows the "Joyce" rule (named after a California court decision) for apportionment. This means that currently, a combined group is allowed to include a no-Texas-nexus entity's gross receipts from everywhere in the denominator of the apportionment factor, but does not include the entity's Texas gross receipts in the numerator. This treatment "dilutes" the apportionment factor, and therefore reduces the combined group's taxable margin. The Texas Comptroller's Office wants to switch to the "Finnegan" method (also named after a California court decision). This method, if adopted, would include the Texas sales of a no-Texas-nexus entity in the numerator of the apportionment factor.
- The margin tax attempts to give a tax credit to entities that had loss carryforwards generated under the old franchise tax. However, the current calculation of the credit is extremely unclear, and appears to be based on a book amount instead of a tax amount—it's based on the amount of deferred tax asset recorded on an entity's financial statements. The Legislature is expected to rewrite the rules so that they make better sense.
- Many of the business incentive credits under the old franchise tax that encouraged economic growth in the state were eliminated under the margin tax. It's expected that some of these credits will eventually be added back to the margin tax.

***What should I advise my clients as we prepare for the first taxable year, 2007?***

Planning matters aside, accountants should quickly gain an understanding of what types of activity will need to be tracked in order to prepare the margin tax return. Although the Comptroller's rules and the tax forms and instructions will no doubt help once they are published, business advisors should already begin to learn about the intricacies of the new law. They may then focus on the areas most important to their clients when the rules and forms are published.

## About the Authors



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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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