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Memorandum

To: TCCI Clients

From: Bruce W. Bringardner

Date: February 21, 2007

Re: Summary of New Texas Margin Tax

In 2006 the Texas Legislature made dramatic changes to the Texas franchise tax law (Chapter 171 of the Texas Tax Code). The franchise tax has been replaced with a new business tax called a "margin tax", which (i) changes the tax base, (ii) reduces the tax rate and (iii) imposes the tax on more types of businesses than were subject to the franchise tax. This Memorandum is intended as an overview of the margin tax and as an alert to potential changes during the 80th Texas Legislative session.

Effective Dates. The new margin tax is effective for tax reports originally due on or after January 1, 2008. It is still a "prepaid" tax that is based on the taxpayer's operations for the previous year. **Therefore, calendar year taxpayers in existence on January 1, 2008 which are subject to the tax must file a report on or before May 15, 2008, which includes a margin tax computed with respect to all revenues earned during calendar year 2007.** Some fiscal year taxpayers will be required to file reports that include activity during 2006.

Old "Franchise" Tax. The current Texas franchise tax is imposed on certain business entities for the privilege of doing business in Texas, though it is essentially a corporate income tax. Under the old franchise tax law, "corporations" (as defined in the Texas Tax Code) and limited liability companies pay a franchise tax equal to the greater of (i) 0.25% of an entity's net taxable capital (stated capital plus capital surplus), or (ii) 4.5% of the entity's net taxable earned surplus (adjusted federal taxable income plus officer and director compensation).

New "Margin" Tax. The new Texas margin tax is imposed on more types of entities, has a different starting point (revenue), is imposed at a rate of 1% (0.5% for wholesale and retail sellers only), and allows deductions from revenue for either (a) cost of goods sold or (b) compensation. Though still technically a "privilege" tax and not an income tax, most tax experts feel a challenge to the constitutionality of the margin tax is likely.

Entities That Are Subject to the Margin Tax. The following "taxable entities" are subject to the margin tax:

* Corporations ("C" and "S");

* General partnerships which have at least one partner that is not a natural person;

* Limited partnerships;

* Limited liability partnerships ("L.L.P.");

* Limited liability companies ("L.L.C.");

* Professional corporations ("P.C.");

* Professional associations ("P.A.");

* Banks;

* Savings and loans;

* Joint ventures (except those electing out of partnership treatment under Internal Revenue Code Sec. 761);

* Holding companies; and

* Other legal entities which provide liability protection to owners.

Entities Not Subject to the Margin Tax.

* Sole proprietorships;

* General partnerships directly owned by "natural persons";

* Certain unincorporated "passive entities" (see definition below);

* Certain entities exempt under Subchapter B of Chapter 171 of the Tax Code;

* Grantor trusts with natural persons or charitable entities as the sole beneficiaries;

* Estates of natural persons;

* Escrows;

* Family limited partnerships that are passive entities;

* Passive investment partnerships -- limited or general partnerships that are "passive entities";

* Trusts with natural persons or charitable entities as the sole beneficiaries that are passive entities;

* Certain real estate investment trusts ("REIT");

* Real estate mortgage investment conduits ("REMIC"); and

* Insurance companies.

Passive Entities. A "passive entity" is not subject to the margin tax, but the tax does apply to several specific entities which are passive entities and meet other criteria. A "passive entity" is defined as a general partnership, a limited partnership or a trust:

(A) with at least 90% of its federal gross income from sources such as dividends, interest, income from a limited liability company, positive distributive shares of partnership income, gains from the sale of real property and securities, royalties, bonuses, or delay rentals from oil and gas interests and income from non-operating working interests; **AND**

(B) with not more than 10% of its federal gross income from an active trade or business, where: (i) the items of income in (A) above are not from an active trade or business, (ii) "active trade or business" is defined in very general terms, and (iii) income from licensing intangibles to affiliates for use in their active trade or business is deemed active to the licensor.

Rental income is active and is not passive. If an entity is the operator of oil and gas wells, the working interest income from those wells is active.

Computation of the Margin Tax.

Starting point:	Total Revenues
Minus:	Either: (a) Cost of Goods Sold, or (b) Total Cash Compensation ($300,000 per person limit) and Employee Benefits (no limit)
Equals	Gross Margin (not to exceed 70% of Total Revenues)
Multiplied by:	Texas Apportionment Factor (Texas Gross Receipts divided by Total Gross Receipts)
Equals:	Taxable Margin
Multiplied by:	1% Tax Rate (0.5% Tax Rate for Wholesalers and Retailers)
Equals:	Tax Payable

Exception for Small Businesses. If Total Revenues for the year are $300,000 or less, or if the margin tax is less than $1,000, no tax is owed for that year but a report must still be filed.

Determining Total Revenues. "Total Revenues" is defined by first including specific line items of income reported by a taxable entity on its federal income tax returns, and then subtracting certain specified items.

(A) **Additions**. Two sets of federal tax return line item entries are includable in income:

(i) one for an entity "treated for federal income tax purpose as a corporation", as reported on IRS Form 1120; and

(ii) the other for an entity "treated for federal income tax purposes as a partnership", as reported on IRS Form 1065.

For other taxable entities, the Comptroller will adopt rules for computing margin "in a manner substantially equivalent" to those definitions.

The specific line items of federal income generally pick up items of gross income before deductions or offsets, although only net income from partnership real property rental activities is included.

(B) **Subtractions**. A taxable entity may subtract, to the extent otherwise included in total revenues, specified items including:

(i) Bad debt if expensed for federal tax purposes, and foreign royalties and dividends;

(ii) Distributive shares of income received by the taxable entity from pass through entities such as partnerships or LLCs, Schedule C deductions, and "items of income attributable to" disregarded entities (in all cases, other than any income from "passive entities");

(iii) "Flow-through" items which must be paid to third parties, including taxes collected and remitted; sales commissions to nonemployees for real estate sales and "sales of products"; and payments to subcontractors for real property surveying, repair, or improvements;

(iv) Dividends and interest from federal obligations, including foreign royalties and dividends, including amounts determined under Section 78 or Sections 951-964 of the Internal Revenue Code;

(v) Principal repayments received by lending institutions;

(vi) The federal tax basis of securities and loans sold (gains from the sale of securities are passive income for purposes of the seller's qualification as a nontaxable passive entity);

(vii) Certain trust fund items and pro bono expenses;

(viii) Reimbursements received by a "management company" for specified costs, including labor costs;

(ix) Certain types of elderly, indigent health care, and workers' compensation, governmental reimbursements and costs of uncompensated care, but limited to the subtraction of 50% of those amounts for "health care institutions" such as hospitals (as opposed to physicians and other "health care providers", who may subtract 100% of those amounts); and

(x) Revenue from small production oil and gas wells during periods of low prices as certified by the Comptroller.

Computation of "Margin". A taxable entity computes its "margin" by subtracting from Total Revenues its choice of either (i) "cost of goods sold" or (ii) "compensation". In either case, the gross margin may not exceed 70% of Total Revenues.

The election between deducting either cost of goods sold or compensation may be changed annually, and the election may be changed after the fact for a given year by filing an amended return. "Goods" means real or tangible personal property sold in the ordinary course of business of a taxable entity. This obviously means that an entity that does not sell goods (such as a law firm or other service business) does not have a choice.

(A) Deduction for Cost of Goods Sold. "Cost of Goods Sold" includes only costs associated with real or tangible personal property (including software and certain films, recordings and books) sold in the ordinary course of business. Tangible personal property does not include sales of services. The statute provides a detailed list of what may be included in Cost of Goods Sold, including up to 4% of administrative and overhead expenses to the extent allocable to the costs of acquiring or producing goods.

(B) Deduction for Compensation. Deductible compensation includes "wages and cash compensation" paid to officers, directors, owners, partners, and employees, but the deduction is capped at $300,000 per person per year (indexed for inflation after January 1, 2009). Deductible "wages and cash compensation" consists of:

(i) Wages and tips reported on Form W-2 for Medicare tax purposes (W-2 wages do not include the employer's share of federal employment taxes).

(ii) Distributive shares of net income to natural persons from partnerships and from LLCs treated as partnerships for federal income tax purposes, as well as distributive shares of net income to natural persons from LLCs and corporations treated as S corporations for federal tax purposes.

(iii) Stock awards and stock options deducted for federal income tax purposes.

(iv) The cost of "all benefits" provided to officers, directors, owners, partners, and employees. "All benefits" is not defined, other than to state that it includes workers' compensation benefits, health care, contributions to employee health savings accounts, and deductible contributions to retirement plans.

No deduction is allowed for "wages and cash compensation" paid to undocumented workers, but the deduction is allowed for the cost of "all benefits" provided to undocumented workers. Special provisions apply to staff leasing companies and management companies.

Combined Reporting. All taxable entities that are part of an "affiliated group" engaged in a "unitary business" must report on a combined basis without regard to the $300,000 floor on revenue.

(A) An "affiliated group" consists of all entities in which a "controlling" 80% or greater interest is owned by a common owner or owners, or by one or more other members of the affiliated group. The 80% test for a corporation applies to "direct or indirect" ownership of total combined voting power of all classes of stock or the "beneficial ownership interest in the voting stock". The 80% test for other entities applies to direct or indirect ownership of "the capital, profits, or beneficial interest" in the entity.

(B) Many states use a "unitary business" method of reporting state income tax. Texas historically has not (although in limited circumstances Texas will consider whether businesses are unitary).

(C) The statute specifies the mechanics for combined group reporting. All combined group members must make a uniform election to deduct either the cost of goods sold or compensation.

Apportionment. The margin tax generally follows the existing Texas franchise tax concepts for apportioning the tax base, i.e., a single factor approach that multiplies the tax base by the ratio of an entity or group's Texas gross receipts to total gross receipts

Tax Rates. The tax rate is 0.5% for entities primarily engaged in a "retail trade" or ""wholesale trade" and for business under Major Group 58 of the 1987 SIC Code (bars and restaurants). The tax rate is 1% for all other taxable entities.

Credits. Certain credits are available to qualifying taxpayers. Taxpayers that have "booked" net operating losses under the existing franchise tax at the end of the taxpayer's 2006 tax year are permitted to take a credit against the margin tax. The temporary NOL credit is calculated by multiplying the taxpayer's apportioned NOLs by the franchise tax rate and then multiplying the sum by 10%. The credit can be taken over a 20 year period.

General Observations.

(A) Margin Tax Applies to Operations in 2007. Although the margin tax becomes effective January 1, 2008, and the first margin tax report for taxable entities on a calendar year will not be due until May 15, 2008, all business plans and projections of calendar year taxable entities must take into account the impact of the margin tax for operations beginning on January 1, 2007.

(B) Form of Entity - Active Trades or Businesses. Active trades or businesses that were organized as limited partnerships or converted to limited partnerships to avoid the franchise tax will now be subject to the margin tax. Those businesses may want to consider converting to a manager-managed limited liability company to eliminate the additional costs attributable to the entities (LLCs or S corporations) that are typically the general partners of limited partnerships.

(C) Form of Entity - Passive Entities. Since "passive entities" are exempt from the margin tax, an entity that will purchase property for investment purposes should consider organizing as a limited partnership. Gain from the sale of real estate is considered "passive income". Assuming at least 90% of the partnership's gross income in the year of sale is "passive", the partnership would

not be subject to the margin tax. Note that corporations and limited liability companies do not qualify as passive entities. The passive entity exemption also suggests that a limited liability company owning investment real estate may want to consider converting to limited partnership form.

(D) Single Member LLCs. An LLC owned by one individual is disregarded for federal tax purposes but is not considered a sole proprietorship for purposes of the margin tax. Therefore, the single member LLC will be subject to the margin tax.

(E) Independent Contractors. It is unclear whether payments to independent contractors (which are reported on IRS Form 1099 and not Form W-2) may be deducted as "wages and cash compensation". If no deduction is allowed for 1099 payments, businesses that use independent contractors for a significant part of their workforce will be at a material disadvantage unless they qualify for the cost of goods sold deduction or are able to deduct commission payments from Total Revenues.

(F) Limited Liability Partnerships. Businesses organized as limited liability partnerships (including professionals such as architects, attorneys, accountants and doctors) were not subject to the franchise tax. The margin tax clearly applies to LLPs with at least one "non-natural" person, but a literal reading of the statute indicates that general partnerships with all natural persons are not subject to the margin tax. Since an LLP is a general partnership with certain statutory protections from liability for its partners, it can be argued that an LLP with all natural persons should not be subject to the margin tax. However, the legislative history of HB3 suggests that the margin tax was intended to apply to LLPs with all natural persons. Clarification is expected in the current session of the Texas Legislature.

(G) Other Businesses. Businesses such as those in the transportation or rental industries which have substantial costs such as interest and deprecation that are not deductible as compensation or cost of goods sold will feel a greater impact under the margin tax than they did under the franchise tax. On the other hand, many oil and gas businesses may qualify as passive entities and therefore be exempt from the margin tax.

(H) Manufacturers, Wholesalers and Retailers. Manufacturers may deduct the cost of goods sold so they may be relatively better off under the margin tax than service businesses. Wholesalers and retailers have the cost of goods sold deduction and a margin tax rate that is 50% of the rate applicable to other taxable entities.

(I) Corrective Legislation and Administrative Guidance. During its current session, the Texas Legislature will consider both substantive changes to the margin tax law as well as technical or clean-up items. The Texas Comptroller of Public Accounts should also be issuing interpretations intended to clarify the new law.

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