Texas Margin Tax Update:  
Key Audit Issues and Planning Opportunities

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The Texas margin tax presents both pitfalls and planning opportunities for most companies. The unusual structure of the margin tax can make predicting the tax implications difficult. The Texas Comptroller is now actively auditing margin tax returns. Some key audit issues have developed that warrant attention for pitfalls and opportunities.

Many companies can benefit from a knowledgeable professional’s careful review of their Texas margin tax filing methodology and related assumptions. Such reviews have led to substantial refunds, and claims are pending for refunds that are even more substantial ($1 million-plus). Even companies that inadvertently underreported taxes can benefit if they limit remedial costs by obtaining waivers of interest and penalties through voluntary disclosures and by making certain adjustments to business activities that may be triggering excessive tax costs.

Understanding the mechanics of the Texas margin tax and how it varies from other states’ business taxes can be crucial to avoid overpaying unnecessary margin taxes. This article provides an overview of the Texas margin tax and addresses some key audit, planning, and refund issues.

MARGIN TAX OVERVIEW

The “margin tax” refers to the current version of the Texas franchise tax that applies to all entities which enjoy the privilege of liability protection. The margin tax applies not only to corporations and LLCs, but also to limited partnerships, limited liability partnerships, professional associations, and business trusts.¹ A business’s tax liability under the margin tax is calculated as the lowest of: (i) 70 percent of total revenue, (ii) total revenue less cost of goods sold (“COGS”), OR (iii) total revenue less compensation; this lowest amount is multiplied by the apportionment factor (Texas sales receipts divided by sales receipts everywhere) and then multiplied by the appropriate tax rate.

¹ Texas Tax Code §§ 171.001(a), 171.0002.
COGS generally includes all direct costs of acquiring or producing goods, certain categories of other costs, and up to 4 percent of indirect and administrative overhead costs, reduced by certain disqualified costs. Compensation generally includes wages and cash compensation, plus certain types of benefits.

The tax rate is 1 percent for all entities except those whose activities are described in wholesale or retail trades, which qualify for a 0.5 percent tax rate. In general, “wholesale trade” is described as selling merchandise to retailers or other businesses to be resold or used. “Retail trade” is described as selling merchandise for personal or household consumption.

The Texas margin tax requires combined reporting for all taxable entities that are: (i) part of an affiliated group; (ii) engaged in a “unitary business”; and (iii) not excluded under the “water’s edge” provision. A “combined group” includes all taxable entities without regard to whether the particular entity has nexus with Texas. The combined group files reports on a combined basis as a single economic unit. Members of the group without nexus individually in Texas exclude their Texas receipts from the numerator of the group’s apportionment factor (i.e., “Joyce” reporting).

**KEY AUDIT ISSUES**

**Cost of Goods Sold**

Many companies have computed cost of goods sold on the basis of amounts included in COGS for federal income tax purposes. In many audits, we have seen the Comptroller review the cost-of-goods-sold calculation and deny federal costs specifically disallowed for margin tax purposes. When faced with this situation, a company should carefully review its general ledger for qualifying costs that are not already included in the federal amount. For example, in certain

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2 Texas Tax Code § 171.1012.

3 Texas Tax Code § 171.1013.

4 Divisions F and G of the 1987 Standard Industrial Classification Manual published by the Office of Management and Budget. A business is considered primarily engaged in retail or wholesale trade if it satisfies three conditions: (1) revenue from the business’s retail or wholesale trade activities is greater than the revenue from its other trade activities (nonretail and nonwholesale activities); (2) less than half of the revenue from its retail or wholesale trade activities results from the sale of products it produces or products produced by an affiliate; and (3) the business does not sell, at retail or wholesale, utilities such as telecommunications, electricity, or gas. Texas Tax Code § 171.002(c). For purposes of the second element, a product is not considered to be produced if modifications made to the acquired product do not increase its sales price by more than 10 percent.

5 Texas Tax Code § 171.002.

6 Texas Tax Code § 171.0001(18).

7 Texas Tax Code § 171.0001(12).

8 Interestingly, unlike most other states, Texas does not have an election related to its “water’s edge” provision.

9 Texas Tax Code § 171.1014.
situations, amounts paid for the use of intellectual property (royalties) are not otherwise included in the federal cost-of-goods-sold amount, but those amounts are generally includable in COGS for margin tax purposes. Similarly, amounts paid for professional services can generally be included in the 4 percent administrative overhead cost-of-goods-sold deduction for margin tax purposes. A practitioner experienced in margin tax issues should be able to review the general ledger and identify additional qualifying costs.

**Joyce Affiliates**

The Comptroller is actively challenging whether affiliates that took a “Joyce” position have nexus with Texas. We have seen some audits in which nexus was asserted against the non-Texas affiliates on the basis of Texas destination sales alone. The affiliate schedules for the Texas margin tax returns identify the no-nexus affiliates. Companies that have taken a Joyce position against Texas should be prepared to document the lack of nexus for the non-Texas affiliates.

**Unitary**

We have seen a variety of instances in which the Comptroller is asserting that every member of the Texas affiliated group must be included in a unitary margin tax return. Relying on the presumption in the Comptroller’s Rule, auditors are taking the position that if an affiliate is greater than 50 percent owned, it is unitary. Companies should keep in mind that the test for determining whether an affiliate is unitary differs from the test for determining affiliation. A given business can be 100 percent affiliated and still not be unitary. Taxpayers taking a “not unitary” position against Texas should be prepared to demonstrate why certain affiliates are not unitary with the other members of the affiliated group.

**Tax Rates and NAICS Codes**

We have seen a variety of instances in which the Comptroller was asserting that a taxpayer did not qualify for the 0.5 percent tax rate on the basis of the NAICS code reported by the taxpayer or the NAICS code recorded by the Comptroller. In many cases, these assertions are based on mistakes and can be corrected. Taxpayers claiming the 0.5 percent tax rate whose reported NAICS code falls outside “retailing” and “wholesaling” should be prepared to explain that discrepancy.

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10 The Texas “Joyce” apportionment methodology, which excludes from the numerator of the apportionment factor receipts of affiliated entities lacking a nexus with Texas, can also lead to less tax owed by combined groups. Under the statute, “[a] combined group shall include in its [Texas] gross receipts . . . the gross receipts of each taxable entity that is a member of the combined group and that has a nexus with this state for the purpose of taxation,” Texas Tax Code § 171.103(b) (emphasis added). The statutes do not define “a nexus,” but in the context of the *Bandag Licensing* decision, it probably means “physical presence” in Texas. *Rylander v. Bandag Licensing Corp.*, 18 S.W.3d 296 (Tex. App.—Austin 2000, pet. denied). A combined group may exclude from the numerator of the group’s apportionment factor receipts from affiliates without “a nexus” or physical presence in Texas, thus reducing the amount of margin apportioned to the state.

11 Comptroller Rule 3.590(b)(6)(B) (“All affiliated entities are presumed to be engaged in a unitary business.”).
Retroactive Change in Cost of Goods Sold / Compensation Election

There have been numerous situations in which the Comptroller refused to allow a company to retroactively change its cost of goods sold or compensation election. For example, companies that originally reported using the standard 70 percent calculation have been prohibited from changing that “election” retroactively to either cost of goods sold or compensation. In June 2012, the Comptroller publicly announced that it had reconsidered that policy and was changing it. Under the revised policy, taxpayers should be allowed to retroactively change the election for all open years.

PLANNING OPPORTUNITIES

Netting Revenue and Expenses

“Total revenue” is computed on the basis of certain enumerated gross revenue lines from federal income tax returns. In some situations, industries or companies have discretion to report a given stream of income at gross and deduct a corresponding expense elsewhere or, instead, to net the revenue against the expense and report the net amount on the federal return. If such net reporting is allowable, it reduces the total revenue flowing into the Texas margin tax return, even if the corresponding expense item is otherwise not deductible.

Take, for example, an airline that sells travel packages consisting of the flight, a hotel room, and a rental car. The airline collects the total amount from the traveler, pays an amount to the hotel for the room and an amount to the rental company for the car, and retains the remainder. If the airline is permitted to report its net retained amount as total revenue on its federal income tax return, the amounts paid to the hotel and the rental company would be excluded from the airline’s margin tax base because those amounts had been netted against total revenue from the customer. Those amounts would not be included in the margin tax base even though they would not qualify for a deduction under the margin tax.

Flow-Through Funds

The statute contains several provisions to address receipts that were commonly referred to as “flow-through” funds when the Texas legislature adopted the margin tax. Under one provision, a taxable entity may deduct from total revenue “flow-through” funds that are mandated by law or fiduciary duty to be distributed to other entities. An example is taxes collected from a third party by the taxable entity and remitted by the taxable entity to a taxing

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13 Texas Tax Code § 171.1011.

14 The terminology “amounts reportable as income” was added as a clarification in House Bill 3928 (2007). The statutory change states that a reference to an “amount reportable as income” on a line number on an IRS form is the amount entered on the line to the extent the amount entered complies with federal income tax law.

15 Texas Tax Code § 171.1011(f).
authority. These amounts may not be excluded, however, if the taxable entity belongs to an affiliated group and the amounts are paid to entities that are members of the affiliated group.\(^{16}\)

While companies can usually determine whether funds are mandated by law to be distributed to other entities, more careful consideration is generally required to evaluate the indicia of a fiduciary duty. Neither the statute nor the related Comptroller Rule defines the term “fiduciary duty” for this purpose. If a company receives significant funds dedicated for payment to a third party, it should consider whether a fiduciary relationship may be developed. Such planning could permit exclusion of these types of funds from the tax base. Obviously, creating a fiduciary relationship has legal implications that should be considered carefully.

Cost of Goods Sold

Taxable margin is computed (in part) by subtracting cost of goods sold.\(^{17}\) COGS includes all direct costs of acquiring or producing the goods.\(^{18}\) A taxable entity is allowed to capitalize costs in the same manner and to the same extent that the taxable entity capitalized that cost on its federal income tax return or, alternatively, to elect to expense qualifying COGS.\(^{19}\) The Comptroller’s Rules provide the administrative details of making that election.\(^{20}\) “Goods” includes “tangible personal property sold in the ordinary course of business.”\(^{21}\) The statutes do not define “sold” or “ordinary course of business,” but other Texas tax provisions may provide helpful guidance.

For most qualifying companies, the largest deduction is COGS. According to the Comptroller, on average COGS equals approximately 82 percent of total revenue, while compensation equals roughly 55 percent. In early revenue estimates, COGS was originally envisioned as equaling about 60 to 65 percent of total revenue. Thousands more businesses claimed the COGS deduction than the Comptroller expected. The COGS deduction is thus fertile ground for questions regarding who and what qualify for this valuable deduction. Here are some examples.

Do Lessors Qualify for COGS?

Arguably, companies leasing tangible personal property or real property (both “goods” under the statute) qualify for the COGS deduction. Such companies would then be entitled to

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\(^{16}\) Texas Tax Code § 171.1011(h).


\(^{18}\) Texas Tax Code § 171.1012(c).

\(^{19}\) Texas Tax Code § 171.1012(g).

\(^{20}\) According to the regulations, the election is made by using one method or the other on the taxpayer’s returns. The election is for the entire period on which the report is based and may not be changed after the due date. If an entity elects to expense costs, costs incurred before the first day of the period on which the report is based cannot be included in the cost-of-goods-sold deduction. Texas Comptroller Rule 3.588(c).

\(^{21}\) Texas Tax Code § 171.1012(a)(1) (emphasis added).
deduct a portion of the acquisition cost of the property ratably over the life of the property, either through depreciation or by deducting a portion of the total cost against each rental payment.

Owning property means having a bundle of rights over something, such as the rights of acquisition, dominion, possession, use and enjoyment, exclusion, disposition, and access.22 In its ordinary legal sense, “the word ‘property’ extends to every species of valuable right and interest.”23 The term “property” includes not only the thing owned, but every right that accompanies ownership and is an incident thereto.24 A “sale” of property, in turn, means any transfer of property from one to another for a valuable consideration or a transfer of something (and title to it) in return for money (or other thing of value) on terms agreed upon between buyer and seller.25 Thus, “sale” means any of the following when done or performed for consideration: a transfer of title or possession of tangible personal property, as well as the exchange, barter, lease, or rental of tangible personal property.26

Each time a company agrees to “rent” property for a particular period in exchange for consideration, the lessor has sold the exclusive right to possess and use the property for that certain period. That is an absolute transfer of title to those rights during that applicable period. The lessee has those exclusive rights even as against the lessor. The cost associated with each sale is by statute expressly allowed to be deducted in computing the margin tax. The Tax Code allows for the recovery of those costs either through periodic depreciation deductions or through deducting a portion of the total cost that is attributable to that sale. Lessors are thus arguably entitled to deduct an applicable portion of the cost of the property over the life of the property.

**What Expenses Are Deductible as Direct Costs?**

Direct costs are the primary component of COGS. While the statute lists examples of direct costs, it does not define, or provide a reference point to determine, “direct costs.”27 The Texas Comptroller of Public Accounts adopted a series of administrative rules interpreting the reformed franchise tax. The applicable Comptroller Rule on Margin: Cost of Goods Sold (34 Tex. Admin. Code 3.588) largely echoes the statutory discussion of “direct costs” but does not define it. The other publicly available guidance from the Comptroller’s Office similarly does not define “direct cost.” From informal conversations with both a senior Comptroller franchise tax auditor and a Comptroller Assistant General Counsel responsible for administrative hearings, we understand that the Comptroller’s Office has not adopted a particular definition of “direct cost” for its internal use. In many seminars on the reformed franchise tax throughout the State of Texas,

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22 73 C.J.S. Property § 2.


25 *See, e.g.*, *McKinney v. City of Abilene*, 250 S.W.2d 924 (Tex. Civ. App.—Eastland 1952, writ ref’d n.r.e.).

26 Texas Tax Code § 151.005.

27 “The cost of goods sold includes all direct costs of acquiring or producing the goods, including . . . .” Texas Tax Code § 171.1012(c) (emphasis added).
taxpayers have repeatedly asked for the definition or meaning of “direct cost.” The answer has always been that there is none, leaving both taxpayers and Comptroller personnel to guess at a meaning.28

There are a number of supportable definitions of “direct cost” that would encompass categories beyond those enumerated in the statute. Many definitions of “direct cost” in turn include examples of qualifying costs, including costs that should qualify for the deduction but are not specifically listed in the margin tax statute. For example, under the Federal Financial Accounting Standards, “direct costs” are those “costs that can be specifically identified with an output.”29 Examples of direct costs are listed, including:

- salaries and other benefits for employees who work directly on the output,
- materials and supplies used in the work; various costs associated with office space, equipment, facilities, and utilities that are used exclusively to produce the output;
- costs of goods or services received from other segments or entities that are used to produce the output.30

Certain types of overhead costs that specifically relate to particular products may qualify as direct costs and be deductible without regard to the normal 4 percent cap on overhead items. For example, Black’s Law Dictionary defines “direct cost” as “the amount of money for material, labor, and overhead to produce a product.”31 Webster’s Dictionary defines “direct cost” as “a cost that may be computed and identified directly with a product, function, or activity and that usually involves expenditures for raw materials and direct labor and sometimes specific and identifiable items of overhead.”32 Various definitions and methodologies employed in cost accounting also identify certain overhead costs as “direct costs.”

Federal concepts of “direct cost” in the context of contracting with the federal government are also useful. In the Code of Federal Regulations, the phrase “direct costs of processing operations” includes, but is not limited to, “[a]ll actual labor costs involved in the growth, production, manufacture, or assembly of the specific merchandise, including fringe benefits, on-the-job training, and the cost of engineering, supervisory, quality control, and

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28 However, on an ad hoc basis, the Comptroller has adopted some fairly narrow views of what constitutes a “direct cost”: STAR 201108182L (Aug. 2011) (“Direct labor costs for cost of goods sold only include the labor of those that physically produce a good or that acquire a good. In the construction industry, direct labor will include only the labor of those individuals that make a physical change to the real property. Supervisory labor, therefore, does not qualify as a direct cost.”).

29 Statement of Fed. Fin. Accounting Standards No. 4, ¶ 90 (emphasis added).

30 Id.

31 BLACK’S LAW DICTIONARY 389 (9th ed. 2009) (emphasis added).

similar personnel; [and] dies, molds, tooling, and depreciation on machinery and equipment which are allocable to the specific merchandise.”33 The CFR definition excludes:

costs which are not directly attributable to the merchandise concerned or are not costs of manufacturing the product, such as (i) profit, and (ii) general expense of doing business which are either not allocable to the specific merchandise or are not related to the growth, production, manufacture, or assembly of the merchandise, such as administrative salaries, casualty and liability insurance, advertising, interest, and salesmen’s salaries, commissions or expenses.34

Another approach would look to the statute’s negative inference from the definition of the term “indirect.” The statute specifically lists things that are “indirect and administrative overhead costs,” like “mixed service costs, such as security services, legal services, data processing services, accounting services, personnel operations, and general financial planning and financial management costs.”35 Under this approach, costs allocable to acquiring or producing goods other than the “indirect” costs specifically listed in the statute would qualify as direct costs. Some definitions of “direct cost” would support this reading, such as Kohler’s Dictionary for Accountants, which defines “direct cost” as “the cost of any good or service that contributes to and is readily ascribable to product or service output, any other cost incurred being regarded as an indirect cost.”36

Which Costs Are Disallowed Costs?

Companies should also avoid reading the list of specifically disallowed costs too broadly. Costs that might, on first glance, seem to be disallowed may not be. For example, the statute disallows “distribution costs, including outbound transportation costs.”37 Costs associated with moving products from one facility to another are transportation costs, but they may not be “outbound” transportation costs that constitute “distribution” costs. Take, for example, a company buying products from wholesalers, initially shipping the products to one distribution center and then shipping the products to a larger, regional distribution center. Arguably, no portion of such transportation cost should be disallowed because the transportation is not outbound “distribution” costs. Other similar situations exist that can minimize amounts treated as disallowed costs.

With regard to the 4 percent cap on the COGS deduction for “indirect and administrative overhead costs,” for example, companies should carefully review their cost categories for “indirect and administrative overhead costs” that are not on the enumerated list. The statute lists

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34 Id.

35 Texas Tax Code § 171.1012(f).


37 Texas Tax Code § 171.1012(e)(3).
examples of qualifying costs, \(^{38}\) but it does not purport to be exhaustive. Other costs may qualify for the deduction even though they are not specifically listed.

**Maximizing the Lower 0.5 Percent Tax Rate**

Thousands of companies beyond what the Comptroller expected have claimed the 0.5 percent tax rate. While the Comptroller certainly has arguments for resisting a broad reading of the applicable statute, a careful reading suggests some planning opportunities.

The Texas Tax Code provides for the following margin tax rates:

(a) Subject to Sections 171.003 and 171.1016 and except as provided by Subsection (b), the rate of the franchise tax is one percent of taxable margin.

(b) Subject to Sections 171.003 and 171.1016, the rate of the franchise tax is 0.5 percent of taxable margin for those taxable entities primarily engaged in retail or wholesale trade.

(c) A taxable entity is primarily engaged in retail or wholesale trade only if:

1. the total revenue from its activities in retail or wholesale trade is greater than the total revenue from its activities in trades other than the retail and wholesale trades;

2. except as provided by Subsection (c-1), less than 50 percent of the total revenue from activities in retail or wholesale trade comes from the sale of products it produces or products produced by an entity that is part of an affiliated group to which the taxable entity also belongs; and

3. the taxable entity does not provide retail or wholesale utilities, including telecommunications services, electricity, or gas.

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\(^{38}\) The statute provides that “[a] taxable entity may subtract as a cost of goods sold indirect or administrative overhead costs, including all mixed service costs, such as security services, legal services, data processing services, accounting services, personnel operations, and general financial planning and management costs, that it can demonstrate are allocable to the acquisition or production of goods, except that the amount subtracted may not exceed four percent of the taxable entity’s total indirect or administrative overhead costs, including all mixed service costs. Any costs excluded under Subsection (e) may not be subtracted under this subsection.” Texas Tax Code § 171.1012(f).
(c-1) Subsection (c)(2) does not apply to total revenue from activities in a retail trade described by Major Group 58 of the Standard Industrial Classification Manual published by the federal Office of Management and Budget.39

“Retail trade” means “the activities described in Division G of the 1987 Standard Industrial Classification [SIC] Manual published by the federal Office of Management and Budget.”40

The Texas Tax Reform Commission (the group appointed by Governor Perry to reform business taxes in Texas) issued the following analysis of the 0.5 percent tax rate:

*Rate and Computation of Tax:* In addition to increasing the number of businesses subject to the tax, the underlying base is changed to “total revenues minus certain deductions” rather than net income or net worth (capital.) As a result, the primary tax rate is lowered from 4.5% to 1%. However, taxable *entities primarily engaged in retail or wholesale trade would pay a reduced rate of 0.5%, in recognition of the low profit margins basic to the industry.* A taxable entity is primarily engaged in retail or wholesale trade if the total revenue from these activities is greater than the total revenue from other activities. As [a] second test, a taxable entity that predominantly sells or resells products it or a member of the affiliated group produces does not qualify for the reduced rate.

Retail or wholesale utilities, including telecommunications services, electricity, or gas also do not qualify for the reduced rate.41

These provisions indicate that some businesses which might not normally be considered retailers or wholesalers may qualify as entities “primarily engaged in retail or wholesale trade” under the statute and intent of the drafters. Many businesses may be described in multiple divisions of the 1987 SIC Manual. Just because a business is also described in a division besides Division G does not exclude the business from qualification under Division G of the SIC Manual. As the following examples indicate, careful parsing of the text of the statutes may indicate that the lower 0.5 percent rate is allowable.

**Renting Tangible Personal Property**

The intent of the drafters of the margin tax was not to distinguish between retail sellers and retail renters. The intent of the drafters was to afford a lower tax rate to companies in a retail

39 Texas Tax Code § 171.002 (emphasis added).
40 Texas Tax Code § 171.0001(13).
or wholesale trade because of lower profit margins within that industry as opposed to manufacturing.

Division G of the 1987 SIC Manual encompasses the following companies:

This division includes establishments engaged in selling *merchandise for personal or household consumption* and rendering services incidental to the sale of the goods. In general, retail establishments are classified by kind of business according to the principal lines of commodities sold (groceries, hardware, etc.), or the usual trade designation (drug store, cigar store, etc.). Some of the important characteristics of retail trade establishments are: the establishment is usually a place of business and is engaged in activities to attract the general public to buy; the establishment buys or receives merchandise as well as sells; the establishment may process its products, but such processing is incidental or subordinate to selling; the establishment is considered as retail in the trade; and the establishment sells to customers for personal or household use. Not all of these characteristics need be present and some are modified by trade practice.

Nothing in the Texas margin tax statutes directly excludes renting from qualifying as “retail trade.”

*Not Excluded by Subcategories Outside Retail and Wholesale Trade*

An entity whose activities meet the broad definitions of “retailer” and “wholesaler” should not be excluded from the 0.5 percent rate merely because its activities are also described in a subcategory under a different division.

For example, unlike Division G, which classifies retailers, Division I (Services) includes “establishments primarily engaged in providing a wide variety of services for individuals, business and government establishments, and other organizations.” Division I, Industry Group 7359 (Equipment Rental and Leasing, Not Elsewhere Classified), however, includes “establishments primarily engaged in renting or leasing (except finance leasing) equipment, not elsewhere classified.” An entity renting consumer goods thus might be described in Industry Group 7359 under Division I and may not seem to qualify for the 0.5 percent rate. However, the statute incorporates Division G, which does include selling goods to consumers, but does not incorporate subcategories under other divisions, like Division I, Industry Group 7359. At least arguably, then, a consumer rental company qualifies for the 0.5 percent rate because its activities are described in Division G, notwithstanding the fact that its activities are also described within a subcategory under Division I.

*Very Limited Nonclassifiable Entities*

It is very rare for an entity to fail to qualify for the 0.5 percent rate because it is classified in the “nonclassifiable” category. The SIC Manual provides that an entity may be treated as “nonclassifiable” only if it “cannot be classified in any other industry. Establishments which can
be classified in a division should be classified in the most appropriate industry within that division.” The default, then, is that a business should be classified within Divisions A–J (if possible), after which it should be assigned to the closest possible industry fit within that division.

**Apportionment**

The Texas apportionment rules largely remained the same in transitioning to the margin tax. The unique Texas apportionment rules, such as the “location of payor” rule for certain types of intangibles and the “location of performance” rule for sourcing services, take an even more important planning role under the margin tax. Certain features of the margin tax, such as passive entities and apportionment of revenue streams flowing up from those entities, lend themselves to careful planning.

**Election of Entities Affiliated With Two Unitary Groups**

The Texas margin tax requires combined reporting for all taxable entities that are: (1) part of an affiliated group; (2) engaged in a “unitary business”; and (3) not excluded under the “water’s edge” provision. A “combined group” includes all such taxable entities without regard to whether the particular entity has a nexus with Texas. The combined group files reports on a combined basis as a single economic unit.\(^42\)

For purposes of defining the members of the combined group, the “affiliated group” includes one or more entities in which a controlling interest is owned by a common owner or owners, either corporate or noncorporate, or by one or more of the member entities. A “controlling interest” is defined as follows:

\begin{enumerate}
\item for a corporation: more than 50 percent of the direct or indirect ownership of the total combined voting power of all classes of stock of the corporation, or of the beneficial ownership interest in the voting stock of the corporation; and
\item for a partnership, association, trust, or other entity: more than 50 percent of the direct or indirect ownership of the capital, profits, or beneficial interest in the partnership, association, trust, or other entity.\(^43\)
\end{enumerate}

Under the Comptroller’s Rule:

[i]f the entity has a unitary relationship with more than one of those affiliated groups, it shall elect to be treated as a member of only one group. The election shall remain in effect until the unitary

\(^{42}\) Texas Tax Code § 171.1014.

\(^{43}\) Texas Tax Code §§ 171.0001(1) and (8).
business relationship between the entity and the other members ceases, or unless revoked with approval of the comptroller.44

There are situations in which this election can significantly reduce the Texas margin tax liability of one or more affiliates.

**Unitary Analysis**

Members of an affiliated group are required to file a combined report only if the members also engage in a unitary business. A “unitary business” means a single economic enterprise made up of separate parts of a single entity or of a commonly controlled group of entities that are sufficiently interdependent, integrated, and interrelated through their activities so as to provide a synergy and mutual benefit that produces a sharing or exchange of value among them and a significant flow of value to the separate parts.45

The U.S. Supreme Court has ruled that the U.S. Constitution prohibits a state from taxing income earned in another state unless the income is earned as part of a unitary business conducted within the taxing state. A state may not tax a nondomiciliary entity’s income, however, if that income is derived from an unrelated business activity constituting a discrete business enterprise.46

The U.S. Supreme Court derived the “unitary” business principle from a series of property tax cases in the late 19th century involving multistate railroad companies. The underlying issue was how to determine and apportion the value of the road and related assets among the states. Rather than viewing the portion of the road located in a particular jurisdiction in isolation and attempting to value that portion separately, the Court sanctioned viewing the road “as a unit” and allowed the jurisdictions to “ascertain the value of the whole road, and apportion the value within the county by its relative length to the whole.”47 The Court subsequently expanded the concept of a “unit rule” beyond cases in which there was a contiguous physical unity (e.g., a railroad) to cases in which there was operational unity.

For a business to be unitary, “the out-of-state activities of the purported ‘unitary business’ must be related in some concrete way to the in-state activities”—i.e., there must be “some sharing or exchange of value not capable of precise identification—beyond the mere flow of funds arising out of a passive investment or a distinct business operation.”48 The U.S. Supreme

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44 Comptroller Rule 3.590(b)(4)(F).
45 Texas Tax Code § 171.0001(17). The Texas definition was essentially copied from the Multistate Tax Commission’s definition. The interpretations of the MTC’s definition may thus be relevant in interpreting the Texas definition.
47 **State Railroad Tax Cases**, 92 U.S. 575, 608 (1875); see also Hellerstein & Hellerstein, **STATE TAXATION** ¶ 8.07[1].
48 **Container Corp. of Am. v. Franchise Tax Bd.**, 463 U.S. 159, 166 (1983).
Court in *Allied-Signal* identified the following factors as relevant in determining whether an entity’s activities are part of a unitary business:

- Functional integration (e.g., transactions not at arm’s length).
- Centralization of management (e.g., parent management grounded in its operational expertise and operational strategy).
- Economies of scale (e.g., same line of business).

Determining whether a unitary business exists is a facts-and-circumstances test. Specific facts the Court has looked to in determining whether a unitary business exists include the following:

- Substantial intercompany transactions (e.g., subsidiary selling exclusively to parent).
- Overlapping officers and directors.
- Centralized site selection, advertising, and accounting control.
- Centralized purchasing, manufacturing, or warehousing.
- Independent or joint financing.
- Centralized training.

Exercise of actual control of a subsidiary, as distinguished from the legal right to control the company, is a prerequisite of a unitary business relationship. States are free to take a more restrictive view of what constitutes a “unitary business” than the view of the U.S. Supreme Court. They cannot, however, take a more expansive view of what constitutes a unitary business.

Carefully defining the unitary group can lead to significant margin tax benefits. If some affiliates are engaged in two unitary groups, one group could elect the COGS deduction while the other group could elect to deduct compensation. Certain benefits associated with apportionment planning can be magnified with two or more unitary groups. Costs incurred by an affiliate (in one unitary group) to produce and sell goods to another affiliate (in a different unitary group) may qualify for the COGS deduction even if the costs would not otherwise qualify. The other examples of planning in the context of two or more unitary groups are quite numerous.

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49 See *Allied-Signal*, 504 U.S. at 770 (sufficient ownership for “potential control is insufficient”).

50 Assume, for example, that: (i) Company A is a member of Unitary Group A that lacks nexus with Texas (or Company A, while unitary with affiliated Company B, qualifies as a foreign entity on the basis of the 80 percent threshold in the water’s edge provision); (ii) affiliated Company B is a member of Unitary Group B that has nexus in Texas; and (iii) Company A sells its goods to Company B, which in turn sells the goods to a third party in Texas. Generally, the arm’s length price that Company A would charge Company B would exceed the value of direct and indirect costs of producing the goods, by incorporating a profit margin. Company B’s COGS deduction thus could incorporate costs not permitted as a deduction by Company A. The intercompany payment would not be eliminated in this context because Company A and Company B are not in the same Texas combined group. See, e.g., Texas Tax Code § 171.1012(l).
Conclusion

As with any new, somewhat complicated tax, the Texas margin tax contains a number of gray areas ripe for audit adjustments and tax planning. In the right situation, a careful review can prevent millions in assessments and/or generate millions in refunds or tax reductions.