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Gross Receipts Tax

Responding to a court order that would have halted school funding because of an unconstitutional property tax, Texas in May enacted a sweeping tax-reform package that replaces the state's franchise tax with a form of gross receipts tax. The new 'margin' tax represents an effort to broaden the state tax base and lower the tax rate, but many businesses can expect to see their taxes go up under the new system. In this analysis, authors Charolette Noel and Karen H. Currie take a closer look at the margin tax and analyze potential complexities for taxpayers.

Texas Replaces Franchise Tax With 'Margin Tax' in Bid To Broaden Base, But Questions Linger for Taxpayers

By Charolette Noel and Karen H. Currie

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After years of trying to close a perceived ''loophole'' exempting limited partnerships from the Texas franchise tax, the Texas Legislature finally enacted new legislation this past May. But the new legislation does not only expand Texas' tax to limited partnerships—it completely changes the Texas franchise tax as we know it.

Responding to a court order that would have halted school funding from the unconstitutional property tax, the Texas Legislature generally accepted a broad tax reform proposal recommended by a bipartisan commission appointed by Republican Governor Rick Perry and led by Democrat and former Texas Comptroller John

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Sharp. To raise revenue and reduce property taxes, the Texas franchise tax was amended to:

- cover all entities with limited liability or owned in part by a non-natural person (unless specifically excluded), and
- limit the available deductions to either cost of goods sold or compensation.

The new franchise tax (known as the ''margin tax'') further broadens the tax base by shifting from separate entity reporting to unitary combined reporting, but imposes the tax at a lower rate. Most businesses will pay at the general rate of 1 percent of taxable margin, while certain retail or wholesale businesses will receive a reduced rate of 0.5 percent. Although the tax effect of the margin tax depends on your particular business, many companies (not just limited partnerships) should expect to see a tax increase.

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Several issues that have arisen with respect to the new margin tax remain unresolved. The basic framework passed by the Legislature will be refined with regulations and further legislation. Legislative technical corrections were proposed but not passed before the short session ended. Although we cannot predict the future, this article describes the basic components of the margin tax and analyzes some of the unresolved issues confronting entities doing business in Texas.

Expanded Definition of 'Taxable Entity'

The Legislature expanded the definition of a ''taxable entity'' to include partnerships, business trusts, professional associations, business associations, joint ventures, joint stock companies, holding companies, and all other legal entities not specifically excluded. Excluded from the definition of ''taxable entity'' are sole proprietorships, general partnerships in which all partners are natural persons, grantor trusts in which all beneficiaries are natural persons or charitable organizations, real estate investment trusts (REITS) that do not directly own real estate, real estate mortgage investment conduits (REMICs), and passive entities. A ''passive entity'' is defined as a general or limited partnership or trust (other than a business trust) that earns at least 90 percent of its income from investments, excluding rent, and no more than 10 percent of its income is from an active trade or business.

Exclusions from the definition of ''taxable entity'' raise several issues for companies doing business in Texas. One such exclusion is for a general partnership ''the direct ownership of which is entirely composed of natural persons.'' This provision on its face seems fairly straightforward, but a partnership wholly owned by natural persons will likely be faced with uncertainty upon the death of a partner. If the partner's interest becomes part of an estate or trust, it is unlikely that the estate or trust would be considered a ''natural person'' under the common meaning of the term. If an estate or trust receives a K-1 from the partnership as a partner, even temporarily, the general partnership may arguably lose its exempt status. The same issue arises regarding the exemption for grantor trusts whose sole beneficiaries are natural persons or charitable entities.

The exclusions from the definition of ''taxable entity'' raise several issues for companies doing business in Texas.

In some situations, a statutory exclusion from the definition of ''taxable entity'' may be somewhat misleading because income earned from the excluded entity remains in the tax base. For example, a ''passive entity'' is expressly excluded from the definition of a taxable entity for purposes of the new margin tax. Although this may seem a significant benefit to such ''passive'' businesses, upon close review the exclusion may be nonexistent for many companies.

The definition of a passive entity is limited solely to flow-through entities (*i.e.*, general or limited partnerships or trusts). An owner of a passive entity is required to include the passive entity's flow-through income in the owner's calculation of the Texas margin tax. Thus, to the extent the owner is a taxable entity, the passive entity's income may be merely shifted from one member of a combined group to another.

Similarly, although REITs are listed as excluded entities, the exclusion is very limited. The statute provides that a REIT is excluded *unless* the REIT has any direct holdings in real estate other than real estate that it occupies for business purposes. Under this provision, most common types of REITs (*i.e.*, those that hold real estate) will in fact be taxable entities in Texas. Only REITs that hold some other type of property (*e.g.*, an interest in a partnership that holds real estate) would be excluded. Furthermore, although a REIT that holds an interest in a limited partnership is not a taxable entity, the limited partnership itself is a taxable entity. Thus, many REITs may find no benefit to the statutory exclusion.

Another complicating issue for determining the appropriate ''taxable entity'' involves the federal entity classification rules (known as the ''check-the-box'' rules). Prior to enacting the margin tax, Texas clearly departed from the federal entity classification rules. Texas previously adopted the Internal Revenue Code in effect in 1996 (prior to the federal adoption of ''check-the-box'' rules). In addition, Texas law imposed the franchise tax based on state law status, not federal income tax status (*e.g.*, Texas taxed all limited liability companies, including those disregarded for federal income tax purposes).

The new margin tax incorporates the I.R.C. effective on Jan. 1, 2006, which adopts the ''check-the-box'' rules. While this change may imply that Texas has adopted the federal entity classification rules, it likely is of little consequence in determining the status of taxable entities because Texas continues to tax specific entities that are not taxable under federal law.

Tax Based on Total Revenue

The legislation provides that an entity's gross margin is based on the lesser of

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- 70 percent of the taxable entity's total revenue, or
- the entity's total revenue with a deduction for either cost of goods sold or compensation.

Total revenue is based on gross receipts per the federal return including dividends, interest, gross rents and royalties, capital gain net income, net gain from Form 4797, and other income. A deduction is allowed for bad debts, foreign royalties and dividends, dividends and interest from federal obligations, net distributive income from partnerships, trusts and LLCs, and certain funds received in trust.

Including specific line items from the federal return in total revenue has led to interesting discrepancies in application. For example, the margin tax calculation of total revenue for a partnership incorporates a specific reference to line 2 of Schedule K, which includes *net* rental income (loss), instead of *gross* rental income. Accordingly, a partnership that receives rental income from real estate may be taxed on its *net* income, while corporations and other entities that own rental real estate are generally taxed on *gross* rental income. This distinction appears to be a drafting error. The 79th Legislature proposed to fix the error in the technical corrections bill that had not passed when the session ended. A House Resolution was issued instructing the 80th Legislature to fix the error.

Another complicating issue for determining the appropriate "taxable entity" involves the federal entity classification rules.

Businesses should review the definition of total revenue carefully because there are numerous irregularities in how the general rules are applied to specific industries. Many industry-specific exceptions relate to service industries that typically are limited to the compensation deduction. For example, certain health care providers are entitled to exclude from total revenue payments received under Medicaid, Medicare, the Indigent Health Care and Treatment Act, Children's Health Insurance programs, and certain payments for services provided in relation to workers' compensation claims. Similarly, an entity that provides legal services is allowed to exclude certain reimbursements of expenses that are not operating expenses and up to $500 of expenses relating to pro bono work.

An entity that qualifies as a "staff leasing services company" is allowed to exclude from total revenue any payments received from a client for wages, payroll taxes on wages, employee benefits, and workers' compensation benefits. To avoid a double benefit, the staff leasing services company may not deduct as compensation the amounts associated with assigned employees. Presumably the purpose of this provision is to appropriately allocate deductions to the company for whom the employee is performing the service. This provision has a narrow application, however, because the term "staff leasing services company" is narrowly defined to include only those companies that are licensed to provide such services pursuant to the Texas Labor Code.

A similar reallocation of the compensation deduction applies for a "management company," which is broadly defined to include any company conducting part of an active trade or business of another entity in exchange for a management fee. Management companies are entitled to exclude from total revenue the reimbursement of specified costs incurred in conducting the active trade or business of a managed entity. The management company may not, however, deduct the reimbursed wages and cash compensation as its compensation.

Alternative Cost of Goods Sold Deduction

Cost of goods sold (COGS) for purposes of the margin tax includes all direct costs associated with the acquisition or production of goods, including costs for labor, materials, handling costs (*i.e.*, processing, assembling, repackaging, and inbound transportation), storage costs, equipment leasing, depreciation, depletion, amortization, research costs, design, equipment maintenance, geological exploration costs, production taxes and electricity costs. Other items deductible as COGS include deterioration, obsolescence, spoilage and abandonment, insurance related costs, utility costs, quality control, licensing and franchise costs. Excluded from COGS are costs for equipment not used in the production of goods, selling costs, advertising costs, distribution costs, interest and financing costs, officers compensation, compensation paid to an undocumented worker, and income taxes.

A "good" is defined as real or tangible personal property sold in the ordinary course of business. Accordingly, only companies engaged in the business of selling real or tangible personal property are entitled to a deduction for COGS. Pure service businesses, regardless of the extent to which they rely on capital, will be limited to the compensation deduction or, if compensation is insufficient, 70 percent of total revenue. Companies that sell both tangible personal property and services may be faced with the challenge of trying to allocate costs to the acquisition or production of goods rather than services.

The distinction between a "direct" and "indirect" cost is controversial. Although "direct" costs are specifically enumerated in the text of the statute, the breadth of deductible costs is often unclear. For example, research and design costs that are "directly related to the production of the goods" are deductible. A strict reading of this statute implies that the deduction for research and design should be limited to the costs attributable to goods that are in fact sold. Thus, taxpayers arguably may be unable to deduct research and design costs attributed to goods that never reach the market.

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Another controversial provision involves the deduction of up to 4 percent of administrative and overhead expenses *allocable to the acquisition or production of goods*. It may be difficult for a taxpayer to determine whether a specific overhead cost is attributed to the acquisition or production of goods. In light of the 4 percent cap, many taxpayers may simply take the 4 percent deduction based on the assumption that the administrative costs *allocable to the acquisition or production of goods* will be greater than the cap.

Alternative Employee Compensation Deduction

Compensation includes:

- wages and cash compensation provided to officers, directors, partners, owners, and employees not exceeding $300,000 for any single person; and
- the cost of all benefits, including workers compensation, health care, and retirement benefits.

''Wages and cash compensation'' is specifically defined as the amount entered in the Medicare wages and tips box of IRS Form W-2.

One difficulty with the compensation deduction is the $300,000 cap on wages that can be deducted for an individual employee or owner. Note, however, that the $300,000 cap applies only to ''wages and cash compensation.'' There is no cap on the deduction for benefits. Thus, there may be an incentive for some companies to shift compensation for highly-paid employees from cash compensation to other non-cash benefits to increase their compensation deduction where possible.

Another limiting factor of the compensation deduction is that it applies only to wages paid to an employee, not an independent contractor. The definition of ''wages and cash compensation'' is specifically limited to the amount entered on Form W-2. Amounts paid to independent contractors are reported on Form 1099. Thus, the deduction may be particularly limited for companies that employ primarily highly-paid individuals (greater than $300,000) *and* independent contractors.

Combined Return Requirement

Taxable entities that are part of an affiliated group engaged in a unitary business are required to file a combined report as a single taxable entity for purposes of reporting the margin tax. A taxable entity is included in the combined group *regardless of whether the entity has nexus with Texas*. In some respects, the Texas unitary combined group is broader than in other states (*i.e.*, includes most partnerships, LLCs and business trusts). In other respects, the Texas unitary combined group is narrower than in other states because the Texas combined group is limited to entities with 80 percent or more common ownership.

The 80 percent ownership requirement may be beneficial to joint ventures or other co-owned entities hoping to sever unity. This benefit may not last long. The technical corrections bill introduced but not passed during the 79th legislative session proposed to change the 80 percent ownership requirement to a broader 50 percent ownership requirement consistent with many other unitary states (*e.g.*, California).

Texas has also incorporated a water's-edge requirement, excluding from a unitary group any entity with 80 percent or more of its property and payroll outside the United States. In some states, a foreign subsidiary of a U.S. parent may break unity so that lower-tier U.S. entities owned by the foreign subsidiary are excluded from the U.S. parent's unitary group. Foreign companies are not likely to break unity among U.S. entities under Texas law. The foreign exclusion applies only to the companies whose property and payroll is outside the United States; all other commonly owned subsidiaries should be included.

Apportionment

The new margin tax retains Texas' apportionment based on a single-factor, receipts. The sourcing rules generally remain unchanged, except that the throwback rule has been repealed.

For a combined group, Texas has adopted the ''Joyce'' rule, which includes only receipts of entities having nexus with Texas in the numerator of the apportionment calculation. All receipts are included in the denominator of the apportionment calculation, regardless of nexus. The ''Joyce'' rule is another provision that may not last. The technical corrections bill that was introduced but not passed before the session ended included a proposed amendment to the apportionment calculation to include Texas receipts of all companies, regardless of nexus.

Conclusion

The gross margin tax applies to reports originally due on or after Jan. 1, 2008. The first regular return will be due May 15, 2008, based on the 2007 tax year. Some fiscal year-end taxpayers are already feeling the impact to the new margin tax. Receipts from activities as early as June 1, 2006, may be included in the 2007 return of a fiscal year-end taxpayer. Taxpayers should analyze the effect on their businesses now. Many companies will need to account for a tax increase as a result of the new legislation. Others may see a decrease in tax, particularly taking into account the property tax reduction.

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