

THE NEW TEXAS MARGIN TAX

An Introduction

Starting in 2007 most entities doing business in Texas will be subject to a new margin tax which largely replaces the old franchise tax. The first return will be due May 15, 2008. Existing franchise taxpayers must have elected by March 1, 2007 whether to carry over any existing net operating losses. Each year 10% of net operating losses which are carried over may be applied against the company's margin tax until the net operating losses are exhausted or until 2026, whichever comes first.

Unlike the old franchise tax, the margin tax is imposed not only on corporations but also on partnerships, limited liability companies, business trusts (such as Massachusetts business trusts), professional associations, joint ventures and other legal entities with a minimum "gross annual income" of \$300,000.

Exempt entities currently are general partnerships composed entirely of natural persons, sole proprietorships, grantor trusts, estates, passive family limited partnerships and other passive entities, escrow accounts, REITs and REMICs. "Passive" income does not include rents or working interests. For general partnerships, limited partnerships and trusts, income is considered "passive" is 90% of the gross income comes from such traditional passive sources as dividends, interest, partnership allocations, capital gains and royalties.

The tax rate is set at 1% (unless a public referendum increases it) but at 0.5% for certain business which have long operated on thin margins. These are the retail, lumber, grocery, apparel, furniture, home furnishings, wine and beer and restaurant businesses; computer and paper businesses; petroleum, chemical, construction materials and professional equipment sellers; and wholesale automobile dealers.

Businesses taxed as corporations and businesses taxed as partnerships (including limited liability companies and S corporations which elect to be taxed as partnerships) are required to calculate their "gross annual income" differently.

Corporations are required to add to their "gross receipts or sales" on line 1c of Internal Revenue Service Form 1120 (the IRS corporate income tax return form) their dividends, interest, gross rents, gross royalties, net capital gains and other income. These appear on lines 4 through 8 of Form 1120. They must then subtract bad debt, foreign income, partnership income and dividends received from subsidiaries.

Partnerships and businesses taxed as partnerships are required to add to their "gross receipts or sales" on line 1c of Internal Revenue Service Form 1065 (the IRS partnership income tax return form) their interest, dividends, royalties, guaranteed payments, net capital gain, net real estate rental income (which the Texas legislature may change to gross real estate rental income) and other net income. They must then subtract bad debt, foreign income and partnership allocations.

Certain exclusions are available. These include monies received as a fiduciary such as a trustee and monies passed through to others. Examples of the latter are sales commissions to non-

employees and payments by a general contractor to a subcontractor. There are also special exclusions for healthcare providers and healthcare institutions.

The Texas state constitution prohibits a gross receipts tax. The new margin tax is not a gross receipts tax because it allows businesses to take one of two deductions: “cost of goods sold” or “compensation.” For margin tax purposes, “cost of goods sold” is limited to direct costs: production labor, materials, inbound transportation, storage, research and development, quality control, equipment and facilities and utilities used directly in production. “Compensation” is defined as wages and cash compensation, distributive net income allocated to natural persons by partnerships, limited liabilities and S corporations, and stock options, up to a maximum of \$300,000 per person per year, plus all the benefits which are deductible for federal income tax purposes.

Under the margin tax regime, Texas for the first time requires combined reporting by related business. It does so if they are 80% affiliated by ownership or control and form an interrelated enterprise.

Similarly, when some of a business is in Texas and some is not, the margin tax is apportioned between the business within Texas and the business outside the state.

By consulting with a tax advisor, businesses can learn how the margin tax applies to their particular situation and whether restructuring might be a viable option.