NEW TAX FOR TEXAS

By Donna Rutter and David Donnelly

We have a new business tax in Texas, the Gross Margin Tax. This was enacted into law in May 2006 with the first returns due in May 2008. The Texas legislature recently passed a technical corrections act which Governor Perry signed in June 2007.

This tax replaces the Franchise tax, which was the greater of 4.5 percent tax on the income of corporations and limited liability companies or .25 percent of the entity's taxable capital. Under the previous Franchise Tax rules, partnerships were not subject to the tax. Many business entities operated in Texas as limited partnerships and paid no Franchise Tax - an inequity which was corrected in the new law.

One reason for the new tax is the Texas Supreme Court found the old method of property taxation to be, in effect, a statewide property tax and unconstitutional. The legislature then had to come up with a new method to tax businesses. Since we have a state constitutional amendment banning an income tax, the legislature had to find an alternate method, thus the Margin Tax. There is a trade-off, however, in that certain property tax rates were reduced in a law enacted during the 2006 legislative session.

This trade-off of reduction in property tax rates may result in an actual reduction of property taxes. The current boom in Texas real estate has wiped out some or all of the benefit of the legislative reduction. Additionally, there is no restriction on the ability to increase the appraised values in the future.

Under the law, most partnerships, associations, business trusts, limited liability companies and corporations will be subject to the new tax. Sole proprietorships, general partnerships owned by natural persons, certain passive income entities (defined below), certain family limited partnerships, real estate mortgage conduits, grantor trusts and estates are not subject to the new tax.

NEW TAX RATES

The new tax is based on the Gross Margin, as defined in the law. The rate is 1/2 percent for retailers and wholesalers, and 1 percent for all other affected businesses.

Wholesaler and retailers are defined as businesses where more than 50 percent of their revenue comes from sale of tangible goods or services.

HOW THE TAX IS CALCULATED

There are two different ways to calculate Gross Margin, and if the taxpayer is eligible for the Cost of Goods Sold deduction, the taxpayer can choose, on an annual basis, the method which produces the least tax. The two methods all start with gross revenue and then deduct one of the following:

> Cost of Goods Sold, as defined by the law; or, Salaries, wages and benefits, as defined by the law, but limited to $300,000 per employee

In no case can the Gross Margin be greater than 70 percent of Gross Receipts.

Cost of Goods Sold has a different definition in the new law than the definition used by Generally Accepted Accounting Principles or by the Internal Revenue Code. Service companies are not eligible to elect the Cost of Goods Sold deduction. Goods, as defined in the law, are tangible real or personal property and must be produced by the taxpayer.

Compensation, as defined in the law, includes wages, contributions to retirement plans, health insurance, partnership distributions, stock awards, and all other benefits. It does not include payments to temporary or contract employees. The maximum amount which can be deducted is $300,000 per employee.

The tax is calculated as follows:

Gross Receipts

> Less either Cost of Goods Sold or the Compensation Deduction, Equals Taxable Margin, Multiplied by the Apportionment Percentage (see below). Multiplied by the applicable tax rate (1/2 percent, or 1 percent, or the phased in rate for small business), Equals Gross Margin Tax Liability

The recently passed technical corrections act does provide small business owners a phased-in rate and an alternative EZ calculation if total revenue is less than $10 million.

APPORTIONMENT

For multi-state entities, the tax is apportioned based on gross receipts in Texas. Texas receipts are defined as: sales of tangible personal property if the property is delivered or shipped to a buyer in Texas; services performed in Texas (except receipts derived from servicing loans secured by Texas property); rental of property in Texas; use of patents, copyrights, franchises or licenses in Texas; and, sales of real property in Texas.

There may be some tax planning available based on the apportionment rules. Most other states use a formula based on a combination of relative sales in that state, fair market value of assets in that state versus total entity-wide fair market value, and total payroll in that state versus total entity-wide payroll.

The law does not include a "Throw-Back" rule, that is, if an entity has sales in another state but does not pay taxes in that other state, the sales are not "Thrown-Back" to Texas. This is very beneficial for Texas based companies.

Certain service providers, such as companies which service employee retirement plans, apportion their margin based on the number of shareholders or beneficiaries in Texas.

UNITARY RULES

Under the new law, an affiliated group is one where a common owner owns more than 50 percent of the controlling interest. A Unitary Business is one where the business activities are integrated or interrelated through their activities. The significance here is that a Unitary Business can only use one method, either the Cost of Goods Sold or the Compensation method to arrive at Gross Margin, which will be punitive for some businesses.

PASSIVE INCOME ENTITIES

Passive Income Entities are excluded from the new tax, as long as they meet the definition of a Passive Income Entity. This status could change on annual basis, depending upon the amount and types of income in the entity. The Passive Income Entity must be a limited or general partnership and 90 percent or more of its federal gross income is derived from dividends, interest, distributive shares in partnership income, capital gains from real property, royalties, delay rentals, or other income from non-operating mineral interests. Rental income from real property is not considered passive for the new law.

This exclusion will be favorable for investment partnerships and, probably more importantly, family limited partnerships. These partnerships should review their sources of income and distribute non-qualifying assets to ensure that the 90 percent threshold is met.

OTHER EXCLUSIONS

Certain other businesses and entities are allowed exclusions under the law. Any flow-through funds which are mandated by law or fiduciary duty are excluded from the calculation of gross margin. Additionally, flow-through funds which are mandated by contract, such as real estate brokers or general contractors, are excluded from the calculation of gross margin. Many service companies that base their revenue on flow-through funds may have severe tax consequences if they are not able to reduce their revenues by those amounts paid to third parties.

SMALL BUSINESS RULES

Businesses with gross receipts under $300,000 are excluded from the tax. Businesses with gross receipts between $300,000 and $900,000 have a phased-in rate and companies which have over $900,000 in total revenue pay the full tax. In addition, businesses with total revenue under $10 million can use the alternate "EZ" tax which is 0.575 percent of gross receipts.

ACCOUNTING FOR THE NEW TAX

This complexity of the new law means that all affected businesses, or their accounting firms, will be required to perform some new calculations. The new Cost of Goods Sold deduction is calculated differently than the federal tax rules or the rules under Generally Accepted Accounting Principles, and will be somewhat onerous to calculate. The Compensation deduction will be somewhat easier to calculate, however, it is a calculation which taxpayers have not previously been required to compute.

These new calculations will result in an increase of 50 percent to 100 percent in the tax preparation fees for most businesses.

THE FUTURE OF THE LAW

There is a great body of legal expertise which asserts that the law is unconstitutional according to the Texas Constitution. There is currently a challenge regarding the constitutionality of the law before the Texas Supreme Court. The old franchise tax was terminated effective December 31, 2006; if the new law is overturned, no one really knows what the legislature will do for revenue. Certainly, few politicians will want to lead the charge to overturn the constitutional amendment making an income tax unconstitutional.

PLANNING

The planning for this new law will evolve over the next few years, however, there are some strategies which are currently apparent: If a business has multiple entities, a re-structuring of the ownership can produce some tax savings; also, if a business is operating in several states, a review of the apportionment of income between states may present opportunities to reduce the overall tax liability of the group.

EFFECT ON BUSINESS

Certainly, the new tax levels the playing field. Most major legal and accounting firms, as well as many major corporations, were operating in Texas as either limited partnerships or limited liability partnerships, and not paying any franchise tax to the state. This inequity has been removed, however, the solution to the old problem produces some new inequities. The oil and gas industry and the medical profession are winners in the new law; any businesses which have large-flow-through funds will be losers under the new law.

Overall, however, the business community as a whole is affected negatively by the new law. The old franchise tax had become routine for most businesses, or their accounting firms, to calculate. The new law adds a whole new layer of complexity to the preparation of the Texas tax returns, which will come at no small cost to most businesses.

The law is also one of the strangest revenue-generating mechanisms in the country. Virtually no other state has a Gross Margin tax, and, no state relies on one for generating such a large amount of revenue.

The tax as a whole has caused the business-friendly environment in Texas to diminish, which could not be good for our economy and will definitely reduce our competitive advantage relative to other states.

This is a brief introduction to the new tax and is not intended to be a detailed analysis and only highlights certain provisions in the statute. Please consult your tax advisor for further guidance. **N**

Donna Rutter is a partner specializing in state and local tax at the accounting firm Hartman, Leito & Bolt, LLP in Dallas/Ft Worth. David Donnelly is a partner, specializing in real estate, at the accounting firm Gainer, Donnelly & Desroches, LLP in Houston.