The Revised Texas Franchise Tax in 2009

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Overview

- Fiscal goals fell $3B short
- 100 new revenue agents trained in franchise tax audits
- Today:
  - Part 1: The Revised Texas Franchise Tax, Step by Step
  - Part 2: Filing Tips

Part 1

The Revised Texas Franchise Tax, Step by Step

Comparison of Old Franchise Tax vs. New Franchise Tax

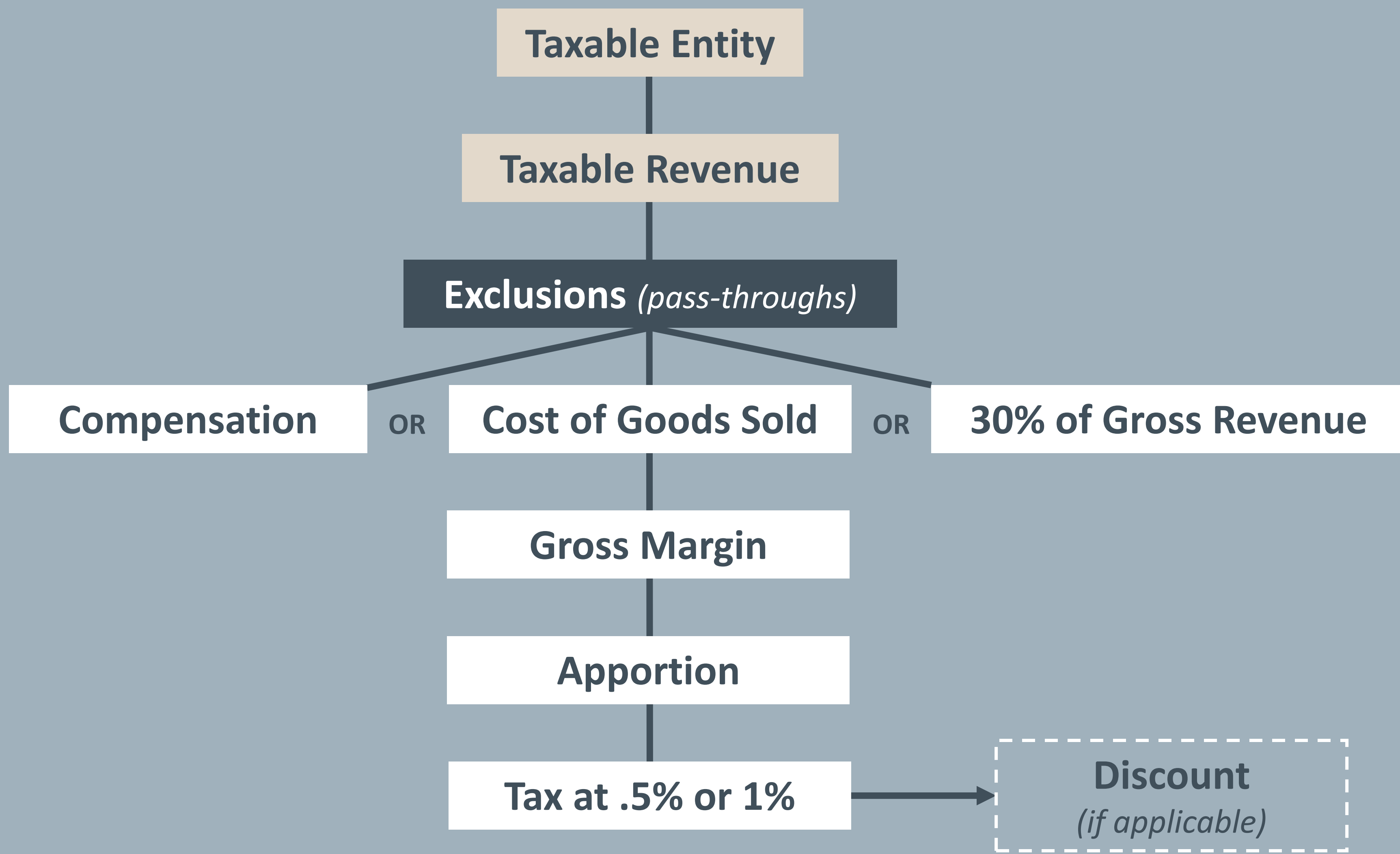
Current Law (Old Franchise Tax)

- Description: The Texas franchise tax is a privilege tax
- Due Date
  - Initial Reports: one year and 89 days after beginning date
  - Annual Reports: May 15
- Accounting Period:
  - Annual Report - Accounting year ending in calendar year prior to report year
- Rate:
  - .25% per year of privilege period of net taxable capital
  - 4.5% of net taxable earned surplus
- Tax Base:
  - Taxable Capital and Earned Surplus

New Law (New Franchise Tax)

- Description: The Texas franchise tax is a privilege tax
- Taxable Entities:
  - Corporations, LLCs, Partnerships (with exceptions), Professional Associations, Joint Ventures, Business Trusts, Other legal entities
- Due Date:
  - No change
- Accounting Period:
  - No change
- Rate:
  - 1.0% for most
  - .5% for entities primarily engaged in wholesale or retail trade
  - .575% if using EZ computation
- Tax Base:
  - Margin

Basic Operation of Margin Tax – Regular Calculation



Basic Operation of Margin Tax – "EZ Computation"

Taxable Entity with Revenues under $10M

Taxable Revenue

Exclusions *(pass-throughs)*

Apportion

Tax at .575%

Discount
(if applicable)

Note: No deductions (COGS or Compensation) allowed.

Taxable Entities

- Partnerships (LP and LLP)
- Corporations
- Banking Corporations
- Savings and Loan Associations
- LLCs (including disregarded entities!)
- Business Trusts
- Professional Associations
- Business Associations
- Joint Ventures
- Joint Stock Companies
- Holding Companies
- “Other Legal Entities”- catch all for new entity types (think LLCs in 1991)

Non-Taxable Entities

- Passive entities
- General partnerships (with all natural-person partners)
- Grantor trusts
- REITs (IRC sec. 856) & REMICs (IRS sec. 860D)
- Certain non-profit/charitable entities
- Estates of natural persons
- Estates are not taxable entities.
  - Estates are “natural persons.”
  - An estate will not cause a taxable entity to lose a compensation deduction for distributions/compensation paid to the estate.
  - An estate will not cause a problem for otherwise non-taxable general partnerships.
- Sole proprietorships
- Escrows
- Non-profit self-insurance trusts
- A trust qualified under sec. 401(a) of the IRC
- A trust or other entity exempt under sec. 501(c)(9) of IRC (voluntary employee benefit associations)

Non-Taxable Entities, Passive Entities

- Entity Type: GP, LP, or Trust
- Income Type: dividends, interest, income from an LLC, distributive shares of partnership income (to the extent greater than zero), capital gains from the sale of real property, gains from the sale of securities
  - NOT rents; NOT ordinary gain from sale of real estate; rent that flows through as distributive share of income from subsidiary partner DOES NOT LOSE ITS CHARACTER AS NONPASSIVE.
    - Rule 3.582- See Q&A 12. Since no legislative clarification, Comptroller will reassert its position.
- Income ratio: “90/10” rule
  - 171.0003(a)(3)(a-1): passive-type income can never be actively earned.
- Comptroller Rule clarifications:
  - Are LLPs eligible for passive entity treatment? Yes.
  - How are “securities defined”
    - Use of “non-controlling interest” language in Comp. Rule 3.582
  - “Net” Capital gains, “net” gains from sale of securities- different from statute
- Passive Entities will be required to “prove” passive status each year; must be a qualifying entity for the entire tax year. *See* Comp. Rule 3.582(c)(1)

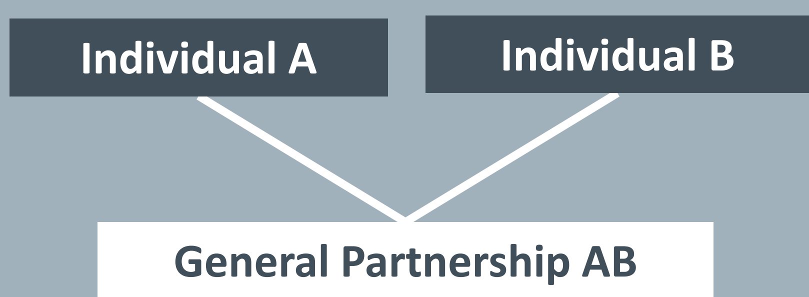
Non-Taxable Entities, Passive Entities:
Family Limited Partnerships

- Family limited partnerships will not be taxable if they meet the definition of a “passive entity.”
  - GP, LP or trust (LLP? Yes.)
  - At least 90% of income comes from passive source
    - Be careful of receiving rents from property held by FLP as these are not passive-type income
- This section was revised from 2006 version to exclude superfluous requirements for FLPs (such as 80% family ownership, etc.)
- May use tiered partnership reporting (if not passive).
- Will cause lower-tier entities to lose compensation deduction.
- Will cause general partnerships in which FLP is a partner to become taxable entities.

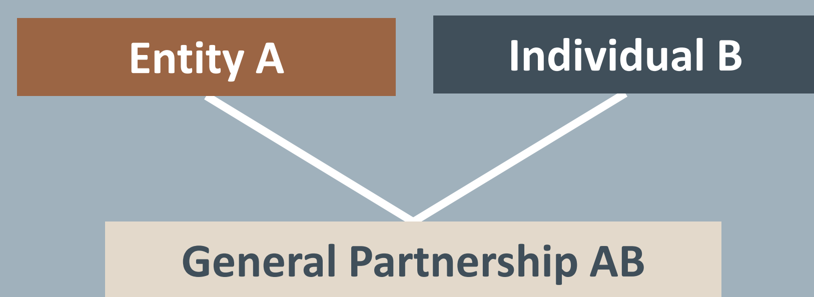
Non-Taxable Entities: General Partnerships

- **General Rule for general partnerships**: A general partnership is not a taxable entity so long as its partners are all natural persons and it does not have liability protection (it is not registered as an LLP). An estate is considered a "natural person." A trust is not.
- **Did your GP receive a notice from the Comptroller's Office last year?** This notice requested a list of all of the partners of the partnership for purposes of determining taxable entity status. If you did not respond, but are on the Comptroller's radar, you will be presumed to be a taxable entity and will receive an estimated tax bill.

Not a Taxable Entity

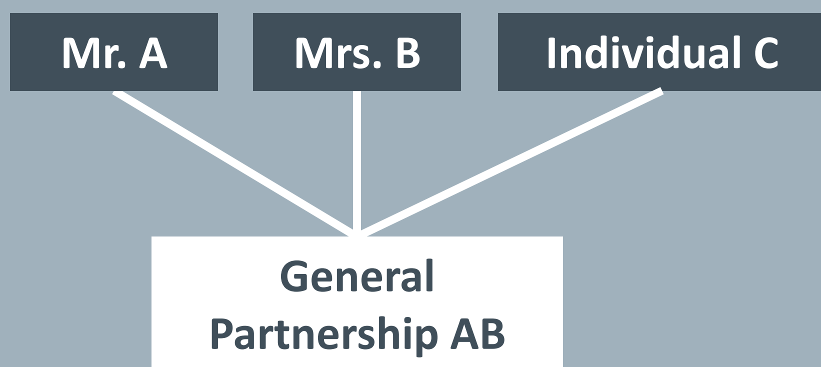


Taxable Entity



Non-Taxable Entities: General Partnerships

- Something to be mindful of:
  - Mr. A and Mrs. B are husband and wife. It might be unclear as to whether they have a general partnership between the two of them in certain circumstances, which could either open up the argument that ABC is not a taxable entity (i.e., if they claim they are one and the same taxpayer), or that it is a taxable entity, (i.e., if they are considered partners for state law purposes). Typically, a partnership is only formed if they manifest an interest to be partners, there is the uncomfortable blending of state entity law and federal tax law in this circumstance.



Non-Taxable Entities, Trusts

- Grantor Trusts are not taxable if:
  - Natural person or charitable entity is beneficiary
  - Trust is under US jurisdiction for administration purposes and one or more US persons has authority to control substantial decisions of trust
- Comptroller says whether or not a trust will be taxable will depend on a "facts and circumstances" test.
- What happens when your grantor dies or you fail to create a grantor trust for estate planning purposes?
  - You have a taxable trust if it does not qualify as passive, maybe ("facts and circumstances" test)
- How is margin tax calculated in a non-grantor trust?
  - Comptroller rules will provide guidance

Effect of Trusts on Other Entities

- A trust, even a grantor trust, is not a “natural person” for margin tax purposes.
- Therefore, an individual who decides to hold an equity interest in an entity in a trust will cause that entity to lose its compensation deduction.
- Won’t usually cause a problem for FLPs since these are typically passive entities.
- This will also cause an otherwise non-taxable general partnership to become taxable.

Non-Taxable Entities, REITs

- A REIT is generally not taxable
- A REIT that holds real estate directly is taxable
- The subsidiary that holds the REIT’s real estate investments will be taxable

Non-Taxable Entities, Exempt Entities

- Charitable entities (including entities that are not corporations, but otherwise qualify under Tax Code Ch. 171) are exempt from margin tax.

Exemptions

- Small Business Exemption
  - $300K or less in total revenue (really $434,782 due to % discount)
    - 2009 Legislative changes: this amount is raised to $1,000,000 for 2010 and 2011 returns. In 2012, it drops down to $600K.
  - Less than $1K owed in tax
  - Both are “cliff” rules- tax is owed on entire amount if above the cutoff.

Total Revenue

- Starting point for calculation of margin tax.
- Not based on federal taxable income.
- Based on certain line items on corporate, partnership tax returns.
- Includes gross receipts, interest, gross rents, gross royalties, capital gain, net income, etc.
- Includes net income from a passive entity in which the taxable entity holds an interest (unless the net income is generated by another taxable entity).

Total Revenue: Exclusions

- Generally: Excludes many items, including items of income attributable to disregarded entities, and net distributive income from partnerships and taxable entities treated as partnerships or s-corporations for federal tax purposes (only to extent included in margin).
  - Exclusions from Corporate Revenue
  - Exclusions from Partnership Revenue
  - Exclusions from Revenue of “Other Entities”

Total Revenue: Exclusions

- Exclusions – General application
  - All "flow-through" funds mandated by law or fiduciary duty to be distributed to other "entities" or "governmental authority"
    - Should encompass sales taxes
  - Certain "flow-through" funds mandated by contract to be distributed to other entities
    - Certain sales commissions
    - Federal tax basis of securities/loans sold
    - Subcontractor payments "handled" by taxable entity
  - Too bad for those with other "flow through" funds that are not excludable

Deductions: Generally

- If using the regular computation method, a taxable entity has a choice of one of three deductions:
  - Compensation
  - Cost of Goods Sold
  - 30% of Total Revenue

Deductions: Compensation

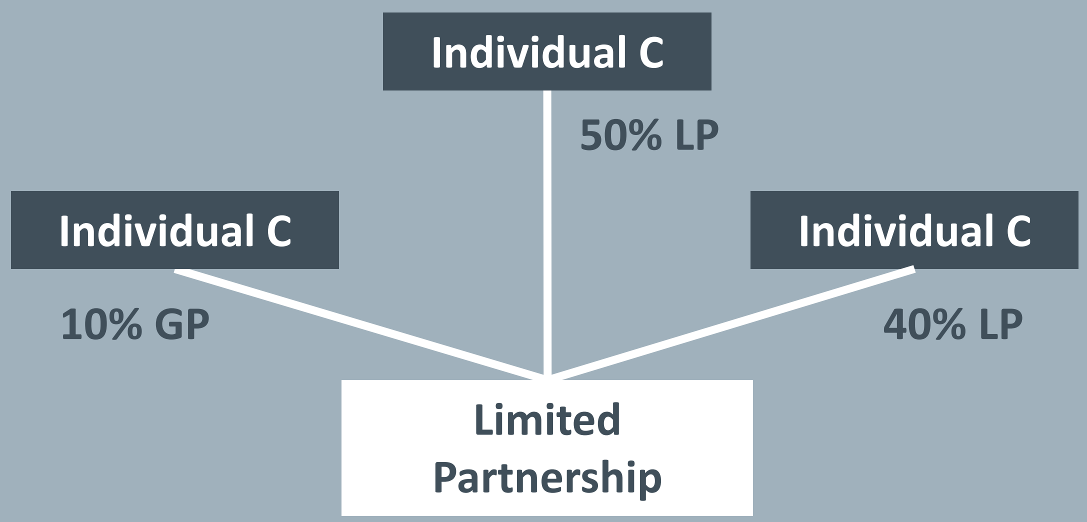
- Entity may deduct its compensation expenses
  - Allowable wages and cash compensation (up to $300K per employee, so long as received by a natural person) and benefits amounts (W-2 amounts, not 1099).
    - Prop. Rule 3.549- should be amended to allow for certain payments on 1099s (such as certain director compensation).
  - Net distributive income from partnerships and LLCs treated as partnerships; LLCs and corporations treated s-corporations; disregarded entities (up to $300K per payee; so long as received by natural person). Does not actually have to be paid out, according to Comptroller.
  - Benefits to extent deductible for federal income tax purposes, including worker's comp., health care, employer contributions to
  - HSAs and retirement.

Deductions: Compensation

- Nondeductible
  - Payments to undocumented workers
  - Payments to employees who work at armed forces lodging on federal property
  - Payments to independent contractor
  - Distributions/payments made to "non-natural person" partners/members/shareholders

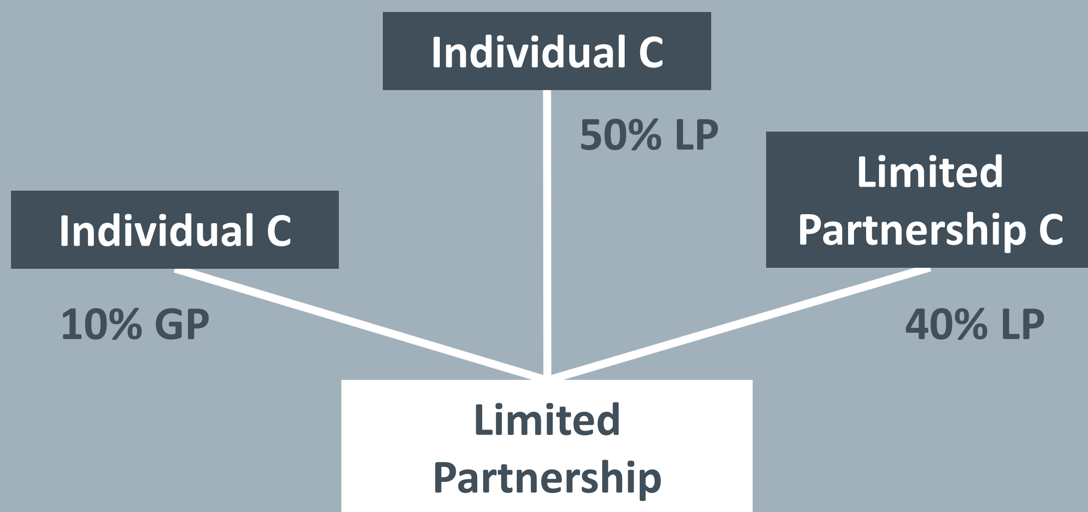
Deductions: Compensation

- The distributions to A, B, and C are all deductible up to $300,000.
- Limited Partnership gets total deduction of $900,000, which equals $9,000 in margin tax savings



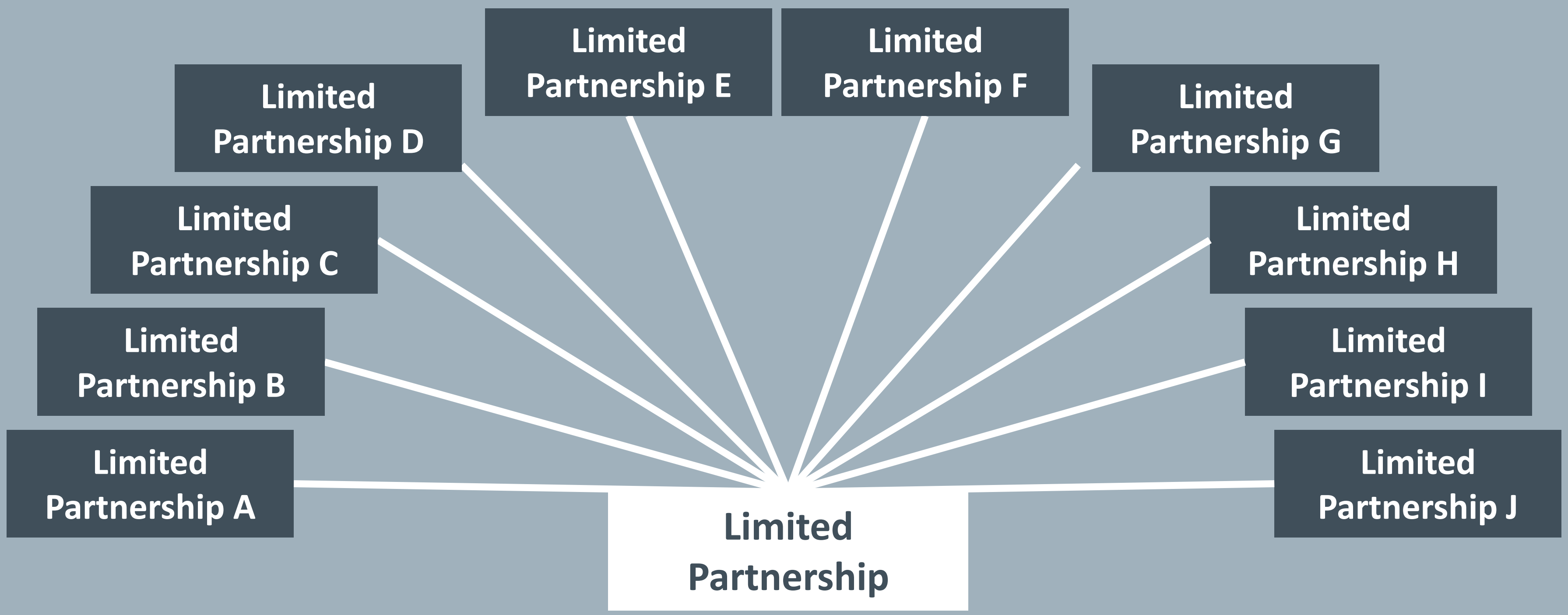
Deductions: Compensation

- The distributions to A and B are deductible up to $300,000.
- The distribution to C is not deductible because C is not a natural person. The limited partnership only gets a $ 600,000 deduction, and will pay $3,000 more in margin tax than if all partners were natural persons.



Deductions: Compensation

- 10 non-natural limited partners:
- $300,000 x 10 = $3 million = $30,000 in margin tax



Deductions: Cost of Goods Sold

- Entity may deduct the cost of goods sold.
  - Real property and tangible property sold as inventory.
  - Must own the goods; Must sell the goods.

- The Texas franchise tax concept of COGS is vastly different from federal COGS. Do not confuse them. You heard correctly—you will have to do two separate COGS calculations.

Deductions: Cost of Goods Sold

- Direct costs
  - Labor, materials
  - Handling costs, storage costs, depreciation
  - Research, experimental costs, etc.
- Those costs related to production or acquisition of goods
  - deterioration, obsolescence, spoilage, abandonment,
  - preproduction direct costs
  - insurance on facilities and equipment used in production of goods, insurance on produced goods
  - licensing or franchise fees
- Some administrative overhead costs
  - Including “mixed” service costs (but no “excluded” costs)
  - Limited to 4% of entity’s overhead costs

Deductions: Cost of Goods Sold

- COGS excludes
  - Payments to undocumented workers
  - Selling costs
  - Advertising
  - Bidding costs
  - Officers compensation
  - Interest
  - Distribution Costs
  - Amount paid to affiliated group member if greater than "armslength" cost
  - Etc.

Deductions: 30% of Total Revenue

- An entity may deduct 30% of its total revenue if neither the COGS nor the compensation deduction reduce its total revenue below 30%.

Apportionment

- Single factor of gross receipts used
  - All revenues reportable by a taxable entity on its federal tax return without deductions
- Apportionment factor is determined by dividing Texas gross receipts of entity's business by total gross receipts.
- Apportionment factor is multiplied by entity's margin to give you taxable margin.

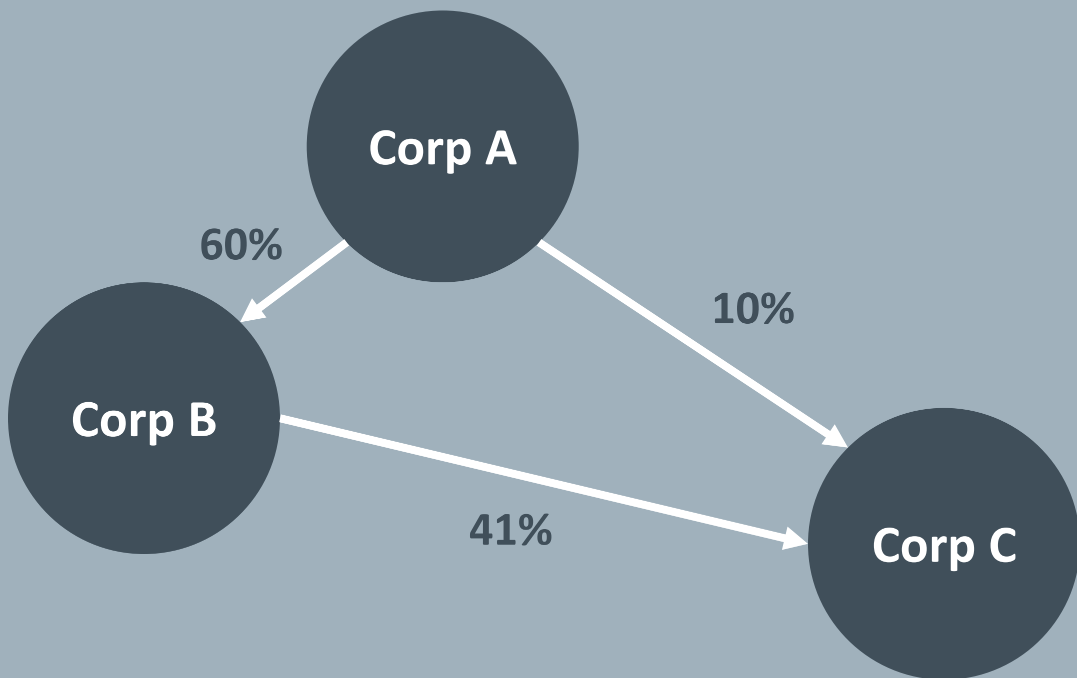
Tax Rate

- .5% for wholesalers and retailers
- 1% for everyone else
- .575% for EZ computation
- After multiplying tax rate by taxable margin, take discount if applicable
  - Margin Tax discount for entities with less than $900K in total revenue
    - Greater than $300K but less than $400K- 80%
    - Equal to $400K but less than $500K- 60%
    - Equal to $500K but less than $700K- 40%
    - Equal to $700K but less than $900K- 20%
  - Note: This can bump a taxpayer into “no tax due” arena

Alternative Reporting: Combined Reporting

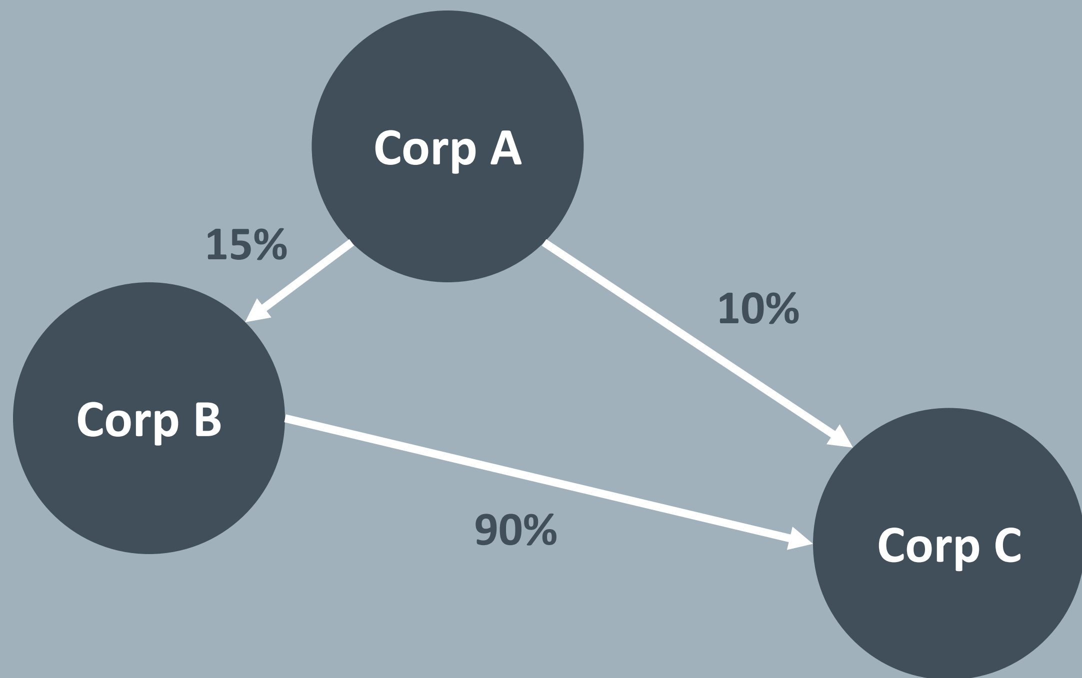
- Facts test
- Applies to members of an affiliated group operating in a unitary manner
  - Affiliated group: a group of one or more entities in which a controlling interest is owned by a common owner or owners.
    - Controlling interest: more than 50%
    - Attribution rules for husband and wife will apply according to Comptroller
  - Unitary business: "single economic enterprise that is made up a 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."
    - Business will be presumed unitary unless they can demonstrate otherwise
      - How do you demonstrate otherwise?
- Computation taken as a whole- the combined group is one taxable entity.
- Entities included regardless of nexus.
- The reporting entity for the group will be either the "parent entity" or the entity that does the most business in Texas.
- All affiliates are jointly and severally liable for payment of the tax.

Alternative Reporting: Combined Reporting



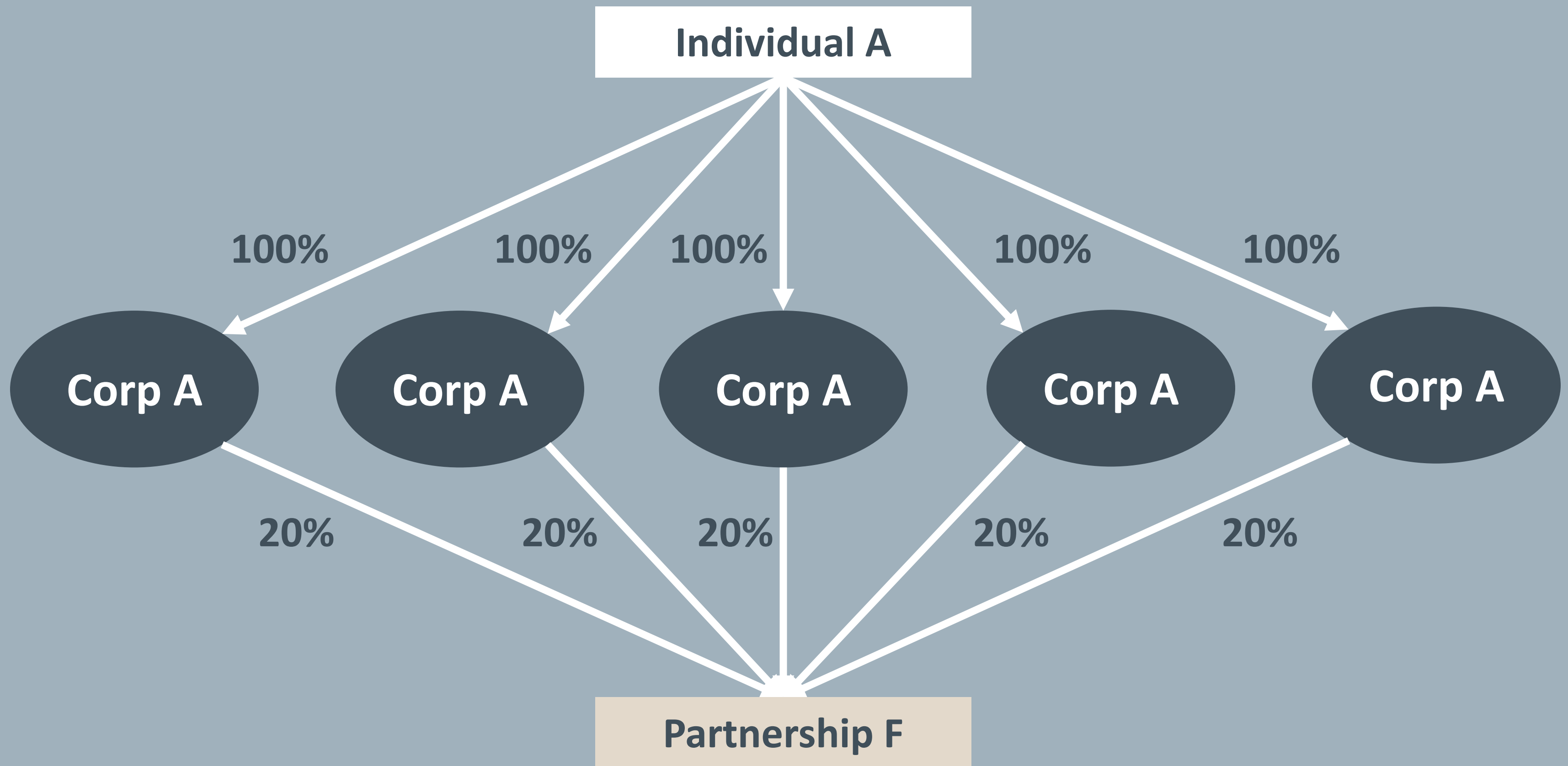
Corp. A has a controlling interest in Corp. B and a controlling interest in Corp. C of 51% stock ownership because it has control of stock owned by Corp B.

Alternative Reporting: Combined Reporting



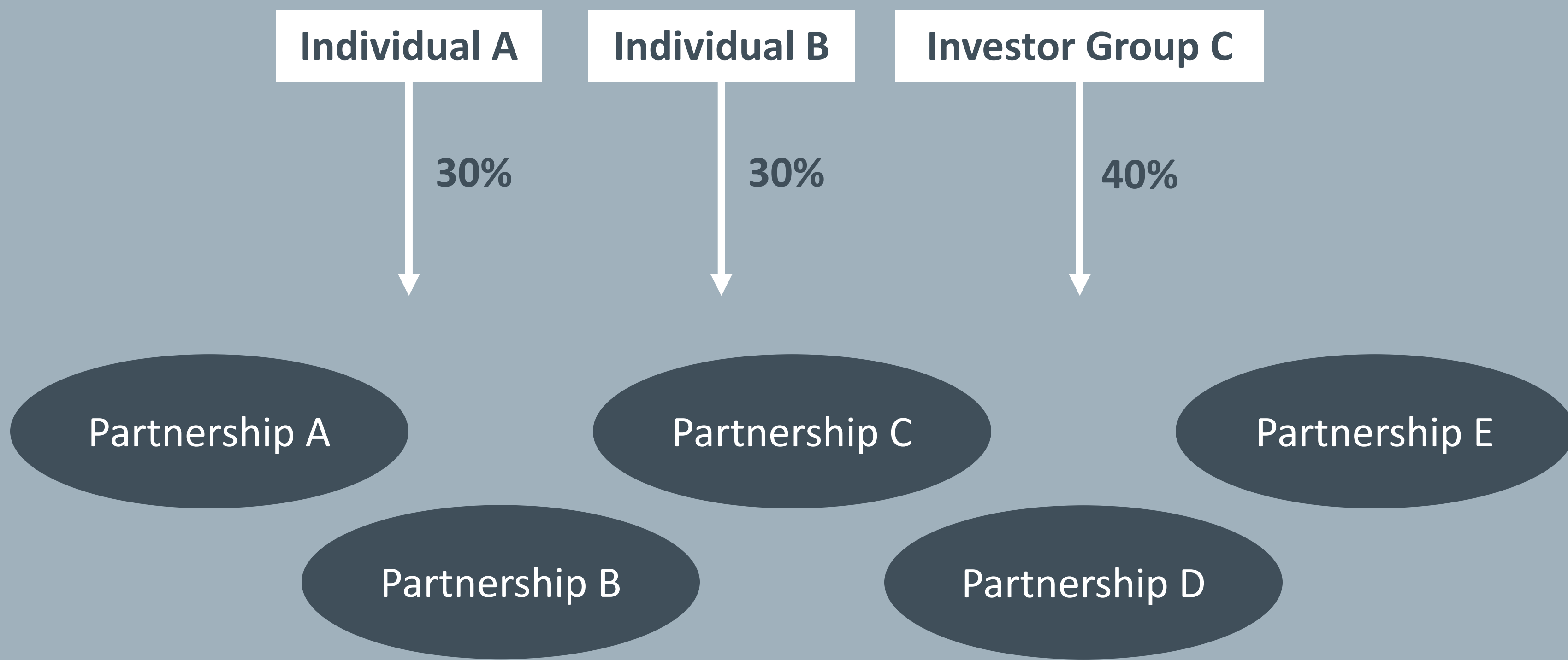
Corp. A does not have a controlling interest in Corp. B and does not have a controlling interest in Corp. C. Corp B. has a controlling interest in Corp. C.

Alternative Reporting: Combined Reporting



Individual A has a controlling interest in each corporation and in Partnership F.

Alternative Reporting: Combined Reporting



Investor Group C is made up of multiple individual investors, different for each partnership.
Common owners in Individuals A and B?

Alternative Reporting: Tiered Partnerships

- "Lower tier" entities (those treated as partnerships or s-corps for FIT purposes) can file a report with the Comptroller's office showing the amount that each "upper tier" entity that owns the lower tier entity should include in its margin tax report.
- Only applicable if combined reporting not required (either less than 50% common ownership, or doesn't meet unitary business requirements, or both).
- Revenue may be passed only to upper tier entities that are subject to Texas franchise tax.
- Revenue is passed to taxable entities based on ownership percentage.
- Deductions (COGS, Compensation) may NOT be passed to an upper tier entity.
- Same restrictions apply for EZ computation, tiered discount, and 'no tax due."
- All taxable entities involved in a tiered partnership relationship MUST file a franchise tax report, an information report, and the 05-175 tiered partnership report.

Administrative: Due Dates

- 2010 due dates:
  - May 15, 2010: due date for returns and extension requests
  - November 15, 2010: extension due date

Part 2

Filing Tips

General Filing Tips

- Use WebFile to file your franchise tax forms online:
  - free, secure and accurate
  - automatically loads the forms you need
  - immediate confirmation that Comptroller’s office received your filing
- You'll need your WebFile number if you're a first-time filer, or your password if you filed franchise tax electronically last year. Make sure to keep your WebFile receipt- it confirms that the Comptroller received your return.
- Use Smart PDF forms to file if you:
  - Don't have your WebFile number or password handy
  - Need to file for multiple taxpayers
  - Want the form to automatically calculate
- Filing Method Alternative:
- If you are unable to file using WebFile or Smart PDF, you can use Simple PDF Reports for 2009.

Third Party Return Prep. Software

- A list of software developers and product versions that are currently approved to reproduce substitute 2009 Texas Franchise Tax forms is available on the next slide, and can also be found on the Comptroller's website.
- Vendor software approved for 2008 Texas Franchise Tax Forms should not be used after December 2008 for filing 2008 or 2009 reports. Using old versions of the software could result in invalid information being posted to a taxpayer's account.
- The approved vendor software for 2009 can be used for report years 2008 and 2009, and contains corrections for issues identified in the 2008 version. *Information on how vendor substitute forms should print:*
  - A 2D barcode should print in the lower portion of each form directly below the Texas Comptroller Official Use Only print. Contact the software vendor if your forms fail to print a 2D barcode.
  - In the upper left corner a version title 'TX2009' should print on every form and must match the approved version number. The agency has provided an approved version number ('Ver. 1.X'); the X is the approved version. If the approved version printed on your forms does not match the version number on the table contact the vendor or download the latest software.
- Important Note About Tax Preparation Software
  - The Comptroller's approves only the placement of the data on the forms, the form calculations and the values populated in the 2D barcode. The accuracy of how data is gathered and processed the responsibility of the developer 42 through the software programs is software developer, distributor and user.

Third Party Return Prep. Software- Approved Vendors

Company Name	Software Package	Vendor	ID
CCH, a Wolters Kluwer business	Perform Plus III	1246	Ver. 1.1
CCH, a Wolters Kluwer business	ProSystem fx Tax	1019	Ver. 1.2
CCH Small Firm Services, a Wolters Kluwer business	ATX	1015	Ver. 1.1
CCH Small Firm Services (Tax Wise)	Tax Wise	1045	Ver. 1.1
Corptax, Inc.	Corptax	1023	Ver. 1.1
CS Professional Suite	UltraTax CS	1022	Ver. 1.2
Data Technology Group	Tax Dimensions State C-corporation and partnership	1053	Ver. 1.1
Drake Tax Software	Drake Tax Software	1024	Ver. 1.1
Intuit	Lacerte	1032	Ver. 1.3
Intuit	TurboTax/ProSeries	1030	Ver. 1.1
Rhodes Computer Service (TaxSlayer)	TaxSlayer	1038	Ver. 1.1
STF Services Corporation	SuperForm Tax Forms	1039	Ver. 1.2
Taxsation Inc.	Corporate Pro	1284	Ver. 1.1
Tax Works	Great Tax, Tax Vision, Crosslink, 1040Works, TaxAgent'	1043	Ver. 1.1
Thomson Reuters (Tax & Accounting) Inc.	E-Form CD and E-Form RS	1062	Ver. 1.1
Thomson Reuters (Tax & Accounting) Inc.	GoSystem and GoSystems RS	1062	Ver. 1.1
Thomson Reuters (Tax & Accounting) Inc.	ONESOURCE Income Tax and ONESOURCE Income Tax RS	1062	Ver. 1.1
Vertex Inc.	Vertex Domestic Compliance	1120	Ver. 1.1

Important Notice Re: Legislative Changes & Return Prep. Software

- From the Comptroller's Website:
  - IMPORTANT: PLEASE READ
  - Posted: Oct. 7, 2009
  - Notice on Using Tax Preparation Software for 2008-2010 Franchise Tax Reports
  - Legislative changes to the Texas franchise tax have prompted the need for revised franchise tax reporting forms to capture additional information and include new edits and calculations. If you use approved tax preparation software to complete your franchise tax reports, please note these important updates:
  - Effective Jan. 1, 2010, the Texas Comptroller of Public Accounts will not be able to accept original franchise tax reports generated from tax preparation software approved for 2008 and 2009 reports.
  - Amended 2008 and 2009 reports generated from previously approved tax preparation software products will still be accepted.
  - What this means: If you are filing an original franchise tax report for 2008, 2009 or 2010, after Dec. 31, 2009, you will need to use tax preparation software approved by the Comptroller's office for the 2010 report year. You should also check with the tax preparation software vendor to determine if the vendor's 2010 software provides the option to submit amended returns for reports originally submitted using 2008 and/or 2009 software.
  - The Comptroller's revised forms for the 2010 reporting year will be available on our agency's Web site on Dec. 7, 2009. These forms will support original and amended reports for report years 2008, 2009 and 2010. We also will notify our franchise tax e-mail subscribers when the forms are available.

General Tips

- Accounting Period vs. Privilege Period:
  - These periods are not the same. Tax due for the privilege period of 2009 is based on an accounting period ending in 2008.
- Corporation or LLC vs. Not Corporation or LLC
  - This is determined by state law classification, not federal tax classification!
- Combined groups: check with Comptroller's office after filing to make sure everything went through alright. Mistake on one entity can revoke good standing of all members of the group.

Forms: No Tax Due

- No Tax Due
- 05-163 No Tax Due Information Report
    - Combined groups may not file. Must file EZ or Long form.
    - Although the No Tax Due report does contain a section to elect COGS, Compensation, or 70% of Revenue deduction, leave these blank.
    - $300K or less threshold is actually $434,782
    - Passive entities do not fill out the “Total Revenue” item in Item 6.
- 05-102 Public Information Report
- 05-167 Ownership Information Report
- 05-175 Tiered Partnership Report

Forms: EZ Computation

- 05-169 EZ Computation Report
  - Do not elect deduction method
- 05-102 Public Information Report
- 05-167 Ownership Information Report
- 05-170 Payment Form
- 05-166 Affiliate Schedule
- 05-175 Tiered Partnership Report

Forms: Long Form

- 05-158-A Franchise Tax Report Page 1
  - Items 1, 2, 3, 4, and 5 may not be negative numbers. If rental income is passed through from a partnership to a partner, the rental income could be negative. Report negative rent in item 7.
- 05-158-B Franchise Tax Report Page 2
- 05-160 Credits Summary Schedule
- 05-102 Public Information Report
- 05-167 Ownership Information Report
- 05-170 Payment Form
- 05-166 Affiliate schedule
- 05-175 Tiered Partnership Report

Forms: Extension

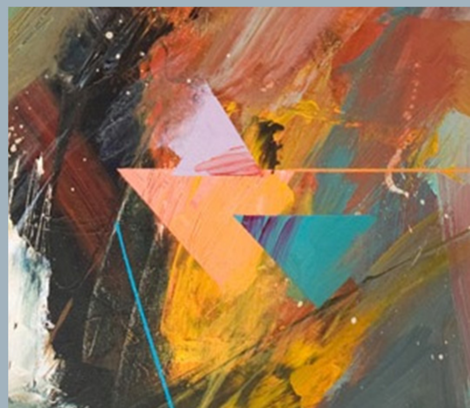
- Extension
- 05-164 Extension Request
- 05-165 Extension Affiliate List

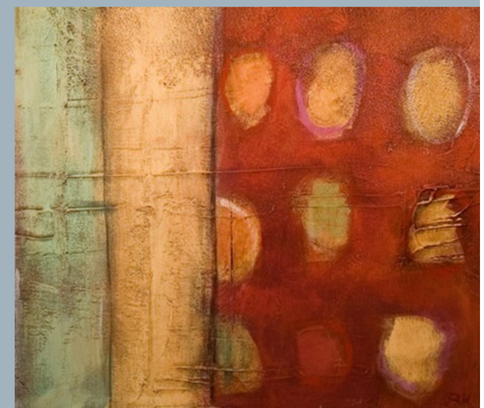
Amended Returns

- Amended franchise tax returns may be filed for the following reasons:
    - To correct a mathematical or other error;
    - To support a claim for refund; or
    - To change from COGS or comp. deduction to 70% or EZ.
- After the due date of the report, a taxable entity may NOT amend to change its method of computing margin to cost of goods sold (COGS) or compensation.

Helpful Resources

- Comptroller's Website:
  http://www.window.state.tx.us/
- Comptroller Franchise Tax FAQs:
  http://www.window.state.tx.us/taxinfo/franchise/faq_questions.html
- Franchise Tax Administrative Rules:
  http://info.sos.state.tx.us/pls/pub/readtac$ext.ViewTAC?tac_view=5&ti=34&pt=1&ch=3&sch=V&rl=Y
- Franchise Tax Statutes:
  http://www.statutes.legis.state.tx.us/Docs/TX/htm/TX.171.htm
- STAR Research System:
  http://cpastar2.cpa.state.tx.us/index.html



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