TFTT10

SELF-STUDY CONTINUING PROFESSIONAL EDUCATION

Companion to PPC's

TEXAS FRANCHISE TAX DESKBOOK

Fort Worth, Texas
(800) 431-9025
trainingcpe.thomson.com

THOMSON REUTERS™

This publication is designed to provide accurate and authoritative information in regard to the subject matter covered. It is sold with the understanding that the publisher is not engaged in rendering legal, accounting, or other professional service. If legal advice or other expert assistance is required, the services of a competent professional person should be sought.—*From a Declaration of Principles jointly adopted by a Committee of the American Bar Association and a Committee of Publishers and Associations.*

The following are registered trademarks filed with the United States Patent and Trademark Office:

Checkpoint® Tools
PPC's *Practice Aids*™
PPC's *Workpapers*™
PPC's *Engagement Letter Generator*™
PPC's *Interactive Disclosure Libraries*™
PPC's *SMART Practice Aids*™

Practitioners Publishing Company is registered with the National Association of State Boards of Accountancy (NASBA) as a sponsor of continuing professional education on the National Registry of CPE Sponsors. State boards of accountancy have final authority on the acceptance of individual courses for CPE credit. Complaints regarding registered sponsors may be addressed to the National Registry of CPE Sponsors, 150 Fourth Avenue North, Suite 700, Nashville, TN 37219-2417. Website: **www.nasba.org**.

QUALITY ASSURANCE SERVICE

Practitioners Publishing Company is registered with the National Association of State Boards of Accountancy (NASBA) as a sponsor of continuing professional education on the National Registry of CPE Sponsors. State boards of accountancy have final authority on the acceptance of individual courses for CPE credit. Complaints regarding registered sponsors may be addressed to the National Registry of CPE Sponsors, 150 Fourth Avenue North, Suite 700, Nashville, TN 37219-2417. Website: **www.nasba.org**.

Registration Numbers

New Jersey	20CE00206800	(CE 2068)
New York	001076	
NASBA Registry	103166	
NASBA QAS	006	

Interactive Self-study CPE

Companion to PPC's Texas Franchise Tax Deskbook

TABLE OF CONTENTS

To enhance your learning experience, the examination questions are located throughout the course reading materials. Please look for the exam questions following each lesson.

INTRODUCTION

Companion to PPC's Texas Franchise Tax Deskbook consists of one interactive self-study CPE course. This is a companion course to *PPC's Texas Franchise Tax Deskbook* designed by our editors to enhance your understanding of the latest issues in the field. To obtain credit, you must complete the learning process by logging on to our Online Grading System at **OnlineGrading.Thomson.com** or by mailing or faxing your completed **Examination for CPE Credit Answer Sheet** for print grading by **March 31, 2011**. Complete instructions are included below and in the Test Instructions preceding the Examination for CPE Credit Answer Sheet.

Taking the Course

The course is divided into lessons. Each lesson addresses an aspect of Texas Franchise Tax. You are asked to read the material and, during the course, to test your comprehension of each of the learning objectives by answering self-study quiz questions. After completing each quiz, you can evaluate your progress by comparing your answers to both the correct and incorrect answers and the reason for each. References are also cited so you can go back to the text where the topic is discussed in detail. Once you are satisfied that you understand the material, **answer the examination questions which follow each lesson**. You may either record your answer choices on the printed **Examination for CPE Credit Answer Sheet** or by logging on to our Online Grading System.

Qualifying Credit Hours—QAS or Registry

PPC is registered with the National Association of State Boards of Accountancy as a sponsor of continuing professional education on the National Registry of CPE Sponsors (Registry) and as a Quality Assurance Service (QAS) sponsor. Part of the requirements for both Registry and QAS membership include conforming to the *Statement on Standards of Continuing Professional Education (CPE) Programs* (the standards). The standards were developed jointly by NASBA and the AICPA. As of this date, not all boards of public accountancy have adopted the standards. Each course is designed to comply with the standards. For states adopting the standards, recognizing QAS hours or Registry hours, credit hours are measured in 50-minute contact hours. Some states, however, require 100-minute contact hours for self study. Your state licensing board has final authority on accepting Registry hours, QAS hours, or hours under the standards. Check with the state board of accountancy in the state in which you are licensed to determine if they participate in the QAS program or have adopted the standards and allow QAS CPE credit hours. Alternatively, you may visit the NASBA website at **www.nasba.org** for a listing of states that accept QAS hours or have adopted the standards. Credit hours for CPE courses vary in length. Credit hours for each course are listed on the "Overview" page before each course.

CPE requirements are established by each state. You should check with your state board of accountancy to determine the acceptability of this course. We have been informed by the North Carolina State Board of Certified Public Accountant Examiners and the Mississippi State Board of Public Accountancy that they will not allow credit for courses included in books or periodicals.

Obtaining CPE Credit

Online Grading. Log onto our Online Grading Center at **OnlineGrading.Thomson.com** to receive instant CPE credit. Click the purchase link and a list of exams will appear. You may search for the exam using wildcards. Payment for the exam is accepted over a secure site using your credit card. For further instructions regarding the Online Grading Center, please refer to the Test Instructions preceding the Examination for CPE Credit Answer Sheet. A certificate documenting the CPE credits will be issued for each examination score of 70% or higher.

Print Grading. You can receive CPE credit by mailing or faxing your completed Examination for CPE Credit Answer Sheet to the Tax & Accounting business of Thomson Reuters for grading. Answer sheets are located at the end of all course materials. Answer sheets may be printed from electronic products. The answer sheet is identified with the course acronym. Please ensure you use the correct answer sheet for each course. Payment of $79 (by check or credit card) must accompany each answer sheet submitted. We cannot process answer sheets that do not include payment. Please take a few minutes to complete the Course Evaluation so that we can provide you with the best possible CPE.

You may fax your completed **Examination for CPE Credit Answer Sheet** to the Tax & Accounting business of Thomson Reuters at **(817) 252-4021**, along with your credit card information.

If more than one person wants to complete this self-study course, each person should complete a separate **Examination for CPE Credit Answer Sheet.** Payment of $79 must accompany each answer sheet submitted. We would also appreciate a separate **Course Evaluation** from each person who completes an examination.

Express Grading. An express grading service is available for an **additional $24.95** per examination. Course results will be faxed to you by 5 p.m. CST of the business day following receipt of your Examination for CPE Credit Answer Sheet. Expedited grading requests will be accepted by fax only if accompanied with credit card information. Please fax express grading to the Tax & Accounting business of Thomson Reuters at (817) 252-4021.

Retaining CPE Records

For all scores of 70% or higher, you will receive a *Certificate of Completion.* You should retain it and a copy of these materials for at least five years.

PPC In-House Training

A number of in-house training classes are available that provide up to eight hours of CPE credit. Please call our Sales Department at (800) 323-8724 for more information.

COMPANION TO PPC'S TEXAS FRANCHISE TAX DESKBOOK

Texas Franchise (Margin) Tax (TFTTG101)

OVERVIEW

COURSE DESCRIPTION: This interactive self-study course provides an introduction to the Texas Franchise (Margin) Tax, including a discussion of combined reporting and unitary groups.

PUBLICATION/REVISION DATE: March 2010

RECOMMENDED FOR: Users of *PPC's Texas Franchise Tax Deskbook*

PREREQUISITE/ADVANCE PREPARATION: Basic knowledge of accounting and Texas franchise tax preparation

CPE CREDIT: 5 QAS Hours, 5 Registry Hours

Check with the state board of accountancy in the state in which you are licensed to determine if they participate in the QAS program and allow QAS CPE credit hours. This course is based on one CPE credit for each 50 minutes of study time in accordance with standards issued by NASBA. Note that some states require 100-minute contact hours for self study. You may also visit the NASBA website at **www.nasba.org** for a listing of states that accept QAS hours.

FIELD OF STUDY: Taxes

EXPIRATION DATE: Postmark by **March 31, 2011**

KNOWLEDGE LEVEL: Intermediate

Learning Objectives:

Lesson 1—Applicability of the Texas Franchise Tax

Completion of this lesson will enable you to:
- Discuss the basic formulas and options for calculating the Texas franchise tax.
- Determine which entities have sufficient contact with the state to subject them to the Texas franchise tax, and identify types of entities exempt from taxation.

Lesson 2—Payment and Filing Requirements

Completion of this lesson will enable you to:
- Analyze which tax rate applies to a taxable entity or combined group.
- Discuss deadlines for franchise tax reports and payments, and summarize franchise tax reporting and estimated payment requirements for franchise tax extensions.

Lesson 3—Taxable Entities

Completion of this lesson will enable you to:
- Identify types of entities subject to the Texas franchise tax and entities excluded from taxation.
- Specify which entities qualify as passive entities.

Lesson 4—Revenue and Apportionment

Completion of this lesson will enable you to:
- Identify the components of revenue and the general and industry-specific exclusions from revenues.
- Identify Texas gross receipts and everywhere gross receipts for apportioning margin, applying the location of payor rule for certain gross receipts.

Lesson 5—Cost of Goods Sold

Completion of this lesson will enable you to:
- Evaluate whether a taxable entity is eligible for the cost of goods sold deduction.
- Identify direct costs, indirect costs, and other costs eligible for the costs of goods sold deduction.

Lesson 6—Compensation

Completion of this lesson will enable you to:
- Identify the elements of the compensation deduction, apply the limits for wages and cash compensation, and discuss the applicability of net distributive income as part of the compensation deduction.
- Discuss the compensation calculation for client entities with leased, managed or temporary workers.

Lesson 7—Combined Reporting

Completion of this lesson will enable you to:
- Apply the attribution rules, affiliation rules and waters edge test to identify which entities are includible in a combined group.
- Discuss the elements of unitary businesses.

TO COMPLETE THIS LEARNING PROCESS:

Send your completed **Examination for CPE Credit Answer Sheet, Course Evaluation,** and payment to:

Thomson Reuters
Tax & Accounting—R&G
TFTTG101 Self-study CPE
36786 Treasury Center
Chicago, IL 60694-6700

See the test instructions included with the course materials for more information.

ADMINISTRATIVE POLICIES:

For information regarding refunds and complaint resolutions, dial (800) 323-8724 for Customer Service and your questions or concerns will be promptly addressed.

Lesson 1: Applicability of the Texas Franchise Tax

INTRODUCTION

The Texas franchise tax is imposed on taxable entities that are organized or chartered under Texas law. The tax is also imposed on foreign (non-Texas) entities that do business in Texas.

Taxpayers and their representatives frequently refer to the tax as the "Texas margin tax" or the "Texas margins tax" because it essentially computes a taxable entity's taxable margin three ways and taxes the least of these computed amounts.

The Comptroller refers to the tax as the "Revised Franchise Tax" because it is calculated in a different manner and imposed on additional types of entities than the previous version of the tax as it was in effect for years before 2008.

In general, an entity is subject to the new Texas franchise tax if state law limits the entity owner's liability. The definition of taxable entities includes partnerships, professional associations, and many other types of entities in addition to corporations and LLCs.

Passive entities, as defined under the franchise tax law, are exempt from taxation. (Passive entities for this purpose are unrelated to activities subject to the passive activity rules of IRC Sec. 469.)

Some entities may be exempt from the franchise tax. The exemptions vary depending on the type of organization.

Taxable entities that are members of an affiliated group engaged in a unitary business are required to file a combined report.

For multistate taxpayers apportioning income, Texas uses a single receipts factor.

Learning Objectives:

Completion of this lesson will enable you to:
- Discuss the basic formulas and options for calculating the Texas franchise tax.
- Determine which entities have sufficient contact with the state to subject them to the Texas franchise tax, and identify types of entities exempt from taxation.

Taxpayers Subject to the Texas Franchise Tax

Entities Subject to the Texas Franchise Tax

The Texas franchise tax is imposed on each taxable entity that:

1. is organized or chartered under the laws of Texas, or

2. does business in Texas.

Nexus

The determination of whether a foreign (non-Texas) entity is doing business in Texas is central to the Texas franchise tax. The relative connection a foreign entity has with Texas is referred to as *nexus*. A foreign taxable entity is doing business in Texas when it has sufficient nexus with Texas to be subject to taxation under the laws of Texas.

Exemptions

Exemptions from the franchise tax are provided for religious, charitable, educational, conservation, and other special activities.

Taxable Entities

In general, an entity is subject to the Texas franchise tax if state law limits the entity owner's liability. Some practitioners take the approach that an entity is taxable unless it clearly meets the definition of an excluded entity.

Combined Groups

The term *taxable entity* includes a combined group. The combined group is treated as a single taxable entity in determining the group's franchise tax.

Combined Reporting Requirement

In lieu of filing separate reports, taxable entities that are part of an affiliated group engaged in a unitary business must file a combined group report based on the combined group's business.

Affiliated Group. An affiliated group means a group of 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. Control is defined as greater than 50% ownership and includes both direct and indirect ownership interests.

A combined group may not include a taxable entity if the taxable entity conducts business outside the U.S. For this purpose, an entity conducts business outside the U.S. if 80% or more of its property or payroll, as determined under Chapter 141 (dealing with the application of the Multistate Tax Compact) are outside the U.S. If the taxable entity has no property or payroll and 80% or more of its gross receipts are outside the U.S., it may not be included in the combined group.

Unitary Business. A unitary business is (a) a single economic enterprise made up of separate parts of a single entity or (b) 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.

In determining whether a unitary business exists, the Comptroller will consider any relevant factor, including whether—

1. *Same General Line.* The activities of the group members are in the same general line, such as manufacturing, wholesaling, retailing of tangible personal property, insurance, transportation, or finance;

2. *Steps in a Vertically Structured Enterprise or Process.* The activities of the group members are steps in a vertically structured enterprise or process, such as the steps involved in the production of natural resources, including exploration, mining, refining, and marketing; or

3. *Functional Integration.* The members are functionally integrated through the exercise of strong centralized management, such as authority over purchasing, financing, product line, personnel, and marketing.

Basic Approach to Combined Reporting

The basic approach to combined reporting is summarized in the following steps:

Step 1 Figure separately for each taxable entity included in the combined group revenue, cost of goods sold, and compensation.

Step 2 Add together each taxable entity's separately computed revenue, cost of goods sold, and compensation.

Step 3 Eliminate intercompany revenues, cost of goods sold, or compensation to prevent double inclusions.

Step 4 Make an election for the combined group to deduct either compensation or cost of goods sold (if eligible), or accept the standard deduction (30% of total revenue).

The cost of goods sold deduction is available only to taxable entities (including combined groups) that sell goods in the ordinary course of business.

Effective Date and Transitional Rules

The current franchise (margin) tax law is generally effective January 1, 2008, and applies to reports originally due on and after that date. Transitional rules are discussed in Rule 3.595.

Margin Tax Formula

The general franchise tax formula begins with total revenue from the entire business, and allows a deduction for the largest of cost of goods sold, compensation, or 30% of total revenue. The computed margin is apportioned to Texas, and a tax rate is applied. The applicable tax rate depends on whether the taxpayer qualifies as a retailer or wholesaler. The general tax rate is 1% (.01), while the rate for retailers and wholesalers is one-half of 1% (.005).

If the taxpayer's total revenue is $10 million or less, an alternative franchise tax formula may be elected. In exchange for the less complicated formula, the taxpayer must accept a tax of .575% (.00575) and forgo any other deduction, credit, or adjustment.

In simplified terms, taxable entities calculate the Texas margin tax as follows:

Regular Margin Tax Formula

Total revenue (from applicable IRS form)
− Greatest of:
  Cost of goods sold (COGS)
  Compensation
  30% of total revenue
− Active duty pay
= Margin before apportionment
× Apportionment factor
= Apportioned margin
− Allowable deductions
= Taxable margin
× Tax rate (0.5% or 1%)
= Tax due on margin before discount and credits
− Tax discount
− Credits
= Net tax due

The tax formula begins with a computation of total revenue from the entire business calculated from amounts reported on the entity's federal tax return.

A deduction is then allowed for compensation, cost of goods sold (if eligible), or 30% of revenues. The cost of goods sold deduction is available only to taxable entities (including combined groups) that sell goods in the ordinary course of business.

An entity that elects to deduct cost of goods sold or compensation is also allowed a deduction for certain active duty compensation, to arrive at margin before apportionment.

Margin before apportionment is multiplied by a gross receipts-based apportionment factor to arrive at apportioned margin.

Certain allowable deductions are subtracted to arrive at taxable margin.

Taxable margin is taxed at the rate of one-half of 1% (0.5%) for wholesalers and retailers, and 1% for all other taxpayers. Tax discounts are available for taxpayers with total revenue under $900,000.

Elective EZ Margin Tax Formula

Elective EZ Method

An elective EZ computation is provided for taxpayers with total revenue of $10 million or less.

In lieu of calculating their franchise tax in accordance with the regular margin tax qualifying formula, taxable entities may elect to calculate the Texas margin tax as follows:

	EZ Computation Formula
	Total revenue (from applicable IRS form)
×	Apportionment factor
=	Taxable margin
×	Tax rate (.575%)
−	Tax discount
=	Net tax due

Tax Discounts. A taxable entity that elects to compute its franchise tax in accordance with the EZ computation may claim a tax discount. However, the entity is not permitted to claim any other deduction, credit, or adjustment.

EZ Computation Report Form. Taxpayers who qualify for and elect the EZ computation method should use Form 05-169 (Texas Franchise Tax EZ Computation Report). The form can be filed as an initial, annual, or final return.

Combined Groups

The elective EZ computation method is available to combined groups with combined total revenue of $10 million or less. Similarly, a combined group with combined total revenue under $900,000 may claim a tax discount.

Annualization Requirement

When the accounting period for a tax report is more or less than 12 months, a taxable entity must annualize its total revenue to determine its eligibility for the elective EZ computation method or a tax discount.

Total Revenue from the Entire Business

The margin tax computation begins with the determination of total revenue from the entire business. Total revenue is defined by reference to specific lines on the taxable entity's federal tax return.

A combined group computes its revenues on a combined basis. The separate revenues for each entity are determined first and then combined, and an adjustment is made to eliminate intercompany payments.

Annual Election

The election to deduct cost of goods sold or compensation must be made by the due date, the extended due date, or the date the report is filed, whichever is latest.

Cost of Goods Sold

The cost of goods sold deduction is available only to taxable entities (including combined groups) that sell goods in the ordinary course of business. If the entity is eligible for the cost of goods sold deduction, it can make an annual election to deduct cost of goods sold or compensation.

The election to deduct cost of goods sold is made by filing a franchise tax report and deducting cost of goods sold. The election is effective for the entire period upon which the report is based. The election to deduct cost of goods sold may not be changed to a compensation deduction by filing an amended report after the due date. However, the original report may be amended to calculate margin using 70% of total revenue or the EZ computation, if qualified.

Compensation

An entity may elect to deduct compensation.

The election to deduct compensation is made by filing a franchise tax report and deducting compensation. The election is effective for the entire period upon which the report is based. The election to deduct compensation may not be changed to cost of goods sold by filing an amended report after the due date. However, the original report may be amended to calculate margin using 70% of total revenue or the EZ computation, if qualified.

30% of Total Revenue

In the absence of an election to deduct cost of goods sold or compensation, the taxable entity accepts a default deduction equal to 30% of its total revenue from the entire business. In essence, this means that a taxable entity will never pay tax on a margin that exceeds 70% of its total revenue.

As illustrated in the margin tax formula, a deduction is allowed from total revenue for compensation, cost of goods sold (if eligible), or 30% of revenues, whichever is greatest.

The cost of goods sold deduction is available only to taxable entities (including combined groups) that sell goods in the ordinary course of business. If the entity is eligible for the cost of goods sold deduction, it makes an annual election to deduct cost of goods sold or compensation. If the entity is not eligible for the cost of goods sold deduction, it may elect to deduct compensation. In the absence of an election, the taxable entity accepts a default deduction equal to 30% of its total revenue from the entire business. In essence, this means that a taxable entity will never pay tax on a margin that exceeds 70% of its total revenue.

Deduction for Active Duty Pay

Taxable entities that elect to deduct cost of goods sold or compensation in computing margin may also deduct compensation paid to Texas residents who are serving on active duty in the United States armed forces. They may also deduct costs of training replacements.

Apportionment Factor

The general formula for the apportionment factor is:

$$\frac{\text{Gross Receipts in Texas}}{\text{Gross Receipts Everywhere}}$$

Special apportionment rules are provided for banking corporations, defense readjustment projects, and sales of services to regulated investment companies (RICs) or to employee retirement plans.

Rule 3.591 provides specific guidance on the apportionment of specific items of gross receipts.

Allowable Deductions

Taxable entities are allowed to take deductions for 10% of the amortized cost of certain solar energy devices used in Texas and 10% of the amortized cost of certain equipment used in clean coal projects in Texas. The deductions are taken from apportioned margin.

Tax Rates

General Tax Rates

In general, the franchise tax rate is 1%. However, the rate is one-half of 1% (.005) for taxable entities primarily engaged in retail or wholesale trade.

EZ Tax Rate

For eligible taxable entities that elect to determine their tax under the EZ tax computation formula, the tax rate is .575% (.00575).

Additional Tax Rate

An exit tax is imposed on a taxable entity when it becomes no longer subject to the franchise tax. This can occur, for example when an entity liquidates or when a foreign (non-Texas) entity reduces its activities in Texas to those that do not establish nexus with Texas. The additional tax is designed to tax the stub period beginning the day after the taxable entity's last accounting period and ending on the day the entity becomes no longer subject to the tax.

The additional tax rate is either 1% or one-half of 1% as explained above. If the taxpayer qualifies for the EZ tax computation, the tax rate is .575% (.00575).

Tax Discounts

Certain small taxpayers are eligible to claim a discount from their computed franchise tax determined before subtracting the discount.

Reports Due in 2008 and 2009

When the accounting period for a tax report is more or less than 12 months, a taxable entity must annualize its total revenue to determine its eligibility for a tax discount.

For reports originally due in 2008 and 2009, there were four discount brackets. The applicable discount varied depending on the entity's annualized total revenue as follows:

- The tax discount was 80% for a taxable entity with annualized total revenue over $300,000, but less than $400,000.
- The tax discount was 60% for a taxable entity with annualized total revenue equal to or greater than $400,000, but less than $500,000.
- The tax discount was 40% for a taxable entity with annualized total revenue equal to or greater than $500,000, but less than $700,000.
- The tax discount was 20% for a taxable entity with annualized total revenue equal to or greater than $700,000, but less than $900,000.

For reports originally due in 2008 and 2009, tax discounts were available to taxpayers that compute their tax under either the general tax formula or the EZ tax formula.

Reports Due in 2010 and 2011

For reports originally due in 2010 and 2011, there are no tax discounts.

Inflation Adjustment. The franchise tax statue requires an inflation adjustment to be applied to the tax discounts. However the no tax due revenue threshold was increased to $1 million for reports originally due in 2010 and 2011. As a result, inflation adjustments to the tax discounts are unnecessary for 2010 and 2011.

Reports Due after 2011

For reports originally due after 2011, there are two discount brackets. The applicable discount varies depending on the entity's annualized total revenue as follows:

- The tax discount is 40% for a taxable entity with annualized total revenue equal to or greater than $600,000, but less than $700,000.
- The tax discount is 20% for a taxable entity with annualized total revenue equal to or greater than $700,000, but less than $900,000.

For reports originally due after 2011, tax discounts are available to taxpayers that compute their tax under either the general tax formula or the EZ tax formula.

Annualization Requirement

When the account period for a tax report is more or less than 12 months, a taxable entity must annualize its total revenue to determine its eligibility for a tax discount.

Credits

The former franchise tax credits have been repealed. The majority of these former credits had no carryover provision, so they no longer provide any franchise tax credit opportunity under the revised franchise (margin) tax. However, the former research and development credit, the former jobs creation credit, and the former investment tax credit provided for the carryover of unused credit. These three credits continue to provide a franchise tax credit opportunity.

A tax credit for capital investment by an enterprise project is available.

A tax credit has also been provided for clean coal projects.

Temporary Credit

A temporary tax credit is available to taxable entities that preserved their right to take the credit for business losses created on the 2003 report and subsequent reports that have not been used on a report due before January 1, 2008. The right to take the credit was preserved by properly notifying the Comptroller before the first report due after January 1, 2008.

Tiered Partnership Structures

An upper tier entity may elect to include in its total revenue its allocable share of revenue from a lower tier partnership or S corporation. The lower tier entity is allowed to exclude from its total revenue the allocable share of revenue reported to the upper tier entity.

Combined Reporting

In lieu of separate reports, taxable entities that are part of an affiliated group engaged in a unitary business must file a combined group report based on the combined group's business.

Net Tax Due

Taxpayers Treated as Owing No Franchise Tax

Taxpayers with *de minimis rules,* total revenue are treated as owing no franchise tax. The *de minimis* amount varies from year to year. Taxpayers with *de minimis* computed tax are treated as owing no franchise tax for the year.

De Minimis Total Revenue Rule for Reports Due in 2008 and 2009

General Rule for Total Revenue. Under the *de minimis* rules, a taxpayer with total revenue of $300,000 or less is treated as owing no tax for the tax year. Taxpayers that qualify under this rule are permitted to file a No Tax Due Information Report.

Annualization Requirement. When the accounting period for a tax report is more or less than 12 months, a taxable entity must annualize its total revenue to determine its eligibility for the $300,000 no tax due threshold.

Special Rule for Taxable Entities Other Than Combined Groups. Although the statute states that a taxpayer with $300,000 or less in total revenue owes no tax, the Comptroller favorably interprets this to allow for the EZ computation method and the applicable tax discount. Accordingly, taxable entities that have annualized total revenue of $434,782 or less are eligible to file a No Tax Due Information Report. (See page 19 of the instructions for 2009 reports.)

De Minimis Total Revenue Rule for Reports Due in 2010 and 2011

General Rule for Total Revenue. Under the *de minimis* rules, a taxpayer with total revenue of $600,000 or less is scheduled to be treated as owing no tax for the tax year. Taxpayers that qualify under this rule are permitted to file a No Tax Due Information Report.

Annualization Requirement. When the accounting period for a tax report is more or less than 12 months, a taxable entity must annualize its total revenue to determine its eligibility for the $1 million no tax due threshold.

De Minimis Total Revenue Rule for Reports Due after 2011

General Rule for Total Revenue. Under the *de minimis* rules, a taxpayer with total revenue of $600,000 or less is scheduled to be treated as owing no tax for the tax year. Taxpayers that qualify under this rule are scheduled to be permitted to file a No Tax Due Information Report.

Annualization Requirement. When the accounting period for a tax report is more or less than 12 months, a taxable entity must annualize its total revenue to determine its eligibility for the $600,000 no tax due threshold.

De Minimis Computed Tax Rule

A taxpayer with a computed franchise tax of less than $1,000 is treated as owing no tax for the tax year. This rule applies to reports originally due after 2007.

Taxpayers that qualify under this rule must file a long-form or EZ computation report. They are not permitted to file a no tax due information report.

Combined Groups

The *de minimis* rules apply to a combined group on the basis of its combined total revenue and its computed franchise tax computed on its combined margin.

Foreign Entities and Nexus

The Texas franchise tax is imposed on each domestic taxable entity that is chartered or organized in Texas and each foreign (non-Texas) taxable entity that does business in Texas.

The relative connection a foreign entity has with Texas is referred to as "nexus" or "doing business" in Texas. The Comptroller has provided guidance on specific activities that establish sufficient nexus with Texas to subject an entity to the franchise tax.

Texas law provides a number of exemptions that exempt qualifying taxpayers from the tax even though they would otherwise be subject to the tax.

The Texas franchise tax law specifically provides that P.L. 86-272 does not apply to the Texas franchise tax.

Taxation Depends on Whether Nexus Exists

Taxable Nexus

The Texas franchise tax is imposed on each domestic taxable entity chartered or organized in Texas. In addition, the tax is imposed on each foreign (non-Texas) taxable entity that does business in Texas. Thus, the principal issue for a foreign taxable entity is the determination of whether it is doing business in Texas and thus has nexus with Texas.

A taxable entity is subject to a state's laws based on the relative connection of its activities to that state. This connection is referred to as "nexus" or "doing business" in the state. Whether the relative connection of the entity's activities to the state is sufficient to establish nexus with the state is based on the type, quantity, and quality of the entity's activities within the state.

Nexus Hierarchy

As the relative connection of an entity's activities to the state increases, the entity becomes increasingly subject to taxation by the state. The following is a generalized hierarchy of state taxation:

1. An entity that solicits sales in a state only by catalog generally has no nexus with the state and is not subject to taxation by the state.

2. An entity that solicits sales in a state by sending sales representatives into the state generally establishes nexus for sales and use taxation. Provided the entity merely solicits sales by sending sales representatives into the state and filling orders by shipments from outside the state, it generally also establishes nexus for a nonincome based franchise tax.

3. An entity that provides post sale services in a state generally establishes nexus for state sales and use taxation, as well as for state income taxation.

4. An entity that maintains rented office space in a state generally establishes nexus for state sales and use taxation, state income taxation, and state payroll taxation.

5. An entity that owns an office building in a state generally establishes nexus for state sales and use taxation, state income taxation, state payroll taxation, and state property taxation.

Nexus for Texas Franchise Tax

The franchise tax is imposed to the extent allowed under the U.S. Constitution and applicable federal law. The Commerce Clause of the U.S. Constitution gives Congress the exclusive power to regulate interstate commerce, while the Due Process Clause of the 14th amendment prevents a state from unfairly or arbitrarily depriving a person of property.

The Supreme Court has held that a tax on the privilege of doing business in a state is permitted under the Commerce Clause. In addition, the Supreme Court has pointed out that Due Process requires some definite link, some minimum connection, between a state and the person, property, or transaction that it seeks to tax.

Business Activities that Establish Nexus

Whether an entity has nexus with Texas is determined based on the business activities it conducts within Texas. Rule 3.586 details 21 specific activities that, if conducted in Texas, establish nexus for the franchise tax.

These specific activities are:

1. *Advertising.* Entering Texas to purchase, place, or display advertising when the advertising is for the benefit of another and in the ordinary course of business.

2. *Consignments.* Having consigned goods in Texas.

3. *Contracting.* Performance of a contract in Texas regardless of whether the taxable entity brings its own employees into the state, hires local labor, or subcontracts with another.

4. *Delivering.* Delivering into Texas items it has sold.

5. *Employees or Representatives.* Having employees or representatives in Texas doing the business of the taxable entity.

6. *Federal Enclaves.* Doing business in any area within Texas, even if the area is leased by, owned by, ceded to, or under the control of the federal government.

7. *Franchisors.* Entering into one or more contracts with persons, corporations, or other business entities located in Texas, by which:

    a. The franchisee is granted the right to engage in the business of offering, selling, or distributing goods or services under a marketing plan or system prescribed in substantial part by the franchisor; and

    b. The operation of a franchisee's business pursuant to such plan is substantially associated with the franchisor's trademark, service mark, trade name, logotype, advertising, or other commercial symbol designating the franchisor or its affiliate.

8. *Holding Companies.* Maintaining a place of business in Texas or managing, directing, and/or performing services in Texas for subsidiaries or investee entities.

9. *Inventory.* Having an inventory in Texas or having spot inventory for the convenient delivery to customers, even if the bulk of orders are filled from out of state.

10. *Leasing.* Leasing tangible personal property that is used in Texas.

11. *Loan Production Activities.* Soliciting sales contracts or loans, gathering financial data, making credit checks, collecting accounts, repossessing property or performing other financial activities in Texas through employees, independent contractors, or agents, regardless of whether they reside in Texas.

12. *Partners.* Acting as a general partner in a general or limited partnership that is doing business in Texas. (However, a foreign taxable entity that is a limited partner in a limited partnership is not doing business in Texas, if that is the limited partner's only connection with Texas.)

13. *Place of Business.* Maintaining a place of business in Texas.

14. *Processing.* Assembling, processing, manufacturing, or storing goods in Texas.

15. *Real Estate.* Holding, acquiring, leasing, or disposing of any property located in Texas.

16. *Services,* including, but not limited to the following:

    a. Providing any service in Texas, regardless of whether the employees, independent contractors, agents, or other representatives performing the services reside in Texas;

    b. Maintaining or repairing property located in Texas whether under warranty or by separate contract;

    c. Installing, erecting, or modifying property in Texas;

    d. Conducting training classes, seminars, or lectures in Texas;

    e. Providing any kind of technical assistance in Texas, including but not limited to, engineering services; or

    f. Investigating, handling, or otherwise assisting in resolving customer complaints in Texas.

17. *Shipment.* Sending materials to Texas to be stored awaiting orders for their shipment.

18. *Shows and Performances.* Staging or participating in shows, theatrical performances, sporting events, or other events within Texas.

19. *Solicitation.* Having employees, independent contractors, agents, or other representatives in Texas, regardless of whether they reside in Texas, to promote or induce sales of the foreign taxable entity's goods or services.

20. *Telephone Listing.* Having a telephone number that is answered in Texas.

21. *Transportation.* Carrying passengers or freight (including oil and gas transmitted by pipeline) from one point in Texas to another point within the state, if pickup and delivery, regardless of origination or ultimate destination, occurs within Texas, or having facilities and/or employees, independent contractors, agents, or other representatives in Texas, regardless of whether they reside in Texas.

These listed activities constitute doing business in Texas and establish nexus for the franchise tax. The list is not intended to be exhaustive.

Certificate of Authority

The mere passive possession of a certificate of authority to do business in Texas is insufficient to subject the entity to the franchise tax. When the entity conducts its activity solely through interstate commerce and lacks any physical presence in Texas, insufficient nexus exists to permit the state to assess tax.

Termination of Nexus

Taxable entities that break nexus with Texas are subject to an additional tax on margin. The additional tax is sometimes referred to as an exit or final tax.

Exemptions from the Texas Franchise Tax

Exemptions from the franchise tax are provided for religious, charitable, educational, conservation, and other special activities.

A qualifying entity must apply to the Comptroller for an exemption. In certain situations, a provisional exemption may be sought. If the Comptroller grants the exemption, it will be effective from the date the entity first qualifies for the exemption. If the exemption is not granted, the applicant can appeal the denial.

An exemption can be revoked if the entity no longer qualifies for the exemption.

Franchise Tax Exemptions

Franchise Tax Exemptions under Subchapter B

Subchapter B of the Texas franchise tax statute provides exemptions from the Texas franchise tax for religious, charitable, educational, conservation, and other special activities. These franchise tax exemptions are available to corporations as well as all other types of entities.

To establish an exemption from the franchise tax, an entity must apply for the exemption and provide sufficient evidence to the Comptroller to substantiate its exempt status. If any doubt exists about whether the entity qualifies for exemption, the Comptroller will deny the exemption.

Currently, the franchise tax statute provides over 30 exemptions. State and federal government entities are automatically exempt from the Texas franchise tax and do not need to qualify for exemption.

Bingo Unit Exemption

Bingo units formed under Subchapter I-1, Chapter 2001, Occupations Code, are exempted from franchise tax under House Bill 1474.

Eligible entities must submit an application for exemption, along with the governing document showing the entity was created under this chapter.

Applying for the Exemption

An entity must apply for an exemption from the Texas franchise tax.

If the entity qualifies for exemption from the Texas franchise tax under TTC Sec. 171.063 because it is exempt from federal tax under paragraph (2), (3), (4), (5), (6), (7), (8), (10), (16), (19), or (25) of IRC Sec. 501(c), it must establish its exemption by submitting a copy of the IRS letter granting its federal tax exemption.

Other entities apply for exemption by submitting the following to the Comptroller:

1. A written request for exemption (using the applicable comptroller form) that indicates the particular exemption claimed.

2. A detailed statement of the entity's past, current, and planned future activities and how these activities relate to the way the entity proposes to implement the purposes clause of its articles of organization or certificate of authority to do business in Texas.

3. A non-Texas entity must also include a file-stamped copy of its formation document or governing document along with a current certificate of existence issued by the secretary of state or other authorized officer of the entity's home jurisdiction.

4. Any additional information the Comptroller requires.

In addition to corporations and LLC's, the exemptions provided in Subchapter B are specifically made available to taxable entities such as partnerships, business trusts, professional associations, etc. However, all taxable entities that qualify for an exemption must follow the same procedures to apply for and obtain the exemption.

Verifying Exempt Status. An organization may verify its exempt status with the Comptroller online at **http://www.window.state.tx.us/taxinfo/exempt/exempt_search.html**.

If the Exemption Is Granted

Date Exemption becomes Effective

If the Comptroller grants the exemption, it will be effective from the first date the entity qualifies for the exemption. The first date the entity qualifies for exemption is the first date on which its activities meet the requirements of an exemption.

If the entity files for its exemption within 15 months after the last day of the calendar month in which its charter or certificate of authority is dated, the exemption is recognized as of the date of the charter or certificate of authority.

Potential Tax Payments or Refund

If the first date the entity qualifies for exemption occurs after the beginning of a privilege period, the entity must pay franchise tax through the end of such privilege period.

If the entity qualifies for exemption subsequent to the payment of franchise tax, it may receive refunds of previously paid franchise taxes for privilege periods during which it qualified for exemption for the entire period. The statute of limitations on refunds is generally four years from the date the tax was due and payable.

An entity that has been subject to the franchise tax may be liable for the additional tax. The additional tax would apply for the period from the last date its taxable margin was taxed on a previous report through the day the entity's exemption becomes effective.

If the Exemption Is Not Granted

If the exemption is not granted, the entity has the following options:

1. pay all taxes, penalties, and interest and request a refund hearing pursuant to Chapter 111, Tax Code;

2. pay all taxes, penalties, and interest under written protest and file a suit for recovery pursuant to Chapter 112, Tax Code; or

3. request a determination of deficiency and, if issued, request a redetermination hearing pursuant to TTC Sec. 111.009.

Revocation of Exemption

An entity that no longer qualifies for a franchise tax exemption must notify the Comptroller in writing of the change.

If at any time the Comptroller has any reason to believe that an exempt entity no longer qualifies, the Comptroller will notify the entity that its exempt status is under review. The entity may be asked to provide additional information about its exempt status. If the Comptroller determines that the entity no longer qualifies for exemption, notice to that effect will be sent. A revocation of exemption is effective from the date the entity's activities no longer qualify it for exemption from franchise tax.

An entity qualifying for exemption under IRC Sec. 501(c) automatically loses its exemption from franchise tax if it loses its federal tax exemption, effective on the same date. The day immediately following the effective date of withdrawal, loss, or revocation of exemption is considered the entity's beginning date for determining privilege periods and other franchise tax matters. The entity must notify the Comptroller in writing within 30 days of receiving a revocation notice from the IRS.

If the exemption is revoked, the entity will be required to pay all accrued back taxes, penalties, and interest for any privilege period that includes the revocation date and any subsequent privilege periods for which no franchise tax was paid. The entity may appeal the revocation using any of the three options specified above.

Trade Show Exemption

Qualifying for the Exemption

In addition to the traditional exemptions for nonprofit entities and the like, an exemption is provided for certain trade show participants. The trade show exemption is available to foreign (non-Texas) taxable entities whose only activity within Texas involves the solicitation of specific types of sales on an occasional basis at trade shows promoted by specific sponsors.

Sponsors. Sponsors include nonprofit trade or professional associations that facilitate soliciting orders from members of the trade or profession; municipal or county-owned convention centers or meeting facilities; and wholesale centers.

Solicitation Periods. A foreign taxable entity must meet two requirements to qualify for the trade show exemption.

First, the solicitation of orders must be conducted on an occasional basis, which is defined as no more than five times during the business period of the entity to which a tax report applies. The entity does not qualify for the exemption if the solicitation of orders is conducted at more than five trade shows during its business period.

Second, each solicitation period may not exceed 120 consecutive hours. The taxable entity does not qualify for the trade show exemption if a single period exceeds 120 consecutive hours.

Wholesale Centers. A tenant leasing space year-round at a wholesale center will qualify for the trade show exemption if it solicits orders on an occasional basis. Soliciting on an occasional basis means the tenant does not solicit orders for more than five periods of 120 consecutive hours each under the normal trade show exemption rules.

A wholesale center is a permanent wholesale facility that has permanent tenants and promotes at least four national or regional trade shows in a calendar year.

Notifying the Comptroller

A foreign (non-Texas) taxable entity does not need to apply to the Comptroller for a trade show exemption.

However, if a foreign taxable entity has previously notified the Comptroller that it is doing business in Texas or if it has obtained a certificate of authority to do business in Texas, it must notify the Comptroller in writing by the due date of the first report for which it qualifies for the exemption that it is exempt from franchise tax. Once this notification is provided, the entity should notify the Comptroller if it fails to continue qualifying for the trade show exemption.

Similarly, a foreign taxable entity that is not doing business in Texas and has not obtained a certificate of authority to do business in Texas is required to notify the Comptroller in writing only if it fails to continue qualifying for that exemption and is otherwise doing business in Texas.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

1. Which of the following statements correctly describes the effective date for the current Texas franchise tax, which is based on the margin calculation (i.e., the "margin tax")?

   a. The franchise tax is effective for franchise tax reports filed after January 1, 2008.

   b. The franchise tax is effective for entities formed after January 1, 2008.

   c. The franchise tax is effective for franchise tax reports filed on or after March 15, 2008.

   d. The franchise tax is effective for franchise tax reports filed on or after June 16, 2008.

2. Which of the following statements correctly describes the EZ computation for calculating the revised Texas franchise tax?

   a. The EZ computation equals an entity's apportioned margin times .5% less any applicable discount.

   b. The EZ computation equals an entity's apportioned margin times 1% less any applicable discount.

   c. The EZ computation equals an entity's apportioned revenues times .575% less any applicable discount.

3. Which of the following statements correctly describes the calculation of margin for Texas franchise tax purposes?

   a. Margin equals an entity's revenues less its cost of goods sold and compensation.

   b. Margin equals an entity's revenues less its choice of cost of goods sold, compensation or 30% of revenues.

   c. Margin equals an entity's income less its choice of cost of goods sold, compensation or 30% of income.

   d. Margin equals an entity's apportioned gross receipts times 30%.

4. In which of the following situations would the Comptroller likely consider the entity to **not** be doing business in Texas for Texas franchise tax nexus purposes?

   a. Spiffy Sales Corporation sends traveling salesmen into Texas for at least one week a month to solicit orders for sales of tangible personal property.

   b. Spiffy Sales Corporation rents office space in Texas.

   c. Spiffy Sales Corporation solicits sales in Texas by catalog.

   d. Spiffy Sales Corporation Spiffy owns office space in Texas.

5. Which of the following business activities establish nexus under the Comptroller's rules?

   a. Holding a certificate of authority to do business in Texas.

   b. Sending catalogs to prospective Texas customers.

   c. Maintaining a website which is accessible by prospective Texas customers.

   d. Maintaining spot inventory in Texas for convenient delivery to customers, where the bulk of orders are filled from out-of-state.

6. An entity must apply for an exemption from the Texas franchise tax. If the comptroller grants the exemption, it will be effective from the first date the entity qualifies for exemption. What happens if the first date the entity qualifies for exemption occurs after the start of a privilege period?

   a. The exemption acknowledged as of the date of the certificate of authority.

   b. The entity is required to pay franchise tax through the end of the privilege period.

   c. The entity can receive refunds from franchise taxes that were previously paid for privilege periods during which the entity qualified for exemption for the entire period.

7. Which of the following types of businesses will generally be exempt from the Texas franchise tax?

   a. A professional association.

   b. A management company.

   c. An educational organization.

   d. A health care provider.

8. Which of the following types of entities must apply with the Texas Comptroller for exempt status?

   a. A federally exempt charitable organization organized under IRC § 501(c)(3).

   b. An entity qualifying for exemption under the *de minimis* trade show exemption.

   c. A federally exempt branch of the federal government.

   d. A Texas state governmental entity.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

1. Which of the following statements correctly describes the effective date for the current Texas franchise tax, which is based on the margin calculation (i.e., the "margin tax")? **(Page 5)**

   a. The franchise tax is effective for franchise tax reports filed after January 1, 2008. [This answer is correct. For existing corporations or LLC's that were subject to the pre-2008 franchise tax, the transition to the new margin tax is straightforward. These taxpayers filed an annual report under the new post-2007 margin tax rules, originally due May 15, 2008, and based on the taxpayer's tax year ending in 2007. For an entity becoming subject to the revised franchise (margin) tax, neither margin nor gross receipts occurring before June 1, 2006, are considered for margin tax purposes.]

   b. The franchise tax is effective for entities formed after January 1, 2008. [This answer is incorrect. The current franchise tax applies to both existing and newly formed entities.]

   c. The franchise tax is effective for franchise tax reports filed on or after March 15, 2008. [This answer is incorrect. While the initial franchise tax report due date for most entities was March 15, 2008, this is not the effective date for the franchise tax.]

   d. The franchise tax is effective for franchise tax reports filed on or after June 16, 2008. [This answer is incorrect. While the Comptroller extended the initial franchise tax report due date for most entities to June 16, 2008, this is not the effective date for the franchise tax.]

2. Which of the following statements correctly describes the EZ computation for calculating the revised Texas franchise tax? **(Page 6)**

   a. The EZ computation equals an entity's apportioned margin times .5% less any applicable discount. [This answer is incorrect. The regular margin tax formula for retailers and wholesalers equals the entity's apportioned margin times .5%.]

   b. The EZ computation equals an entity's apportioned margin times 1% less any applicable discount. [This answer is incorrect. The regular margin tax formula for entities other than retailers and wholesalers equals the entity's apportioned margin times 1%.]

   c. The EZ computation equals an entity's apportioned revenues times .575% less any applicable discount. [This answer is correct. To arrive at apportioned revenue or taxable margin, multiply the apportionment factor by total revenue.]

3. Which of the following statements correctly describes the calculation of margin for Texas franchise tax purposes? **(Page 5)**

   a. Margin equals an entity's revenues less its cost of goods sold and compensation. [This answer is incorrect. An entity may not deduct both cost of goods sold and compensation.]

   b. Margin equals an entity's revenues less its choice of cost of goods sold, compensation or 30% of revenues. [This answer is correct. To pay the least amount of tax the entity should choose the greatest of these three items.]

   c. Margin equals an entity's income less its choice of cost of goods sold, compensation or 30% of income. [This answer is incorrect. The margin tax calculation is not based on income.]

   d. Margin equals an entity's apportioned gross receipts times 30%. [This answer is incorrect. Apportionment occurs after the calculation of margin.]

4. In which of the following situations would the Comptroller likely consider the entity to **not** be doing business in Texas for Texas franchise tax nexus purposes? **(Page 11)**

   a. Spiffy Sales Corporation sends traveling salesmen into Texas for at least one week a month to solicit orders for sales of tangible personal property. [This answer is incorrect. Sending salesmen into the state to solicit orders for sales of tangible personal property establishes nexus. Although these activities may be protected from a tax imposed on or measured by net income under Public Law 86-272, the legislature has stated that the margin tax is not to be considered a "net income tax" for purposes of Public Law 86-272.]

   b. Spiffy Sales Corporation rents office space in Texas. [This answer is incorrect. Renting office space in a state generally establishes nexus for state sales and use taxation, state income taxation and state payroll taxation. Therefore, it would also create nexus for Texas sales tax purposes.]

   c. Spiffy Sales Corporation solicits sales in Texas by catalog. [This answer is correct. Under the Quill case, an entity that solicits orders within a state by catalog only, does not establish the requisite physical presence to create nexus within that state.]

   d. Spiffy Sales Corporation Spiffy owns office space in Texas. [This answer is incorrect. Owning office space in a state generally establishes nexus for state sales and use taxation, state income taxation and state payroll taxation. Therefore, it would also create nexus for Texas sales tax purposes.]

5. Which of the following business activities establish nexus under the Comptroller's rules? **(Page 11)**

   a. Holding a certificate of authority to do business in Texas. [This answer is incorrect. The mere passive possession of a certificate of authority to do business in Texas is insufficient to subject the entity to the franchise tax. When the entity conducts its activity solely through interstate commerce and lacks any physical presence in Texas, insufficient nexus exists to permit the state to assess tax.]

   b. Sending catalogs to prospective Texas customers. [This answer is incorrect. Sending catalogs to prospective customers in Texas by common carrier, such as the U.S. mail, is insufficient to subject the entity to the franchise tax. When the entity conducts its activity solely through interstate commerce and lacks any physical presence in Texas, insufficient nexus exists to permit the state to assess tax.]

   c. Maintaining a website which is accessible by prospective Texas customers. [This answer is incorrect. Maintaining a website which is accessible by prospective Texas customers is insufficient to subject the entity to the franchise tax. When the entity conducts its activity solely through interstate commerce and lacks any physical presence in Texas, insufficient nexus exists to permit the state to assess tax. Owning or renting server space in Texas for the website may subject the entity to nexus.]

   d. Maintaining spot inventory in Texas for convenient delivery to customers, where the bulk of orders are filled from out-of-state. [This answer is correct. Comptroller Rule 3.586 states that having an inventory in Texas or having spot inventory for the convenient delivery to customers is sufficient to create nexus, even if the bulk of orders are filled from out of state.]

6. An entity must apply for an exemption from the Texas franchise tax. If the comptroller grants the exemption, it will be effective from the first date the entity qualifies for exemption. What happens if the first date the entity qualifies for exemption occurs after the start of a privilege period? **(Page 13)**

    a. The exemption acknowledged as of the date of the certificate of authority. [This answer is incorrect. If the entity files for its exemption within 15 months after the last day of the calendar month in which its charter or certificate of authority is dated, the exemption is recognized as of the date of the charter or certificate of authority.]

    b. The entity is required to pay franchise tax through the end of the privilege period. [This answer is correct. According to TTC Sec. 171.051(b), if the first date the entity qualifies for exemption occurs after the beginning of the privilege period, the entity must pay franchise tax through the end of such period.]

    c. The entity can receive refunds from franchise taxes that were previously paid for privilege periods during which the entity qualified for exemption for the entire period. [This answer is incorrect. If the entity qualifies for exemption subsequent to the payment of franchise tax, it may receive refunds of previously paid franchise taxes for privilege periods during which it qualified for exemption for the entire period.]

7. Which of the following types of businesses will generally be exempt from the Texas franchise tax? **(Page 13)**

    a. A professional association. [This answer is incorrect. According to the Tax Code, professional associations were not previously subject to the franchise tax on earned surplus and taxable capital. However, they are subject to the franchise tax on margin, effective January 1, 2008.]

    b. A management company. [This answer is incorrect. Management companies are subject to the tax as long as they are organized as taxable entities. There is no exemption for management companies per the Tax Code.]

    c. An educational organization. [This answer is correct. Subchapter B of the Texas franchise tax statute provides exemptions from the Texas franchise tax for religious, charitable, educational, conservation and other special activities.]

    d. A health care provider. [This answer is incorrect. Health care providers are subject to the tax as long as they are organized as taxable entities. There is no exemption for health care providers per the Tax Code.]

8. Which of the following types of entities must apply with the Texas Comptroller for exempt status? **(Page 13)**

    a. A federally exempt charitable organization organized under IRC § 501(c)(3). [This answer is correct. An entity exempt under IRC § 501(c)(3) must separately qualify for exemption under the Texas franchise tax.]

    b. An entity qualifying for exemption under the *de minimis* trade show exemption. [This answer is incorrect. The *de minimis* trade show exemption is available to foreign (non-Texas) taxable entities whose only activity within Texas involves the solicitation of specific types of sales on an occasional basis. The entities are not required to apply for exemption but should maintain detailed records proving their limited activities in Texas.]

    c. A federally exempt branch of the federal government. [This answer is incorrect. Federal governmental entities are not subject to the Texas franchise tax under constitutional provisions.]

    d. A Texas state governmental entity. [This answer is incorrect. Texas state governmental entities are not subject to the Texas franchise tax under constitutional provisions.]

EXAMINATION FOR CPE CREDIT

Lesson 1 (TFTTG101)

Determine the best answer for each question below. Then mark your answer choice on the Examination for CPE Credit Answer Sheet located in the back of this workbook or by logging onto the Online Grading System.

1. Which of the following is correct with respect to combined groups?

   a. Combined group members may choose the most advantageous deduction (compensation, cost of goods sold, or 30%) and may combine the deductions to obtain the lowest possible margin.

   b. Each combined group member may deduct up to $300,000 per person for the compensation deduction.

   c. A taxable entity may choose the most advantageous deduction (compensation, cost of goods sold, or 30%) and use that deduction to obtain the lowest possible margin.

   d. Once a taxable entity has elected a choice of deduction (compensation, cost of goods sold, or 30%), it may not change that deduction in future years.

2. Which of the following reporting methods is elective if the requisite elements are met?

   a. The EZ computation.

   b. Combined reporting.

   c. Waters edge reporting.

   d. The apportionment formula.

3. Which of the following businesses is eligible for the EZ Computation?

   a. A business with margin of $10 million or less.

   b. A business with revenues of $10 million or less.

   c. A business with Texas gross receipts of $10 million or less.

   d. A business with cost of goods sold of $10 million or less.

4. Which of the following businesses is eligible for a small business discount?

   a. A business with total revenues of $9 million.

   b. A business with total revenues of $900,000.

   c. A business with total revenues of $800,000.

   d. A business with gross receipts of $900,000.

5. Which of the following types of entities are generally exempt from tax if the Comptroller grants them an exemption?

   a. A public charity.

   b. A limited liability partnership.

   c. A general partnership.

   d. A single-member LLC.

Lesson 2: Payment and Filing Requirements

INTRODUCTION

Tax rates, tax payments and deposits, filing requirements and due dates, extensions, and amended reports are covered in this lesson.

Learning Objectives:

Completion of this lesson will enable you to:

- Analyze which tax rate applies to a taxable entity or combined group.
- Discuss deadlines for franchise tax reports and payments, and summarize franchise tax reporting and estimated payment requirements for franchise tax extensions.

Two tax rates are provided, depending on whether the taxpayer is a retailer or wholesaler. An alternative tax rate applies to taxpayers who qualify for and elect to compute their franchise tax liability under the EZ computation method.

Tax discounts are available for small businesses.

Tax Rates

General Tax Rate

The general tax rate is 1%. This rate applies to all taxpayers other than taxpayers engaged primarily in retail or wholesale trade, and taxpayers who qualify for and elect the EZ computation method.

Tax Rate for Retailers and Wholesalers

The tax rate for taxpayers primarily engaged in retail and wholesale trades is one-half of 1% (.005).

Tax Rate under the Elective EZ Computation Method

The tax rate is .575% (.00575) for taxpayers who qualify for and elect to use the EZ computation method to compute their franchise tax liability.

Additional Tax Rate

The additional tax (sometimes referred to as an exit tax) is imposed on a taxable entity when it becomes no longer subject to the franchise tax. This can occur, for example, when an entity liquidates or when a foreign (non-Texas) entity reduces its activities in Texas to those that do not establish nexus with Texas. The additional tax is designed to tax the stub period beginning the day after the taxable entity's last full accounting period and ending on the day the entity becomes no longer subject to the tax.

The additional tax rate is determined under TTC Sec. 171.002, so it is either 1% or one-half of 1% as explained above. If the taxpayer qualifies for the EZ tax computation, the tax rate is .575% (.00575).

Retail and Wholesale Trade

Taxpayers Eligible for the Tax Rate for Retailers and Wholesalers

Taxable entities primarily engaged in retail or wholesale trade are eligible for the one-half of 1% (.005) tax rate.

Wholesale Trade

Wholesale trade means the activities described in Division F of the 1987 Standard Industrial Classification Manual published by the federal Office of Management and Budget (1987 SIC Manual). Division F includes Major Groups 50 and 51.

Retail Trade

Retail trade means the activities described in Division G of the 1987 SIC Manual. Division G includes Major Groups 52 through 59.

Primarily Engaged in Retail or Wholesale Trade

A taxable entity is primarily engaged in retail or wholesale trade if it meets all of the following tests:

1. The total revenue for the taxable entity's 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. Less than 50% of the taxable entity's total revenue comes from the sale of products the entity produces (or products produced by an entity that is part of the taxable entity's affiliated group).

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

Exception for Eating and Drinking Places. Item 2 in the preceding list does not apply to total revenue from activities in a retail trade described by Major Group 58 of the 1987 SIC Manual. Major Group 58 includes eating and drinking places.

Combined Reporting

The determination of whether a combined group qualifies as a retailer or wholesaler is made on a combined basis. Accordingly, a combined group qualifies for the lower tax rate for retailers and wholesalers if the combined revenue from each member's retail and wholesale businesses is more than half the group's combined total revenues, after eliminations.

1987 Standard Industrial Classification Manual

The 1987 SIC Manual can be found on the U.S. Department of Labor's website at **www.osha.gov**/**pls**/**imis**/**sic_manual.html**. The webpage clearly reveals the structure of the 1987 SIC Manual and can be conveniently searched by SIC code.

De Minimis Rules

Taxpayers Treated as Owing No Franchise Tax

The franchise tax statute treats certain taxpayers as owing no franchise tax. There are two *de minimis* rules. An additional rule is provided for taxpayer that have zero Texas gross receipts.

De Minimis Total Revenue. The first rule applies to taxpayers with de minimis total revenue. The *de minimis* total revenue amount varies depending on when the taxpayer's franchise tax report is originally due. The taxpayer's total revenue amount must be computed in accordance with the annualization requirement.

Taxpayers that qualify under this rule are eligible to file a No Tax Due Information Report (Form 05-163). They must also file either a Public Information Report (Form 05-102) or an Ownership Information Report (Form 05-167).

De Minimis Computed Tax Liability. The second rule applies to taxpayers with a *de minimis* computed tax liability.

These taxpayers must file a long-form report (Form 05-158) or an EZ computation report (Form 05-169) to establish their eligibility to be treated as owing no franchise tax. They must also file either a Public Information Report (Form 05-102) or an Ownership Information Report (Form 05-167).

De Minimis Total Revenue Rule for Reports Due in 2008 and 2009

General Rule for Total Revenue. Under the *de minimis* rules, a taxpayer with total revenue of $300,000 or less is treated as owing no tax for the tax year. Taxpayers that qualify under this rule are permitted to file a no tax due information report.

Annualization Requirement. When the accounting period for a tax report is more or less than 12 months, a taxable entity must annualize its total revenue to determine its eligibility for the $300,000 no tax due threshold.

Special Rule for Taxable Entities Other Than Combined Groups. Although the statute states that a taxpayer with $300,000 or less in total revenue owes no tax, the Comptroller favorably interprets this to allow for the applicable tax discount. Accordingly, taxable entities (other than combined groups) that have annualized total revenue of $434,782 or less are eligible to file a no tax due information report.

***De Minimis* Total Revenue Rule for Reports Due in 2010 and 2011**

General Rule for Total Revenue. Under the *de minimis* rules, a taxpayer with total revenue of $1 million or less is treated as owing no tax for the tax year. Taxpayers that qualify under this rule are permitted to file a no tax due information report.

Annualization Requirement. When the accounting period for a tax report is more or less than 12 months, a taxable entity must annualize its total revenue to determine its eligibility for the $1 million no tax due threshold.

***De Minimis* Total Revenue Rule for Reports Due after 2011**

General Rule for Total Revenue. Under the *de minimis* rules, a taxpayer with total revenue of $600,000 or less is treated as owing no tax for the tax year, as amended effective January 1, 2012. Taxpayers that qualify under this rule are permitted to file a no tax due information report.

Annualization Requirement. When the accounting period for a tax report is more or less than 12 months, a taxable entity must annualize its total revenue to determine its eligibility for the $1 million no tax due threshold.

***De Minimis* Computed Tax Rule**

A taxpayer with a computed franchise tax of less than $1,000 is treated as owing no tax for the tax year. This rule applies to reports originally due after 2007.

Taxpayers that qualify under this rule must file a long-form or EZ computation report. They are not permitted to file a no tax due information report.

Zero Texas Gross Receipts Rule

A taxpayer that has zero Texas gross receipts has an apportionment factor equal to zero. Such taxpayers are treated as owing no Texas franchise tax and are eligible to file a No Tax Due Information Report.

Combined Groups

The *de minimis* rules apply to a combined group on the basis of its combined total revenue and its computed franchise tax computed on its combined margin. The group will be treated as owning no franchise tax if its computed tax (calculated on its combined margin) is less than $1,000. Similarly, the group will be treated as owing no franchise tax if its combined total revenue is *de minimis.*

A combined group is not allowed to file a No Tax Due Information Report. (See the Instrustions Form 05-163.) Instead, it must file a long-form report (Form 05-158) or an EZ computation report (Form 05-169). If group's combined total revenue computed at Item 10, Form 05-158 or Form 05-169, is *de minimis*, the group will not have to complete the rest of the form. The group should file the form showing its combined total revenue along with the a public information or ownerhip information report.

Tax Payments and Deposits

Franchise tax payments are due on or before the report filing deadline.

Certain taxpayers are required to remit franchise tax payments via electronic funds transfers (EFT). The threshold triggering the requirement to remit funds electronically is currently $10,000.

Credit cards can be used to remit certain delinquent taxes and related penalties and interest. Protest payments may be made under certain circumstances.

Texas does not require tax deposits or estimated payments.

Payment Due Dates

Due Dates

Franchise tax payments are due on or before the filing deadline for the applicable tax report.

Annual Reports. Annual reports are originally due by May 15 each year.

Initial Reports. Initial reports are originally due within 90 days after the date the initial period ends.

Final Reports. Final reports are originally due within 60 days.

Extensions

An extension to file a report does not extend the date payment is due. However, in certain cases, full payment is not required to obtain an extension.

Late Payment Penalties and Interest

Late payments are subject to interest and penalties.

Payment by Electronic Funds Transfer

Certain taxpayers are required to make tax payments by means of electronic funds transfer (EFT).

EFT Requirement

$10,000 Per Year Rule. For payments due on or after May 1, 2008, a $10,000 EFT remittance threshold applies to taxpayers who paid at least $10,000 in franchise tax during the preceding state fiscal year.

$100,000 Per Year Rule. For payments due before May 1, 2008, the EFT threshold was $100,000.

State Fiscal Year. The Texas state fiscal year begins September 1 and ends on August 31 of the following year.

Example 2F-1 Aggregate tax payments during the Texas state fiscal year may trigger the requirement to remit payments electronically.

Quick Shop is a taxable entity. In 2009, it had not met the $10,000 payment threshold and was not required to remit payments electronically. Quick Shop filed a franchise tax extension and remitted payment of $7,000 by May 15, 2009.

On November 2, 2009, Quick Shop filed its 2009 annual franchise tax report and remitted the remitted the $3,000 balance due.

In 2010, Quick Shop based its extension payment on its prior year tax liability and remitted $10,000 to the Comptroller with its extension request.

Because the applicable Texas state fiscal year runs from September 1, 2009 through August 31, 2010, Quick Shop exceeded the $10,000 threshold by paying $3,000 in November 2009 with its 2009 report and $10,000 in May 2010 with its extension request. Quick Shop is now presumably required to remit tax payments electronically. The Comptroller will notify Quick Shop if it is required to remit payments electronically.

Waiver

Taxpayers who cannot pay electronically due to hardship, impracticality or other valid reason may submit a written request to the Comptroller for waiver. The waiver request can be mailed to Electronic Reporting Section, P.O. Box 13528, Austin, TX 78711 or faxed to (877) 882-8894.

Penalties and Interest

Late Payments. Late EFT payments are subject to the normal penalties and interest. Additionally, taxpayers who do not comply with the requirement to remit payments electronically can be assessed a 5% penalty.

Failure to Pay by EFT when Required. A taxpayer can be assessed a penalty equal to 5% of the tax due if it must pay its franchise tax by EFT but fails to do so. This penalty is in addition to any other penalty.

Comptroller Notifies the Taxpayer Subject to the EFT Requirement

Taxpayer Notification. Each year the Comptroller's office reviews franchise tax payments to determine which taxpayers must remit future payments by EFT. Taxpayers identified as required to pay by EFT are notified at least 60 days prior to the date their first EFT payment is due. A combined group is required to electronically transmit payments if any member of the group receives notice that it is required to make payment electronically.

Voluntary EFT Payments. Taxpayers not otherwise required to remit franchise tax payments by EFT may nevertheless choose to do so voluntarily. Taxpayers should complete Form 00-107 to set up an account with the Comptroller.

Protest Payments

A taxpayer may occasionally contend that a tax collected by the Comptroller is unlawful or collected unlawfully. In such cases, the taxpayer may pay the tax under protest. The payment should be submitted along with a written protest stating fully and in detail each reason for recovering the protest payment. Within 91 days after making the protest payment, the taxpayer may file a suit against the state to recover the protested tax.

Taxpayers who are otherwise required to remit tax payments by electronic funds transfer (EFT) are not required to remit protest payments by EFT.

Filing Requirements and Due Dates

Annual franchise tax reports are normally due May 15 of each year. The due date for initial reports has changed. For entities that became subject to the franchise tax on or after October 4, 2009, the taxpayer's initial report is normally due by May 15 of the calendar year following year in which the entity becomes subject to the franchise tax. For entities that became subject to the franchise tax prior to this date, the initial report is normally due 90 days after the end of the entity's initial privilege period. Final reports are normally due 60 days after the entity becomes no longer subject to the tax.

Certain taxpayers may qualify to file a No Tax Due Information Report, and special reporting rules apply to nontaxable entities.

Electronic filing, weekend and holiday, and postmark rules are covered, as well as the special rule that applies to survivors of mergers. Information for taxpayers with accounts not in good standing is also included.

Annual Franchise Tax Report

Filing Requirement and Due Date

Due Date. An annual Texas franchise tax report is due by May 15 of each year.

Business Period Reported. The tax due is based on business done during the business period that ends during the preceding calendar year. This period will normally coincide with the entity's federal year year ending during the preceding calendar year.

Privilege Period Covered. Payment of franchise taxes grants the entity the right to do business in Texas for the regular annual privilege period. This is normally the calendar year during which the tax report is due.

First Franchise Tax Report

Entities Becoming Subject to the Franchise Tax after October 3, 2009—First Annual Report Rules

Simplified Due Date Rules. The Comptroller has simplified the rules for the taxpayer's first franchise tax reports. For entities that become subject to the franchise after October 3, 2009, the taxpayer's first report will be due by May 15 of the calendar year following the year in which the entity first becomes subject to the franchise tax. Under the simplified rules, the taxpayer's first report will be an annual report. This report is referred to as the *first annual report*.

Beginning Date. The date the entity first becomes subject to the franchise tax is referred to as its *beginning date*.

Business Period. Under the simplified rules, the taxpayer's first annual franchise tax report is based on the taxpayer's business done during the period starting on the beginning date and ending on the last accounting period ending date for federal income tax purposes that is in the same calendar year as the beginning date.

Entities Becoming Subject to the Franchise Tax before October 4, 2009—Initial Report Rules

Due Date Rules. For entities that became subject to the franchise tax before October 4, 2009, the taxpayer's initial report will due within 90 days after the end of the taxable entity's initial privilege period. The initial privilege period begins on the beginning date and ends on the day before the first anniversary of that date.

Privilege Period Covered. Payment of the franchise tax due on an initial report grants the entity the right to do business in Texas for the initial privilege period and the second privilege period. The second privilege period is essentially a stub period, which begins when the initial period ends and ends on the following December 31.

In certain circumstances, the initial report will cover the initial, second, and first regular annual privilege periods. When the first regular annual privilege period is included on the initial report, payment of the franchise tax due on the initial report also grants the entity the right to do business during its first regular annual privilege period.

Business Period Reported. The business periods upon which the tax is based are defined by the franchise tax statute. For initial reports, such "business periods" do not always coincide with an entity's fiscal accounting year.

Survivors of Certain Mergers

If a taxable entity is the survivor of a merger, the initial report is due within 91 days after the merger.

Final Franchise Tax Report

Filing Requirement and Due Date

A taxable entity's requirement to file a final report is triggered by any event that causes the entity to become "no longer subject to" the franchise tax. The final report is designed to tax the stub period beginning the day after the taxable entity's last full accounting period and ending on the day the entity becomes no longer subject to the tax.

The final report is due within 60 days after the taxpayer dissolves or merges out of existence, withdraws from Texas, or no longer has sufficient nexus with Texas to be subject to the franchise tax.

Filing a Final Report to Obtain a Certificate of Account Status

For a domestic (Texas) taxable entity to dissolve, merge with another entity, or withdraw from Texas, the entity must file a Certificate of Account Status with the Texas Secretary of State's Office.

Similarly, for a foreign (non-Texas) taxable entity to withdraw from Texas, the entity must file a Certificate of Withdrawal with the Texas Secretary of State's Office.

To obtain the Certificate of Account Status, the entity must file its final franchise tax report and pay the final tax along with any other Texas taxes that are due. Form 05-359 (Request for Certificate of Account Status to Terminate a taxable entity's Existence in Texas) must be completed. In most cases it will be necessary to base the final tax report and payment on preliminary data and amend it at a later date when an accurate accounting is available. Once all tax requirements have been met, the Comptroller will issue the Certificate of Account Status to the taxpayer to file with the Secretary of State.

No Tax Due Information Report and Due Date

A taxable entity that owes no franchise tax is normally not required to file a long-form report. However, it may be required to file an information report.

A No Tax Due Information Report (Form 05-163) can be filed as an initial, annual, or final report. The due date for such a report is the same as that for other initial, annual, or final reports.

Taxable Entities Eligible to File a No Tax Due Information Report

Taxable entities are eligible to file a No Tax Due Information Report in the following situations:

1. The entity has *de minimis* annualized total revenue.
2. The entity has zero Texas gross receipts.
3. The entity qualifies as a passive entity.
4. The entity is a real estate investment trust (REIT) that meets certain requirements.

***De Minimis* Annualized Total Revenue**

A taxpayer with *de minimis* annualized total revenue can file a No Tax Due Information Report. The *de minimis* amount varies depending on the year in which the taxpayer's franchise tax report is originally due.

Reports Due in 2008 and 2009. For reports originally due in 2008 and 2009, a taxpayer with annualized total revenue of $300,000 or less was treated as owing no franchise tax for the tax year and was permitted to file a No Tax Due Information Report.

Although the statute stated that a taxpayer with $300,000 or less in total revenue was treated as owing no franchise tax, the Comptroller favorably interpreted this to allow the applicable tax discount and the EZ tax computation method. Accordingly, a taxable entity that had annualized total revenue of $434,782 or less was eligible to file a No Tax Due Information Report.

Reports Due in 2010 and 2011. For reports originally due in 2010 and 2011, a taxpayer with annualized total revenue of $1 million or less is treated as owing no franchise tax and is permitted to file a No Tax Due Information Report.

Reports Due after 2011. For reports due after 2011, a taxpayer with total revenue of $600,000 or less is scheduled to be treated as owing no franchise tax. Taxpayers that qualify under this rule are scheduled to be permitted to file a No Tax Due Information Report.

Annualization Requirement. When the accounting period for a tax report is more or less than 12 months, a taxable entity must annualize its total revenue to determine its eligibility for the *de minimis* no tax due threshold ($434,782 or less for 2008 and 2009, $1 million or less for 2010 and 2011, and $600,000 or less after 2011).

No Gross Receipts in Texas

A taxable entity that is (a) not the survivor of a merger and (b) has no gross receipts in Texas is eligible to file a No Tax Due Information Report because its computed franchise tax liability will be zero.

Example 2L-1 No gross receipts in Texas.

StockVestors is a taxable entity that derives income solely from its investments in corporate stock. The dividends received on these stocks are apportioned to the legal domiciles of the corporations. Because the corporations paying the dividends are domiciled outside the state of Texas, the dividends are apportioned to non-Texas sources. Consequently, StockVestors' apportionment ratio is zero, and it will have no apportioned taxable margin. Thus, its computed franchise tax is zero and it can file the No Tax Due Information Report.

Passive Entities

Entities that meet the qualifications to be considered a passive entity for the reporting period will owe no tax. Such entities can file a No Tax Due Information Report. Passive entities are not required to file ownership information reports.

REITs

Statutory exclusions are specifically provided for certain entities. Among these statutory exclusions, certain real estate investment trusts (REITs) and their REIT subsidiaries are not taxable entities. These entities are eligible to file a No Tax Due Information Report.

Ineligible Entities

Taxpayers with Computed Tax of under $1,000. A taxpayer with a computed franchise tax of less than $1,000 is treated as owing no tax for the tax year. Although taxpayers qualifying under this rule owe no franchise tax, they are not permitted to file a No Tax Due Information Report. Instead, they must file a long-form (Form 05-158) or, if qualified, an EZ computation report (Form 05-169) to establish their eligibility to be treated as owing no tax report.

Tiered Partnerships. When the tiered partnership provisions apply, a No Tax Due Information Report cannot be filed for either the upper or lower tier entity if, before the attribution of total revenue by a lower tier entity to the upper tier entities, the lower tier entity is not eligible to file a No Tax Due Information Report.

Combined Groups. A combined group is eligible to file a No Tax Due Information Report. The determination of whether the combined group is eligible to file the report is based on the group's combined total revenue after eliminations. Each member of the group must be included in the group's report, even if a member's separate total revenue is *de minimis* ($434,782 or less for 2008 and 2009, $1 million or less for 2010 and 2011, and $600,000 or less after 2011).

A combined group that files a No Tax Due Information Report must file an Affiliate Schedule (Form 05-166).

Nontaxable Entity Information Report

Notification Requirement

The Comptroller is authorized to require any entity to file an information report to verify that it is not subject to the franchise tax.

Passive Entities

The Comptroller may require passive entities to file an information report to verify their qualification as a passive entity. Passive entities normally file a No Tax Due Information Report for this purpose.

Nontaxable Entities

A nontaxable entity that has not notified the Comptroller or the Secretary of State that it is doing business in Texas, or that has previously notified the Comptroller that it is not taxable, must notify the Comptroller in writing only when the entity no longer qualifies as a nontaxable entity.

Tax Exempt Entities

Exemptions from the franchise tax are provided for religious, charitable, educational, conservation, and other special activities.

Comptroller Inquiries

If an entity receives written notification from the Comptroller inquiring if the entity is taxable, the entity must reply to the Comptroller within 30 days of the notice.

Combined Reports

Combined Reporting

Combined Report Requirement. Taxable entities that are part of an affiliated group engaged in a unitary business file combined group reports in lieu of individual reports, except that public information reports or ownership information reports must be filed for each member of the combined group with nexus in Texas. A taxable entity that is not included in a combined report must file a separate report.

Annual Reports

Annual Report Requirement. Combined groups file only annual reports.

Separate Annual Report Requirement. For any accounting period during which an entity is not part of a combined group, the entity must file a separate report.

Example 2N-1: Existing entity entering and exiting a combined group.

Corporation A is an existing separate entity that began filing franchise tax reports in 2000. It has a December 31 federal accounting year end.

On July 1, 2009, Combined Group X acquires Corporation A. Combined Group X has a March 31 federal accounting year end.

On October 1, 2009, Combined Group X sells Corporation A to Combined Group Y. Combined Group Y has a December 31 federal accounting year end.

Corporation A will file a 2010 annual report for the period January 1, 2009, through June 30, 2009, which is the period of its separate existence prior to acquisition.

Combined Group X will file a 2010 combined annual report for the period April 1, 2008 through March 31, 2009. Combined Group X will not include Corporation A in its 2010 combined annual report because Corporation A was not part of the combined group during the accounting period on which the report is based. However, Combined Group X will include Corporation A in its 2011 combined annual report for the period July 1, 2009, through September 30, 2009.

Combined Group Y will file a 2010 combined annual report for the period January 1, 2009, through December 31, 2009 and will include Corporation A for the period October 1, 2009, through December 31, 2009.

Initial Reports—Entities First Subject to the Franchise Tax before October 4, 2009

A newly created member of a combined group is normally not required to file a separate initial report. However, because a taxable entity is included in a combined group report for only the accounting period during which it is a

member of the combined group, it should file a separate initial report for any period during which it is not considered a member of the combined group.

Newly Created Member That Leaves the Group. A newly created member of a combined group that leaves the combined group during the accounting period that would be covered by its initial report is required to file a separate initial report for the period beginning on the date it leaves the group through the date of its normal accounting year end that is at least 60 days prior to the original due date of its initial report.

Example 2N-2: Newly created member leaving the group.

On April 3, 2009, Combined Group Z forms Corporation B as new member of the group. Corporation B is spun off as a separate non-unitary entity on August 15, 2009. The federal accounting year end for all parties is December 31.

Combined Group Z will file a 2010 combined annual report that includes Corporation B for April 3, 2009, through August 14, 2009, the period before the spin-off.

Because Corporation B's beginning date occurred before October 4, 2009, its initial report is filed under the initial report due date rules in effect prior to that date. Accordingly, Corporation B will file a 2010 initial report due July 1, 2010, for August 15, 2009 through December 31, 2009, the period after the spin-off.

Newly Created Entity Acquired by a Combined Group. A newly created taxable entity that is acquired by a combined group is required to file a separate initial report for the period prior to its acquisition date.

Example 2N-3: Newly created entity acquired by a combined group.

Corporation C was formed on November 15, 2008, and has a June 30 federal accounting year end. Combined Group Z acquires Corporation C on February 1, 2009. Combined Group Z has a December 31 federal accounting year end.

Combined Group Z will file a 2010 combined annual report that includes Corporation C for the period February 1, 2009, through December 31, 2009.

Because Corporation C's beginning date occurred before October 4, 2009, its initial report is filed under the initial report due date rules in effect prior to that date. Accordingly, Corporation C will file a 2010 initial report due February 12, 2010. Because Corporation C was acquired by Combined Group Z on February 1, 2009, Corporation C will include only the period from November 15, 2008, through January 31, 2009 on its initial report.

First Annual Reports—Entities First Subject to the Franchise Tax after October 3, 2009

Newly Created Member That Leaves the Group. A taxable entity formed after October 3, 2009 as a member of a combined group and which subsequently leaves the combined group during the accounting period that would be covered by its first annual report, is required to file a separate annual report for the period beginning on the date it leaves the group through the date of its last federal accounting year that ends in the calendar year prior to the year its first annual report is originally due.

Example 2N-4: Newly created member leaving the group.

Corporation D is formed on April 3, 2010, as a member of Combined Group W. It is subsequently spun off as a separate nonunitary entity on August 15, 2010. The federal accounting year end for all parties is December 31.

Combined Group W will file a 2010 combined annual report that includes Corporation D for the period before the spin-off (April 3, 2010, through August 14, 2010).

Because Corporation D's beginning date occurred after October 3, 2009, its first report is filed under the simplified first annual report due date rules in effect after that date. Accordingly, Corporation D will file a 2011

first annual report due May 15, 2011. Corporation D will report its separate business for the period after the spin—off (August 15, 2010, through December 31, 2010).

Newly Created Entity Acquired by a Combined Group. A taxable entity formed as a separate entity after October 3, 2009, and subsequently acquired by a combined group is required to file a first annual report for the period prior to the acquisition date.

Example 2N-5: Newly created entity acquired by a combined group.

Corporation E is formed as a separate entity on June 15, 2010. Later that year, Combined Group W acquires Corporation E on December 1, 2010. The federal accounting year end for all parties is December 31.

Combined Group W will file a 2010 combined annual report that includes Corporation E for the period December 1, 2010, through December 31, 2010.

Because Corporation E's beginning date occurred after October 3, 2009, its first report is filed under the simplified first annual report due date rules in effect after that date. Accordingly, Corporation E will file a 2011 first annual report due May 15, 2011. Corporation E will report its separate business for period before the acquisition date (June 15, 2010, through November 30, 2010).

Final Reports

Termination of Entire Group. When every member of a combined group ceases doing business in Texas, a final report must be filed and the applicable additional (exit) tax must paid before a taxable entity will receive clearance from the comptroller for termination, cancellation, withdrawal or merger. In all other cases, for the period a combined group exists, the combined group will file only annual reports.

Termination of an Existing Group Member. A member of a combined group that ceases doing business in Texas will not file a final report. Instead, the data that would have been reported on the terminating member's final report will be included in the combined group's annual report for the corresponding accounting period.

Existing Entity Joins a Group and Then Terminates. A separate entity that joins a combined group and then ceases doing business in Texas in the accounting period that would be covered by a final report is required to file a final report for the period that is prior to the acquisition date. The period from the acquisition date through the date the entity ceased doing business in Texas will be reported on the combined group's annual report for the corresponding period.

Example 2N-6: Existing entity joins group and then terminates.

Corporation F is an existing separate entity with a December 31 accounting year end. Combined Group T acquires Corporation F on July 1, 2008. Combined Group T also has a December 31 accounting year end. On October 31, 2008 Corporation F is dissolved.

Combined Group T will file a 2009 combined annual report that includes Corporation F for the period July 1, 2008 through October 31, 2008.

Corporation F will file a final report due (60 days after October 31, 2008) on December 30, 2008, for the period January 1, 2008, through June 30, 2008, which is the period of its separate existence before its acquisition by Combined Group T.

Member of a Group Leaves Group and Then Terminates. A member of a combined group that leaves the combined group and then ceases doing business in Texas during the accounting period that would be covered by a final report is required to file a final report for the period from the date the entity left the combined group through the date the entity ceased doing business in Texas.

Example 2N-7: Group member leaves group and then terminates.

Corporation G is a member of Combined Group U. Both Corporation G and Combined Group U have a September 30 accounting year end.

Corporation G leaves the combined group on May 1, 2008, and subsequently dissolves on August 15, 2008.

Combined Group U will file a 2009 combined annual report that includes Corporation G for the period October 1, 2007, through April 30, 2008.

Corporation G will file a final report due (60 days after August 15, 2008) on October 14, 2008, for the period May 1, 2008, through August 15, 2008, which is the period of its separate existence after it left Combined Group U through the date of its dissolution.

Weekends and Holidays

If the date on which a report or payment is due falls on a Saturday, Sunday, or legal holiday, the next day that is not a Saturday, Sunday, or legal holiday becomes the due date.

Electronic Reporting

Certain taxpayers are required to file franchise tax reports electronically. Other taxpayers may do so voluntarily.

Electronic Filing Requirement

Requirement to File Reports Electronically. Taxpayers who paid $50,000 or more in franchise tax during the preceding fiscal year must file franchise tax reports electronically.

Tax Preparation Software Options. A taxpayer filing a report electronically may use an application or software provided by the Comptroller or by a commercial software vendor that satisfies requirements provided by the Comptroller.

Filing Reports Electronically Using a Comptroller Provided Application

The Comptroller provides the WebFile system and Smart PDF forms for filing franchise tax reports.

WebFile. WebFile is the Comptroller's web-based system that allows taxpayers to electronically file franchise tax reports and submit payment (by credit card, electronic check, or via TEXNET).

WebFile is available for all franchise tax reports. The system allows a taxpayer or its representative to select the desired forms packet and file it electronically. Forms packets are dynamic in nature and automatically add all the required forms. The following forms packets are available:

- Extension Request,
- No Tax Due Report (including information reports),
- EZ Computation Report (including information reports), and
- Long Form Report (including applicable information reports).

WebFile is a secure system protected by a taxpayer-specific number and password. First-time users are asked for specific information to confirm they are the taxpayer or a representative authorized to file returns for the taxpayer.

WebFile cannot be used to file an amended report to respond to notices sent by the Comptroller to the taxpayer.

WebFile Numbers. WebFile numbers are issued by the Comptroller's office. About six weeks before the due date of the next report the Comptroller mails a notification letter to each taxable entity. The taxpayer's WebFile number is located in the upper-right corner of the notification letter. The number begins with the letters XT and is followed by six numbers. The WebFile number is used only once. When the number is used the first time, the taxpayer or its representative will establish a password for future access to the WebFile system.

Lost WebFile Numbers. If the notification letter cannot be located, the taxpayer or its representative can contact the Comptroller's office at (800) 252-1381 to request a duplicate letter. WebFile numbers can also be provided over the phone; however, the taxpayer or its representative will need to provide proper information, such as past gross receipts or last payment amounts before the confidential number will be provided. The Comptroller's Office will provide only three WebFile numbers at a time. To request more than three numbers, an email should be sent to **WebFileHelp@cpa.state.tx.us**.

Smart PDF Forms. The Comptroller's smart PDF format offers a dynamic way to complete franchise tax reports with built-in calculations to reduce errors and speed processing. The system initially presents all possible forms for the filing type selected. As data is entered electronically, forms that are not applicable will be withdrawn by the application.

Smart PDF forms can be accessed from the Comptroller's website at **http://www.window.state.tx.us/taxinfo/tax-forms/05—forms.html**.

Filing Reports Electronically Using Approved Vendor Software

Many taxpayers and their representatives use vendor tax preparation software to prepare and file franchise tax reports. According to the Comptroller's website, approved vendor software for 2010 may be used for all original reports filed for report years 2008, 2009, and 2010. (See **www.window.state.tx.us/taxinfo/franchise/approved_form_vendors.html**.)

The Comptroller's list of 2010 approved tax preparation software for Texas franchise tax (as updated December 18, 2009,) includes the following:

Company Name	Software Package	Vendor ID	Approved Version Number
CS Professional Suite	UltraTax CS	1022	Ver. 1.0
Thomson Reuters (Tax & Accounting) Inc.	E-Form CD and E-Form RS	1062	Ver. 1.0
Thomson Reuters (Tax & Accounting) Inc.	GoSystem; GoSystem RS and ONESOURCE and ONESOURCE RS	1062	Ver. 1.0

Effective January 1, 2010, the Comptroller will not accept *original* franchise tax reports generated from tax preparation software approved for 2008 and 2009 reports. However, *amended* 2008 and 2009 reports generated from previously approved tax preparation software products will still be accepted.

Accordingly, taxpayers or their representative who use vendor software to file *original* franchise tax reports for 2008, 2009 or 2010, after December. 31, 2009, will need to verify that they are using software approved by the Comptroller's office for the 2010 report year. Taxpayers or their representatives should check with the software vendor to determine if the vendor's 2010 software provides the option to submit amended returns for reports originally submitted using 2008 or 2009 software.

Signature Requirement

No signature is required for reports filed electronically, . Electronic submission is considered a signed document. Taxpayers who file a report electronically should not sign or mail the printed copy.

Delinquent Notices and Franchise Account Status

The filing of the first reports under the revised franchise tax system in 2008 brought an unforeseen problem stemming from the expanded definition of taxable entities to include those that were previously nontaxable.

The franchise tax account statuses of some newly taxable entities showed them to be not in good standing for franchise tax purposes. In November 2008, the Comptroller began sending delinquent notices to taxpayers with accounts not in good standing for their first reports under the revised franchise tax.

The "Not in Good Standing" designation evidently related to the processing of the entities' nexus or business questionnaire forms (Forms AP-114, AP-223 and AP-224). These forms establish franchise tax responsibility for new entities or entities not previously subject to the franchise tax. Each of the questionnaires requires for the taxpayer to list its entity type. If the questionnaire was not filed or if the 2008 franchise tax report was processed before the questionnaire, the Comptroller's office evidently automatically set up the taxpayer as a corporation, even if the report correctly indicated that the entity was other than a corporation or LLC.

Other reasons for delinquency include—

1. Failure to file a report.

2. Failure to file both pages of the long form franchise report (Form 158).

3. Failure to file a credit summary schedule (Form 05-160) or affiliate schedule (Form 05-166) when required, or filing an incomplete affiliate schedule.

4. Failure to file the tiered partnership report (Form 05-175) or filing it without a tax report.

5. Failure to file the public information report (Form 05-102) or ownership information report (Form 05-167) or filing an incomplete or unsigned report.

6. Failure to pay balance due on franchise tax report.

An account status that shows the taxpayer to be not in good standing can have serious consequences to the taxpayer beyond merely straightening out the taxpayer's filing status with the Comptroller's office. These consequences can include impairment of the taxpayer's credit status with its bank or other creditors. If the taxpayer's account status is not expeditiously resolved, the taxpayer's charter or certificate of organization could even be forfeited.

The Comptroller has created section on her website with information on how to resolve each delinquency issue. (See **http://www.window.state.tx..us/taxinfo/franchise/ft_delinquency.html**).

Extensions

Taxable entities have several options for obtaining an extension of time to file an annual report. Filing an extension request and making the required payment will normally extend the due date of an annual report from May 15 to November 15. However, entities required to pay tax by means of electronic funds transfer (EFT) can only obtain an extension from May 15 to August 15, with a follow-up extension available to November 15. Extension requests can be made online or by filing an extension request.

For initial and final reports, a 45-day extension is available.

Special rules apply to victims of natural disasters.

Annual Report

Availability of Extensions

Extensions of time to file franchise tax reports are available for annual reports, initial reports, and final reports. The length of time granted in the extension varies depending on the type of report and whether the taxpayer is required to remit franchise tax payments electronically.

Extension requests postmarked after the due date will not be granted. The postmark date (meter mark if there is no postmark) on the envelope in which the Comptroller receives the extension determines the date of filing.

Annual Report Extensions

Extensions of time to file annual reports are available. The length of time granted depends on whether the taxpayer is required to remit franchise tax payments electronically. Taxpayers not required to remit tax payments electronically can qualify for an extension to November 15. Taxpayers required to remit tax payments electronically can qualify for an extension to August 15 with the possibility of an additional extension to November 15.

Special rules apply when the taxpayer's previously filed report was an initial report. The special rules limit the taxpayer's ability to base their annual report extension payment on the prior year's reported tax liability.

Annual Reports—Extension to November 15

Taxpayers Not Required to Remit Franchise Tax Payments Electronically. For taxpayers not required to remit franchise tax payments electronically, an extension to November 15 is available for filing a regular annual Texas franchise tax report. No further extensions are allowable.

To be eligible for the extension, the entity must:

1. Request an extension by May 15 of the current year on a form provided by the Comptroller, and
2. Remit with the extension request a tax payment not less than:
    a. 90% of the tax that will be reported as due when the annual report is filed, or
    b. 100% of the previous year's reported tax liability as shown on a franchise tax report filed on or before May 14 of the current calendar year.

Combined Groups. When the taxpayer is a combined group, each member of the group must have filed a franchise tax report in the prior year in order to qualify the group for the option to base its extension payment on 100% of the prior year's tax liability. However, if the group has a new member that was not included in the prior year group report, the group may not use the 100% option.

Certain Taxpayers Cannot Use the 100% of Prior-Year's Tax Rule. A taxpayer is not allowed to base an annual report extension payment on 100% of the prior year's reported tax liability if it did not file a report in the previous year. Accordingly, a newly taxable entity is not allowed to base an extension payment on 100% of the prior year's tax.

Example 2S-1 New taxable entity filing a first annual report.

Newco is a taxable entity formed on October 12, 2009. For federal tax purposes, Newco uses a December 31 year end. Because Newco's beginning date is after October 3, 2009, Newco's first annual report is due May 17, 2010, (because May 15, 2010 falls on a Saturday).

Because Newco has not previously filed a franchise tax report, it cannot base an extension payment on the 100% option. Accordingly, to obtain an extension to November 15, 2010, Newco must remit at least 90% of the tax it will calculate on its extended return.

A separate entity that was included in a combined group report the prior year may not use the 100% of prior year's tax rule.

Example 2S-2 Separate taxable entity formerly a member of a combined group.

Oldco has been a member of a combined group since it formed in 2008. On August 1, 2009, Oldco was spun off as a nonunitry separate entity. Oldco is required to file a separate annual report for the period August 1, 2009, through December 31, 2009. Oldco's annual report is due May 17, 2010, (because May 15, 2010 falls on a Saturday).

Because Oldco was included in a combined group report in 2009, it cannot base its extension payment on the 100% option. To obtain an extension to November 15, 2010, Oldco must remit at least 90% of the tax it will calculate on its extended separate return.

Filing an Extension Request. A taxpayer must submit an extension request to be granted an extension to file the report even if the taxpayer does not owe tax. The request is made by filing Form 05-164 (Extension Request). Combined groups must include Form 05-165 (Extension Affiliate List). Extensions must be postmarked on or before May 15. Alternatively, taxpayers may request an extension electronically using WebFile.

Annual Report When Previous Report Was an Initial Report

A special rule applies to taxable entities whose previous report was an initial report, including those entities required to pay tax by EFT.

To obtain an extension under this special rule, when the taxable entity's previous report was an initial report, the entity must:

1. Request an extension by May 15 of the current year on a form provided by the Comptroller, and

2. Remit with the extension request a tax payment not less than:

    a. 90% of the tax that will be reported as due when the annual report is filed, or

    b. the amount computed by multiplying the taxable margin shown on the initial report (filed on or before May 14 of the current calendar year) by the tax rate in effect on January 1 of the year in which the report is due.

The tax rate in effect on January 1 of the year in which the report is due is determined under TTC Sec. 171.002. Currently, the rate is 1/2 of 1% (.005) for retailers and wholesalers and 1% for other taxpayers. If the taxpayer qualifies for and elects to compute its franchise tax under the EZ computation method, the applicable tax rate is presumably .575% (.00575).

Example 2S-3 Extension payment based on 90% of current year's estimated tax.

Assume that a taxable entity's previous report was an initial report, and its first regular annual report is due May 17, 2010. It will owe $3,000 in franchise tax with that report. The entity will qualify for an extension to November 15, 2009 if it files an extension request and makes a payment of at least $2,700 (90% $\times$ $3,000) by May 15, 2010. It should file its franchise tax report and pay the additional $300 of tax by November 15, 2010.

Example 2S-4 Extension payment based on recomputed tax on initial report.

Assume that the initial report of a taxable entity showed that it had taxable margin of $200,000, and the entity is not a retailer or wholesaler and does not elect to compute its tax under the EZ computation method. Taxable margin of $200,000 multiplied by 1% is $2,000. The entity will qualify for the extension of its annual report to November 15, 2010 if it files its initial report by May 14, 2010, and makes a payment of $2,000 with its extension request.

Corporations Required to Pay Tax by EFT—Extension to August 15, then November 15

Electronic Remittance Threshold. For payments due on or after May 1, 2008, a $10,000 EFT remittance threshold applies to taxpayers who paid at least $10,000 in franchise tax during the preceding state fiscal year. The Texas state fiscal year begins September 1 and ends on August 31 of the following year.

Extension to August 15. Taxable entities required to remit franchise tax by means of EFT can obtain an extension to August 15 (instead of November 15) by filing an extension request by May 15 on Form 05-164, and remitting (1) 90% of the tax due as shown on a report filed by August 15 of the current year, or (2) 100% of the tax reported on the previous year's franchise tax report filed on or before May 14 of the current calendar year.

Additional Extension to November 15. The entities that obtain an extension to August 15 can obtain an additional extension to November 15 by filing an additional extension request (Form 05-164) on or before August 15 and remitting the balance of their franchise tax as shown on a report filed by November 15 of the current year.

Failure to Timely File an Extension

A taxable entity that fails to timely file a valid extension will suffer the following consequences:

1. The taxable entity will not be allowed to deduct active duty pay.

2. The taxable entity loses its temporary credit for the year and is not allowed to carry the lost credit forward.

Penalties and Interest

Failure to make adequate payment with the extension may subject the taxable entity to penalties and interest.

Initial Report

Initial Report Extension—45 Days

An initial report is due within 90 days after the end of the entity's initial privilege period, or within 91 days after the date of a merger.

The franchise tax statute does not provide for an extension of time to file the initial report or pay the tax due on the initial report. However, the Comptroller is authorized to grant a reasonable extension of time of not more than 45 days to file a report required by Title 2 of the Texas Tax Code. The initial report is a report required by Title 2.

Final Report

Final Report Extension—45 Days

A final franchise tax report is due within 60 days after the taxable entity becomes "no longer subject to" the franchise tax. An entity becomes no longer subject to the tax when it ceases doing business in Texas for any reason (dissolution, withdrawal, merger, etc.).

The franchise tax statute does not provide for an extension of time to file the final report or pay the tax due on the final report. However, the Comptroller is authorized to grant a reasonable extension of time of not more than 45 days to file a report required by Title 2 of the Texas Tax Code. The final report is a report required by Title 2.

Public Information and Ownership Information Reports

Corporations and LLCs are required to file public information reports. Similarly, other entities are required to file ownership information reports.

Because these reports are due at the same time an entity files an initial or annual franchise tax report, an extension of time to file the franchise tax report is also an extension to file the public information or ownership information report.

Public information and ownership information reports are not required to be filed with final reports.

Natural Disasters

TTC Sec. 111.058 gives the Comptroller authority to grant a 90-day extension to any person whom the Comptroller finds to be a victim of a natural disaster. The Tax Code does not define natural disaster. It appears that the Comptroller has the discretion to determine whether a person is the victim of a natural disaster. The person owing

the tax must request an extension within 90 days after the original due date of the report and payment. If the Comptroller grants the extension, penalty and interest do not begin to accrue until the day after the extension expires.

Presumably, disaster victims may request an additional extension until November 15 under the procedures that apply to regular annual reports. However, for initial or final reports, the Comptroller does not have authority to grant disaster victims an extension past the 90 days. Therefore, initial and final reports of disaster victims are due no later than August 15.

Amended Reports

Taxpayers voluntarily file amended franchise tax reports after the due date for many reasons, including correcting errors and claiming refunds, and changing the method of computing margin to 70% of total revenue of the EZ computation. In some situations, taxpayers are required to file amended reports. Finally, a taxpayer may merely wish to notify the Comptroller's Office of a change in address or telephone number.

General Rules for Amended Reports

Rule 3.584(f) provides the general rules for amended reports. Under these rules, a taxable entity may file an amended report after the due date for three purposes:

1. to correct a mathematical or other error;

2. to support a claim for refund; or

3. to change the method of computing margin to 70% of total revenue or, if qualified, the EZ computation method.

A claim for refund may be filed by an entity's attorney, assignee, or receiver at any time within the statute of limitations period when the entity has overpaid its franchise tax.

An amended report may not be filed after the due date to change the method of computing margin to a cost of goods sold deduction or to a compensation deduction. However, an entity is permitted to amend its report after the due date to the 70% of total revenue method of computing margin or, if qualified, to the EZ computation method (tax rate of 575% of total revenue).

Amended Reports Are Required in Certain Situations

Amended Report Following an IRS Audit or an Amended Federal Return

A taxable entity is required to file an amended franchise tax report if:

1. the IRS audits the entity and makes adjustments that affect its taxable margin, or

2. the entity files an amended federal income tax return that affects its taxable margin.

The entity is also required to file an amended franchise tax report if its taxable margin is changed by "another competent authority other than the IRS". Other competent authority includes the U.S. Tax Court, U.S. District Courts, U.S. Courts of Appeal, and the U.S. Supreme Court.

The amended franchise tax report is due within 120 days after the entity files the amended federal income tax return. Similarly, the amended franchise tax report is due within 120 days after the IRS Revenue Agent's Report (RAR) is finalized. The RAR is considered finalized when all administrative appeals with the IRS have been exhausted or waived. An administrative appeal with the IRS does not include any proceedings in the United States Tax Court or any other federal court. Similar rules apply if the change is made by another competent authority.

To enforce the requirement to file an amended franchise tax report within 120 days, the entity can be assessed a penalty equal to 10% of the tax that should have been reported on the amended franchise tax report and not previously reported to the Comptroller. This 10% penalty applies in addition to any other penalties and interest that may be assessed. The 10% penalty obviously does not apply when the taxpayer fails to file an amended return that results in a refund.

Amended Report Following an Administrative or Judicial Proceeding

Changes resulting from a "final determination" must be reported to the Comptroller within 120 days after the day the determination becomes final. The amended report must be accompanied by a cover letter with a detailed explanation of the reasons for the difference in tax liability. A final determination results from:

1. an administrative proceeding of a local, state, or federal regulatory agency, or the IRS; or
2. a judicial proceeding arising from an administrative proceeding of a local, state, or federal regulatory agency, or the IRS.

Extension of Statute of Limitations

The statute of limitations on assessment is generally held open for one year following the date an amended franchise tax report is filed. If no amended report is filed, the statute is held open indefinitely.

Similarly, the statute of limitations on claims for refund is generally held open for one year following the date of a final determination. However, the taxpayer generally has only 180 days to file a claim for refund of any tax assessed in a final determination.

Public Information and Ownership Information Reports

Corporations, LLCs, and financial institutions subject to the franchise tax are required to file Form 05-102 (Texas Franchise Tax Public Information Report). Other taxable entities are required to file Form 05-167 (Texas Franchise Tax Ownership Information Report). These reports are due May 15 and are generally prepared and filed along with the taxpayer's franchise tax report.

Who Must File

Public Information Reports

A public information report must be filed by corporations, LLCs, and financial institutions on which the franchise tax is imposed. Thus, all domestic (Texas) and foreign (non-Texas) corporations, LLCs, and financial institutions subject to the franchise tax must file a public information report.

Ownership Information Reports

An ownership information report must be filed by taxable entities (other than corporations, LLCs, and other financial institutions) on which the franchise tax is imposed. This requirement applies to both domestic and foreign taxable entities.

Reports Are Required Even If No Tax Is Due

A corporation, LLC, or financial institution is required to file the applicable public information report even if it files a No Tax Due Information Report.

A taxable entity's ownership information report must also be filed even if the entity qualifies to file a No Tax Due Information Report.

Entities Not Required to File

Exempt Entities. A corporation or LLC that is exempt from the franchise tax is not required to file a public information report. Such corporations and LLCs are not subject to the tax, so the requirement to file a public information report

does not apply. This relief also applies to exempt taxable entities that would otherwise be required to file ownership information reports.

Combined Group. Taxable entities that (a) are members of a combined group and (b) have no nexus with Texas are not required to file a public information report or an ownership information report.

Forms

Public Information Report

The public information report must be filed on a form prescribed by the Comptroller. The Comptroller currently provides Form 05-102 (Texas Franchise Tax Public Information Report). The public information report requests the following information from the corporation:

1. The name, title, and mailing address of each of its officers and directors. The corporation must also state the expiration date, if any, of each person's term as an officer or director.
2. The name and address of its registered agent.
3. The address of its principal office and principal place of business.
4. The name of each corporation that owns a 10% or greater interest in it, and the name of each corporation in which it owns a 10% or greater interest.

Due Date

Due Date and Filing Requirement

The applicable public information or ownership information report is due each time a taxable entity's initial or annual franchise tax report is due.

A public information report is not filed with a final report. Similarly, an ownership information report is not filed with a final report.

Failure to File

Without the public information or ownership information report, an initial or annual franchise tax report is considered incomplete. Thus, failure to file or sign the applicable information report can result in forfeiture of corporate or business privileges. Each officer or director of the taxable entity may be liable for each debt the entity incurs in Texas after the report's due date and before the corporate or business privileges are revived. These provisions do not apply to a banking taxable entity or a savings and loan association.

Mailing

Public Information Report

A copy of the public information report must be mailed to each person named in the report who is an officer or director of the corporation or LLC and who is not employed by the corporation or LLC or a related (at least 10% ownership) corporation or LLC on the date the report is filed. Directors are considered employed by the corporation or LLC whether they are paid as employees (W-2 wages) or for service rendered (Form 1099 compensation).

A person who is no longer an officer or director but whose name was included on the public information report or the ownership information report, can file a sworn statement with the Comptroller's Office that he is disclaiming his status as an officer or director as shown in the information report.

Ownership Information Report

There is no similar mailing requirement for ownership information reports.

Signature

An officer or director of the corporation or another authorized person must sign the public information report to certify that (1) it is true and correct to the best of his knowledge and (2) a copy of the report has been mailed to each person who must receive a copy of it.

An officer, director, or other authorized person must sign the ownership information report to certify that it is true and correct to best of his knowledge.

A public information or ownership information report is considered delinquent if it is not signed. Thus, failure to sign the report can result in forfeiture of corporate or business privileges. Each officer or director of the taxable entity may be liable for each debt of the entity incurred in Texas after the date on which the report is due and before the corporate or business privileges are revived. These provisions do not apply to a banking corporation or a savings and loan association.

A public information or ownership information report that is filed electronically is deemed to comply with the signature and certification requirements.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

9. Which of the following is a requirement for the reduced .5% tax rate?

    a. The entity must engage in activities described under Division F or Division G of the 1987 SIC manual.

    b. More than 50% of the taxable entity's total revenue must come from the sale of products the entity produces.

    c. The total revenue generated by the entity's activities in wholesale or retail trade must be less than the total revenue generated by the entity's other activities.

    d. The taxable entity must provide wholesale or retail utilities, such as telecommunications, electricity or gas.

10. Which of the following types of businesses would **not** qualify for the reduced tax rate of .5%?

    a. A taxpayer primarily engaged in wholesale or retail trade with total revenues of $12 million.

    b. A taxpayer primarily engaged in bar and restaurant operations with total revenues of $9 million.

    c. A taxpayer primarily engaged in bar and restaurant operations with total revenues of $4 million and manufacturing operations with total revenues of $5 million.

    d. A taxpayer primarily engaged in wholesale and retail trade with total revenues of $5 million and manufacturing operations with total revenues of $4 million.

11. What is the general deadline for filing regular annual reports?

    a. May 1.

    b. May 15.

    c. June 16.

    d. December 31.

12. In general, what is the original deadline for filing initial reports?

    a. May 1.

    b. 90 days after the date the initial privilege period ends.

    c. December 31.

13. In general, what is the deadline for filing a final exit tax report?

    a. 60 days after the date the entity is no longer subject to the franchise tax.

    b. 60 days after the date the entity becomes a passive entity not subject to the franchise tax.

    c. 90 days after the date the entity is no longer subject to the franchise tax.

    d. 90 days after the date the entity becomes a passive entity not subject to the franchise tax.

14. Which of the following statements is correct regarding the amount of estimated tax that must be paid with a franchise tax extension request?

    a. A corporation that was subject to the franchise tax in the prior year must pay at least 90% of the current year's estimated tax liability with the extension request, or be subject to penalties and interest.

    b. A corporation that was subject to the franchise tax in the prior year must pay at least 90% of the prior year's estimated tax liability with the extension request, or be subject to penalties and interest.

    c. A corporation that was subject to the franchise tax in the prior year must pay at least 100% of the prior year's tax liability with the extension request, or be subject to penalties and interest.

15. Which of the following statements is correct regarding the amount of estimated tax that must be paid with a franchise tax extension request for combined groups?

    a. A combined group comprised solely of entities that were subject to tax in the prior year may pay 100% of the prior year's tax liability with its extension request and avoid penalties.

    b. A combined group comprised solely of entities that were subject to tax in the prior year may pay 90% of the prior year's tax liability with its extension request and avoid penalties.

    c. A combined group comprised solely of newly taxable entities that were not subject to tax in the prior year must pay 100% of the current year's estimated tax liability with its extension request in order to avoid penalties.

    d. A combined group with three entities that were subject to tax in the prior year and one newly taxable entity may pay 100% of the prior year's tax liability with its extension request and avoid penalties.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

9. Which of the following is a requirement for the reduced .5% tax rate? **(Page 23)**

   a. The entity must engage in activities described under Division F or Division G of the 1987 SIC manual. [This answer is correct. According to TTC Sec. 171, this is a requirement for the reduced wholesale/retail rate.]

   b. More than 50% of the taxable entity's total revenue must come from the sale of products the entity produces. [This answer is incorrect. The requirement is that less than 50% of the taxable entity's total revenue must come from the sale of products the entity produces per TTC Sec. 171.]

   c. The total revenue generated by the entity's activities in wholesale or retail trade must be less than the total revenue generated by the entity's other activities. [This answer is incorrect. The requirement is that the total revenue generated by the entity's activities in wholesale or retail trade must be more than the total revenue generated by the entity's other activities per TTC Sec. 171.]

   d. The taxable entity must provide wholesale or retail utilities, such as telecommunications, electricity or gas. [This answer is incorrect. The requirement is that the taxable entity must not provide retail or wholesale utilities per TTC Sec. 171.]

10. Which of the following types of businesses would **not** qualify for the reduced tax rate of .5%? **(Page 23)**

   a. A taxpayer primarily engaged in wholesale or retail trade with total revenues of $12 million. [This answer is incorrect. The requirements for the .5% retail/wholesale rate do not include a revenue requirement. This taxpayer would qualify for the reduced rate per TTC Sec. 171.]

   b. A taxpayer primarily engaged in bar and restaurant operations with total revenues of $9 million. [This answer is incorrect. Bar and restaurant operations specifically qualify as wholesale and retail trade under the Texas Tax Code and the SIC codes. The requirements for the .5% retail/wholesale rate do not include a revenue requirement. This taxpayer would qualify for the reduced rate per TTC Sec. 171.]

   c. A taxpayer primarily engaged in bar and restaurant operations with total revenues of $4 million and manufacturing operations with total revenues of $5 million. [This answer is correct. The revenues from manufacturing operations exceed the revenues from the bar and restaurant operations. Therefore, this taxpayer is not predominately engaged in retail or wholesale trade. Bar and restaurant operations specifically qualify as wholesale and retail trade under the Texas Tax Code and the SIC codes.]

   d. A taxpayer primarily engaged in wholesale and retail trade with total revenues of $5 million and manufacturing operations with total revenues of $4 million. [This answer is incorrect. The requirements for the .5% retail/wholesale rate do not include a revenue requirement. This taxpayer would qualify for the reduced rate because this taxpayer is predominately engaged in retail or wholesale trade per TTC Sec. 171.]

11. What is the general deadline for filing regular annual reports? **(Page 26)**

    a. May 1. [This answer is incorrect. The Comptroller extended the deadline for initial reports in 2008 to May 1, 2008. However, this is not the general deadline for filing regular annual reports according to TTC Sec. 171.]

    b. May 15. [This answer is correct. Franchise tax payments are due on or before the report filing deadline according to TTC Sec. 171. Texas does not require tax deposits.]

    c. June 16. [This answer is incorrect. The Comptroller extended the deadline for annual reports in 2008 to June 16, 2008. However, this is not the general deadline for filing regular annual reports according to TTC Sec. 171.]

    d. December 31. [This answer is incorrect. December 31 is the general year-end for calendar year taxpayers for calculating margin. However, it is not the general deadline for filing regular annual reports according to TTC Sec. 171.]

12. In general, what is the original deadline for filing initial reports? **(Page 28)**

    a. May 1. [This answer is incorrect. The Comptroller extended the deadline for initial reports in 2008 to May 1, 2008. However, this is not the general deadline for filing initial reports.]

    b. 90 days after the date the initial privilege period ends. [This answer is correct. This is the general deadline for filing regular annual reports.]

    c. December 31. [This answer is incorrect. December 31 is the general year-end for calendar year taxpayers for calculating margin. However, it is not the general deadline for filing initial annual reports.]

13. In general, what is the deadline for filing a final exit tax report? **(Page 28)**

    a. 60 days after the date the entity is no longer subject to the franchise tax. [This answer is correct. This is the general deadline for filing final exit tax reports per TTC Sec. 171.]

    b. 60 days after the date the entity becomes a passive entity not subject to the franchise tax. [This answer is incorrect. The determination of whether an entity is passive is a year-by-year determination. The comptroller may require passive entities to file an information report to verify its qualification as a passive entity.]

    c. 90 days after the date the entity is no longer subject to the franchise tax. [This answer is incorrect. According to TTC Sec. 171, this is not the general deadline for filing final exit tax reports.]

    d. 90 days after the date the entity becomes a passive entity not subject to the franchise tax. [This answer is incorrect. According to TTC Sec. 171, the determination of whether an entity is passive is a year-by-year determination. An entity that is taxable in one year and passive the next year is not required to file a final exit tax report.]

14. Which of the following statements is correct regarding the amount of estimated tax that must be paid with a franchise tax extension request? **(Page 36)**

    a. A corporation that was subject to the franchise tax in the prior year must pay at least 90% of the current year's estimated tax liability with the extension request, or be subject to penalties and interest. [This answer is incorrect. The statute does not require a corporation that was subject to the franchise tax in the prior year to pay 90% of the current year's estimated tax liability if a certain other amount is less.]

    b. A corporation that was subject to the franchise tax in the prior year must pay at least 90% of the prior year's estimated tax liability with the extension request, or be subject to penalties and interest. [This answer is incorrect. It does not correctly state the estimated tax requirement for a corporation that was subject to the franchise tax in the prior year.]

    c. A corporation that was subject to the franchise tax in the prior year must pay at least 100% of the prior year's tax liability with the extension request, or be subject to penalties and interest. [This answer is correct. In order to qualify for this rule, a corporation must have filed its prior franchise tax report and paid the associated liabilities by the May 14 deadline for filing the current year's extension request.]

15. Which of the following statements is correct regarding the amount of estimated tax that must be paid with a franchise tax extension request for combined groups? **(Page 36)**

    a. A combined group comprised solely of entities that were subject to tax in the prior year may pay 100% of the prior year's tax liability with its extension request and avoid penalties. [This answer is correct. If the taxpayer is a combined group, each member of the group must have filed a franchise tax report in the prior year in order to qualify the group for the option to base its extension payment on 100% of the prior year's tax liability.]

    b. A combined group comprised solely of entities that were subject to tax in the prior year may pay 90% of the prior year's tax liability with its extension request and avoid penalties. [This answer is incorrect. It does not correctly state the estimated tax payment requirement for combined groups.]

    c. A combined group comprised solely of newly taxable entities that were not subject to tax in the prior year must pay 100% of the current year's estimated tax liability with its extension request in order to avoid penalties. [This answer is incorrect. It does not correctly state the estimated tax payment requirement for combined groups.]

    d. A combined group with three entities that were subject to tax in the prior year and one newly taxable entity may pay 100% of the prior year's tax liability with its extension request and avoid penalties. [This answer is incorrect. A combined group with a newly taxable entity as a member may not use this option for estimating its tax liability.]

EXAMINATION FOR CPE CREDIT

Lesson 2 (TFTTG101)

Determine the best answer for each question below. Then mark your answer choice on the Examination for CPE Credit Answer Sheet located in the back of this workbook or by logging onto the Online Grading System.

6. A business manufactures shoes. It also makes retail sales of shoes and other accessories. Its revenues from its own products total $4,000,000. Its revenues from the other products total $5,000,000. Is the business eligible for the reduced .5% tax rate?

    a. No. The business cannot qualify as a retailer or wholesaler because it manufactures its own products.

    b. No. The business cannot qualify as a retailer or wholesaler because less than 90% of its revenues are from products it manufactures.

    c. Yes. The business can qualify as a retailer or wholesaler because it manufactures its own products.

    d. Yes. The business can qualify as a retailer or wholesaler because more of its revenues come from the sale of goods manufactured by others than from sales of its own products.

7. Which of the following businesses could qualify for the .5% tax rate?

    a. A restaurant that generates 70% of its revenue from sales of meals that it prepares and 30% of its revenues from candy and pastries that it purchases from a neighborhood bakery.

    b. A telecommunications provider that generates 70% of its revenue from telecommunications services and 30% of its revenues from sales of equipment that it purchases from others.

    c. A doll maker that generates 70% of its revenue from sales of dolls that it custom manufactures and 30% of its revenues from dolls that it purchases from a factory.

    d. A playground equipment company that generates 70% of its revenue from sales of playground equipment and 30% of its revenues from installation services. The playground equipment company is affiliated with the manufacturing company.

8. What is the latest date to which a taxable entity may extend its franchise tax filing deadline?

    a. May 15.

    b. June 16.

    c. October 15.

    d. November 15.

9. Which of the following is correct with respect to franchise tax extensions?

    a. A 90-day extension is available to victims of natural disasters.

    b. A 90-day extension is available for initial reports.

    c. A 90-day extension is available for final reports.

    d. No extension is available for exit tax reports.

10. Which of the following is correct with respect to amended reports?

    a. A taxpayer may file an amended report to correct a mathematical error.

    b. A taxpayer may file an amended report to change the deduction from compensation to cost of goods sold.

    c. A taxpayer may file an amended report to change the deduction from cost of goods sold to compensation.

    d. A taxpayer may file an amended report to change the deduction from the 30% deduction to compensation.

Lesson 3: Taxable Entities

INTRODUCTION

The Texas franchise tax applies to almost every type of entity with limited liability protection. Before the franchise tax revisions effective for 2008, the tax was imposed only on corporations and LLCs. Accordingly, many Texas businesses formed partnerships and out of state entities to avoid the tax. Now that the tax is imposed on an expanded scope of entities, many of those former entity structures may no longer be necessary.

The franchise tax statute lists the types of entities that are taxable entities subject to the franchise tax. The statute also lists the types of businesses that are either not taxable or exempt from the tax. In addition, the statute addresses a category of entities called "passive entities," which are not taxable entities, but whose status can change from year to year based upon the types of revenues they receive.

Learning Objectives:

Completion of this lesson will enable you to:
- Identify types of entities subject to the Texas franchise tax and entities excluded from taxation.
- Specify which entities qualify as passive entities.

Limited Liability Protection and Texas' Ability to Tax

Taxable Entities

Limited Liability Protection. To determine whether an entity is subject to the Texas franchise tax, the Texas Tax Code considers the entity's legal status based on the laws under which it is formed or governed. As a general rule, if the law or formation document provides some form of limited liability protection, the entity will be subject to the franchise tax.

Federal Elections Ignored. For purposes of determining whether an entity is subject to the franchise tax, the franchise tax law ignores federal tax elections.

Example 3A-1 Disregarded limited liability company.

Mary forms a single member limited liability company. Unless she elects corporate status for federal tax purposes, the LLC will be treated as a disregarded entity. The business will report its revenues, expenses, gains, and losses on Mary's Schedule C (Form 1040), "Net Profit from Business."

For state law purposes, the LLC is treated as a separate legal entity, apart from its owner. The owner will receive limited liability protection under state law for certain debts and liabilities of the LLC. For Texas franchise tax purposes, the LLC is a taxable entity.

Example 3A-2 Sole proprietorship electing corporate status.

Bob is the sole shareholder of an S corporation doing business in Texas. The S corporation converts under state law to a sole proprietorship. The resulting proprietorship elects corporate status to provide continuity for federal tax purposes and avoid gain recognition at the federal level.

For state law purposes, the sole proprietorship is not considered a separate legal entity. Bob directly owns all of the business assets and is individually liable for all of its debts and obligations. For Texas franchise tax purposes, the sole proprietorship is not a taxable entity.

Texas Constitutional Law Prohibits Taxing Natural Persons

Texas constitutional law restricts the state from imposing a tax on *natural persons*. The Texas constitution requires a majority vote by the citizens of Texas before it may impose a tax on the net incomes of natural persons, including a person's share of partnership and unincorporated association income.

The franchise tax defines a *natural person* as a human being or the estate of a human being. The term does not include a purely legal entity given recognition as the possessor of rights, privileges, or responsibilities, such as a corporation, limited liability company, partnership, or trust.

The Comptroller's rules define *estate of a natural person* for franchise tax purposes to include:

1. U.S. estates as defined under IRC Sec. 7701(a)(30)(D), and

2. Revocable trusts that elect to be treated as part of a taxable estate in accordance with IRC Sec. 645.

The term does not include estates that are taxable as business entities under Treas. Reg. 301.7701-4(b).

These types of estates are subject to the franchise tax.

Taxable Entities

The franchise tax includes almost every type of limited liability entity in its list of "taxable entities." The list of taxable entities includes, but is not limited to, the entities discussed here.

Partnerships

Partnerships doing business in Texas may be subject to the franchise tax. This includes domestic, foreign, and international partnerships.

Title 4 of the Texas Business Organizations Code (TBOC) governs partnerships. Texas law defines a *partnership* as an association of two or more persons to carry on a business for profit as owners. A partnership is formed as a matter of law in various circumstances.

A business meeting that definition will be treated as a partnership under Texas law regardless of whether it is called a partnership, joint venture, or some other name.

Under the TBOC, a partnership may arise where the individuals engaged in business do any of the following:

- Receive or are entitled to receive a share of the business's profits.
- Express an intent to be business partners.
- Participate or have the right to participate in control of the business.
- Share or agree to share business losses.
- Share or agree to share liability for third party claims against the business (e.g., personal guarantees on loans, etc.).
- Contribute or agree to contribute money or property to the business.

For federal tax law purposes, Subchapter K of the Internal Revenue Code governs partnerships. It treats partnerships as pass-through entities. For federal tax purposes, partnerships file Form 1065 (U.S. Return of Partnership Income). However, the tax itself is paid at the individual partner level. The partnership provides the information to the partners on Schedule K-1 (Partner's Share of Income, Credits, Deductions, etc.) and the partners report the information from the Schedule K-1 on their individual federal tax returns.

The Texas Tax Code treats partnerships as taxable entities. Partnerships calculate margin by reference to amounts reported on their federal Forms 1065 and on the partnership's books and records. Thus, partnerships may owe a Texas franchise tax even though they are pass-through entities for federal tax purposes.

Partnerships are presumptively taxable under state law, even though some types of partnerships will be exempt from the franchise tax or not subject to it.

Limited Liability Partnerships (LLPs)

Limited liability partnerships (LLPs) are taxable entities subject to the franchise tax. They are governed by Chapter 152, Subchapter J of the Texas Business Organizations Code. A limited liability partnership is a type of general partnership that registers for limited liability status by filing an application with the Texas Secretary of State.

Partners in limited liability partnerships generally are not responsible for partnership debts or obligations arising from another partner's error, omission, negligence, incompetence, or malfeasance. Limited liability partnerships are subject to the Texas franchise tax.

Corporations

Corporations governed by Titles 2 and 7 of the Texas Business Organizations Code are subject to the franchise tax. Under Texas law, the term *corporation* includes for-profit corporations, nonprofit corporations, and professional corporations. Unless otherwise exempted, these entities are subject to the Texas franchise tax.

Texas has historically imposed franchise tax on corporations, including regular corporations, close corporations, and corporations that have elected to be treated as pass-through S corporations under federal law.

C Corporations. Regular corporations are often referred to as "C corporations" because they are governed by Subchapter C of the Internal Revenue Code. They are treated as separate legal entities, apart from their owners, for both state and federal tax purposes.

Close Corporations. Close corporations are for-profit corporations that elect under Texas law to be governed as close corporations. Texas law offers simplified procedures and corporate formalities for close corporations. The provisions of the Texas Close Corporation Law (or another state's close corporation law) determine if a corporation with no more than 35 shareholders is eligible to file as a close corporation.

Nonprofit Corporations. Nonprofit corporations are also presumed to be subject to the franchise tax, unless they are specifically excluded or exempted from taxation under the Texas Tax Code or the Comptroller's Rules. The Comptroller will generally grant an exemption based on the entity's federal exemption from the IRS.

S Corporations. S corporations are entities that elect, for federal tax purposes, to be governed under Subchapter S of the Internal Revenue Code. To qualify as S corporations, entities must make an election and maintain eligibility requirements. For example, federal law requires S corporations to have no more than 100 shareholders. The shareholders must not be nonresident aliens, and there must be no more than one class of stock. Additional eligibility requirements also apply, which are beyond the scope of these materials. S corporations, like partnerships, are flow-through entities under federal law. They are treated as taxable entities for Texas franchise tax purposes.

Trusts

Trusts are generally taxable entities unless they are (1) grantor trusts in which all of the grantors and beneficiaries are natural persons or charities, (2) real estate investment trusts (REITs), (3) nonprofit self-insurance trusts, (4) retirement plan trusts, or (5) charitable trusts. Business trusts and all other trusts not mentioned here are considered taxable entities unless they qualify as passive entities. Most private trusts will, however, qualify as passive entities unless they have significant rental income or other nonpassive income.

Electing Small Business Trusts (ESBTs). The Comptroller has not specifically ruled on whether ESBTs are taxable entities for franchise tax purposes. Electing small business trusts are trusts that own S corporation stock and elect to be taxed as an ESBT. They may also own other assets besides the S stock. Because an ESBT is not treated as a grantor trust, it should be a taxable entity for franchise tax purposes. However, if an ESBT qualifies as a passive entity, it is a nontaxable entity. But this may be hard to do if the S corporation involves a profitable business that constitutes more than 10% of the ESBT's federal gross income.

Failing to qualify as a passive entity will cause all of the trust's revenue to be subject to the franchise tax. However, the trust can exclude its share of the S corporation income from its total revenue because it is a distributive share

of income from another taxable entity. But even without that exclusion, the ESBT should be able to exclude its share of the S corporation income because the rules only tax revenue reported on certain lines of the trust return. The S corporation income of an ESBT does not appear on any line of the ESBT's Form 1041. Instead, it appears on a plain paper schedule attached to the back of the return.

In summary, an ESBT will usually be required to file a Texas Franchise Tax Report. However, it will rarely owe any tax because either (1) it qualifies as a passive entity, (2) it excludes the S corporation revenue because it was included in the margin of another entity, (3) it excludes the S corporation revenue because it does not appear on any line of the Form 1041, (4) the ESBT's total revenue is less than the *de minimis* amount ($1 million for reports due in 2010 and 2011), or (5) its tax is less than $1,000.

Banking Corporations

The term *banking corporation* means each state, national, domestic, or foreign bank, whether organized under the laws of Texas, another state, another country, or under federal law. This definition includes:

- State banks,
- National banks,
- Domestic banks,
- Foreign banks,
- Limited banking associations organized under Subtitle A, Title 3, Finance Code, and
- Banks organized under Section 25(a), Federal Reserve Act (12 U.S.C. Secs. 611–631) (edge corporations).

Bank Holding Companies. A bank holding company is generally any company that has control over any bank. Bank holding companies are taxable entities subject to the Texas franchise tax as holding companies. However, they are not treated as banking corporations for apportionment purposes.

Savings & Loan Associations

For Texas franchise tax purposes, a savings and loan association includes not only a traditional savings and loan association but also a savings bank. The entity may be taxable in Texas regardless of whether it is organized under Texas law, the law of another state or country, or federal law.

Limited Liability Companies (LLCs)

Limited liability companies have historically been subject to franchise tax and remain taxable entities under the margin computation. Under Texas state law, LLCs have liability protection similar to that afforded corporations. Under federal tax law, LLCs are treated as partnerships or disregarded entities, unless the owner or owners make a check-the-box election to treat the LLC as a corporation.

Business Trusts

A trust is characterized by having a trust corpus (the trust assets), a trustee (who manages the assets), and at least one beneficiary (current or future). A business trust is a trust formed for the purpose of making a profit.

Business trusts (also known as commercial trusts) are generally created by the beneficiaries as a device to carry on a profit-making business that normally would have been carried on through business organizations classified as corporations or partnerships.

Business trusts generally engage in some sort of commercial activity. They are generally governed by officers who have management duties. The owners of a business trust generally hold transferable certificates of interest. A business trust is a separate legal entity that survives the death of its beneficiaries (the corporate characteristic of

continuity of interest) and benefits their beneficiaries by limited liability and other legal protections. Therefore, they are subject to the franchise tax.

Professional Associations (PAs)

A professional association is formed as an association, as distinguished from a partnership, a corporation, or a trust.

The term *association* includes a cooperative association, a nonprofit association, and a professional association.

To qualify as a professional association, an association must be formed for the purpose of providing certain qualified professional services. The qualifying services include those rendered by medical doctors, doctors of osteopathy, podiatrists, dentists, chiropractors, optometrists, therapeutic optometrists, veterinarians, and licensed mental health professionals.

The association must also be governed as a professional entity under Texas law. Texas law defines professional entities as those rendering professional services only through their owners, members, managerial officials, employees, or agents. To qualify, each of these persons or entities must be either a professional individual or professional organization.

Business Associations

The Texas Business Organizations Code broadly defines a business as any trade, occupation, profession, or other commercial activity. A business association is a business entity formed to conduct one or more of these activities. Business associations are taxable entities.

Joint Ventures

Joint ventures are subject to the Texas Franchise Tax.

A joint venture (JV) is generally a temporary partnership formed to carry on a business project or activity. A joint venture may be organized as a partnership or other form of business entity. In Texas, a joint venture may become a partnership, under operation of law, if the parties to the venture agree to share in management and divide profits.

Joint Stock Companies

Joint stock companies are subject to the Texas Franchise Tax.

A joint stock company generally combines partnership features with those of corporations. They are generally able to access the stock markets' liquidity and financial reserves as a corporation would. However, stockholders are often liable for the joint stock company's debts and endure other restrictions, similar to partners in a partnership.

Holding Companies

Holding companies are subject to the Texas Franchise Tax.

A holding company is an entity formed for the sole purpose of owning and controlling other companies. Holding companies are taxable entities.

Combined Entities

The definition of taxable entities subject to the franchise tax includes combined groups. The franchise tax statute defines a combined group as a group of taxable entities that are part of an affiliated group engaged in a unitary business and required to file a group report. In Texas, combined reporting is compulsory so long as certain criteria are met. Affiliated entities engaged in a unitary business are required to file a combined report. Only taxable entities may be members of the combined group.

Other Legal Entities

The list of taxable entities concludes with any "other legal entity." If the Texas Tax Code does not list a type of business entity as exempt from the tax, the law presumes it is a taxable entity.

Nontaxable Entities

The franchise tax statute provides two lists of entities that are not subject to the franchise tax. Together they include the nontaxable entities discussed here.

Sole Proprietorships

A sole proprietorship is a business owned and controlled by one person. Sole proprietorships are not separate legal entities from their owners and do not offer any form of legal liability protection. The owner of a sole proprietorship owns all of the business's assets and is personally responsible for all of its liabilities.

For federal tax purposes, sole proprietors report their business income and expenses on Schedule C (Form 1040), "Profit or Loss from Business." All income is immediately taxable to the proprietor.

For Texas franchise tax purposes, sole proprietorships generally are not taxable entities. However, sole proprietorships *are* taxable entities if they receive any limited liability protection (including formation in foreign countries that limits liability).

General Partnerships Comprised of Only Natural Persons

A general partnership is not subject to franchise tax if it is directly owned solely by natural persons. A natural person includes a human being or the estate of a human being. Thus, if an LLC, trust, IRA, partnership, charity, or other nonnatural person is a partner, the general partnership is a taxable entity.

Example 3C-1 General partnership of natural persons.

Partnership P is a general partnership with three owners, Individual A, Individual B, and Individual C. The general partnership is comprised solely of natural persons and therefore qualifies for exclusion from franchise tax. If any of the partners die, the general partnership is still a nontaxable entity because a natural person includes the estate of a natural person.

Example 3C-2 General partnership interest held in an LLC.

Home Style Partnership is a general partnership owned 49% each by Mom and Pop. The other 2% interest is held by an LLC. Mom and Pop are the sole owners of the LLC. The general partnership does not qualify for exclusion from franchise tax because the direct interests in the partnership are not held solely by natural persons. The LLC's ownership interest causes the partnership to be a taxable entity.

Like sole proprietorships, general partnerships are also taxable if they have limited liability. To be considered a nontaxable entity, the liability of the general partnership must *not* be limited under a statute of Texas or another state, including by registration as a limited liability partnership.

Passive Entities

Certain entities will qualify as passive entities and will therefore not be required to pay the franchise tax. The determination of whether an entity is passive is a year-by-year determination. Therefore, the Comptroller will likely require annual reporting from passive entities, regardless of whether they will be required to pay the franchise tax.

Entities Exempt from Taxation under Subchapter B

The revised franchise tax continues to exempt corporations and LLCs that previously qualified for exemption under Subchapter B. In addition, the ability to qualify for an exemption has been extended to all taxable entities.

These exempt entities include:

- Nonprofit entities organized for religious worship.
- Nonprofit entities organized solely for educational purposes, including student loans and scholarships.
- Public charities.
- Entities exempt from federal income tax under IRC Sec. 501(c)(2–10), (16), (19), or (25).
- Agricultural nonprofits.
- Farm mutual insurance companies, local mutual aid associations, and burial associations.
- Railway terminal associations with no annual net business income.
- Open-ended investment companies registered under the Securities Act.
- Entities engaged solely in the business of manufacturing, selling, or installing solar energy devices.
- Entities engaged in conservation, recycling operations, water supply or sewer services.
- Certain homeowners' associations and nonprofit housing cooperatives.
- Farmers' co-ops and agricultural marketing associations.
- Credit unions and credit co-ops.
- Electrical and telephone co-ops.
- Other listed entities formed for exempt or public purposes.

Estates

A deceased person's estate generally is not subject to franchise tax. An estate is created, formed, or arises as a matter of law when a person dies. An estate is not taxable for the same reasons that sole proprietors and natural persons are not subject to the franchise tax which is because they have no state law protection against liabilities.

The franchise tax defines an estate by reference to IRC Sec. 7701(a)(30)(D), which includes any estate except a foreign estate. However, estates that are taxable as business trusts pursuant to Treas. Reg. 301.7701-4(b) are not included in the franchise tax definition of an estate and therefore are treated as taxable entities. It is unclear whether the estate of a sole proprietor would constitute a business trust subject to the franchise tax.

The Comptroller's rules define an estate for franchise tax purposes to include estates defined under IRC Sec. 7701(a)(30)(D) and revocable trusts created during the decedents lifetime that elect to be treated as part of a taxable estate in accordance with IRC Sec. 645. IRC Sec. 645 allows qualified revocable trusts to be treated as part of a person's estate for federal estate tax purposes. These trusts will be treated as part of the estate for franchise tax purposes.

Grantor Trusts

A grantor trust is not subject to franchise tax as long as the grantors and beneficiaries are all natural persons or charitable entities. Charitable entities are defined by reference to IRC Sec. 501(c)(3).

The franchise tax statute defines a grantor trust by reference to IRC Secs. 671 and 7701(a)(30)(E). IRC Sec. 671 discusses income, deductions, credits, and other trust items that are attributable to their owners. IRC Sec. 7701(a)(30)(E) defines a United States person to include a United States grantor trust. These provisions generally

treat the grantor trust as a disregarded entity for federal tax purposes, the income of which is directly taxable to the owner or owners.

A grantor trust is generally formed or created when assets are placed into a trust by a grantor who retains some control over the assets. For federal tax purposes, grantor trusts are treated as disregarded entities. For franchise tax purposes, they are excluded from the definition of a taxable entity. This means that grantor trusts established for minors, disabled persons, or charitable purposes will generally be exempt.

As with estates, the Comptroller's Rules do not allow a business trust pursuant to Treas. Reg. 301.7701-4(b) to be treated as a nontaxable grantor trust. Trusts that are taxable as business trusts under Treas. Reg. 301.7701-4(b) are not excluded from the definition of a taxable entity and will be subject to franchise tax.

Qualified Subchapter S Trusts (QSSTs). The Comptroller has not specifically ruled on whether QSSTs are taxable or nontaxable entities for franchise tax purposes. A QSST is a trust with a single current income beneficiary that is required to distribute all its income to that beneficiary and is qualified to hold S corporation stock. The portion of a QSST that constitutes Subchapter S stock is treated as a grantor trust for federal tax purposes. Because the franchise tax rules adopt the federal definition of grantor trust, QSSTs should be exempt from the margin tax based on their status as grantor trusts.

However, a QSST can own other assets besides the S stock. In that case, the portion of the trust that holds the other assets is usually not a grantor trust for federal income tax purposes. A trust that owns both S stock and other assets is treated as a single trust with two portions for federal income tax purposes. It files a single Form 1041 (U.S. Fiduciary Income Tax Return) reporting the non-S portion income on page 1 and the S portion (grantor portion) income on a plain paper schedule attached to the back of the return.

In this case, it is not certain whether the Comptroller would view the trust as one or two trusts for margin tax purposes. If viewed as two separate trusts, the S portion would be exempt as a grantor trust and the non-S portion would qualify as a passive entity if at least 90% of its federal gross income is from passive sources. But if the two portions are considered a single trust, as they are for federal income tax purposes, it may be difficult for the trust to meet the 90% passive income test. This is especially true if the S corporation operates a profitable business because flow-though income from an S corporation trade or business is not passive income. If the trust does not meet the passive income test, all of its revenue is subject to the margin tax, except for its net distributive income from the S corporation.

Escrows

An escrow is also not subject to franchise tax. Escrows are generally formed or created when funds are set aside by a third party trustee on behalf of a party to a transaction. Many practitioners do not consider an escrow to be an entity, but the franchise tax statute nonetheless clarifies that they are not taxable entities.

REITs

A real estate investment trust (REIT) is not subject to franchise tax.

The franchise tax statute defines a REIT by reference to IRC Sec. 856. A REIT is generally an investment entity in which investors hold shares that represent indirect interests in real estate. IRC Sec. 856 imposes various restrictions on REITs, such as the number of owners, the activities in which the entity may engage, and other requirements.

To qualify for exclusion from franchise tax, a REIT may not hold any direct interest in real estate other than the real estate it occupies for its own business purposes, such as office space. If a REIT holds a direct interest in real estate that does not meet these qualifications, it is a taxable entity.

REITs must instead own interests in partnerships or other entities that directly hold the real estate. The partnerships or other entities that directly hold the real estate are subject to the franchise tax. Therefore, the exclusion of REITs from franchise tax helps to prevent multiple taxation of the same margin.

A qualified REIT subsidiary (QRS) is a subsidiary owned wholly by the REIT. They are generally formed to perform various tasks, such as maintenance and groundskeeping, which the REIT is prohibited from performing on its own. A QRS is also excluded from tax. The franchise tax statute defines a QRS by reference to IRC Sec. 856(i)(2).

REMICs

A real estate mortgage interest conduit (REMIC) is not subject to franchise tax. A REMIC is an investment entity, structured somewhat like a REIT, that holds investments in real estate mortgages and other qualified investments, such as Ginnie Mae, Freddie Mac, and other mortgage-backed securities. The franchise tax statute defines a REMIC by reference to IRC Sec. 860D. A REMIC must elect special federal tax treatment. If it does, it will also qualify for franchise tax exclusion.

Nonprofit Self-Insurance Trusts

A nonprofit self-insurance trust is not subject to franchise tax. The franchise tax statute defines a nonprofit self insurance trust by reference to the Texas Insurance Code, Chapter 2212. This statute establishes procedures for businesses to establish self-insurance trusts to handle health care insurance liability claims. Health care liability claims are causes of action against physicians or dentists for treatment, lack of treatment, or other claimed departure from accepted standards of health care or safety that proximately results in injury to or death of the patient.

Qualified Retirement Plan and Stock Bonus Trusts

Qualified retirement plans and stock bonus trusts are not subject to franchise tax. The franchise tax statute defines qualified retirement plans and stock bonus trusts by reference to IRC Sec. 401(a). IRC Sec. 401(a) is the federal tax provision that defines most pension, profit-sharing, stock bonus, and other similar deferred compensation plans established by an employer for the exclusive benefit of its employees.

VEBAs

A voluntary employees' beneficiary association (VEBA) is not subject to franchise tax. The franchise tax statute defines a VEBA by reference to IRC Sec. 501(c)(9). IRC Sec. 501(c)(9) is the provision that defines a voluntary employee benefit association as an exempt organization for federal tax purposes. VEBAs provide for the payment of life, sick, accident, or other benefits to VEBA members, their dependents, or their designated beneficiaries. To qualify as a VEBA, no part of the association's net earnings may inure to the benefit of any private shareholder or individual, other than through qualified payments for life, sick, accident, or other qualifying benefits.

Passive Entities

Nontaxable Status

Entities that qualify as passive entities are not subject to the franchise tax.

To qualify as a passive entity, the entity must:

1. Be formed as a qualifying type of entity,
2. Receive at least 90% of its federal gross income from passive sources, and
3. Receive less than 10% of its federal gross income from active sources.

Yearly Determination. The qualification of an entity as passive is a year-by-year determination. An entity may be passive one year and active the next, or vice-versa. Transitioning from taxable status in one year to passive status in the next will not subject a passive entity to the exit tax.

Qualifying Type of Entities

To qualify as a passive entity, an entity must first be formed as a general partnership, limited partnership, limited liability partnership, or nonbusiness trust. Thus, C and S corporations and LLCs cannot be passive entities.

An entity's status under the jurisdiction where it is formed determines whether it will qualify as a passive entity for purposes of the Texas franchise tax.

Example 3D-1 Status under applicable state law determines eligibility for qualification as a passive entity.

Bum Steer, LLC, is a limited liability company organized under the laws of Nevada. It is treated as a partnership for federal tax purposes.

Because Bum Steer is organized as an LLC, it is not eligible for treatment as a passive entity despite its treatment for federal tax purposes as a partnership.

To qualify as passive, an entity must be a qualified entity for the entire accounting period.

Example 3D-2 Mid-year conversion of an LLC to a limited partnership.

Continuing with the facts of Example 3D-1, assume Bum Steer converts to a limited partnership during the current year. Bum Steer will not qualify as passive for the year of conversion.

Example 3D-3 Mid-year dissolution with reorganization as a new entity.

Continuing with the facts of Example 3D-1, it may be better to dissolve Bum Steer and transfer the assets to a limited partnership rather than convert the LLC to a limited partnership. The rules only require that the entity meet the active and passive income tests for the period on which margin is based. Therefore, if the limited partnership was not in existence the entire year, it would be hard to deny passive entity treatment if the new entity met the test during its accounting period, even a short period.

90% Passive Income Sources Test

In order to qualify as passive, an entity must receive at least 90% of its federal gross income from passive sources. Passive income is very narrowly defined.

Passive Income. The following income sources are passive for Texas franchise tax purposes:

- Dividends.
- Interest.
- Gains on foreign currency exchanges.
- Periodic and nonperiodic payments with respect to notional principal contracts.
- Option premiums.
- Cash settlement or termination payments with respect to a financial instrument.
- Income from a limited liability company.
- Distributive shares of partnership income to the extent that they are greater than zero, *excluding* rental income.
- Capital gains from the sale of real property.
- Gains from the sale of commodities traded on a commodities exchange.
- Gains from the sale of securities.

- Royalties, bonuses, or delay rental income from mineral properties.
- Income from other nonoperating mineral interests (as long as the recipient is not affiliated with the operator).

Many of these income sources are traditionally considered to be passive, such as dividends, interest, and gains on sales of investments. However, some income sources do not follow federal tax law, such as rental payments which are considered to be active income sources. In addition, the Comptroller has ruled that—

1. Lottery winnings are not passive income.
2. Depreciation recapture under IRC Secs. 1245, 1250, and 1254 is not passive income.
3. Net Section 1231 recapture is not passive income.

Federal Gross Income Defined. The franchise tax statute does not define federal gross income. In December 2009, the Comptroller amended Rule 3.582 to define *federal gross income* as income that is reported on the entity's federal income tax return, to the extent the amount reported complies with federal tax law.

Prior to the adoption of this definition, federal gross income was defined by reference to IRC Sec. 61(a)). Under this definition, federal gross income included a partner's share of partnership gross income and a shareholder's share of S corporation gross income. That made it very difficult for entities that owned an interest in a partnership or S corporation to qualify as passive entities because they would have to include in federal gross income their share of the gross income of the entities in which they owned an interest. In addition, they may not have had access to this information. Therefore, the Comptroller's amendments to TAC Rule 3.582(b)(3) clarify that for franchise purposes, gross income includes only the amount actually reportable on the partner or shareholder's return.

As a result of this change, federal gross income includes only the net income reported to an entity on Schedule K-1 by a partnership or S corporation in which it owns an interest, rather than the partner or shareholder's share of the partnership's or S corporation's gross income.

Example 3D-4 Including net income reported by pass-through entity.

ABC is a partnership that owns a 1% interest in an LLC. During the current year, ABC has $300,000 of passive income. ABC receives a Schedule K-1 from the LLC showing that its share of the LLC's gross income is $100,000, and its distributive share of the LLC's trade or business income is $10,000.

ABC qualifies as a passive entity because only the $10,000 distributive share (rather than the $100,000 share of gross income) is included in the denominator of the 90% test ($300,000 ÷ $310,000 = 96.7%). As a passive entity, ABC does not owe any franchise tax.

If ABC were required to include its $100,000 share of the LLC's gross income in the denominator of the 90% test, it would not qualify as a passive entity ($300,000 ÷ $400,000 = 75%). In this case, ABC would be subject to the margin tax on its total revenue of $300,000, which excludes the $10,000 because it is subject to the margin tax of another entity.

Comptroller's Interpretation. The Comptroller's Rules narrow the scope of what may be considered passive income. The Comptroller has interpreted *capital gains* from the sale of real property to be *net capital gains*.

Similarly, the Comptroller has also interpreted *gains* from sales of commodities and securities to be *net gains*. Thus, gains are first netted against losses and then added to other income sources to determine whether at least 90% of the income is passive.

Gains from sales of real property are considered passive only if they are capital gains for federal tax purposes. That means many forms of recapture income will not qualify as passive if they are treated as ordinary income for federal tax purposes.

Income from Mineral Interests. Income that a non-operator receives under a joint operating agreement does not qualify as passive if the nonoperator is a member of the same affiliated group as the operator. A non-operator and an operator generally will be considered to be affiliated if they share more than 50% common ownership.

Distributive Shares of Rental Income. In December 2009, the Comptroller adopted amended TAC Rule 3.582. The rule, as amended, applies to reports due on or after January 1, 2008.

For purposes of the 90% passive income test for qualification as a passive entity, the amended rule provides that—

1. Rental income is not passive.

2. Distributive shares of partnership income (to the extent that those distributive shares are greater than zero) are passive.

Example 3D-5: Pass-through rental income.

A trust has $300,000 of passive income and $100,000 of gross rental income. It does not meet the 90% passive income test because only 75% of its federal gross income is passive ($300,000 ÷ $400,000 = 75%).

The trust transfers its rental property to a partnership in which it owns a 98% interest. The partnership issues a Schedule K-1 to the trust reflecting its share of net rental income of $60,000.

After the transfer, the trust qualifies as a passive entity because all of its gross income is passive, including the $60,000 distributive share of partnership rental income.

10% Active Trade or Business Income Test

To qualify as passive, an entity must receive 10% or less of its federal gross income from active sources. An entity that meets the 90% test for passive revenues generally will meet this test as well.

An entity is considered to be carrying on an active trade or business if it performs active management and operation functions or if it carries on one or more active operations for the purpose of earning a profit. This may include activities performed by independent contractors or others outside the business entity who perform services on behalf of the entity.

Exceptions. The franchise tax statute specifies that income from certain activities will not constitute income from an active trade or business:

- Owning royalties or nonoperating working interests in mineral rights.

- Paying compensation to employees or independent contractors for financial or legal services reasonably necessary to operate the entity.

- Holding a seat on the board of directors of an entity does not, on its own, constitute the conduct of an active trade or business.

Although the income listed in the previous paragraph is not active, it is not passive either. There may be many types of income that are not neither active nor passive. (See the discussion in the next section.)

Some Income Is Neither Active Nor Passive

Because passive and active income are narrowly defined, it is possible that some types of income will not fall into either category. Thus, an entity could receive less than 10% of its federal gross income from active sources but still fail to qualify as a passive entity because less than 90% of its federal gross income is from passive sources.

For example, income from the activities listed in the preceding section is not active income because it does not constitute income from an active trade or business. Such income is not passive because it is not included among the types of income that qualify as passive income.

There may be other types of income that are neither active nor passive. For example, royalties for the use of an entity's intangible property may not constitute active income if the entity performs no active management or operational functions.

Lottery winnings are not passive because such income is not included among the types of income that qualify as passive income. Such income is not active because it is not derived from the active conduct of a trade or business.

Example 3D-6 Income that is neither passive nor active.

Lucky is a taxable entity that receives royalties on intangible property that it owns. Lucky also won a lottery during the current year.

Neither the royalties on the intangible property nor the lottery winnings are passive income or active income.

Under these facts, Lucky would receive less than 10% of its federal gross income from active sources. Although none of its income is active, Lucky would not qualify as a passive entity because it does not receive at least 90% of its federal gross income from passive sources.

Reporting Requirements

In December 2009, the Comptroller adopted amended rules that clarify the circumstances under which passive entities must file reports.

First, a partnership or trust that is registered with the Comptroller's office or with the Secretary of State's office must file an information report as a passive entity for the first report that it qualifies as passive. An entity that has filed as passive on a previous report will not be required to file subsequent franchise tax reports, as long as the entity continues to qualify as passive. This rule is a welcome change from the pre-amendment rules that required passive entities, that were already registered with the Secretary of State, to file annual reports regardless of their status as passive.

Second, for a partnership or trust not registered with the Comptroller's office or with the Secretary of State's office, the amended rules continue the previous rule that a partnership or trust qualifying as a passive entity for the period upon which the franchise tax report is based will not be required to register with or file a franchise tax report with the comptroller's office.

And finally, the amended rule clarifies that any passive entity (whether or not registered with the Comptroller's or the Secretary of State's office) that no longer qualifies as passive, must register with the Comptroller's office and file a franchise tax report for the period in which it does not qualify as passive, and any subsequent periods, until it once again files with the Comptroller's office as a passive entity.

An entity that filed franchise tax reports in the past and ceases to file reports pursuant to these rules is quite likely to receive an inquiry from the Comptroller's office asking for an explanation of its tax status. If a passive entity receives notification in writing from the Comptroller asking if it is taxable, the entity should reply to the comptroller within 30 days of the notice. The entity should write the Comptroller a letter explaining its tax status.

Taxable Entity Owning a Passive Entity

Pass-through Income. A passive entity's income does not necessarily escape taxation. A taxable entity that owns a passive entity must include its share of the passive entity's net income in its revenues except to the extent it was generated by the margin of another taxable entity and passed through to the taxable entity.

Example 3D-7 Taxable entity that owns a passive entity.

Holding Company is a taxable entity that owns a 50% interest in Passive Partnership, which owns an interest in an LLC.

Passive Partnership has self-generated income of $100,000 and $70,000 of administrative expenses, Passive Partnership receives a Schedule K-1 from LLC that reports $5,000 of net income.

Passive Partnership passes through $50,000 (50% × $100,000) of self-generated income to Holding Company. In addition, Passive Partnership passes through $2,500 ($5,000 × 50%) of LLC's net income to Holding Company. Passive Partnership also passes through $35,000 (50% × $70,000) of separately stated administrative expenses to Holding Company.

Holding Company will include in revenue the $50,000 of income from Passive Partnership, but will exclude the $2,500 of net income originally generated by LLC because that income was originally generated by a taxable entity (i.e., by LLC).

Combined Reporting and Tiered Partnerships

Passive entities may not be part of a combined group because only taxable entities may be part of a combined group. Nor can a passive entity participate in a tiered partnership arrangement for the same reason. Only taxable entities can be part of a tiered partnership arrangement. However, a member of a combined group will include in its total revenue a pro rata share of the net income from a passive entity it owns to the extent the income was not included in the margin of another taxable entity.

Even though a passive entity may be affiliated with other entities, it cannot file a combined report with those entities.

Example 3E-1 Passive entity affiliated with taxable entities.

Parent Corporation owns 95% of Passive Partnership, Active Partnership, and Active LLC. Parent Corporation, Passive Partnership, Active Partnership, and Active LLC are engaged in a unitary business.

Even though the entities appear to qualify for combined reporting, Passive Partnership cannot be included in the combined group. Nevertheless, Parent Corporation will be required to include 95% of the net income from Passive Partnership in its revenues for purposes of computing taxable margin.

A passive entity's direct or indirect ownership in a lower tier entity would be considered for purposes of attributing ownership to an upper tier entity.

Example 3E-2 Passive entity ownership considered for affiliation.

Corporation A owns 10% of Corporation B and 60% of Passive Partnership. Passive Partnership owns 51% of Corporation B.

Even though Passive Partnership would not be eligible to file a combined report with Corporation A and Corporation B, its ownership in Corporation B is attributed to Corporation A for purposes of determining whether Corporations A and B are affiliated.

Corporation A is treated as owning a controlling interest (61%) of Corporation B. The controlling interest is composed of the direct 10% interest in B plus the 51% indirect interest held through Corporation A's controlling ownership interest in Passive Partnership.

Passive Partnership is an affiliate of both Corporation A and Corporation B and will be subject to the arms-length pricing requirements for cost of goods sold purposes. However, it will not be eligible for combined reporting with Corporation A and Corporation B because Passive Partnership is a passive entity.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

16. Which of the following types of entities will generally be subject to the Texas franchise tax?

    a. A general partnership owned by Mr. Adams, Mrs. Ballard, Mr. Cooper and Mrs. Dennison.

    b. A general partnership owned by Mr. Adams, Mrs. Ballard, Mr. Cooper and a general partnership formed by Mrs. Dennison.

    c. A real estate investment trust owned by Mr. Adams, Mrs. Ballard, Mr. Cooper and Mrs. Dennison.

    d. A sole proprietorship owned by Mrs. Ballard.

17. Which of the following types of entities will generally be excluded from paying the Texas franchise tax?

    a. A limited partnership whose owners are natural persons.

    b. A limited liability partnership whose owners are natural persons.

    c. A business trust whose owners are natural persons.

    d. A grantor trust whose grantors and beneficiaries are natural persons.

18. Which of the following entities may qualify as passive?

    a. A limited liability partnership with $45,000,000 of interest income, $50,000,000 of gains from the sale of securities and $5,000,000 of income from operating a cattle ranch.

    b. A limited liability corporation with $45,000,000 of interest income, $50,000,000 of gains from the sale of securities and $5,000,000 of income from operating a cattle ranch.

    c. A limited liability partnership with $45,000,000 of income from rental real estate, $50,000,000 of gains from the sale of securities and $5,000,000 of interest income.

19. Which of the following entities may qualify as passive?

    a. A family limited partnership that receives bonus payments, delay rentals and royalties from an oil and gas well. The family limited partnership is owned 30% by Mom, 30% by her husband Pop, 5% by Sis and 5% by Bro. Mom also owns 51% of a general partnership that is the operator of the oil and gas well.

    b. A limited liability corporation that receives bonus payments, delay rentals and royalties from an oil and gas well. The limited liability corporation is owned 30% by Mom, 30% by her husband Pop, 5% by Sis and 5% by Bro. Mom and pop each own 25% of a general partnership that is the operator of the oil and gas well.

    c. A family trust that receives bonus payments, delay rentals and royalties from an oil and gas well. The family trust is owned 30% by Mom, 30% by her husband Pop, 5% by Sis and 5% by Bro. Mom also owns 51% of a general partnership that is the operator of the oil and gas well.

    d. A family limited partnership that receives bonus payments, delay rentals and royalties from an oil and gas well. The family limited partnership is owned 30% by Mom, 30% by her husband Pop, 5% by Sis and 5% by Bro. Mom and Pop each own 25% of a general partnership that is the operator of the oil and gas well.

20. Which of the following types of entities are generally taxable?

    a. A real estate partnership.

    b. A real estate investment trust.

    c. A real estate escrow.

    d. A real estate mortgage interest conduit.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

16. Which of the following types of entities will generally be subject to the Texas franchise tax? **(Page 58)**

    a. A general partnership owned by Mr. Adams, Mrs. Ballard, Mr. Cooper and Mrs. Dennison. [This answer is incorrect. A general partnership owned solely by natural persons is not subject to tax. This presumes the general partnership has not registered for limited liability protection in its jurisdiction of formation.]

    b. A general partnership owned by Mr. Adams, Mrs. Ballard, Mr. Cooper and a general partnership formed by Mrs. Dennison. [This answer is correct. This general partnership is subject to tax because it is not owned solely by natural persons.]

    c. A real estate investment trust owned by Mr. Adams, Mrs. Ballard, Mr. Cooper and Mrs. Dennison. [This answer is incorrect. A real estate investment trust is not subject to tax.]

    d. A sole proprietorship owned by Mrs. Ballard. [This answer is incorrect. A sole proprietorship is not subject to tax. This presumes the sole proprietorship has not registered for limited liability protection in its jurisdiction of formation.]

17. Which of the following types of entities will generally be excluded from paying the Texas franchise tax? **(Page 58)**

    a. A limited partnership whose owners are natural persons. [This answer is incorrect. According to TTC Sec. 171, a limited partnership is subject to the Texas franchise tax. It does not matter if its owners are natural persons or entities.]

    b. A limited liability partnership whose owners are natural persons. [This answer is incorrect. A limited liability partnership is subject to the Texas franchise tax. It does not matter if its owners are natural persons or entities.]

    c. A business trust whose owners are natural persons. [This answer is incorrect. According to TTC Sec. 171, a business trust is subject to the Texas franchise tax. It does not matter if its owners are natural persons or entities.]

    d. A grantor trust whose grantors and beneficiaries are natural persons. [This answer is correct. A grantor trust is not subject to the franchise tax if its grantors and beneficiaries are natural persons.]

18. Which of the following entities may qualify as passive? **(Page 61)**

    a. A limited liability partnership with $45,000,000 of interest income, $50,000,000 of gains from the sale of securities and $5,000,000 of income from operating a cattle ranch. [This answer is correct. A limited liability partnership is a qualifying type of entity. The income of $45,000,000 from interest and $50,000,000 from gains from the sale of securities qualify as passive. The $5,000,000 of income from the cattle ranch is active income. The passive sources make up 95% of the total income of the entity. Since at least 90% is passive income, the entity qualifies as passive.]

    b. A limited liability corporation with $45,000,000 of interest income, $50,000,000 of gains from the sale of securities and $5,000,000 of income from operating a cattle ranch. [This answer is incorrect. A limited liability corporation is a not a type of entity that can qualify as passive per TTC Sec. 171.]

    c. A limited liability partnership with $45,000,000 of income from rental real estate, $50,000,000 of gains from the sale of securities and $5,000,000 of interest income. [This answer is incorrect. The income of $5,000,000 from interest and $50,000,000 from gains from the sale of securities qualify as passive. The $45,000,000 of income from the rental real estate is active income. The passive sources make up only 55%

of the total income of the entity. Since less than 90% is passive income, the entity does not qualify as passive.]

19. Which of the following entities may qualify as passive? **(Page 61)**

    a. A family limited partnership that receives bonus payments, delay rentals and royalties from an oil and gas well. The family limited partnership is owned 30% by Mom, 30% by her husband Pop, 5% by Sis and 5% by Bro. Mom also owns 51% of a general partnership that is the operator of the oil and gas well. [This answer is incorrect. This entity does not qualify as passive. Mom and Pop's ownership is combined to determine affiliation. The FLP is affiliated with the operator. Therefore, the revenues don't qualify as passive.]

    b. A limited liability corporation that receives bonus payments, delay rentals and royalties from an oil and gas well. The limited liability corporation is owned 30% by Mom, 30% by her husband Pop, 5% by Sis and 5% by Bro. Mom and pop each own 25% of a general partnership that is the operator of the oil and gas well. [This answer is incorrect. A limited liability corporation may not qualify as passive.]

    c. A family trust that receives bonus payments, delay rentals and royalties from an oil and gas well. The family trust is owned 30% by Mom, 30% by her husband Pop, 5% by Sis and 5% by Bro. Mom also owns 51% of a general partnership that is the operator of the oil and gas well. [This answer is incorrect. This entity does not qualify as passive. Mom and Pop's ownership is combined to determine affiliation. The trust is affiliated with the operator. Therefore, the revenues don't qualify as passive.]

    d. A family limited partnership that receives bonus payments, delay rentals and royalties from an oil and gas well. The family limited partnership is owned 30% by Mom, 30% by her husband Pop, 5% by Sis and 5% by Bro. Mom and Pop each own 25% of a general partnership that is the operator of the oil and gas well. [This answer is correct. This entity qualifies as passive. Mom and Pop's ownership is combined to determine affiliation. However, the common ownership interest of 50% is not sufficient for the entities to be affiliated. Therefore, the revenues qualify as passive.]

20. Which of the following types of entities are generally taxable? **(Page 54)**

    a. A real estate partnership. [This answer is correct. Domestic, foreign, and international partnerships doing business in Texas may be subject to the franchise tax.]

    b. A real estate investment trust. [This answer is incorrect. REITs are specifically excluded from tax under the Texas Tax Code.]

    c. A real estate escrow. [This answer is incorrect. Escrows are specifically excluded from tax under the Texas Tax Code.]

    d. A real estate mortgage interest conduit. [This answer is incorrect. REMICs are specifically excluded from tax under the Texas Tax Code.]

EXAMINATION FOR CPE CREDIT

Lesson 3 (TFTTG101)

Determine the best answer for each question below. Then mark your answer choice on the Examination for CPE Credit Answer Sheet located in the back of this workbook or by logging onto the Online Grading System.

11. Which of the following is a taxable entity?

    a. Credit union.

    b. Bank holding company.

    c. Credit co-op.

    d. Open-ended investment companies registered under the Securities Act.

12. Which of the following types of entities are generally taxable?

    a. A grantor trust whose grantors and beneficiaries are natural persons.

    b. A real estate investment trust.

    c. A charitable trust.

    d. A business trust.

13. Which of the following types of entities are generally excluded from tax?

    a. A limited liability partnership.

    b. A limited liability company.

    c. A sole proprietorship.

    d. A single member LLC.

14. Which of the following is a taxable entity?

    a. A sole proprietorship that is treated as a corporation for federal tax purposes.

    b. A sole proprietorship that elects limited liability protection in a foreign jurisdiction.

    c. A general partnership with only natural person partners.

    d. A general partnership with an LLC partner that generates only interest and dividends.

15. Which of the following is correct about passive entities?

    a. A passive entity may elect to be a member of a combined group.

    b. A passive entity may elect tiered reporting, so long as it is owned solely by taxable entities.

    c. A passive entity that was formerly taxable must file an exit tax report when it ceases to be subject to the franchise tax.

    d. A passive entity's federal gross income that is derived from active sources must be less than 10%.

16. Which of the following entities would qualify as passive?

    a. A family trust with income from a cattle ranch operation in which the family does not materially participate.

    b. A general partnership owned by two natural persons and an LLC, which generates its income from gains on sales of publicly traded commodities.

    c. A limited liability partnership owned by two natural persons and an LLC, which generates its income from oil and gas royalties, delay rentals and bonus payments. The LLC is the operator. The two natural persons own the LLC.

    d. A limited liability corporation owned by two natural persons, which generates its income from oil and gas royalties, delay rentals and bonus payments. The LLC is not affiliated with the operator.

Lesson 4: Revenue and Apportionment

INTRODUCTION

The determination of a taxable entity's taxable margin begins with the computation of its total revenue from the entire business. This computation begins with the amounts reported on the entity's federal income tax return. After determining the entity's total gross revenue from its federal income tax return, certain deductions and exclusions are allowed for franchise tax purposes.

Special rules are provided for tiered partnership arrangements and combined reporting entities.

Learning Objective:

Completion of this lesson will enable you to:

- Identify the components of revenue and the general and industry-specific exclusions from revenues.
- Identify Texas gross receipts and everywhere gross receipts for apportioning margin, applying the location of payor rule for certain gross receipts.

Total Revenue, Gross Receipts, and Federal Gross Income

It is easy to confuse total revenue, gross receipts, and federal gross income because these terms are used throughout the Texas Franchise Tax Code. They are explained below.

Total Revenue

Starting Point. Total revenue is the starting point for computing the Texas franchise (margin) tax.

"Frozen" IRC. Total revenue is based on the Internal Revenue Code (IRC) of 1986 in effect for the federal tax year beginning January 1, 2007, and any regulations adopted under that Code applicable to that period. However, it does not include any changes made by federal law after that date. For example, total revenue for franchise tax purposes would ignore the federal election under IRC Sec. 108(i) that allows a taxpayer to include income from the reacquisition of a debt instrument purchased after December 31, 2008, and before January 1, 2011, ratably over a four or five year period, depending on when the repurchase occurs.

Total Revenue. Total revenue includes all revenues reportable by a taxable entity on its federal income tax return without deduction for cost of property sold, materials used, labor performed or other costs incurred, less certain statutorily provided subtractions and exclusions. It is defined by amounts reported on specific lines of the entity's federal income tax return. The specific line numbers are specified in TTC Sec. 171.1011(a)–(c) and the rules promulgated thereunder at Rule 3.587(d)(1)–(6). It is then adjusted for any amounts that are disregarded because they were effective after 2007.

Total revenue also serves other functions. Namely, it is the threshold to determine whether the entity qualifies for the following tax benefits:

- Qualification under the *de minimis* total annual revenue rules to file a no tax due information report.
- Qualification to file an EZ computation report.
- Qualification for a tax discount.

Gross Receipts and Apportionment

Gross Receipts. Gross receipts are calculated the same way as total revenue with only a few exceptions. Both gross receipts and total revenue include all revenues reportable by a taxable entity on its federal income tax return pursuant to the Internal Revenue Code as it applies to 2007 tax years, without deduction for the cost of property

sold, materials used, labor performed, or other costs incurred, less certain statutorily provided subtractions and exclusions. However, gross receipts for apportionment are not reduced by deductions for pro bono services, uncompensated care, or the tax basis of securities and loans sold where the loan or security is inventory of the seller or, after 2009, is categorized as "Securities available for Sale" or "Trading Securities" under FAS No. 115. Thus, total revenue may differ from gross receipts for legal services entities, healthcare providers, and lending institutions. In all other cases, it will be the same.

Apportionment. A company's gross receipts determines its apportionment factor. That is, the ratio of Texas gross receipts to total gross receipts determines what portion of a taxable entity's margin is taxable.

Federal Gross Income

The term *federal gross income* is used only to determine whether an entity qualifies as a passive entity that is exempt from the franchise tax under TTC Sec. 171.0003. As such, it acts as a threshold determination for passive entity exclusion and does not enter the calculation of an entity's taxable margin. Federal gross income is defined as income that is reported on the entity's federal income tax return, to the extent the amount reported complies with federal income tax law.

Special Rules for Computing Revenue of Combined Groups and Tiered Entities

Special rules apply for computing the total revenue of a combined group of affiliated entities and for certain tiered partnership and S corporation arrangements.

Annualized Revenue for Short Period

If the accounting period on a franchise tax report is not 12 months, revenue must be annualized to determine the entity's eligibility for the no-tax-due threshold, discounts on tax due that are based on total revenue and qualification for the EZ computation.

To annualize total revenue, an entity will divide total revenue by the number of days in the period upon which the report is based, then multiply the result by 365.

Example 4A-1 Annualizing revenue for a period less than 12 months.

A taxable entity's 2010 franchise tax report is based on the period September 15, 2009 through December 31, 2009 (108 days), and its total revenue for the period is $150,000. The taxable entity's annualized revenue is $506,944 ($150,000 ÷ 108 days × 365 days).

Based on its annualized revenue the taxable entity qualifies for the $1 million or less (for 2010) no-tax-due threshold. It is also eligible to file using the EZ computation.

Reporting Gross Revenue

General Rule for Gross Revenue

Gross revenue refers to the line items of income on a taxable entity's federal income tax return before deducting statutorily prescribed subtractions and exclusions.

Gross Revenue of an Entity Treated as a Corporation

For a taxable entity treated as a corporation for federal income tax purposes, total revenue begins with the amounts entered on:

- Form 1120, line 1c plus lines 4 through 10.

In addition, the corporation must add any total revenue reported by a lower tier entity as includible in the taxable entity's total revenue. It must also ignore any changes made by federal tax law for tax years after 2007.

Gross Revenue of an Entity Treated as an S Corporation

For a taxable entity treated as an S corporation for federal income tax purposes, total revenue begins with the amounts entered on:

- Form 1120S, line 1(c) plus lines 4 and 5,
- Form 1120S, Schedule K, lines 3a and 4 through 10, and
- Form 8825, line 17.

In addition, the S corporation must add any total revenue reported by a lower tier entity as includible in the taxable entity's total revenue. It must also ignore any changes made by federal tax law for tax years after 2007.

Gross Revenue of an Entity Treated as a Partnership

For a taxable entity treated as a partnership for federal income tax purposes, total revenue begins with the amounts entered on:

- Form 1065, page 1, line 1c plus lines 4, 6, and 7,
- Form 1065, Schedule K, lines 3a and 5 through 11,
- Form 8825, line 17, and
- Form 1040, Schedule F, line 11, plus line 2 or line 45.

In addition, the partnership must add any total revenue reported by a lower tier entity as includible in the taxable entity's total revenue. It must also ignore any changes made by federal tax law for tax years after 2007.

Gross Revenue of an Entity Treated as a Trust

For a taxable entity treated as a trust for federal income tax purposes, total revenue begins with the amounts entered on:

- Form 1041, lines 1, 2a, 3, 4, 7, and 8,
- Form 1040, Schedule E, lines 3, 4, 32, and 37, and
- Form 1040, Schedule F, line 11, plus line 2 or line 45.

In addition, the trust must add any total revenue reported by a lower tier entity as includible in the taxable entity's total revenue. It must also ignore any changes made by federal tax law for tax years after 2007.

Gross Revenue of an Entity Treated as a Single Member LLC

For a limited liability company treated as a sole proprietorship, total revenue includes any revenue that relates to the activities conducted by the LLC and begins with the sum of:

- Form 1040, Schedule C, line 3 and line 6,
- Form 4797, line 17,
- Form 1040, Schedule E ordinary income or loss from partnerships, S corporations, estates, and trusts,
- Form 1040, Schedule D, line 16,

- Form 1040, Schedule E, lines 3 and 4, and
- Form 1040, Schedule F, line 11, plus line 2 or line 45.

In addition, the LLC must add any total revenue reported by a lower tier entity as includible in the taxable entity's total revenue. It must also ignore any changes made by federal tax law for tax years after 2007.

Gross Revenue of a Taxable Entity That is Exempt from Federal Income Tax

For a taxable entity, other than a political organization, that is exempt from federal income tax, total revenue begins with the amounts reported as income on:

- Form 990T, Part I, Column A.

In addition, the entity must add any total revenue reported by a lower tier entity as includible in the entitys total revenue. It must also ignore any changes made by federal tax law for tax years after 2007.

Gross Revenue of a Political Organization

For a political organization, total revenue begins with the amounts reported as income on:

- Form 1120-POL, lines 1 through 7, or
- Form 990T, Part I, Column A (if the entity files a Form 990T).

In addition, the entity must add any total revenue reported by a lower tier entity as includible in the entity's total revenue. It must also ignore any changes made by federal tax law for tax years after 2007.

Gross Revenue of a Taxable Homeowner's Association

A taxable homeowner's association that files IRS Form 1120-H computes total revenue based on the amounts reported as income on:

- Form 1120-H, lines 1 through 7, or
- Form 1120, lines 1c and lines 4 through 10 (if the entity files a Form 1120).

In addition, the entity must add any total revenue reported by a lower tier entity as includible in the entity's total revenue. It must also ignore any changes made by federal tax law for tax years after 2007.

Gross Revenue of Other Taxable Entities

Total revenue for all other taxable entities will be an amount determined in a manner substantially equivalent to the amount calculated for the entities discussed earlier in this lesson.

Subtractions from Gross Revenue

The following items can be subtracted from revenue to the extent included in the calculation of revenue.

Bad Debts

Bad debts that are expensed for federal income tax purposes can be subtracted from total revenue to the extent they were included in current or prior year revenue. No deduction is allowed unless the bad debt is reported on the entity's federal income tax return.

Foreign Royalties and Dividends

Foreign royalties and dividends, including amounts determined under IRC Secs. 78 or 951–964 (Subpart F) may be subtracted from total revenue. Generally, this includes Subpart F income of a controlled foreign corporation, which

the Internal Revenue Code requires U.S. corporations to include in income. In addition, a corporation must gross up any foreign dividend for the foreign taxes withheld if the corporation elects to take a credit rather than deduct them.

Net Distributive Income from Partnerships or S Corporations

A taxable entity may subtract from total revenue *net distributive income* from a taxable entity treated as a partnership or as an S corporation for federal income tax purposes to the extent it is included in gross revenue. The purpose of this rule is to avoid a double tax on the income of the flow-through entity. The Comptroller's rules define *net distributive income* as the net amount of income, gain, deduction, or loss relating to a pass-through entity or disregarded entity reportable to the owners for the tax year of the entity. Guaranteed payments to partners are included when computing net distributive income. However, if the net distributive income is a negative number, then it is treated as a negative number when computing total revenue. In other words, only positive net income from taxable flow-through entities is excluded from revenue.

Example 4C-1 Positive distributive income from partnerships and S corporations.

S Corp owns a 50% interest in Partnership P, which owns and leases residential real property.

In 2009, P issues a Schedule K-1 to S Corp reflecting $25,000 of net rental income. S Corp may exclude the $25,000 of income from its total revenue because P is a taxable entity and the rental income was subject to P's margin tax. However, if the K-1 reflected a $25,000 loss, S Corp would include the loss as part of its total revenue.

Revenue from Disregarded Entities

A taxable entity may exclude income attributable to entities that are disregarded for federal income tax purposes, to the extent such revenue is included in income. This rule prevents double taxation of the disregarded entity's revenue.

Form 1120, Schedule C Special Deductions

A taxable entity may subtract from total revenue the allowable deductions from Form 1120, Schedule C, Special Deductions, to the extent the relating dividend income is included in total revenue. There are a surprisingly large number of dividends on Schedule C that qualify for a special deduction.

Exclusions from Gross Receipts

Exclusions

In addition to the subtractions from total revenue discussed above, the Franchise Tax Code also provides nearly a dozen exclusions from total revenue. Some of the exclusions, such as flow-through funds, would have been deductible from total revenue as cost of goods sold or compensation regardless.

Advantage of Exclusions. Exclusions are advantageous because they reduce total revenue, which is the threshold for determining (a) whether an entity may file a no tax due report, (b) claim a small business discount, or (c) use the EZ tax computation. In addition, many of these exclusions would not have been deductible as cost of goods sold or compensation and therefore would have been subject to the margin tax without the exclusion.

Income from Passive Entities

A taxable entity that owns an interest in a passive entity should exclude its share of the passive entity's net income to the extent it was generated by the margin of another taxable entity. In other words, a taxable entity must report income of a passive entity except to the extent that income was generated by the margin of another taxable entity.

Example 4D-1 Income from a passive entity included in total revenue.

S Corp owns a 50% interest in Partnership P, a passive entity, which owns a securities portfolio and a rent house. Partnership P issues a Schedule K-1 to S Corp reflecting S Corp's share of partnership income equal

to $20,000 of dividends and interest, $75,000 of capital gains, and $4,000 of net rental income. S Corp must include the entire $99,000 of Schedule K-1 income in its total revenue because none of it was included in the margin of another taxable entity.

Example 4D-2 Income from a passive entity excluded from total revenue.

Assume the same facts as example 4D-1, only Partnership P owns an interest in the rent house through a limited liability company (LLC) instead of outright. The LLC is a taxable entity. Therefore, S Corp may exclude its $4,000 share of rental real estate income from Partnership P because it was included in the margin of another taxable entity.

Flow-through Funds Mandated by Law or Fiduciary Duty

A taxable entity excludes from its total revenue, to the extent included therein, flow-through funds that are mandated by law or fiduciary duty to be distributed to other entities, including taxes collected from a third party by the taxable entity and remitted by the taxable entity to a taxing authority.

Example 4D-3 Flow-through taxes.

D Corp. is a taxable entity that owns a restaurant. It collects 8¼% state and local sales taxes on its prepared food sales, which it separately identifies as a sales tax on the customer's ticket. It also pays a 14% gross receipts tax on its mixed beverage sales, which it does not separately identify on the ticket nor add to the selling price. Both types of taxes may be excluded from total revenue.

Tenant Reimbursements to a Landlord. When a tenant reimburses a landlord for property tax and insurance expenses, the reimbursements are revenue for Texas franchise tax purposes and may not reduce revenue as a flow through fund.

The Comptroller relies on Treas. Reg. Sec. 1.61-8(c), which states, "As a general rule, if a lessee pays any of the expenses of his lessor such payments are additional rental income of the lessor …" Total revenue for franchise tax reporting is specifically defined in TTC Sec. 171.1011 and is tied to the amounts entered on specific lines from the federal return to the extent the amount entered complies with federal income tax law, minus statutory exclusions. Based on this IRS regulation, the reimbursement of landlord expenses should be reported for federal tax purposes in gross rental income and not used to offset expenses. Therefore, for franchise tax reporting purposes, these expense reimbursements are included in total revenue.

Flow-through Funds Mandated by Contract

A taxable entity may exclude from its total revenue, to the extent included therein, certain flow-through funds that are mandated by contract to be distributed to other entities. These are limited to:

1. Sales commissions to nonemployees, including split-fee real estate commissions,
2. The tax basis as determined under the Internal Revenue Code of securities underwritten, and
3. Subcontracting payments handled by the taxable entity to provide services, labor, or materials in connection with the actual or proposed design, construction, remodeling, or repair of improvements on real property or the location of the boundaries of real property.

Sales Commissions. Sales commissions, which can be excluded from a taxable entity's total revenue, are broadly defined.

They include any form of compensation paid to a licensed real estate broker or salesperson who is not an employee.

They also cover compensation paid by a principal to a sales representative that is based on the amount or level of certain orders for or sales of the principal's product and that the principal is required to report to the IRS on Form 1099-MISC .

Note that *principal* is also broadly defined to include a person who:

1. Manufactures, produces, imports, distributes, or acts as an independent agent for the distribution of a product for sale,

2. Uses a sales representative to solicit orders for the product, and

3. Compensates the sales representative wholly or partly by sales commission.

Real Estate Subcontracting Payments. A taxable entity may also exclude from its total revenue, to the extent included therein, subcontracting payments to provide services, labor, or materials in connection with the actual or proposed design, construction, remodeling, or repair of improvements on real property or the location of the boundaries of real property.

Example 4D-4 Surveying fees.

R Corp is a taxable entity that builds custom homes. A customer hired R to build a new home for him for $500,000. R pays a surveyor $8,000 to draw the boundary lines and also pays $400,000 to other subcontractors to build the home. When R sells the home, R may exclude the $408,000 paid to subcontractors from its total revenue.

Insurance Commissions. Neither the Texas Tax Code nor the Comptroller's Rules specifically address how the margin tax applies to independent insurance agents who bill their customers for gross premiums, remit the wholesale premium to the insurance company, and retain only the difference as a commission. In this situation the insurance agent only retains the net premium.

Based on informal discussions with independent insurance agents, it appears that the industry practice is to record only the commission as income and to record the amount due the insurance company as a liability. Thus, it appears that only the commission income is revenue for margin tax purposes.

Example 4D-5 Independent insurance agents' commissions.

Smith Agency, Inc. operates an independent insurance agency. It bills Sally Jones $2,500 for her 2009 homeowner's insurance premium. Of the $2,500 billed, the agency owes $2,000 to the insurance company and may only keep $500 as its commission. Smith Agency, Inc. records the transaction on Form 1120, line 1c. on its books and records as follows:

Accounts Receivable	$ 2,500	
Revenue		$ 500
Accounts Payable		2,000

Smith Agency also reports $500 as revenue for on Form 1120, line 1c. Thus, for franchise tax purposes, it has $500 of total revenue. On the other hand, if Smith Agency, Inc. reports the full $2,500 homeowners insurance premium as income on its Form 1120, line 1c, then $2,500 is included in total revenue for franchise tax purposes.

Dividends and Interest from Federal Obligations

Taxable entities may exclude from revenue the amounts of dividends and interest earned from investments in federal obligations.

Federal Obligations. Federal obligations include stocks and other direct obligations of, and obligations unconditionally guaranteed by, the United States government and United States government agencies. They also include direct obligations of a United States government-sponsored agency.

Obligation. Obligation means any bond, debenture, security, mortgage-backed security, pass-through certificate, or other evidence of indebtedness of the issuing entity. The term does not include a deposit, a repurchase

agreement, a loan, a lease, a participation in a loan or pool of loans, a loan collateralized by an obligation of a United States government agency, or a loan guaranteed by a United States government agency.

United States Government. United States government means any department or ministry of the federal government, including a federal reserve bank. The term does not include a state or local government, a commercial enterprise owned wholly or partly by the United States government, or a local governmental entity or commercial enterprise whose obligations are guaranteed by the United States government.

United States Government Agency. United States government agency means an instrumentality of the United States government whose obligations are fully and explicitly guaranteed as to the timely payment of principal and interest by the full faith and credit of the United States government. The term includes the Government National Mortgage Association, the Department of Veterans Affairs, the Federal Housing Administration, the Farmers Home Administration, the Export-Import Bank, the Overseas Private Investment Corporation, the Commodity Credit Corporation, the Small Business Administration, and any successor agency.

United States Government-sponsored Agency. United States government-sponsored agency means an agency originally established or chartered by the United States government to serve public purposes specified by the United States Congress but whose obligations are not explicitly guaranteed by the full faith and credit of the United States government. The term includes the Federal Home Loan Mortgage Corporation, the Federal National Mortgage Association, the Farm Credit System, the Federal Home Loan Bank System, the Student Loan Marketing Association, and any successor agency.

Lending Institutions

Exclusions. Lending institutions may exclude from total revenue the proceeds from the principal repayment of loans. They may also exclude the tax basis of securities and loans sold.

For this purpose, *securities* has the same meaning as IRC Sec. 475(c)(2), and includes instruments described in IRC Sec. 475(e)(2)(B), (C), and (D).

A *lending institution* is an entity that makes loans and is regulated by certain governmental bodies such as the:

- Federal Reserve Board,
- Office of the Comptroller of the Currency,
- Federal Deposit Insurance Corporation,
- Commodity Futures Trading Commission,
- Office of Thrift supervision,
- Texas Department of banking,
- Office of Consumer Credit Commissioner,
- Credit Union Department, and
- Other comparable regulatory bodies.

Lending institutions also include entities licensed by, registered with, or otherwise regulated by the Department of Savings and Mortgage Lending. The term also includes brokers and dealers as defined by the Securities Exchange Act of 1934.

Other Special Provisions for Lending Institutions. Other provisions of the Texas franchise tax also address lending institutions.

First, lending institutions that elect to deduct cost of goods sold may include interest expense in cost of goods sold.

Second, revenue from loans and securities treated as inventory is apportioned in and out of Texas based on the location of the payor.

Third, gross receipts for apportionment are not reduced by the tax basis of securities and loans sold where the loan or security is inventory of the seller or, after 2009, the securities or loans are classified under FAS No. 115 as "Securities available for Sale" or "Trading Securities." Thus, total revenue will be a different amount than gross receipts for lending institutions. For most other entities, it is the same.

Legal Services

A taxable entity that provides legal services, such as a law firm, may exclude from total revenue certain flow-through funds and $500 per *pro bono* case it handles.

Flow-through Funds. Flow-through funds that are eligible to be excluded from total revenue are those that are mandated by law, contract, or fiduciary duty to be distributed by a claimant's attorney to the claimant or to other entities on behalf of the claimant. The statute lists the following eligible flow-through funds:

- Damages due to the claimant,
- Funds subject to a lien or other contractual obligation arising out of the representation, excluding fees owed to the attorney,
- Funds subject to a subrogation interest or other third-party contractual claim,
- Payments to other attorneys who are not a member, partner, shareholder or employee of the taxable entity, or
- Reimbursed expenses incurred in prosecuting a claimant's matter that are specific to the matter and not general operating expenses.

Because the statute refers to *claimant*, this exclusion appears to apply only where litigation is involved. However, the term *claimant* is not defined in the statute or the Comptroller's Rules. In fact, the Rules do little more than repeat the statutory provisions. But even assuming this exclusion applies only to matters being litigated, it is unclear whether it covers costs incurred before a lawsuit is actually filed or those incurred in other types of disputes that are resolved before litigation ensues.

Pro bono Cases. Attorneys may also exclude $500 per *pro bono* services case handled as long as they maintain a record of the *pro bono* services for auditing purposes in accordance with the manner in which those services are reported to the State Bar of Texas. This exclusion amounts to $5 ($1% $\times$ $500) per *pro bono* case.

It is unclear what records an attorney should maintain other than a well-documented case file. He or she should probably also report the *pro bono* hours to the State Bar. It is interesting to note that the original margin tax as passed in 2006 required the attorney to track out-of-pocket costs. But this provision was dropped in the Technical Corrections Act. Now the attorney need only maintain a record of the *pro bono* services he or she performed to be eligible for the *pro bono* exclusion.

Pro bono services means the direct provision of legal services to the poor, without expectation of compensation. It does not include services that are uncompensated for other reasons such as failure of the client to pay. Nor does it include *pro bono* services to individuals, charities, and other institutions that are not poor.

Pharmacy Cooperatives

A taxable entity that is a pharmacy cooperative excludes flow-through funds from rebates of pharmacy wholesalers that are distributed to the pharmacy cooperative's shareholders.

Staff Leasing Companies

Staff leasing services companies may exclude from total revenue payments received from their clients for wages, payroll taxes on those wages, employee benefits, and workers' compensation benefits for the employees of the client company. A staff leasing company cannot exclude payments received from a client company for payments made to independent contractors assigned to the client company and reported on Form 1099. By the same token, the staff leasing company may not deduct compensation assigned to client companies. Instead the client companies may claim this deduction based on information required to be provided by the staff leasing company.

Staff Leasing Services Company. A staff leasing services company is a business entity that hires a client's employees and then leases them back to the client company for a profit.

The Franchise Tax Code uses the same definition as the Texas Labor Code Sec. 91.001, which defines a staff leasing services company as a business that offers an arrangement by which employees of a license holder are assigned to work at a client company and in which employment responsibilities are shared by the license holder and the client company, the employee's assignment is intended to be of a long-term or continuing nature, rather than temporary or seasonal in nature, and a majority of the work force at a client company worksite or a specialized group within that work force consists of assigned employees of the license holder.

The term does not include:

1. Temporary help,

2. An independent contractor,

3. The provision of services that otherwise meet the definition of "staff leasing services" by one person solely to other persons who are related to the service provider by common ownership, or

4. A temporary common worker (common laborer) employer.

Temporary Employment Services. A staff leasing services company also includes a temporary employment service. The Tax Code refers to the Labor Code which defines a temporary employment service as a person who employs individuals and assigns them to clients to support or supplement the client's workforce, or in special work situations, including an employee absence, a temporary skill shortage, a seasonal workload, or a special assignment or project.

Management Companies

A taxable entity that is a management company must exclude from its total revenue reimbursements of specified costs incurred in its conduct of the active trade or business of a managed entity.

To qualify as a management company, an entity must perform active and substantial management and operational functions, control and direct the daily operations, and provide services such as accounting, general administration, legal, financial and other similar services. If the entity does not conduct all of the active trade or business of the managed entity, the entity must conduct all operations for a distinct, revenue-producing component.

A management company is generally an entity retained by owners to manage properties such as hotels and resorts. Providing services in the regular course of business and services performed under a cost-plus contract do not qualify for the management company provisions under TTC Sec. 171.0001(11). Other examples of services that do not qualify under the management company provisions include providing shipping or accounting services to another company.

To qualify for the exclusion, a management company must be organized as a corporation, limited liability company, or other limited liability entity and must conduct all or part of the active trade or business of another entity ("the managed entity") in exchange for:

1. A management fee, and

2. Reimbursement of specified costs incurred in the conduct of the active trade or business of the managed entity, including wages and cash compensation as determined under TTC Secs. 171.1013(a) and (b).

In addition, the management company may not include compensation paid to the employees of the managed company in its compensation deduction for purposes of computing its margin. However, the managed entity may include the reimbursements made to the management company for wages and compensation as if the reimbursed amounts were paid directly to employees of the managed company.

Management Companies and Destination Management Companies Distinguished. *Management companies* under TTC Sec. 171.1011(m-1) should not be confused with *qualified destination management companies* under TTC Secs. 171.1011(g-1) and 151.0565.

The 81st Texas Legislature (2009) amended TTC Sec. 171.1011 to allow a qualified destination management company to exclude from total revenue payments made to persons providing services, labor, or materials in connection with the provision of destination management services.

A qualified destination management company is specifically defined in TTC Sec. 151.0565 as (among other specifications) a corporation or limited liability company that receives at least 80% of its annual total revenue from providing, or arranging for the provision of, destination management services, maintains a permanent nonresidential office, and has at least 80% of its clients located outside of Texas.

Destination management services (defined in TTC Sec. 151.0565) include an exclusive list of services that must be provided under a qualified destination management services contract if the payments are to be excluded. The destination management services contract must be for at least three destination management services provided in Texas to a client that is not an individual, social club or fraternal organization and that has its principal place of business outside of the county where the services are provided.

Because of the many restrictions and qualifications placed on the destination management services revenue exclusion, few businesses will qualify for this exclusion.

Health Care Providers and Institutions

The Texas franchise tax statute provides an extensive list of health care providers and institutions that qualify to exclude certain revenues from government programs.

Health Care Providers—100% Exclusion. Health care providers can exclude 100% of their revenue from specifically enumerated government programs. This exclusion also applies to co-payments or deductibles received from the patient or supplemental insurance. In addition, capitation revenues paid by Medicare-managed plans to healthcare providers based on a capitation award for each patient each month can be excluded from total revenues.

A *health care provider* is any taxable entity that participates as a provider of services in any one or more of the following government programs:

1. Medicaid program,
2. Medicare program,
3. Children's Health Insurance Program (CHIP),
4. State worker's compensation program, or
5. TRICARE military health insurance system.

These health care providers are allowed to exclude from their total revenue 100% of the payments they receive—

1. Under the Medicaid program, Medicare program, Indigent Health Care and Treatment Act, and Children's Health Insurance Program (CHIP), including any plans under these programs.

2. For professional services provided in relation to a workers' compensation claim.

3. For professional services provided to a beneficiary rendered under the TRICARE military health insurance system, including any plans under this program.

4. From a third-party agent or administrator for revenue earned under items 1–3 of this list.

Costs of Uncompensated Care. In addition, health care providers may exclude 100% of the actual costs of uncompensated (*pro bono*) care from total revenue, if the provider maintains records of the uncompensated care for auditing purposes.

Healthcare institutions are entitled to exclude only 50% of their uncompensated care costs from revenue.

The actual cost of uncompensated care that can be excluded is the amount determined by multiplying operating expenses by the uncompensated care ratio.

The *uncompensated care ratio* means uncompensated care charges less partial payments divided by total charges.

Uncompensated care charges are the standard charges for health care services where the provider has not received any payment or where the provider has received partial payment for health care provided to the patient. In addition, the Comptroller has amended TAC Rule 3.587(b)(1)(c) to include charges for services covered by Medicare, Medicaid, and similar programs, services performed for a contracted rate from a private health care plan, and services performed for an agreed-upon rate from an individual but only if the partial payments do not cover the cost of the care provided. Standard charges must be comparable to the charges for services provided to all patients of the health care provider.

In no event do uncompensated care charges include any portion of a charge that the health care provider has no right to collect under a private health care plan, under an agreement with an individual for a specific amount, or under the charge limitations imposed by Medicaid, Medicare, the Indigent Health Care and Treatment Act, and the Children's Health Insurance program (CHIP), the Workers Compensation Act, and the TRICARE military health insurance system.

Partial payment is an amount that has been received toward uncompensated care charges that does not cover the cost of the services provided. Total charges are charges for all health care services, including uncompensated care.

Operating expenses are the amounts reported on lines 2 and 21 of Form 1065 or the amounts reported on lines 2 and 20 of Form 1120S or the corresponding line items from any other federal form filed, less any items that have already been subtracted from total revenue (e.g., bad debts).

A corresponding adjustment must be made to reduce the cost of goods sold deduction or the compensation deduction for the portion of the cost of goods sold or compensation that has been excluded from revenue. The cost of goods sold deduction is reduced by subtracting the product of the cost of goods sold under TAC Rule 3.588 multiplied by the uncompensated care ratio. The compensation deduction is reduced by subtracting the product of the compensation and benefits amounts under TAC Rule 3.589 multiplied by the uncompensated care ratio.

Example 4D-6 Excluding uncompensated care costs from revenue.

In 2009, the Houston Eye Care Clinic provided free eye care for students at the River Bend Elementary School. The clinic would normally have charged $50,000 for these services. During the year, it billed $4 million in fees to its regular patients and its operating expenses were $2 million, which included $1.5 million in compensation and benefits.

The clinic's uncompensated care ratio is 1.2345% ($50,000 ÷ $4,050,000). Therefore it can exclude $24,690 (1.2345% × $2 million) from its total revenue. It must also reduce its compensation deduction by $18,518 (1.2345% × $1.5 million).

Under the facts of this example, the Houston Eye Care Clinic will save $61.72 [1% × ($24,690 – $18,518)] in franchise taxes due on uncompensated care valued at $50,000.

Health care providers are required to keep records that clearly identify each patient, the procedure performed, the standard charges for the service, and any payments received from these patients.

It is critical that health care providers keep adequate records to support the amounts collected under Medicaid, Medicare, and uncompensated care in case of a state franchise tax audit.

Health Care Institutions—50% Exclusion. A surprisingly large number of institutions also qualify as health care providers. These institutions may only exclude 50% of their revenues from the government programs listed above. Similarly, health care institutions may only deduct 50% of the cost of uncompensated (pro bono) care.

A *health care institution* includes any of the following types of businesses:

- Ambulatory surgical centers,
- Assisted living facilities,
- Emergency medical services providers,
- Home and community support services agencies,
- Hospices,
- Hospitals,
- Hospital systems,
- Intermediate care facilities for the mentally retarded or a home and community-based services waiver program for persons with mental retardation,
- Birthing centers,
- Nursing homes,
- End stage renal disease facilities, and
- Pharmacies.

Example 4D-7 Payments received by health care institutions.

Casa, Ltd., a partnership, is a hospice that qualifies as a health care provider and is a health care institution. For 2009, Casa calculates $3 million in revenue (before exclusions) by adding the designated line items of its federal partnership return. Standard charges for its *pro bono* healthcare services were $100,000. Casa also has $1.5 million in operating expenses.

Of the $3 million in revenue, $150,000 was received under Medicaid and $750,000 was received under Medicare.

Casa may exclude $450,000 [50% × ($150,000 + $750,000)] of these fees from its total revenue. Thus, its total revenue is $2,550,000.

In addition to excluding 50% of the Medicare and Medicaid payments, Casa, Ltd. may exclude 50% of the actual cost of uncompensated care even though the uncompensated care was not included in total revenue. Its uncompensated care ratio is 3.77% [$100,000 ÷ ($100,000 + $2,550,000)]. Thus, it can exclude $28,275 (50% × 3.77% × $1,500,000) from revenue.

Facilities Used by the Federal Government

A taxable entity may exclude from its total revenue, to the extent included therein, all revenue that is directly derived from the operation of a facility that is:

1. Located on property owned or leased by the federal government, and

2. Managed or operated primarily to house members of the armed forces of the United States.

Oil and Gas Produced During Certain Dates

A taxable entity shall exclude, to the extent included, total revenue received from oil or gas produced, during certain dates certified by the Comptroller, from:

1. An oil well designated by the Railroad Commission of Texas or similar authority of another state whose production averages less than 10 barrels a day over a 90-day period, and

2. A gas well designated by the Railroad Commission of Texas or similar authority of another state whose production averages less than 250 mcf a day over a 90-day period.

The Comptroller will certify dates during which the monthly average closing price of West Texas Intermediate crude oil is below $40 per barrel and the average closing price of gas is below $5 per MMBtu, as recorded on the New York Mercantile Exchange (NYMEX).

Qualified Destination Management Companies

Effective for reports originally due on or after January 1, 2010, a taxable entity that is a *qualified destination management company,* as defined by TTC Sec. 151.0565, may exclude from its total revenue payments made to other entities or persons to provide services, labor, or materials, in connection with the provision of *destination management services*, as defined in TTC Sec. 151.0565.

A qualified destination management company is a corporation or limited liability company that receives at least 80% of its annual total revenue from providing, or arranging for the provision of, destination management services, maintains a permanent nonresidential office from which the destination management services are provided, and has at least 80% of its clients located outside of Texas.

In addition, a qualified destination management company must:

1. have at least three full-time employees;

2. spend at least 1% of the entity's annual gross receipts to market the destinations with respect to which destination management services are provided;

3. not own equipment used to directly provide destination management services, including motor coaches, limousines, sedans, dance floors, decorative props, lighting, podiums, sound or video equipment, or equipment for catered meals, other than such equipment used in the conduct of the entity's business;

4. not do business as a caterer;

5. not provide services for weddings;

6. not own a venue at which events or activities for which destination management services are provided occur; and

7. not be a subsidiary of another entity nor a member of an affiliated group, as defined by TTC Sec. 171.0001, if another member is doing business as, or owns or operates another entity doing business as, a caterer or owns or operates a venue as described above.

The following services are destination management services when provided under a qualified destination management services contract:

1. transportation management;
2. booking and managing entertainers;
3. coordination of tours or recreational activities;
4. meeting, conference, or event registration;
5. meeting, conference, or event staffing;
6. event management; and
7. meal coordination.

A *qualified destination management services contract* means a contract under which at least three of the destination management services are provided in Texas to a client that (a) is a corporation, partnership, limited liability company, trade association, or other business entity, other than a social club or fraternal organization; (b) has its principal place of business outside the county where the destination management services are to be provided; and (c) agrees to pay the qualified destination management company for all destination management services provided to the client under the terms of the contract.

Because of the many restrictions and qualifications placed on the destination management services revenue exclusion, travel agencies will not qualify for this exclusion. Nor will very many other businesses.

Combined Reporting Entities.

Special rules apply to determine the total revenue of a combined group. A combined group is a group of taxable entities that are part of an affiliated group engaged in a unitary business. The members of the combined group file a single group report in lieu of individual reports based on the combined group's business.

A combined group determines its total revenue by:

1. Determining the total revenue of each of its members as if the member were an individual taxable entity;
2. Adding the total revenues of the members together; and
3. Subtracting items of total revenue received from a member of the combined group.

Tiered Entity Reporting and Combined Groups. If a lower tier entity is required to participate in a combined group report, the tiered entity provisions do not apply to it.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

21. Which of the following types of receipts are **not** a part of revenues?

    a. Dividends and interest.

    b. Capital gains on sales of real estate.

    c. Receipts from sales of tangible personal property.

    d. Sales tax collected from purchasers of tangible personal property.

22. Which of the follow types of receipts are **not** excluded from revenues?

    a. Real estate subcontracting payments.

    b. Interest from corporate bonds.

    c. Interest from government bonds.

    d. Net distributive income received from an LLC.

23. Which of the following types of receipts are specifically excluded from revenues under the Texas Tax Code?

    a. Subcontracting payments a manufacturer handles on behalf of a subcontractor to provide labor and materials in connection with the construction of equipment.

    b. Flow-through funds an attorney receives that are mandated by law, by contract, or fiduciary duty to be distributed by a claimant's attorney to the claimant.

    c. Flow-through funds a travel agency receives that are mandated by contract to be distributed to airlines, hotels, cruise lines and other service providers.

    d. Flow-through funds a credit card processing company receives that are mandated by contract to be distributed to the stores where its customers make purchases.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

21. Which of the following types of receipts are **not** a part of revenues? **(Page 77)**

    a. Dividends and interest. [This answer is incorrect. Dividends and interest are part of revenues.]

    b. Capital gains on sales of real estate. [This answer is incorrect. Capital gains on sales of real estate are part of revenues.]

    c. Receipts from sales of tangible personal property. [This answer is incorrect. Receipts from sales of tangible personal property are part of revenues.]

    d. Sales tax collected from purchasers of tangible personal property. [This answer is correct. Sales taxes are mandated by law or fiduciary duty to be transferred to the government. Therefore, they are not part of revenues.]

22. Which of the following types of receipts are **not** excluded from revenues? **(Page 77)**

    a. Real estate subcontracting payments. [This answer is incorrect. The franchise tax statute excludes subcontracting payments to provide services, labor, or materials in connection with the actual or proposed design, construction, remodeling, or repair of improvements on real property or the location of the boundaries of real property.]

    b. Interest from corporate bonds. [This answer is correct. Taxable entities may not exclude from revenue interest earned from corporate bonds.]

    c. Interest from government bonds. [This answer is incorrect. According to TTC Sec. 171, taxable entities may exclude from revenue interest earned from investments in federal obligations.]

    d. Net distributive income received from an LLC. [This answer is incorrect. According to TTC Sec. 171, taxable entities may exclude from revenue net distributive income received from an LLC.]

23. Which of the following types of receipts are specifically excluded from revenues under the Texas Tax Code? **(Page 77)**

    a. Subcontracting payments a manufacturer handles on behalf of a subcontractor to provide labor and materials in connection with the construction of equipment. [This answer is incorrect. The franchise tax statute excludes subcontracting payments to provide services, labor, or materials in connection with the actual or proposed design, construction, remodeling, or repair of improvements on real property or the location of the boundaries of real property. However, this exclusion does not apply to manufacturers of real property.]

    b. Flow-through funds an attorney receives that are mandated by law, contract, or fiduciary duty to be distributed by a claimant's attorney to the claimant. [This answer is correct. Per TTC Sec. 171, flow-through funds are eligible to be excluded from total revenue if they are mandated by law, contract, or fiduciary duty to be distributed by a claimant's attorney to the claimant or to other entities on behalf of the claimant.]

    c. Flow-through funds a travel agency receives that are mandated by contract to be distributed to airlines, hotels, cruise lines and other service providers. [This answer is incorrect. The Texas franchise tax does not allow for such an exclusion from revenues.]

    d. Flow-through funds a credit card processing company receives that are mandated by contract to be distributed to the stores where its customers make purchases. [This answer is incorrect. The Texas franchise tax does not allow for such an exclusion from revenues.]

Apportionment

Taxable entities subject to the Texas franchise tax must determine and report gross receipts on their franchise tax reports. A key step in the preparation of Texas franchise tax reports is the apportionment of gross receipts between Texas and non-Texas sources. This is important in order to determine the correct apportionment factor.

The apportionment factor is the ratio of Texas gross receipts to total gross receipts everywhere. The apportionment factor is used to determine how much of the entity's margin is taxable by the state of Texas.

The franchise tax law and the Comptroller's Rules provide the framework for determining what gross receipts are and how they are apportioned to Texas and non-Texas sources.

Gross Receipts

Gross Receipts for Margin

Gross receipts from the entire business are calculated the same way as total revenue from the entire business with only a few exceptions.

Both total gross receipts and total revenue include all revenues reportable by a taxable entity on its federal income tax return without deduction for the cost of property sold, materials used, labor performed, or other costs incurred, less certain statutorily provided subtractions and exclusions. In addition, they are both on the Internal Revenue Code of 1986 as in effect for 2007, unchanged by subsequent amendments.

Differences. In most cases, total revenue and total gross receipts will be the same. However, total revenue may differ from total gross receipts for legal services entities, healthcare providers, and lending institutions. These differences occur because gross receipts for apportionment are not reduced by deductions for *pro bono* services, uncompensated care, or the tax basis of securities and loans sold where the loan or security is inventory of the seller. Adjustments to the entity's gross receipts must be made for these differences.

Gross Receipts Tied to the Entity's Federal Tax Return

Deemed Election to Use FIT Methods. A taxable entity is deemed to have made an election to use the same methods of accounting that it uses in filing its federal income tax return. This is critical from a planning standpoint.

Frozen Internal Revenue Code. The franchise tax statute freezes the Internal Revenue Code. For franchise tax purposes, the *Internal Revenue Code* means the Internal Revenue Code of 1986 as in effect for the federal tax year beginning on January 1, 2007, and any regulations adopted under that Code applicable to that tax year. Thus, any federal tax law changes to that Code are ignored.

Changes in Accounting Methods—The Four-year Rule. A taxable entity is allowed to change its method of accounting for gross receipts once every four years without first obtaining the Comptroller's consent. However, it is not clear how this four-year rule applies in practice. Because a taxable entity is generally required to use the same methods of accounting that it uses for federal income tax purposes, any change in federal income tax methods presumably would have to follow the federal rules on changes in accounting methods. Thus, this rule seems to be at odds with the general requirement to determine gross receipts using federal income tax accounting methods. However, there may be some changes in reporting that would not be considered a change in accounting method requiring permission form the IRS, but that would affect the franchise tax liability.

52–53 Week Year. A taxable entity that uses a 52–53 week year that has an accounting year that ends during the first four days of January of the year in which the franchise tax report is originally due may use the preceding December 31 as the date through which margin is computed.

Business Periods

Annual Reports. Gross receipts are determined based on the business done by the taxable entity beginning with the day after the day's business included in the entity's previous report and ending with the last accounting period ending date for federal income tax purposes.

Initial Reports. Gross receipts are determined based on the business done by the taxable entity beginning on its beginning date and ending on the last accounting period ending date that occurs at least 60 days before the original due date.

Apportionment Factor

Taxable entities calculate the apportionment factor using gross receipts. The apportionment factor is the ratio of Texas gross receipts to total gross receipts. This ratio determines what portion of a taxable entity's margin is taxable margin.

Apportionment Factor

General Rule—Apportionment Based on Gross Receipts

A taxable entity's franchise tax liability (before allowable deductions, credits, and discounts) is computed by multiplying the taxable entity's taxable margin by the appropriate tax rate.

A taxable entity's taxable margin is determined by apportioning the entity's margin to Texas. This is accomplished by multiplying the entity's margin by an apportionment factor.

The formula for the apportionment factor is:

$$\frac{\text{Gross Receipts in Texas}}{\text{Gross Receipts Everywhere}}$$

The franchise tax report instructions require the apportionment factor to be stated as a four-place decimal. The instructions require the fourth digit past the decimal to be rounded.

Example 4H-1 Calculating the apportionment ratio.

Multistate Business, LLP has gross receipts everywhere of $7,000,000. Of this, Texas gross receipts are $1,500,000. Multistate's apportionment ratio is 0.2143 ($1,500,000 ÷ $7,000,000).

A taxable entity for which gross receipts in Texas and everywhere are the same will have an apportionment factor of 1.0000. A corporation that has no Texas gross receipts will have zero for its apportionment factor and will owe no tax.

Regulated Investment Companies

A special apportionment formula is provided to determine a taxable entity's margin that is derived directly or indirectly from the sale of management, distribution, or administration to or on behalf of a regulated investment company.

A regulated investment company is any domestic corporation that—

1. At all times during the taxable year is registered under the Investment Company Act of 1940, as amended, as a management company or unit investment trust, or has in effect an election under the Act to be treated as a business development company, or

2. Is a common trust fund or similar fund that is (a) excluded by 15 U.S.C. 80a-3(c) from the definition of "investment company" and (b) not included in the definition of "common trust fund" by IRC Section 584(a).

Accordingly, a taxable entity's margin that is derived, directly or indirectly, from the sale of services to a regulated investment company (RIC), including a taxable entity that includes trustees or sponsors of employee benefit plans that have accounts in a RIC, is apportioned to Texas by multiplying the entity's total margin derived from the sale of such services by the following fraction:

$$\frac{\text{Average of the sum of shares owned at the beginning of the year and the sum of the shares owned at the end of the year by the RIC's shareholders who are commercially domiciled in Texas or if the shareholders are individuals who are residents of Texas}}{\text{Average of the sum of shares owned at the beginning of the year and the sum of the shares owned at the end of the year by all of the RIC's shareholders}}$$

Employee Retirement Plans

A special apportionment formula is provided to determine a taxable entity's margin that is derived, directly or indirectly, from the sale of management, administration, or investment services to an employment retirement plan.

An employee retirement plan is a plan or other arrangement that is qualified under IRC Sec. 401(a), or satisfies the requirements of IRC Sec. 403, or that is a government plan described in IRC Sec. 414(d).

Accordingly, a taxable entity's margin that is derived, directly or indirectly, from the sale of services to an employee benefit plan is apportioned to Texas by multiplying the entity's total margin derived from the sale of such services by the following fraction:

$$\frac{\text{Average of the sum of the beneficiaries domiciled in Texas at the beginning of the year and the sum of the beneficiaries domiciled in Texas at the end of the year}}{\text{Average of the sum of all beneficiaries at the beginning of the year and the sum of all beneficiaries at the end of the year}}$$

Total Gross Receipts from the Entire Business

Total Gross Receipts

Total gross receipts from the entire business is determined in the same manner as total revenue from the entire business, with a few exceptions.

Exclusions. Any item of revenue excluded from total revenue under Texas law or federal law is also excluded from total gross receipts from the entire business and from Texas gross receipts.

Apportionment Factor. The entity's total gross receipts is used in the denominator of the apportionment factor.

Basic Inclusions

No Deduction for Costs. Both total gross receipts and total revenue include all revenues reportable by a taxable entity on its federal income tax return without deduction for the cost of property sold, materials used, labor performed, or other costs incurred.

Investments and Capital Assets. A taxable entity that sells an investment or capital asset, includes only the net gain from the sale in its gross receipts from its entire business for taxable margin.

Combined Reporting. A combined group includes the gross receipts of each taxable entity that is a member of the combined group, without regard to whether that entity has a nexus with this state.

Adjustments for Tiered Partnerships and S Corporations

Special rules apply to tiered partnership arrangements that allow a lower tier entity to exclude from its total revenue any amount of revenue that it elects to pass through to an upper tier entity. Thus, an adjustment to federal income is needed to include the pass-though income in the upper tier entity's gross receipts. Similarly, an adjustment is needed to exclude the pass-though income from the federal income of the lower-tier entity.

Allocated Revenue Excluded under Rule 3.587(c)(9)

Allocated revenue is any revenue that Texas cannot tax because the activities generating that item of revenue do not have sufficient unitary connection with the entity's other activities conducted in Texas to be included in the entity's

total revenue from the entire business. Any item of allocated revenue that is excluded revenue is also excluded from total gross receipts everywhere and Texas gross receipts.

Texas Gross Receipts

Once the entity's total gross receipts have been determined, the next step is to categorize those gross receipts as connected with Texas or not. This requires the apportionment of the entity's gross receipts to Texas or non-Texas sources.

The Texas franchise tax statute and the Comptroller's Rules provide guidance on apportioning the entity's gross receipts between Texas and non-Texas sources. More specifically, the statute and the Rules provide guidance on what constitutes a Texas gross receipt. A receipt that is not categorized as a Texas gross receipt is automatically a non-Texas gross receipt. Accordingly, the discussion in this section will focus on identifying and categorizing Texas gross receipts.

Texas Gross Receipts

A taxable entity's gross receipts from its business done in Texas is the sum of the taxable entity's receipts from the following:

1. Each sale of tangible personal property if the property is delivered or shipped to a buyer in this state regardless of the FOB point or another condition of the sale;
2. Each service performed in this state, except that receipts derived from servicing loans secured by real property are in this state if the real property is located in this state;
3. Each rental of property situated in this state;
4. The use of a patent, copyright, trademark, franchise, or license in this state;
5. Each sale of real property located in this state, including royalties from oil, gas, or other mineral interests; and
6. Other business done in this state.

Apportionment Factor. The entity's Texas gross receipts are used in the numerator of the apportionment factor.

Generalizations

Gross receipts are apportioned to Texas or non-Texas sources principally based on location. The following generalizations can be made:

1. Gross receipts from sales of tangible personal property are generally apportioned based on the location where delivery occurs.
2. Gross receipts from services are generally apportioned based on the location where the services are performed.
3. Gross receipts from rentals are generally apportioned based on the location of the rental property.
4. Gross receipts from *sales* of intangibles are generally apportioned based on the location of the payor.

Location of Payor

Location of Payor Rule. The location of payor rule is one of the fundamental gross receipts apportionment rules. Generally, it applies to intangibles. The following is a list of some of the intangibles that may be subject to apportionment under the location of payor rule. This list is based on Rule 3.591(e)(2) and (3).

- Stocks.

- Bonds.
- Commodities.
- Futures contracts.
- Patents.
- Copyrights.
- Licenses.
- Trademarks.
- Franchises.
- Goodwill.
- General receivable rights.
- Computer programs.

Location of Payor Refers to Legal Domicile. The location of payor is defined as the legal domicile of the payor. When apportionment is based on the location of payor, it is necessary to determine where the payor's legal domicile is located. The legal domicile of the payor is specifically defined for corporations, LLC, partnerships, trusts, and joint ventures.

The legal domicile of a corporation or LLC is its state of formation.

The legal domicile of a partnership, trust, or joint venture is its principal place of business. The principal place of business is the location of the day-to-day operations. However, when the day-to-day operations are conducted equally or fairly evenly in more than one state, the principal place of business is the commercial domicile of the partnership or trust. Commercial domicile is the place where the entity's trade or business is directed. Thus, an entity's commercial domicile is its main headquarters.

Example 4J-1 Applying the location of payor rule.

Assume that LOP, Inc., received gross receipts apportioned to the location of the payor. To properly apportion the gross receipts, LOP must first determine what type of entity made the payment. If the payor is a corporation, LOP must determine whether the corporation is chartered in Texas or in another state (or foreign country). If the payor is a Texas corporation, LOP apportions the gross receipts to Texas. If the payor is not a Texas corporation, LOP apportions the gross receipts as non-Texas gross receipts.

Specific Guidance

Rule 3.591 provides specific rules for apportioning receipts to Texas. These rules are discussed in the remainder of this lesson.

Sales of Tangible Personal Property

Each sale of tangible personal property delivered or shipped to a buyer in this state generates Texas gross receipts regardless of the FOB point or other condition of sale.

Delivery in Texas. This includes tangible personal property delivered in Texas to the purchaser, to a storage facility in Texas controlled by the purchaser, or to a carrier under the purchaser's control if the carrier takes control of the goods in Texas.

Example 4J-2 Goods delivered or shipped to buyers in Texas.

Commerce Company is a Texas corporation that sells limited edition prints exclusively to art galleries. Commerce has one storage facility for prints located in Dallas. Commerce sells to art galleries in Texas, Louisiana, Alabama, and Florida. Commerce uses its own carrier to ship the merchandise.

Only the sales to the galleries in Texas result in Texas gross receipts to Commerce when it uses its own carrier, because delivery (i.e., transfer of possession or control of the prints) to the purchasers outside Texas occurs out of state.

If any of the out-of-state galleries use their own carriers to pick up the merchandise from Commerce in Dallas, those sales would be included in Texas gross receipts, because delivery to the purchaser would be within the state of Texas.

Common Carrier—Texas Destination. Sales of tangible personal property delivered to a common carrier outside Texas and shipped by that carrier to a Texas purchaser result in Texas gross receipts.

Example 4J-3 Goods shipped by common carrier to Texas.

A Missouri company ships goods to a purchaser in Texas by common carrier. The sale results in Texas gross receipts regardless of where the common carrier receives the goods.

Common Carrier—Non-Texas Destination. Tangible personal property delivered in Texas to an independent contract carrier, common carrier, or freight forwarder hired by the purchaser does not result in Texas gross receipts if the carrier transports or forwards the property to the purchaser outside Texas.

Example 4J-4 Goods shipped by common carrier outside of Texas.

A Texas corporation delivers goods to a common carrier in Dallas to be delivered to a purchaser in Utah. The corporation does not incur Texas gross receipts.

Interstate Pipeline. The sale of oil or related products to an interstate pipeline company, with delivery in Texas, results in Texas gross receipts.

Drop-shipments. Goods drop-shipped to Texas on the purchaser's behalf result in Texas gross receipts for both the seller and the purchaser. A drop-shipment is a shipment of goods directly from a seller to a purchaser's customer, at the purchaser's request, without the goods passing through the purchaser's hands.

Example 4J-5 Goods drop-shipped.

Seller Corp. is located in Miami. Purchaser Corp. is located in Atlanta and asks Seller to ship tangible personal property to Texas to a third party who is a customer of the purchaser. Both Seller and Purchaser have Texas gross receipts from this transaction.

Necessary Delay in Transit. Where the ultimate destination of goods is outside the state of Texas, property delivered to a storage facility in Texas at the purchaser's request because of a necessary delay in transit of the property to the purchaser is not considered Texas gross receipts.

No Throwback for Sales to Buyers in Other States. Sales delivered to buyers located outside Texas do not constitute Texas gross receipts. There is no throwback rule under the post-2007 franchise (margin) tax statute.

Under the throwback rule, a sale of tangible personal property that is shipped from one state (for example Texas) to a purchaser in another state would be thrown back to the first state (i.e., would be considered a Texas gross receipt) if the other state could not impose tax on the seller.

Mixed Service/Sale Transactions. When a transaction involves elements of both a sale of tangible property and a service, and there is no documentation showing separate charges for the sale and service elements, the receipt may be allocated based on the relative fair values of the property and the service.

Exchanges

Exchanges. Exchanges of property are included in gross receipts to the extent the exchange is recognized as a taxable transaction for federal tax purposes. The exchange normally is included in receipts based on the gross exchange value.

Deemed Asset Sales under IRC Sec. 338. Amounts deemed received by the target taxable entity are treated as sales of assets by the target and are apportioned according to the rules that apply to asset sales.

Capital Assets and Investments

Special rules apply to sales of investments and capital assets. A *capital asset* is any asset (other than an investment) held for use in the production of income, and is subject to depreciation, depletion, or amortization. An *investment* is any non-cash asset that is not a capital asset.

Net gains and losses from sales of investments and capital assets should be added together to determine the total receipts from such transactions. If both Texas and non-Texas sales have occurred, a separate calculation of net gains and losses on Texas sales must be made. If the combination of net gains and losses results in a net loss, the taxable entity should net the loss against other receipts, but not below zero. The apportionment factor cannot be greater than 1.

Services

Texas gross receipts includes gross receipts from each service performed in this state. The identification of the type of service performed is integral to determining where it is performed.

If a taxable entity provides services to a Texas-based customer, but the services are provided both within and without the state of Texas, care should be given to ensure that only the receipts for the services provided in Texas are included in Texas gross receipts. A combined invoice for all services provided may cause the taxpayer to overstate Texas gross receipts.

Example 4J-6 Billing for services performed in Texas.

An Arkansas corporation, Renner, Inc., provides sales training seminars to the employees of car dealerships all over the United States. One of Renner's largest clients is located in Houston, Texas. Renner provides services for this client in Texas, and four other states.

The invoice for all the services is sent to the customer's headquarters in Houston. However, only the portion of the fee that relates to services provided within the state of Texas should be considered Texas gross receipts.

Computer Software Services. Gross receipts from the sale of computer *software services* are apportioned to the location where the services are performed. Gross receipts from the sale of a *computer program* (as defined in Rule 3.308) are considered receipts from the sale of an intangible asset and apportioned to the legal domicile of the payor.

Educational Training Programs. Revenues from educational training programs produced in Texas and broadcast nationwide via satellite and videotape have been held to be Texas receipts because the services are performed in Texas.

Printing. The printing of materials is considered the performance of a service for franchise tax purposes even though it is considered the sale of tangible personal property for sales tax purposes.

Internet Advertising. Internet advertising revenues are receipts from the performance of services and are apportioned to the location where the services are performed.

Services Procurement. Revenues from the procurement of services are apportioned to the place where the service procurement is performed.

Rentals

Texas gross receipts includes receipts from each rental property situated in the state of Texas.

Real Property. Receipts from the lease or sublease of real property are apportioned according to the location of the property. Presumably, this would apply to income from mineral interests such as royalties production payments, lease bonuses, delay rentals, and the like. In Texas, oil and gas in place is an interest in real property, and conveyances of mineral interests are subject to the same rules as conveyances of real property.

Tangible Personal Property. Receipts from the lease or sublease of tangible personal property are apportioned to the location of the property. If the property is in Texas for only part of the year, lease payments should be apportioned based on the number of days spent at the respective locations. If the amount of receipts due under the lease is based on mileage, the apportionment should be based on the number of miles driven in Texas divided by the total number of miles driven.

Receipts from the lease or sublease of a vessel that engages in commerce are apportioned to Texas based on the ratio of number of days the vessel is engaged in commerce in Texas waters to the number of days the vessel is engaged in commerce anywhere.

Lump Sum Charges. When a lump sum is charged for property leased or subleased but only a portion of the property is in Texas, the receipts should be apportioned based on the rental value of each item of property.

Intangibles

Sale of an Intangible. Receipts from the sale of an intangible asset or intangible rights are apportioned to the location of the payor.

Membership Fees for Access to Benefits. Membership or enrollment fees for access to member benefits are considered gross receipts from the sale of an intangible asset. They are apportioned to the legal domicile of the payor.

Computer Software. Gross receipts from the sale of a computer program (as defined in Rule 3.308) are considered receipts from the sale of an intangible asset and apportioned to the legal domicile of the payor. Gross receipts from the sale of computer software services are apportioned to the location where the services are performed.

Securities. Receipts from the sale of securities are apportioned to the location of the payor. The location of the payor is defined as its legal domicile. If securities are sold through an exchange, and the buyer cannot be identified, 7.9% of the revenue is Texas receipts.

Use of an Intangible. Texas gross receipts includes gross receipts for the use of intangible rights in Texas.

A patent is used in Texas to the extent that it is utilized in production, fabrication, manufacturing, or other processing in Texas. A copyright is used in Texas to the extent that printing or other publication originates in Texas. Similarly, Texas gross receipts include the owner's receipts for the use of trademarks, franchises, or licenses in Texas.

Foreign Royalties. Royalties received from an affiliated taxable entity that does not transact a substantial portion of its business or regularly maintain a substantial portion of its assets in the U.S. are excluded from Texas receipts and receipts everywhere.

Dividends and Interest

Dividends and Interest Received. In general, dividends and interest from any source are apportioned to the legal domicile of the payor.

Legal Domicile. The legal domicile of a corporation or LLC is the state in which it is formed. The legal domicile of a partnership, trust, or joint venture is its principal place of business. The principal place of business of these entities is the location of their day-to-day operations. However, when such day-to-day operations are conducted equally or

fairly evenly in more than one state, the principal place of business is the commercial domicile of the partnership or trust. Commercial domicile is the place from which the entity's trade or business is directed. Thus, an entity's commercial domicile is its main headquarters.

Dividends and Interest Received from a National Bank. Dividends and interest received from a national bank are apportioned to Texas if the national bank's principal place of business is in Texas.

Federal Interest and Dividends. Interest and dividends received on federal obligations that is excluded from revenue is also excluded from total gross receipts everywhere and from Texas gross receipts. Similarly, dividends and interest that are exempt from federal taxation are excluded from total gross receipts everywhere and from Texas gross receipts.

Federal Schedule C Special Deductions. Federal Schedule C special deductions are deductible on Form 1120 for federal tax purposes by a C corporation or an LLC taxed as a C corporation. For franchise tax purposes, they are excluded from total revenue as well as from Texas gross receipts and gross receipts everywhere.

Foreign Dividends. Dividends from a subsidiary, associate, or affiliated taxable entity that does not transact a substantial portion of its business or regularly maintain a substantial portion of its assets in the U.S. are excluded from total gross receipts everywhere and from Texas gross receipts.

Banking Corporations. A banking corporation is allowed to exclude from Texas gross receipts (but not from total gross receipts everywhere) interest earned on federal funds and interest on securities sold under a repurchase agreement and held in a correspondent bank domiciled in Texas.

Advertising Revenues

Newspapers and magazines. The advertising revenues of a newspaper or magazine (including revenue derived from out-of-state advertisements) are apportioned to Texas based on the number of newspapers or magazines distributed in Texas. All other receipts must be apportioned in accordance with the normal apportionment rules.

Radio and TV. The advertising revenues of a radio or television station that broadcasts or transmits from a location in Texas constitute Texas receipts, even though some of the listening or viewing audiences are located outside Texas. All other receipts must be apportioned in accordance with the normal apportionment rules.

Internet Advertising. Internet advertising revenues are receipts from the performance of services and are apportioned to the location where the services are performed.

Debts

Bad Debts. Bad debt recoveries are gross receipts.

Debt Forgiveness. Debt forgiveness is a gross receipt and is apportioned to the legal domicile of the creditor.

Debt Retirement. Revenues from the retirement of a taxable entity's own debt (e.g., when the taxable entity purchases its own bonds at a discount) are gross receipts apportioned to the taxable entity's legal domicile. The debt is treated as an investment.

Loans

Loan Servicing of Real Property. Receipts from the servicing of loans secured by real property are apportioned to the location of the collateral real property that secures the loan being serviced.

Loans and Securities. An entity that treats a loan or security as inventory for federal tax income purposes reports the gain on the sale of these items as total revenue, but reports the *gross proceeds* on the sale of these items as gross receipts everywhere. The gross proceeds from the sale of a loan or security treated as inventory of the seller for federal income tax purposes are considered gross receipts.

Lending Institutions. For reports originally due after 2009, if a lending institution categorizes a loan or security as "Securities Available for Sale" or "Trading Securities" under Financial Accounting Standard No. 115, the gross proceeds of the sale of that loan or security are considered gross receipts.

Financial Accounting Standard No. 115 means the Financial Accounting Standard No. 115 in effect as of January 1, 2009, not including any changes made after that date.

Insurance, Condemnation, and Litigation Awards

Business Interruption Insurance. Proceeds from business interruption insurance are gross receipts when the proceeds are intended to replace lost profits. The proceeds are apportioned to the legal domicile of the payor.

Fire and Casualty Insurance. Revenues from fire and casualty insurance proceeds are apportioned to the location of the damaged or destroyed property.

Condemnation. Revenues from condemnation that result from the taking of property are gross receipts that are apportioned based on the location of the condemned property.

Litigation Awards. Revenues realized from litigation awards are gross receipts that are apportioned to the legal domicile of the payor of the proceeds. However, if the litigation awards are intended to replace receipts for which another apportionment rule is provided in this lesson, then the apportionment must be made in accordance with that rule.

Telephone and Internet Access

Telephone Calls Entirely in Texas. Revenues from telephone calls that both originate and terminate in Texas are Texas receipts.

Telephone Calls Not Entirely in Texas. Revenues from telephone calls that originate in Texas but terminate outside of Texas or that originate outside of Texas but terminate in Texas are excluded from Texas receipts.

Other Telecommunication Services. Revenues from telecommunication services (other than the phone services in two previous paragraphs) are Texas receipts if the services are performed in Texas.

Internet Access Fee. A fee charged to obtain access to the Internet in Texas is a Texas gross receipt.

Transportation and Shipping

Transportation Companies. Transportation companies report Texas receipts from intrastate commerce by either (a) including revenues derived from the transportation of goods or passengers in intrastate commerce within Texas, or (b) multiplying total transportation receipts by total mileage in intrastate transportation within Texas divided by the total mileage everywhere.

Texas Waters. Revenues from transactions within Texas waters are Texas receipts. Texas waters extend nine nautical (10.359 statute) miles from the Texas coastline.

Leased Vessels. Receipts from the lease or sublease of a vessel that engages in commerce are apportioned to Texas based on the ratio of number of days the vessel is engaged in commerce in Texas waters to the number of days the vessel is engaged in commerce everywhere.

Other Business

Federal Enclave. All revenues from a taxable entity's sales, services, leases, or other business activities that are transacted on a federal enclave that is located in Texas are Texas receipts, unless otherwise excepted.

Sales Tax. State or local sales taxes imposed on the customer, but collected by a seller are not gross receipts of the seller. However, discounts that a seller is allowed to take in remittance of the collected sales tax are gross receipts to the seller.

Subsidies and Grants. Proceeds of subsidies or grants that a taxable entity receives from a governmental agency are gross receipts, except when the funds are required to be expended dollar-for-dollar (i.e., passed through) to third parties on behalf of the agency. Receipts from a governmental subsidy or grant are apportioned in the same manner as the item to which the subsidy or grant was attributed.

Net Distributive Income. The net distributive income from a passive entity included in total revenue is apportioned to the principal place of business of the passive entity.

Natural Gas Production

Revenues realized from sales of gas by a gas producer are Texas gross receipts if the gas is delivered in Texas.

Revenues realized by a gas producer from a judgment, compromise, or settlement agreement relating to the recovery of the contract price of gas are Texas gross receipts if the contract specified delivery of the gas in Texas.

Revenues realized by a gas producer from payments by a purchaser under contract for the sale or purchase of gas to be produced (even if the gas is never produced and delivered to the purchaser) are gross receipts and are apportioned to the legal domicile of the payor.

Revenues realized by a gas producer from breach of contract litigation awards are gross receipts apportioned to the legal domicile of the payor.

Revenues realized by a gas producer from payments made by a purchaser to terminate a gas contract are gross receipts apportioned to the legal domicile of the payor.

Revenues realized by a gas producer from payments made by a purchaser to amend any provision in the gas purchase contract are gross receipts apportioned to the legal domicile of the payor. Any revenues related to the amendment of price of the gas are Texas receipts if delivery of the gas is in Texas.

Mineral Interests

The franchise tax statute has no specific rule apportioning royalties, production payments, delay rentals, lease bonuses, take-or-pay payments, and the like from interests in real property. However, because an interest in minerals in Texas is considered an interest in real property, presumably these types of income would be apportioned based on the location of the mineral interest, rather than the location of the payor.

Combined Groups

Texas Gross Receipts. A combined group determines its Texas gross receipts by including the Texas-sourced receipts for each taxable entity that is a member of the combined group and that has nexus with the state of Texas.

Information Reporting. A combined group must include in an initial and each annual report the following information for each member of the combined group that does not have nexus with this state for the purpose of taxation:

1. The member's Texas gross receipts, and

2. The member's Texas gross receipts that are subject to taxation in another state under a throwback law or regulation.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

24. Which of the following is generally correct with respect to apportioning the Texas franchise tax?

    a. Gross receipts from sales of tangible personal property delivered to Texas are apportioned to Texas.

    b. Gross receipts from sales of services are apportioned based on the location from where the billing occurs.

    c. Gross receipts from rentals are generally apportioned based on the location where the rental agreement is signed.

    d. Gross receipts from sales of intangibles are generally apportioned based on the location where the intangible will be used.

25. Which of the following types of sales are generally apportioned using the location of payor rule?

    a. Sales of commodities futures.

    b. Sales of real estate.

    c. Sales of tangible personal property.

    d. Loan servicing receipts.

26. Which of the following statements is generally correct with respect to the location of payor rule?

    a. The legal domicile of a corporation or LLC is its principal place of business.

    b. The legal domicile of a partnership, trust, or joint venture is its principal place of business.

    c. When day-to-day operations are conducted equally or fairly evenly in more than one state, the principal place of business is the state where a partnership or trust is formed.

    d. Commercial domicile is the location where most of the entity's sales are made.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

24. Which of the following is generally true with respect to apportioning the Texas franchise tax? **(Page 94)**

    a. Gross receipts from sales of tangible personal property delivered to Texas are apportioned to Texas. [This answer is correct. Each sale of tangible personal property, if the property is delivered or shipped to a buyer in Texas, regardless of the FOB point or another condition of the sale, is included in the sum of the taxable entity's gross receipts.]

    b. Gross receipts from sales of services are apportioned based on the location from where the billing occurs. [This answer is incorrect. Gross receipts from services are generally apportioned based on the location where the services are performed.]

    c. Gross receipts from rentals are generally apportioned based on the location where the rental agreement is signed. [This answer is incorrect. Gross receipts from rentals are generally apportioned based on the location of the rental property.]

    d. Gross receipts from sales of intangibles are generally apportioned based on the location where the intangible will be used. [This answer is incorrect. Gross receipts from sales of intangibles are generally apportioned based on the location of the payor.]

25. Which of the following types of sales are generally apportioned using the location of payor rule? **(Page 94)**

    a. Sales of commodities futures. [This answer is correct. Sales of commodities futures are intangibles that may be subject to apportionment under the location of payor rule.]

    b. Sales of real estate. [This answer is incorrect. Sales of real estate are generally apportioned based upon the location of the real estate per TTC Sec. 171.]

    c. Sales of tangible personal property. [This answer is incorrect. Sales of tangible personal property are generally apportioned based upon the customer's location per TTC Sec. 171.]

    d. Loan servicing receipts. [This answer is incorrect. According to TTC Sec. 171, receipts from the servicing of loans secured by real property are apportioned to the location of the collateral real property that secures the loan being serviced.]

26. Which of the following statements is generally correct with respect to the location of payor rule? **(Page 94)**

    a. The legal domicile of a corporation or LLC is its principal place of business. [This answer is incorrect. The legal domicile of a corporation or LLC is the state in which it is formed.]

    b. The legal domicile of a partnership, trust, or joint venture is its principal place of business. [This answer is correct. The location of their day-to-day operations is the principal place of business of these entities. However, the commercial domicile of the partnership or trust will be the principal place of business if the day-to-day operations are conducted equally in more than one state.]

    c. When day-to-day operations are conducted equally or fairly evenly in more than one state, the principal place of business is the state where a partnership or trust is formed. [This answer is incorrect. The legal domicile of a partnership, trust, or joint venture is its principal place of business. The principal place of business of these entities is the location of their day-to-day operations. However, when such day-to-day operations are conducted equally or fairly evenly in more than one state, the principal place of business is the commercial domicile of the partnership or trust. Commercial domicile is the place from which the entity's trade or business is directed. Thus, an entity's commercial domicile is its main headquarters.]

    d. Commercial domicile is the location where most of the entity's sales are made. [This answer is incorrect. Commercial domicile is the place from which the entity's trade or business is directed. Thus, an entity's commercial domicile is its main headquarters per TAC Rule 3.591.]

EXAMINATION FOR CPE CREDIT

Lesson 4 (TFTTG101)

Determine the best answer for each question below. Then mark your answer choice on the Examination for CPE Credit Answer Sheet located in the back of this workbook or by logging onto the Online Grading System.

17. An entity's total revenue determines its apportionment factor.

    a. Yes.

    b. No.

    c. Do not select this answer choice.

    d. Do not select this answer choice.

18. Federal gross income is used to determine which of the following?

    a. Total revenue of a combined group.

    b. If the entity qualifies for the EZ computation for total revenues of $10 million or less.

    c. If an entity qualifies as a passive entity that is exempt from the franchise tax under TTC Sec. 171.0003.

    d. If the entity qualifies for discounts of 20-80% for entities with less than $900,000 of total revenue.

19. Which of the following items is excluded from total revenue for taxable entities providing legal services?

    a. Funds subject to a lien or other contractual obligation arising out of the representation, excluding fees owed to the attorney.

    b. Reimbursed expenses incurred in prosecuting a claimant's matter that are general operating expenses.

    c. Funds subject to a lien or other contractual obligation arising out of the representation, such as fees owed to the attorney.

    d. Damages due to the attorney.

20. Which of the following items are excluded from total revenue for health care providers?

    a. Payments for attorneys' fees incurred in relation to a workers' compensation claim.

    b. Payments from ambulatory surgical centers for services provided to patients under the health care provider's care.

    c. Payments received under the Medicaid program, Medicare program, Indigent Health Care and Treatment Act, and Children's Health Insurance Program (CHIP).

    d. Payments from intermediate care facilities for the mentally retarded for services provided to patients under the health care provider's care.

21. Which of the following types of revenues are sourced based upon the location of payor rule?

    a. General receivable rights.

    b. Rental income.

    c. Sales of tangible personal property.

    d. Gains on sales of real estate.

22. Which of the following statements is correct with respect to apportionment?

    a. The apportionment factor is an average of property and payroll.

    b. A taxpayer with no nexus outside Texas will have an apportionment factor of 1.

    c. The entire business's total gross receipts are calculated in the same manner as total revenue with no exceptions.

    d. A combined group includes the gross receipts of each taxable entity that is a member of the combined group, without regard to whether that entity has a nexus with this state.

23. Parent has $9 million of Texas gross receipts and $10 million of everywhere gross receipts. Subsidiary has $500,000 of Texas gross receipts and $800,000 of everywhere gross receipts. Presuming Parent has no nexus with Texas, what is the apportionment formula?

    a. $9,500,000 / $10,800,000.

    b. $500,000 / $10,800,000.

    c. $1,300,000 / $19,000,000.

    d. $500,000 / $800,000.

Lesson 5: Cost of Goods Sold

INTRODUCTION

Certain taxpayers subject to the Texas franchise tax may elect to deduct cost of goods sold. The election is made annually on the taxpayer's margin tax report. A taxpayer may elect to deduct cost of goods sold or compensation, but not both. However, once the election is made and the report is filed, the taxpayer may not file an amended report (after the due date) to change the election, although it may amend a report to change from the COGS deduction to the 70% of total revenue method of computing margin. The taxpayer may also amend a report to change to the EZ computation method if it has annualized total revenue of $10 million or less.

To determine a taxable entity's cost of goods sold for the margin calculation, a return preparer must know (1) whether the items being sold are "goods" according to the franchise tax definition; (2) whether the taxable entity owns the items being sold; and (3) which costs are eligible for the cost of goods sold deduction. These provisions are generally effective for franchise tax reports filed on or after January 1, 2008.

Learning Objectives:

Completion of this lesson will enable you to:

- Evaluate whether a taxable entity is eligible for the cost of goods sold deduction.
- Identify direct costs, indirect costs, and other costs eligible for the costs of goods sold deduction.

Taxable Entities Eligible to Deduct Cost of Goods Sold

Only certain taxable entities will be eligible for the cost of goods sold deduction. The deduction applies only to taxable entities selling *goods* in the ordinary course of business. The statute defines *goods* to include tangible personal property and real property. To be eligible for the deduction, the entity taking the deduction must own the goods being sold.

Goods Defined

Texas franchise tax law defines *goods* to include real or tangible personal property sold in the ordinary course of business of a taxable entity.

Tangible Personal Property

Tangible personal property includes items that can be seen, weighed, measured, felt, or touched or that are perceptible to the senses in any other manner.

Computer Programs

For Texas tax purposes, tangible personal property includes computer programs. The franchise tax statute defines computer programs by reference to the Texas sales and use tax laws, which define a computer program as a series of instructions that are coded for acceptance or use by a computer system and that are designed to permit the computer system to process data and provide results and information.

Television, Radio, Books, Videos and Films

The franchise tax statute also defines tangible personal property to include various other types of media, such as films, sound recordings, videotapes, live and prerecorded television and radio programs, books, and other similar property embodying words, ideas, concepts, images, or sound. These various types of media are considered to be *goods* for franchise tax purposes without regard to the means or methods of distribution or the medium in which the property is embodied. Media is considered a *good* if it is intended to be mass-distributed (or if it is reasonably likely to be mass-distributed) in a form that is not substantially altered. It does not matter if the distributor is the creator of the media or a third-party distributor.

Example 5B-1 Employee policy manual is not considered a *good*.

ABC Company hires XYZ Consulting to create an employee policy manual. The policy manual is proprietary and includes detailed information regarding the policies and processes internal to ABC Company. The manual is designed and produced for limited internal use within ABC company. The employee policy manual will likely not be considered a *good* for Texas franchise tax purposes. Therefore XYZ Company will not be allowed to deduct the costs of creating the policy manual in computing its Texas margin tax.

Example 5B-2 TV mini-series is considered a *good*.

ABC Production Company creates a three-part television mini-series which it intends to broadcast throughout the United States and Canada. Even if the distribution is limited to a small local area, the costs of producing the mini-series will likely be deductible in determining margin. The production is a *good* under the franchise tax statute's media definition for tangible personal property. It is intended that the medium in which the mini-series is embodied will be mass-distributed to a variety of viewing audiences.

Example 5B-3 Cable television is considered a good.

Clear Choice Cable TV, LLP is a cable television company. It provides cable television services to subscribers.

For Texas franchise tax purposes, cable television companies, such as Clear Choice, are considered to be broadcasting and distributing tangible personal property and may calculate cost of goods sold for qualifying costs.

Example 5B-4 Movies shown in a theater are not considered goods.

Showbiz Theaters, Inc. runs a movie theater and sells movie tickets, popcorn, drinks, and concessions. The Comptroller considers a movie theater to be a service provider. As such, Showbiz qualifies for a cost of goods sold deduction only for its concession sales.

Because Showbiz is considered a service provider and not a distributor of tangible personal property in the form of a film, it is not allowed to include royalty payments made for the right to use the property (films) in cost of goods sold.

Real Property

Real property generally refers to land and includes structures and other improvements that are embedded into or permanently affixed to the land.

Producers of *goods* for franchise tax purposes include producers of commercial and residential real property. This part of the franchise tax definition for *goods* extends well beyond the traditional sales and use tax concept of *goods*.

The franchise tax defines *production* of goods to include construction, installation, manufacture, development, mining, extraction, improvement, creation, raising or growth. This encompasses a variety of activities related to improving or developing real estate, such as oil and gas production activities, coal and precious metal mining activities, raising of livestock and growth of crops.

Example 5B-5 Oilfield services.

Well Servicing Company, LLC is a taxable entity that performs services on oil wells. It drills new wells, performs well fracturing and acidizing, and performs other well services to stimulate production.

Oil and gas wells are considered real property under state law and for purposes of TTC 171.1012(i) (Comptroller FAQ No. 22, *Cost of Goods Sold*, last updated June 19, 2008.) Therefore, the labor and materials used in the construction, improvement, remodeling, repair, or industrial maintenance of oil wells can be included in Well Servicing's cost of goods sold deduction (Comptroller FAQ No. 23, *Cost of Goods Sold*, revised June 19, 2008).

Contract Manufacturers

Contract manufacturers are treated differently from real estate contractors and are ineligible to deduct cost of goods sold. The Comptroller does not consider a taxable entity that contracts with an unrelated third party to manufacture goods to the taxable entity's specifications to be a producer of those goods for purposes of TCC Sec. 171.002(c)(2).

Agricultural Goods

The franchise tax statute specifically states that *goods* include the husbandry of animals, the growing and harvesting of crops, and the severance of timber from realty. Many farmers do not calculate a cost of goods sold deduction for federal tax purposes. This creates challenges for margin tax purposes. Agricultural entities that do not use cost of goods sold for federal tax purposes will likely use the expense method to compute their cost of goods sold in determining their taxable margin.

SIC Codes and Sales of Goods

The Comptroller's office has initiated a desk audit program, which reviews a taxpayer's SIC code and evaluates whether a business in that SIC code would be eligible for the cost of goods sold deduction. In particular, the Comptroller's office is questioning any taxable entity that deducted cost of goods sold and reported an SIC code in the service industry.

Items That Are Not Goods

Certain items are ineligible for the cost of goods sold deduction. Even though a particular taxable entity (e.g., a pipeline company) may calculate cost of goods sold for federal tax purposes, that does not mean the taxable entity will be eligible to deduct cost of goods sold when computing taxable margin. The following categories of items are not considered *goods* for purposes of the cost of goods sold deduction.

Intangible Property

Trademarks, copyrights, formulas, recipes and other intangible items are not considered *goods*. Costs associated with the production and sales of these items are not eligible for the cost of goods sold deduction.

Sellers of stock certificates, partnership shares, royalties and other intangibles are also ineligible for the cost of goods sold deduction. In the context of apportionment, the Comptroller provides the following examples of intangibles: stocks, bonds, commodities, futures contracts, patents, copyrights, licenses, trademarks, franchises, goodwill, and general receivable rights.

Services

Service providers are generally ineligible for the cost of goods sold deduction. Even though service providers may consume or transfer goods to their customers in connection with providing their services, they cannot take a cost of goods sold deduction for their purchases of the goods used or transferred.

Leased and Rented Goods

Equipment leasing and rental companies are also generally ineligible for the cost of goods sold deduction.

Example 5C-1 Leasing company is not eligible for COGS deduction.

ABC Leasing Company leases washers, dryers, and refrigerators to its customers. ABC delivers the items to the customers. Title does not transfer to the customer but remains with the leasing company. ABC is not eligible for the cost of goods sold deduction for any of the costs associated with the leased goods.

Variation: Assume ABC Appliance Company sells (rather than leases) washers, dryers, and refrigerators to its customers. ABC delivers the items to the customers. Upon making the purchase, the title transfers to the

customer. Under these facts, ABC is eligible for the cost of goods sold deduction for all eligible direct and indirect cost of acquiring the goods for sale.

Exceptions. The franchise tax statute offers three limited exceptions: (1) motor vehicle leasing companies that remit gross rental receipts tax; (2) heavy construction equipment leasing companies; and (3) railcar rolling stock rental or leasing companies. These three types of businesses are eligible to take a cost of goods sold deduction, even though they are not transferring title to the goods.

The Comptroller's rules define heavy construction equipment to include self-propelled, self-powered, or pull-type equipment that weighs at least 3,000 pounds and intended to be used for construction. Vehicles that are required to be titled or registered for highway use are not eligible for this exception.

Mixed Transactions

Partial COGS Deduction Allowed

In general, only entities that sell real or tangible personal property in the ordinary course of business are eligible to deduct the cost of goods sold in computing margin. The performance of a service is not considered the sale of tangible personal property.

However, a deduction is allowed for the cost of goods transferred to the customer in a mixed transaction.

Mixed Transaction

A mixed transaction is a transaction that contains elements of both a sale of tangible personal property and a service.

In a mixed transaction, a taxable entity may subtract as cost of goods sold only the costs otherwise includable in the cost of goods sold deduction that have been incurred in relation to tangible personal property sold either directly or as part of a mixed transaction.

Example 5D-1 Oil change services.

Speedy Lube & Oil Change Services, Inc. is a taxable entity that provides oil change services. It incurs costs for labor and materials used in performing the service.

Speedy Lube may include in its cost of goods sold computation only the cost of the oil filter and oil that is included in the performance of the service. Speedy Lube installs these items in the vehicle and transfers them to the customer as part of the service. However, Speedy Lube may not deduct any labor costs as part of its cost of goods sold.

Example 5D-2 Crop dusting.

Stay-Green Crop Dusting Company is a taxable entity that provides crop dusting services. Stay-Green hires a pilot and rents a plane to perform the crop dusting services. Stay-Green incurs costs for fuel and chemicals used in performing the service.

Stay-Green may include in cost of goods sold the cost of chemicals used in the performance of the service. However, Stay-Green may not include the costs of aviation fuel, labor, airplane rental, or other expenses in its cost of goods sold deduction.

Example 5D-3 Veterinary services.

Dr. Doolittle's Vet Clinic, LLC performs veterinary services. The clinic incurs costs for the medical technician who assists in performing the veterinary services. It also incurs costs for the receptionist who books the appointments. In addition, the clinic incurs costs for the pharmaceuticals and other veterinary supplies used in evaluating and treating the animals. It also incurs fees for hazardous waste disposal.

The Vet Clinic may include in cost of goods sold only the pharmaceuticals and other medical (veterinary) supplies. No labor costs or fees can be included.

Determining Ownership of Goods

A taxable entity may deduct cost of goods sold only if it owns the goods being sold. The franchise tax statute directs the Comptroller to consider all of the relevant facts and circumstances in determining who owns the goods. These facts and circumstances include the various benefits and burdens of ownership that a taxable entity incurs in connection with the goods being sold.

Benefits and Burdens of Ownership

Benefits of ownership vested in a particular taxable entity may include the right to receive income from the goods, the right to possession of the goods, the right to alter the goods, the right to enter onto property, the right to make modifications or improvements to property, etc.

Burdens of ownership may include such factors as the duty to provide insurance on the goods or property, the requirement to pay property taxes in connection with real estate or business property, the obligation to pay restitution if a user is harmed by the goods or property, etc.

Ownership of Real Property

The franchise tax statute treats a taxable entity that furnishes labor or materials to a real estate project as the owner of the labor and materials that the taxable entity contributes to the project.

For purposes of this provision, real estate projects include those involving construction, improvement, remodeling, repair, or industrial maintenance of real property. Construction includes all new improvements to real property, including the initial finish out work to the interior or exterior of the property. Remodeling includes rebuilding, replacing, altering, modifying, or upgrade existing real property. Repairs include work performed to mend or bring back real property that was broken, damaged, or defective as near as possible to its original working order. Maintenance includes any scheduled, periodic work that is necessary to sustain or support safe, efficient, continuous operations, or to prevent the decline, failure, lapse, or deterioration of a real property improvement.

Contractors and subcontractors working on real property projects are considered the owners of the labor and/or materials they contribute to the real property project. Taxable entities working as contractors and subcontractors may include these costs in the computation of their cost of goods sold.

Government Contractors

The franchise tax statute also treats taxable entities as the owners of goods being manufactured or produced under a contract with the federal government. This includes contractors working on subcontracts that support a contract with the federal government. Even though the applicable Federal Acquisition Regulation may require that title or risk of loss with respect to those goods be transferred to the federal government before the manufacture or production of the goods is complete, the franchise tax statute treats these contractors as the owners of the goods they produce for sale to the federal government.

Combined Group Members

The franchise tax statute allows a member of a combined group to claim a cost of goods sold deduction for costs associated with goods owned by another member of the combined group.

Method for Calculating Costs of Goods Sold

The franchise tax statute requires taxable entities to determine cost of goods sold in accordance with the methods they used to compute their federal tax returns. The applicable federal tax methods are those for the federal reporting period on which the Texas franchise tax is based.

Example 5F-1 Determining which federal tax methods apply.

ABC's Texas franchise report due May 17, 2010 (because May 15, 2010 falls on a Saturday) will be based upon the 2008 federal tax reporting period. Therefore, the 2009 federal tax accounting methods will determine the appropriate methods for calculating the 2010 Texas franchise tax cost of goods sold.

The federal accounting methods do not affect which categories of cost of goods sold may be deducted. A taxpayer will still look to the Texas franchise tax statute to determine the appropriate categories of goods. These will sometimes differ from the federal cost of goods sold categories, depending on the taxable entity's industry.

Example 5F-2 Franchise tax deduction may not agree with federal deduction.

XYZ Company is in the oil and gas well drilling business in Texas. XYZ Company amortized geological and geophysical costs for federal tax purposes. XYZ Company also incurred intangible drilling costs that were ineligible for inclusion in cost of goods sold for federal tax purposes.

In determining its Texas franchise tax cost of goods sold, XYZ company may include both the geological and geophysical costs and the intangible drilling costs that are allocable to the goods sold during the period on which margin is based.

Approved Tax Preparation Software Vendors

Tax preparers should be careful to use only an approved software vendor for franchise tax report preparation.

The Comptroller revised its lists of approved vendor software for 2010. This software must be used for all original reports filed for report years 2008, 2009 and 2010.

Effective January 1, 2010, the Comptroller will not accept original franchise tax reports generated from tax preparation software approved for 2008 and 2009 reports. However, amended 2008 and 2009 reports generated from previously approved tax preparation software products will still be accepted.

As with any return preparation product, preparers should be careful to review the completed report for any calculation problems or discrepancies. For example, an apportionment ratio should never be greater than 100%. Also, return preparers should ensure that the calculations for the various elements of the tax, such as cost of goods sold, revenue exclusions and compensation, are tested manually to ensure that they are properly computed. This is particularly true for combined group reporting. These errors can be costly and can cause the taxpayer to pay more tax than is due. If the Comptroller determines the report to be in error, the taxpayer may be liable for not only the tax, but also penalties and interest.

Using the correct software helps to ensure appropriate computation of cost of goods sold. Often, for businesses operating in the oil and gas industry, cost of goods sold for Texas franchise tax purposes may exceed the cost of goods sold that the taxable entity computes for federal income tax purposes.

Electing to Capitalize or Expense Costs of Goods Sold

Taxpayers who are subject to capitalization requirements under the Internal Revenue Code may elect to either capitalize or expense their cost of goods sold for Texas franchise tax purposes.

Eligibility for Election

Eligible entities include those required to capitalize costs under IRC Secs. 263A, 460, or 471. IRC Sec. 263A generally requires taxpayers to capitalize costs associated with real or personal property produced by the taxpayer or acquired for resale. IRC Sec. 460 requires taxpayers to capitalize certain costs associated with long-term contracts. IRC Sec. 471 requires capitalization in connection with items held in inventory.

If these provisions apply for federal tax purposes, the taxable entity may elect to capitalize costs in the same manner and to the same extent the entity capitalized costs for its federal income tax return. Alternatively, the taxable

entity may expense those costs that are includible in the computation of cost of goods sold for franchise tax purposes.

Example 5G-1 Eligibility for the election.

Brunhilda Brooms, LLC manufactures brooms for retail and wholesale sale. Its procurement department purchases raw materials, such as handles, bristles, and wires. Brooms stores the raw materials in raw goods inventory until the brooms are produced.

Brooms hires workers who remove the raw materials from inventory and use them to create brooms. The finished brooms are stored in finished goods inventory until a customer orders a broom. When customers order the brooms, they are removed from finished goods inventory and delivered to the customers' locations.

At the end of the year, Brooms holds goods in raw materials inventory, work-in-process inventory and finished goods inventory. It can elect to capitalize its costs of goods sold or expense them.

Electing to Capitalize

A taxable entity that elects to capitalize cost of goods sold for Texas franchise tax purposes must capitalize each cost allowed under Texas law that it capitalized on its federal tax return.

Taxpayers generally capitalize cost of goods sold for federal tax purposes using the following formula:

	Beginning Inventory
+	**Purchases**
−	**Ending Inventory**
=	**Cost of Goods Sold**

Example 5G-2 Capitalization election.

Assume the same facts as Example 5G-1. If Brunhilda Brooms, LLC elects the capitalization method, the cost of goods sold calculation will correspond to the period on which margin is based. If Brooms files a franchise tax report in 2010 using the margin calculation, it will base its beginning inventory on its 2009 federal tax return.

Assuming Brooms is a calendar year taxpayer for federal tax purposes, its beginning inventory will be the January 1, 2010 inventory. Brunhilda will add its raw materials purchases for the year and will capitalize the labor related to the creation of the brooms. It will deduct its ending inventory as of December 31, 2010 in order to calculate cost of goods sold.

Brooms will use the same calculation methods for calculating cost of goods sold on its 2010 Texas franchise tax report as it used for its 2010 federal tax return.

Making the Election

The election to capitalize or expense allowable costs is made by filing a franchise tax report using one method or the other. The election is for the entire period on which the report is based and cannot be changed after the due date or the date the report is filed.

Electing to Expense

An entity that elects to expense its costs is not allowed to subtract costs that were incurred prior to the first day of the period on which margin is based.

Changing an Election

Entities that change their cost of goods sold election may lose their eligibility to deduct certain costs. If an entity originally elects to capitalize its costs of goods sold and later changes its election to expense its costs, it may not

deduct any cost incurred before the first day of the period on which the report is based, including any ending inventory on a prior report. If an entity originally elects to expense cost of goods sold and later changes its election to capitalize its costs, it may not capitalize costs incurred prior to the accounting period on which the report is based.

Costs Eligible for the Cost of Goods Sold Deduction

Costs Includible in the Cost of Goods Sold Deduction

The costs eligible for inclusion in a taxable entity's cost of goods sold deduction fall in one of the following three categories:

1. Direct costs,
2. Indirect costs, limited to 4%, and
3. Additional or other costs.

Direct Costs

The first category of costs includes the direct costs listed in TTC Sec. 171.1012(c). This category includes all the direct costs of acquiring or producing goods. While the statute specifically lists certain types of costs that fall within this category, the statute's list is presumably not a complete listing.

Partnership Contributions. Certain contributions to partnerships in which the taxable entity owns an interest are also considered a direct cost includible in the entity's cost of good sold.

Distinguishing Characteristic. There is a direct relation between the cost and the acquisition or production of goods.

Indirect or Administrative Overhead Costs

The second category of costs includes the costs listed in TTC Sec. 171.1012(f). This category includes indirect or administrative overhead costs. All mixed service costs are treated as indirect or administrative overhead costs.

4% Limit on Deduction. The amount of indirect or administrative costs that can be included in the cost of goods sold deduction is limited to 4% of the total indirect or administrative overhead costs.

The Comptroller also takes the position that any ineligible costs are not includable in the computation of the 4% limit on indirect costs.

Distinguishing Characteristic. There is an indirect relation between the cost and the acquisition or production of goods. Because the relation is indirect, the entity must be able to demonstrate how the cost relates to the acquisition or production of goods.

Other or Additional Costs

The third category of costs includes the costs listed in TTC Sec. 171.1012(d). This category includes costs incurred in relation to the taxable entity's goods. While it is not entirely clear, the list of additional or other costs is presumably not a complete listing of the eligible costs included in this category.

The statute refers to these as "additional costs." Taxpayers and their representatives frequently refer to them as "other costs."

Distinguishing Characteristic. These costs are incurred in relation to the taxable entity's goods. Note that the type of relation (direct, indirect, or otherwise) is not specified.

Ineligible Costs

Certain costs are not includable in the cost of goods sold deduction.

Entities that Producers and Entities that Employ Others to Produce

The Tax Code specifically references production costs as part of the description for several categories of cost of goods sold.

Production Costs. Producers are generally allowed to deduct the direct costs of producing goods. In particular, costs such as research, experimental, engineering, and design activity costs must be directly related to the production of goods.

Costs Relating to Goods. Certain other costs incurred in relation to the entity's goods are includable in the computation of cost of goods sold. These include, for example, acquisition, storage, and handling costs, among others.

Entities that Employ a Third-Party Producer. The Comptroller reads the statute to restrict the inclusion of costs such as research, experimental, engineering, and design activity costs in the computation of cost of goods sold when the entity uses an unrelated third party (i.e., a submanufacturer) to produce its goods.

Under this restrictive interpretation, the Comptroller reads the statutory language to mean that an entity that is *not* a producer of goods is limited to acquisition, storage, handling and other costs specified in TTC Sec 171.1012(d) in computing the cost of goods sold.

Federal and Franchise Tax Cost of Goods Sold Computations Are Not Identical

Practitioners used to calculating federal cost of goods sold should be cautious in determining which costs are eligible for Texas cost of goods sold. The franchise tax statute defines cost of goods sold for Texas margin to include items that otherwise would not be includible for federal tax purposes. It also excludes certain items that taxpayers may generally include in cost of goods sold for federal tax purposes.

Categorizing Costs

It may be difficult to categorize costs that appear to fit into more than one category. Some costs may appear to be so similar to an identified category that they are automatically accorded similar treatment during a franchise tax report preparation engagement. The Comptroller's Rules recognize that some costs may qualify as direct costs or as other costs.

Taxpayers and their representatives should carefully review costs and activities with an eye to properly categorizing the costs. Categorizing a cost as a direct cost to the extent it can be shown to directly relate to the acquisition or production of the company's goods will help ensure the maximum cost of goods sold deduction. Categorizing a cost as an additional or other cost to the extent it is incurred in relation to the company's goods will similarly maximize the company's cost of goods sold deduction. Costs categorized in the indirect or administrative overhead category will be subject to the 4% rule limiting their deduction.

Taxpayers and their representatives should also carefully review the company's general ledger to ensure that it captures the details needed for preparing the company's franchise tax reports. This might include a review of account titles to ensure they accurately describe the account. It might also include a review and realignment of the accounts to improve effective cost tracking.

Direct Costs Eligible for the Cost of Goods Sold Deduction

Deductible Direct Costs

A taxable entity's cost of goods sold includes all direct costs of acquiring or producing goods.

While the statute specifically lists certain types of costs that fall within this category, the statute's list is presumably not a complete listing. The costs specifically listed in the statute are discussed in the remainder of this lesson.

Direct Labor

Employees. Direct labor costs include payments to workers who acquire or produce the goods that the taxable entity sells. These costs include wages and benefits allocable to the workers.

Independent Contractors. Direct labor costs are not limited to employee wages, but may include payments made to independent contractors whose pay will be reported on Form 1099 for federal tax purposes. Payments to undocumented workers are not eligible for the deduction.

The Comptroller's rules provide that direct labor costs include W-2 wages, IRS Form 1099 payments, temporary labor, payroll taxes and benefits.

COGS Direct Labor v. Compensation Deduction. The eligibility to deduct costs associated with direct labor for cost of goods sold is broader than the compensation deduction in that payments to independent contractors are eligible. However, it is more limited in that not all payments to workers may be eligible. The workers must be involved in the acquisition or production of goods. It is also more limited in that direct labor cannot include officer compensation while the compensation deduction can include officer compensation, capped at $320,000 (for reports due in 2010 and 2011).

Direct Materials

Integral Parts and Components. Taxable entities may deduct the cost of materials that are an integral part of the specific property produced. This includes component parts that become part of a good being manufactured for sale.

Consumed Materials. Taxable entities may deduct the cost of materials that are consumed in the ordinary course of performing production activities.

Handling and Storage Costs

Handling Costs. Taxable entities may deduct handling costs incurred in connection with the acquisition or production of goods. These include costs attributable to processing, assembling, repackaging, and inbound transportation.

Storage Costs. Taxable entities may deduct storage costs incurred in connection with the acquisition or production of goods. This includes the costs of carrying, storing, or warehousing property.

Depreciation, Depletion, and Amortization

Taxable entities may deduct the costs of depreciation, depletion, and amortization that is associated with and necessary for the production of goods. This includes cost recovery under IRC Sec. 197 for amortization of goodwill, going-concern value and certain other intangibles.

Leasing and Rental Costs

Equipment, Facilities, and Real Property. Taxable entities may deduct the costs of renting or leasing equipment, facilities, or real property that is directly used for the production of goods.

Intangible Drilling Costs. Deductible leasing and rental costs include intangible drilling and dry hole costs.

Pollution Control. The costs of leasing or renting pollution control equipment are deductible as leasing and rental costs.

Repairs and Maintenance

Equipment, Facilities, and Real Property. Taxable entities may deduct the costs of repairing and maintaining equipment, facilities, or real property directly used for the production of goods.

Pollution Control. Costs incurred in connection with repairing and maintaining pollution control devices are also deductible.

Research and Development

Taxable entities may deduct costs attributable to research, experimental, engineering, and design activities directly related to the production of the goods. This includes all research or experimental expenditures under IRC Sec. 174. These items represent research and development costs in the experimental or laboratory sense.

The term *research and development* generally includes costs incurred in connection with the development or improvement of a product. An example of deductible costs may include costs incurred in connection with obtaining a patent, such as an attorney's fees for completing, filing and perfecting the patent application.

Generally research and development costs are incurred in connection with activities that aim to discover information in order to eliminate uncertainty regarding the development or improvement of a product. Research and development is generally conducted in order to eliminate uncertainties such as the appropriate capacity or methodology to develop or improve a product or product design.

For federal tax purposes, the government considers the nature of the activity, rather than the nature of the product or improvement being developed, in determining whether a particular cost is a research or experimental expense. The level of technological advancement the product or improvement represents is generally not dispositive.

Geological and Geophysical Costs

A taxable entity may deduct geological and geophysical costs incurred to identify and locate property that has the potential to produce minerals. These costs are generally amortized for federal tax purposes, but may be deductible as cost of goods sold for purposes of calculating taxable margin.

Taxes

A taxable entity may deduct taxes paid in relation to acquiring or producing any material, or taxes paid in relation to services that are a direct cost of production. This would include any sales or use taxes paid in connection with acquiring goods or taxable services. It may also include business personal property taxes related to materials used in production.

Electricity Acquisition Costs

A taxable entity that sells electricity may deduct the cost of producing or acquiring the electricity sold.

Indirect Costs Eligible for the Cost of Goods Sold Deduction

Indirect or Administrative Overhead Costs

A taxable entity may subtract as a cost of goods sold any indirect or administrative overhead costs that it can demonstrate are allocable to the acquisition or production of goods.

Indirect or administrative overhead costs include, but are not limited to, all mixed service costs such as security services, legal services, data processing services, accounting services, personnel operations, general financial planning, and financial management costs.

Duplicate deductions are not allowed. Thus, any cost deducted as a direct cost or as an other cost cannot be deducted as an indirect or administrative cost.

4% Limit on Deduction. The total amount of indirect or administrative costs that can be included in the cost of goods sold deduction is limited to 4% of the total indirect or administrative overhead costs. The Comptroller also takes the position that any ineligible costs are not includable in the computation of the 4% limit on indirect costs.

Security Services

Security services generally include charges for activities requiring a license as a private investigator or a private security agency. These services may include investigations, guard services, alarm systems, armored car services, special courier services, guard dog services, private security officers, detectives, or private investigators. To the extent they are allocable to the acquisition or production of goods, they are includible in cost of goods sold. See Rule 3.333 (pertaining to sales tax on security services).

Legal Services

A taxable entity may deduct legal fees allocable to the acquisition or production of goods. Legal services may include attorney fees, filing fees, and court costs incurred in connection with the acquisition or production of goods.

Data Processing Services

A taxable entity may deduct costs of data processing services that are allocable to the acquisition or production of goods.

Data processing services involve the processing of information for the purpose of compiling and producing records of transactions, maintaining information, and entering and retrieving information. It specifically includes word processing, payroll and business accounting, and computerized data and information storage or manipulation. Examples of data processing services include entering inventory control data for a company, maintaining records of employee work time, filing payroll tax returns, preparing W-2 forms, and computing and preparing payroll checks.

Accounting Services

A taxable entity may deduct costs of accounting services allocable to the acquisition or production of goods. Accounting services include the application of accounting principles and tax laws to prepare financial reports; prepare federal income tax, state franchise tax, or state sales and use tax returns; create management reports and financial budgets; and related activities. These accounting costs are deductible to the extent they are allocable to the acquisition or production of goods, such as inventory accounting, cost accounting for acquisition or production, and related accounting activities.

Personnel Operations

A taxable entity may deduct costs of personnel operations allocable to the acquisition or production of goods. Management of human resources and benefits associated with procurement and manufacturing personnel would likely be includable in cost of goods sold.

General Financial Planning

The allocated costs of general financial planning are includable in cost of goods sold to the extent the financial planning activities are associated with acquiring and producing goods.

General Financial Management

The allocated costs of general financial management activities are includable in cost of goods sold to the extent the financial management activities are associated with acquiring and producing goods.

Limitation on Indirect Costs—the 4% Rule

Indirect and Administrative Overhead Costs

Indirect or administrative overhead costs include, but are not limited to, all mixed service costs such as security services, legal services, data processing services, accounting services, personnel operations, general financial planning, and financial management costs.

4% Limitation

The total amount of indirect or administrative overhead costs that can be included in the cost of goods sold deduction is limited to 4% of the total indirect or administrative overhead costs.

Application to Combined Groups

It is not clear how the 4% limitation applies to a combined group. In the authors' opinion, the limit presumably applies at the combined group level (rather than separately to each member of the group).

Other Costs Eligible for the Cost of Goods Sold Deduction

The franchise tax statute allows certain other costs to be included in the cost of goods sold deduction. These other costs are in addition to the direct and indirect costs described earlier.

Deterioration, Obsolescence, and Spoilage

A taxable entity may deduct costs incurred in connection with deterioration, obsolescence, spoilage, or abandonment of goods produced or acquired for sale. This includes costs of rework labor, reclamation, and scrap. Reclamation generally involves the process of deriving by-products or other usable materials from waste products resulting from the production of goods.

Certain Preproduction Costs

A taxable entity may deduct direct preproduction costs associated with property being held for future production. Allocable direct preproduction costs include the costs of purchasing, storing, and handling the goods.

Certain Post-production Costs

A taxable entity may deduct direct post-production costs associated with property being held for future production. Allocable direct post-production costs include storage and handling costs.

Insurance

A taxable entity may deduct the costs of maintaining insurance on a plant or a facility, machinery, equipment, or materials directly used in the production of the goods.

A taxable entity may also deduct the cost of maintaining insurance covering the produced goods being held for sale or delivery.

Utilities

A taxable entity may deduct costs incurred to purchase utilities, such as electricity, gas and water. To be eligible for the cost of goods sold deduction, the utilities must be used directly in the production of goods.

Quality Control

A taxable entity may deduct eligible quality control costs. Eligible costs include the replacement of defective components pursuant to standard warranty policies, inspections that are directly allocable to the production of the goods, and repairs and maintenance of goods held for sale or delivery.

Licensing and Franchising

A taxable entity may deduct licensing or franchise costs directly associated with the goods produced. This includes fees incurred in connection with securing the contractual right to use a trademark, corporate plan, manufacturing procedure, special recipe, or other similar right.

Eligible Costs for Specific Industries

The franchise tax includes special provisions for specific industries, which are eligible to deduct cost of goods sold. Some entities, such as lending institutions, are eligible to deduct certain expenses as costs of goods sold even though they are not selling any items that would be described in the franchise tax definition of goods.

Lending Institutions

Unlike other taxable entities, lending institutions may deduct interest. The franchise tax statute provides that, notwithstanding any other cost of goods sold provision, if the taxable entity is a lending institution that offers loans to the public and elects to deduct cost of goods sold, the entity may subtract as a cost of goods sold an amount equal to interest expense.

A motor vehicle sales finance company licensed through the Office of Consumer Credit Commissioner that offers loans to the public meets the definition of a "lending institution" and may deduct interest expense as cost of goods sold.

Leasing Companies

Unlike other taxable entities that lease or rent goods and are not eligible for the cost of goods sold deduction, the following types of taxable entities may deduct costs incurred in the ordinary course of business in connection with rentals or leases, even though they are not transferring title to the goods leased or rented:

1. Motor vehicle rental or leasing companies that remit motor vehicle gross rental receipts tax imposed under TTC Sec. 152.026;

2. Heavy construction equipment rental or leasing companies; and

3. Railcar rolling stock rental or leasing companies.

The Comptroller's rules define heavy construction equipment to include self-propelled, self-powered, or pull-type equipment that weighs at least 3,000 pounds and is intended to be used for construction. Vehicles that are required to be titled or registered for highway use are not eligible for this exception.

Restaurants

Taxable entities engaged in operating a bar or restaurant may include in cost of goods sold only their direct, indirect, or other eligible costs that relate to the production of food. Any costs incurred in connection with both the production of food and other activities (e.g., gas, electricity, waitstaff, cleaning services, etc.) must be allocated to food production on a reasonable basis.

Construction Contractors

The franchise tax statute treats a taxable entity that furnishes labor or materials to a real estate project as the owner of the labor and materials that the taxable entity contributes to the project.

Contractors and subcontractors working on real property projects are therefore considered to be the owners of the labor and/or materials they contribute to the real property project. Taxable entities working as contractors and subcontractors may include these costs in the computation of their cost of goods sold.

Films and Broadcasting

The franchise tax statute treats films and television broadcasts as goods eligible for the cost of goods sold deduction. A taxable entity is eligible for the deduction if it is principally engaged in the business activity of film or television production or broadcasting, the sale of broadcast rights, or the distribution of films, sound recordings, videotapes and other similar items.

If the taxable entity elects to deduct cost of goods sold to determine its margin, it may deduct the direct, indirect, and other costs associated with those activities. In addition, it may also deduct deprecation, amortization and other expenses directly related to the acquisition, production, or use of the property, including expenses incurred in connection with broadcast rights.

Costs Ineligible for the Cost of Goods Sold Deduction

Certain costs are ineligible for the cost of goods sold deduction. If costs are listed as ineligible, they are generally not deductible, even though they may also fit into another category of costs.

Taxable entities may not deduct the costs discussed in the remainder of this lesson.

Non-production Rentals and Leases

A taxable entity may not deduct the cost of renting or leasing equipment, facilities, or real property that are not used for producing goods. This may include leases and rentals associated with office space, break rooms, copier equipment, administrative facilities and similar expenses.

Selling and Distribution

A taxable entity may not deduct the costs of selling and distributing goods. This includes employee expenses, such as salesmen's salaries and benefits. It also includes outbound transportation costs of delivering the goods to customers.

Advertising

A taxable entity may not deduct advertising or promotional costs associated with a good or product. The compensation and benefits of a salesperson are considered a selling cost and therefore cannot be included in COGS.

Idle Facilities

A taxable entity may not deduct costs incurred in connection with idle facilities.

Example 5N-1 Nondeductible idle facilities costs.

Schnazzy Automotive produces convertible cars and luxury SUVs. Schnazzy's production schedule is designed to make the convertibles available during the spring and summer, when they are in highest demand. The SUVs are available during the winter, when customers are seeking a large enclosed space to hold their passengers and their packages.

Schnazzy Automotive rents separate warehouses and owns separate production lines for its convertibles and its SUVs. Schnazzy incurs facilities rental costs in connection with the warehouses and depreciation costs in connection with the production lines.

For purposes of the cost of goods sold deduction, Schnazzy may not include the facilities rental or production line depreciation costs for the periods that these facilities are idle. Schnazzy may not deduct costs for the convertible line during the winter and may not deduct costs for the SUV line during the summer.

Rehandling

A taxable entity may not deduct costs incurred in connection with rehandling goods that have been produced and sold. Rehandling costs generally arise when goods are returned and prepared for resale. Thus, while handling costs related to the initial sale of goods are deductible, any rehandling costs related to the return and resale of the goods are *not* deductible.

Bidding Costs

A taxable entity may not deduct costs incurred in connection with the bidding process, regardless of whether the bidding was successful or not. TTC Sec. 171.1012(e)(7) disallows costs incurred in connection with successful

bidding, where the solicited contract is ultimately awarded to the taxable entity. TTC Sec. 171.1012(e)(8) disallows costs incurred in connection with unsuccessful bidding, where the solicited contract is not awarded to the taxable entity.

Interest

A taxable entity may not deduct interest costs incurred on debt financing the production of goods. TTC Sec. 171.1012(e)(9) provides a very limited exception for financial institutions.

Partner Contributions Already Deducted

As a consistency matter, a taxable entity may not claim an additional cost of goods sold deduction to the extent the cost was funded by partner contributions and deducted as an item for which an in-kind distribution was made.

Income Taxes

A taxable entity may not deduct income taxes. This includes any local, state, federal, or foreign income taxes. This also includes any franchise taxes assessed on the taxable entity based on its income.

Strike Expenses

A taxable entity may not deduct strike expenses. This includes costs associated with hiring workers to replace striking employees. However, taxable entities may still deduct eligible direct labor costs of replacement personnel. They may also deduct costs incurred in connection with providing security. In addition, taxable entities may deduct attorney fees incurred in connection with settling strikes.

Officers' Compensation

A taxable entity may not deduct as cost of goods sold compensation expenses paid to its officers. This differs from the compensation deduction, which allows a taxable entity to deduct payments made to all eligible employees.

Undocumented Workers

A taxable entity may not deduct payments to undocumented workers who produce goods. *Undocumented workers* are those who are not lawfully entitled to be present and employed in the United States. This includes payments made to migrant farm workers who are raising animals or livestock, growing or harvesting crops, or severing timber from realty.

Armed Forces Housing

A taxable entity may not deduct the costs of operating a facility located on property leased or owned by the federal government and managed or operated primarily to house members of the United States armed forces.

Transactions between Related Parties

Transactions between affiliated entities that are not members of a combined group must be made at arms length in order to be includible as costs of goods sold.

In general, entities are affiliated if they share more than 50% direct or indirect common ownership or control by an owner or group of owners.

For purposes of the Texas franchise tax, *arm's length* means the standard of conduct under which entities that are not related parties and that have substantially equal bargaining power, each acting in its own interest, would negotiate or carry out a particular transaction.

A *related party* directly or indirectly owns or controls more than 50% of another party. A related party may be a person, corporation, entity, or set of related entities. Related party attribution may arise regardless of whether the

entity is a pass-through or disregarded entity for federal tax purposes. It may also arise regardless of whether the entity causing the attribution is subject to the franchise tax.

Example 5O-1 Related party attribution.

Entity A owns 51% of Entity B and 10% of Entity C. Entity B owns 45% of Entity C.

Under these facts, B's ownership in C is attributed to A because A owns more than 50% of B. Therefore, A is treated as owning 55% of C (10% directly, plus 45% attributed through B).

Transactions among these three related parties must be at arm's length to be deductible for cost of goods sold.

Variation: Assume B is an insurance company that pays the insurance gross premiums tax. Attribution may arise from B's ownership in C, even though B is not subject to the franchise tax.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

27. Which of the following businesses would most likely be eligible for the cost of goods sold deduction?

    a. An appliance sales business.

    b. An appliance rental business.

    c. An appliance delivery business.

    d. An appliance repair business.

28. Which of the following businesses would be eligible for the cost of goods sold deduction?

    a. A party supplies leasing business.

    b. A furniture leasing business.

    c. A heavy construction equipment leasing business.

    d. An aircraft leasing business.

29. Which of the following costs are eligible for the cost of goods sold deduction?

    a. Freight costs associated with selling and delivering pianos to customers.

    b. Sales commissions associated with sales of real estate.

    c. Direct labor costs incurred in connection with producing a motion picture.

    d. Advertising costs incurred by a facility that manufactures and sells dolls.

30. Which of the following costs are eligible for the cost of goods sold deduction?

    a. The cost of renting a building where aircraft equipment is manufactured.

    b. The cost of bidding on an aircraft equipment manufacturing contract, where the manufacturer is awarded the bid on the contract.

    c. The cost of bidding on an aircraft equipment manufacturing contract, where the manufacturer is unsuccessful in obtaining the bid on the contract.

    d. Interest incurred in connection with renting a building where aircraft equipment is manufactured.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

27. Which of the following businesses would most likely be eligible for the cost of goods sold deduction? **(Page 107)**

    a. An appliance sales business. [This answer is correct. An appliance sales business sells tangible personal property in the ordinary course of business. It owns the goods that it sells.]

    b. An appliance rental business. [This answer is incorrect. An appliance rental business is not necessarily making "sales" in the ordinary course of business. Only certain rental businesses may qualify for the cost of goods sold deduction under the statute.]

    c. An appliance delivery business. [This answer is incorrect. An appliance delivery business is generally a service. Services are not eligible for the cost of goods sold deduction.]

    d. An appliance repair business. [This answer is incorrect. An appliance repair business is generally a service. Services are not eligible for the cost of goods sold deduction.]

28. Which of the following businesses would be eligible for the cost of goods sold deduction? **(Page 109)**

    a. A party supplies leasing business. [This answer is incorrect. A party supplies leasing business is not necessarily making "sales" in the ordinary course of business. Rental Companies generally are ineligible for the costs of goods sold deduction.]

    b. A furniture leasing business. [This answer is incorrect. A furniture leasing business is not necessarily making "sales" in the ordinary course of business. Only certain rental businesses may qualify for the cost of goods sold deduction under the statute.]

    c. A heavy construction equipment leasing business. [This answer is correct. The statute makes certain exceptions for leasing businesses regarding eligibility for the cost of goods sold deduction, even though the title to the goods is not transferred.]

    d. An aircraft leasing business. [This answer is incorrect. An aircraft leasing business is not necessarily making "sales" in the ordinary course of business. One exception to the franchise tax statue is a motor vehicle leasing company that remits gross rental receipts tax. Per TTC Sec. 171, equipment leasing companies are generally ineligible for the cost of goods sold deduction.]

29. Which of the following costs are eligible for the cost of goods sold deduction? **(Page 107)**

    a. Freight costs associated with selling and delivering pianos to customers. [This answer is incorrect. According to TTC Sec. 171, outbound freight is not eligible for the cost of goods sold deduction.]

    b. Sales commissions associated with sales of real estate. [This answer is incorrect. According to TTC Sec. 171, selling costs are not eligible for the cost of goods sold deduction. However, certain sales commissions may be eligible for exclusion from revenue. The statute allows taxpayers to exclude from revenue certain sales commissions to nonemployees, including split-fee real estate commissions.]

    c. Direct labor costs incurred in connection with producing a motion picture. [This answer is correct. Direct labor costs are eligible for the cost of goods sold deduction. Motion pictures are considered "goods" for purposes of the cost of goods sold deduction.]

    d. Advertising costs incurred by a facility that manufactures and sells dolls. [This answer is incorrect. Advertising costs are not eligible for the cost of goods sold deduction per TTC Sec. 171.]

30. Which of the following costs are eligible for the cost of goods sold deduction? **(Page 115)**

    a. The cost of renting a building where aircraft equipment is manufactured. [This answer is correct. According to TTC Sec. 171, the costs of renting or leasing equipment, facilities, or real property that is directly used for the production of goods are eligible for the cost of goods sold deduction.]

    b. The cost of bidding on an aircraft equipment manufacturing contract, where the manufacturer is awarded the bid on the contract. [This answer is incorrect. A taxable entity may not deduct costs incurred in connection with the bidding process, TTC Sec. 171.1012(e)(7) disallows costs incurred in connection with successful bidding, where the solicited contract is ultimately awarded to the taxable entity.]

    c. The cost of bidding on an aircraft equipment manufacturing contract, where the manufacturer is unsuccessful in obtaining the bid on the contract. [This answer is incorrect. A taxable entity may not deduct costs incurred in connection with the bidding process, TTC Sec. 171.1012(e)(8) disallows costs incurred in connection with unsuccessful bidding, where the solicited contract is not awarded to the taxable entity.]

    d. Interest incurred in connection with renting a building where aircraft equipment is manufactured. [This answer is incorrect. A taxable entity may not deduct interest costs incurred on debt financing the production of goods per TTC Sec. 171.1012(d)(5).]

EXAMINATION FOR CPE CREDIT

Lesson 5 (TFTTG101)

Determine the best answer for each question below. Then mark your answer choice on the Examination for CPE Credit Answer Sheet located in the back of this workbook or by logging onto the Online Grading System.

24. Which of the following items is considered a "good" for purposes of the Texas franchise tax?

    a. A lawn mower repair service.

    b. A live performance.

    c. Cable television show.

    d. An employee policy manual.

25. Which of the following is a "good" for purposes of the Texas franchise tax?

    a. Movie shown in theater.

    b. Husbandry of animals.

    c. Commodities futures.

    d. Stock certificates.

26. Only certain businesses are eligible for the cost of goods sold deduction. Which of the following businesses is eligible for the cost of goods sold deduction?

    a. A rental car business.

    b. A dry cleaning business.

    c. An advertising agency.

    d. A travel agency.

27. Which of the following businesses is eligible for the cost of goods sold deduction?

    a. A real estate subcontractor.

    b. A manufacturing subcontractor.

    c. A real estate rental business.

    d. An appliance rental business.

28. A business pays cash compensation of $500,000 to an independent contractor for his work manufacturing furniture for sale to its customers. How may this be deductible for Texas franchise tax purposes?

    a. $500,000 as a compensation deduction.

    b. $300,000 as a compensation deduction.

    c. $500,000 as a cost of goods sold deduction.

    d. $300,000 as a cost of goods sold deduction.

29. A taxable entity's costs of goods sold includes all direct costs of acquiring or producing goods. Which of the following costs are eligible for the cost of goods sold deduction?

    a. Selling and distribution costs.

    b. Rehandling costs of produced and sold goods.

    c. Costs in obtaining a patent.

    d. Successful and unsuccessful bidding costs.

30. Which of the following cost of goods sold items is limited to 4% of total indirect or administrative costs?

    a. Costs incurred in connection with repairing and maintaining pollution control devices.

    b. Research and development costs.

    c. Geological and geophysical costs incurred to identify and locate property that has the potential to produce minerals.

    d. Data processing services that are allocable to the acquisition or production of goods.

31. Choose from the list below. Which of the following costs are eligible for the cost of goods sold deduction?

    a. Interest expense.

    b. Income tax expense.

    c. Strike expenses.

    d. Franchising expenses.

32. Which of the following costs may a restaurant deduct as cost of goods sold in full?

    a. The cost of paying a chef to cook the food.

    b. The cost of paying a cashier to sell the food.

    c. The cost of paying a waitress to deliver the food.

    d. The cost of paying a busboy to clear the tables after the food is consumed.

Lesson 6: Compensation

INTRODUCTION

Taxpayers subject to the Texas franchise tax may elect to deduct compensation or cost of goods sold, but not both.

Taxpayers make the election annually on the franchise tax report. Under current law, taxpayers may not change the election after filing the original franchise tax report for a particular year. However, taxpayers are allowed to use the 30% standard deduction or the EZ computation if applicable in computing the franchise tax on an amended report.

To determine a taxable entity's compensation deduction for the margin calculation, a return preparer must know (1) the persons for whom compensation payments are includable, (2) the amount of wages and cash compensation, and (3) the amount of benefits.

Learning Objectives:

Completion of this lesson will enable you to:

- Identify the elements of the compensation deduction, apply the limits for wages and cash compensation, and discuss the applicability of net distributive income as part of the compensation deduction.
- Discuss the compensation calculation for client entities with leased, managed or temporary workers.

The Compensation Deduction

The compensation deduction consists of wages and cash compensation, plus benefits.

The deductible amount of wages and cash compensation is limited to $320,000 per person (for reports originally due in 2010 and 2011).

Benefits are unlimited in amount but are only includible in the compensation deduction to the extent they are deductible for federal tax purposes.

Only payments made by a taxable entity to its officers, directors, owners, partners, and employees are eligible for the deduction. This includes eligible payments made through staff leasing companies, management companies and temporary help services, but it does not include payments made to independent contractors.

Eligible Persons

Eligible Persons

To qualify for deduction, the wages and cash compensation and the benefits must be paid or provided only to eligible recipients.

Wages and Cash Compensation. To qualify for the compensation deduction, wages and cash compensation must be paid by the taxable entity to its officers, directors, owners, partners, or employees.

Net Distributive Income. Wages and cash compensation includes net distributive income, provided the recipient is a natural person. However, net distributive income that is subtracted from total revenue may not be included in the determination of compensation.

Benefits. Only benefits provided by the taxable entity to its officers, directors, owners, partners, or employees qualify for deduction.

Ineligible Persons

Wages and cash compensation and benefits paid or provided to ineligible recipients are not deductible.

Undocumented Workers. A taxable entity may not deduct payments to undocumented workers, even though the payments would otherwise be eligible for the compensation deduction. Undocumented workers are those who are not lawfully entitled to be present and employed in the United States.

Independent Contractors. Independent contractors are not included as eligible persons. Thus, an entity may not deduct payments to independent contractors. Payments to independent contractors are generally reported on federal tax Form 1099. They are not includible in the compensation deduction for Texas franchise tax.

Payments to independent contractors and undocumented workers made through staff leasing companies, management companies, and temporary help services are also not deductible.

Other Payments Reportable on Form 1099. In addition to payments made to independent contractors, any other payments reportable on IRS Form 1099 (or that would be reportable on Form 1099 if the amount had met the IRS's minimum reporting requirement), are not includible in the determination of compensation. This includes payments to employees of a taxable entity who may receive both a Form 1099 and a Form W-2.

Calculating Compensation

Compensation includes *wages and cash compensation* plus *benefits*.

Wages and Cash Compensation

Wages and cash compensation includes W-2 wages, net distributive income, and other items.

Per-Person Limit. Wages and cash compensation is subject to a per-person limit. For reports originally due in 2010 and 2011, the limit is $320,000 per person. For reports originally due in 2008 and 2009, the limit was $300,000 per person. The per-person limit will be adjusted biennially for inflation.

An entity that makes payments of W-2 wages and reports Schedule K-1 income to a single individual must aggregate those payments to determine the amount of compensation.

Example 6C-1 Aggregating W-2 wages and income report on a Schedule K-1.

Bob is the owner and national sales manager for TexCo, LLC. TexCo reports income to Bob on a Schedule K-1. It also pays Bob a salary and reports it to him on a Form W-2. The W-2 wages and K-1 distributive income must be aggregated before applying the $320,000 cap (for reports originally due in 2010 and 2011).

An entity that makes payments of W-2 wages and payments reportable on Form 1099 to the same individual may only include the W-2 wages in compensation.

Example 6C-2 Aggregating W-2 wages and income reported on a Form 1099.

John is a regional sales manager for TexCo, LLC. It pays John a regular salary and also pays him a commission for sales his group makes during the period on which margin is based. TexCo reports the wages to John on a Form W-2 and the sales commissions on Form 1099. TexCo may include only the W-2 wages and not the 1099 amounts in computing compensation.

Combined Groups. The limit is applied on a combined group basis. Therefore, if multiple members of a combined group make payments or distributions to a single person, those payments or distributions are aggregated for purposes of applying the limit.

Requirement to Annualize. A taxpayer filing a report for less than a 12-month period must annualize or prorate the per-person compensation.

Example 6C-3 Annualizing the $320,000 limit.

BigCo, LLC, is a calendar year taxpayer that ceases operations on June 30, 2010. BigCo files a final franchise tax report covering the period January 1, 2010 through June 30, 2010. BigCo is limited to a compensation deduction of $160,000 per person ($^{6}/_{12} \times \$320{,}000$) in calculating the compensation deduction.

Wages and Cash Compensation

Wages and cash compensation includes traditional wages, net distributive income, stock compensation, and other forms of compensation.

W-2 Wages

Wages and cash compensation includes the amount entered in the "Medicare wages and tips" box of IRS Form W-2 (or any subsequent form that the IRS may issue with a different number or designation that substantially provides the same information).

Medicare wages and tips is reported on Form W-2, Box 5. It generally includes—

- Total wages (before payroll deductions).
- Tips.
- Elective deferrals to certain qualified cash or deferred compensation arrangements.
- Elective deferrals to certain qualified retirement plans.
- Designated Roth contributions made under an IRC Sec. 401(k) plan.
- Designated Roth contributions made under an IRC Sec. 403(b) salary reduction agreement.
- Signing bonuses an employer pays for signing or ratifying an employment contract.
- Taxable cost of group term life insurance over $50,000.
- Certain costs of accident and health insurance premiums for 2% or more shareholder-employees paid by an S corporation.
- Employee and nonexcludable employer contributions to a medical savings account or health savings account.
- Employee contributions to a SIMPLE retirement account.
- Qualified adoption benefits under an adoption assistance program.

Net Distributive Income

Wages and cash compensation includes net distributive income from certain taxable entities to a natural person. *Net distributive income* is the net amount of income, gain, deduction, or loss relating to a pass-through entity or disregarded entity reportable to the owners for the tax year of the entity.

Type of Entity Requirement. The deduction for net distributive income taken by taxable entities are treated as partnerships, S corporations, or sole proprietorships for federal tax purposes. This includes standard partnerships, LLCs treated as partnerships or sole proprietorships, trusts treated as partnerships or sole proprietorships, corporations treated as S corporations, and other similar entities.

Natural Person Requirement. To qualify for the deduction, the net distributive income must be payable to a natural person. Net distributive income payable to a legal entity does not qualify.

Stock Awards and Stock Options

Stock awards and stock options are also includable in compensation to the extent the taxable entity is eligible to deduct them for federal tax purposes. Stock awards are outright transfers of a corporation's stock. Stock options are grants of rights to purchase a corporation's stock.

Limit on Wages and Cash Compensation

Per-Person Limit

Wages and cash compensation is subject to a per-person limit for each 12-month period on which margin is based. For reports originally due in 2010 and 2011, the limit is $320,000 per person. For reports originally due in 2008 and 2009, the limit was $300,000 per person. The per-person limit will be adjusted biennially for inflation.

Combined Groups

The $320,000 per-person compensation deduction limit is applied on a combined group basis. If multiple members of a combined group make payments or distributions to a single person, those payments or distributions are aggregated for purposes of applying the limit.

Example 6E-1 Applying the $320,000 cap on compensation.

Mark works as chief financial officer for Parent Corporation. He also assists Parent Corporation's three subsidiaries and manages their chief financial officers. Mark receives compensation of $135,000 from the Parent Corporation, plus $75,000 from each of the subsidiaries. Parent Corporation and its subsidiaries are 100% commonly owned and operate as a unitary business. Therefore, they are required to file a combined group report. The total compensation to Mark is $360,000. Even though the payments from each of the entities is less than the $320,000 limit, the combined group may only include $320,000 of the compensation payments.

Example 6E-2 Shifting compensation to benefits may increase the compensation deduction.

Consider the same facts as in Example 6E-1. Parent Corporation changes the compensation arrangement for Mark, such that $40,000 of his compensation is in the form of benefits, which are not includable on Form W-2, Box 5, Medicare Wages and Tips. Now, the combined group may include the $300,000 in compensation, plus it may include the $60,000 of benefits, to the extent they are deductible for federal tax purposes.

Inflation Adjustment

The per-person limit will be adjusted biennially with relation to the consumer price index. On January 1 of each even-numbered year, the amount will increase or decrease by the percentage increase or decrease during the preceding state fiscal biennium in the consumer price index. The adjusted number will be rounded to the nearest $10,000.

For reports originally due in 2008 and 2009, the limit was $300,000 per person. For reports originally due in 2010 and 2011, the limit is $320,000 per person. The next scheduled inflation adjustment will occur January 1, 2012.

Benefits

Benefits include workers' compensation benefits, health care, employer contributions made to employees' health savings accounts, and retirement. Benefits are includable in compensation to the extent they are deductible for federal tax purposes. A taxable entity may include in compensation the cost of benefits it provides to its officers, directors, owners, partners, and employees.

Workers' Compensation

Workers' compensation benefits are generally those that are mandated by statute to compensate employees for occupational injuries or illness. However, federal law also treats as workers' compensation payments made to compensate employees for employment-related disabilities.

In Texas, the Workers' Compensation Division of the Texas Department of Insurance is the state agency that regulates the delivery of workers' compensation benefits to injured employees and to eligible family members of

employees who are killed on the job. The state does not pay benefits directly. Instead, employers purchase plans from workers' compensation insurance companies.

In Texas, workers' compensation insurance will generally replace a portion of the employees' wages if a work-related injury or illness causes them to lose all or part of their wages for seven days or more. The payments an entity makes for workers' compensation insurance are includable in compensation for purposes of calculating the compensation deduction.

Health Care

Health care benefits include employer contributions to the cost of health insurance and other health-related benefits. The expenses pertaining to health care benefits are includable in compensation to the extent the taxable entity paying the benefits may deduct the costs for federal tax purposes.

Employee Health Savings Accounts

A health savings account (HSA) allows employees to set aside pre-tax dollars for future medical, retirement, or long-term care expenses. The HSA allows employees to invest the funds in the account and to use them for qualified expenses when they need them. HSA funds can roll over from year to year and are portable when an employee changes jobs. An employer's expenses incurred in connection with health savings accounts are includable in compensation for purposes of calculating the compensation deduction.

Retirement Benefits

The Internal Revenue Code establishes various types of retirement accounts including, 401(k)s, 403(b)s, IRAs, pension plans, Keoghs, SIMPLEs, SEPs, and others. Costs incurred in connection with these plans are includable in compensation to the extent the employer may deduct them for federal tax purposes.

Limitations on Benefits

The following paragraphs discuss items that are not deductible because they are not included in the term *benefits*.

Wages and Cash Compensation

If an item is already included in the calculation of wages and cash compensation, it may not be included twice, even though it may also meet the definition of a *benefit*. This includes health care and other benefits required to be reported in Box 5 of Form W-2 (Medicare Wages and Tips).

Employee Discounts

A taxable entity is not allowed to include in benefits any amounts associated with discounts on the entity's own merchandise for its employees, officers, directors, owners, or partners that are not available to other customers.

Employer's Share of Payroll Taxes

A taxable entity may not deduct the employer's share of FICA, federal unemployment taxes, state unemployment taxes, social security, and other employment taxes. Only the employee's portion is includable, as a part of wages and cash compensation, but not as a benefit.

Working Condition Fringe Benefits

A taxable entity may not deduct expenses incurred in connection with working condition fringe benefits. Working condition fringe benefits are those provided for employees to be able to perform their work. This includes benefits such as travel reimbursements, use of a company car for business purposes, job-related education expenses, and similar benefits.

Employee's Share of Contributions

The employer's deduction for benefits does not include employee contributions. This includes employee contributions associated with health care plans (e.g., deductibles and co-pays), employee contributions in connection with retirement accounts, employee payments made to exercise stock options, etc.

Nondeductible Expenses

Excluded items

A taxable entity may not deduct as compensation items that have been excluded from revenues.

The Comptroller's rules direct taxpayers to use a reasonable basis to allocate compensation between included and excluded revenues.

Undocumented Workers

A taxable entity may not deduct wages and cash compensation to undocumented workers. *Undocumented workers* are those who are not lawfully entitled to be present and employed in the United States. This includes payments made to migrant farm workers who raise animals or livestock, grow or harvest crops, or sever timber from realty. The statute does not specifically restrict payment of benefits to undocumented workers.

Armed Forces Housing

A taxable entity may not deduct the compensation costs of operating a facility located on property leased or owned by the federal government and managed or operated primarily to house members of the United States armed forces. This includes wages and cash compensation and benefits.

Employer's Share of Payroll Taxes

A taxable entity may not deduct the employer's share of FICA, federal unemployment taxes, state unemployment taxes, social security, and other employment taxes. Only the employee's portion is includable, as a part of wages and cash compensation, but not as a benefit.

Additional Deduction for Military Compensation

In addition to the regular compensation deduction, taxpayers may deduct compensation paid to military workers on active military duty.

Availability of Deduction

This deduction is available both for employers electing to deduct compensation and employers electing to deduct cost of goods sold. It is not available for taxpayers who elect the standard 30% deduction from total revenues.

Calculating Additional Military Compensation

Eligible taxpayers may subtract compensation paid to individuals during the period they are serving on active duty as a member of the United States armed forces. To qualify, the individual receiving the compensation must be a Texas resident at the time he or she is ordered to active duty.

The statute references *compensation*. Presumptively, this would equal compensation, plus benefits for active duty military personnel. This presumably also includes net distributive income allocable to natural person partners who are serving on active duty.

Cost of Training

In addition to compensation, eligible taxpayers may deduct the costs of training a replacement for the individual who is serving on active military duty.

Additional Deduction for Health Care Benefits

Small employers electing to deduct compensation may also deduct an additional amount for new health care plans.

The margin tax statute defines *small employer* by reference to the Texas Insurance Code Sec. 1501.002. The Insurance Code defines *small employer* as a person who employed an average of at least two employees but no more than 50 eligible employees on business days during the preceding calendar year and who employs at least two employees on the first day of the plan year. The term includes a governmental entity. For purposes of this definition, a partnership is the employer of a partner.

The additional deduction applies only to a small employer that has not provided health care benefits to any of its employees in the calendar year preceding the beginning date of its franchise tax reporting period. The additional deduction for health care benefits is in addition to the regular compensation deduction for health care and other benefits. To qualify for the health care deduction, the entity must elect to deduct compensation for the applicable taxable years. The deduction applies to the first two years the taxpayer reports its franchise tax using the margin calculation. The taxable entity must provide health care benefits to all of its employees.

Amount of Deduction—First 12 Months

For the first 12-month period on which margin is based and in which the taxable entity provides health care benefits to all of its employees, the taxpayer may deduct an additional amount equal to 50% of the cost of health care benefits provided to its employees for that period.

Amount of Deduction—Second 12 Months

For the second 12-month period on which margin is based and in which the taxable entity provides health care benefits to all of its employees, the taxpayer may deduct an additional amount equal to 25% of the cost of health care benefits provided to its employees for that period.

Employee's Contributions Not Included

The additional health care deduction does not include amounts representing the employee's contributions.

Management Companies

Management Companies and Managed Entities

Management Company. A management company is an entity that conducts all or part of another entity's active trade or business for a fee. The management company must be formed as a corporation, a limited liability company, or other form of limited liability entity, and it must receive a reimbursement of specified expenses from the managed entity, plus a fee.

To qualify as a management company, the entity must perform active and substantial management and operational functions, control and direct the daily operations and provide services such as accounting, general administration, legal, financial or similar services. If the entity does not conduct all of the active trade or business of an entity, the entity must conduct all of the operations described above, for a distinct revenue-producing component of the entity.

Managed Entity. A managed entity is a taxable entity managed by a management company.

Reimbursement Structure. To qualify for special treatment, a management company must comply with the reimbursement structure set forth in the statute. Accordingly, it must receive a management fee plus a reimbursement of specified costs. Specified costs are those incurred in conducting the active trade or business of the managed entity and must include wages and cash compensation.

Special Rules for Management Companies

Nondeductible Expenses. A management company may not deduct any expense that is reimbursed by the managed entity.

Deductible Compensation. A management company may deduct as compensation only expenses that are *not* reimbursed by the managed entity. Thus, a management company's compensation deduction generally is limited to the wages and cash compensation plus benefits it pays or provides to its own managers and staff.

Revenue Exclusion. A management company is allowed to exclude reimbursements of specified costs from its total revenues. These are the specified costs the management company incurred in conducting the active trade or business of the managed entity, including the costs of wages and cash compensation.

Special Rules for Managed Entities

Deductible Expenses. The managed entity is allowed to treat the reimbursements (paid to the management company) as if the reimbursed amounts had been paid to its own employees. Thus, the managed entity is allowed to take a deduction for the wages and cash compensation the management company pays to the managed entity's workers. The managed entity is also allowed to deduct any benefits that it directly provides to its own workers.

Staff Leasing Companies

Staff Leasing Companies and Client Companies

Businesses often hire staff leasing companies to reduce the administrative burdens and expenses associated with having employees. Staff leasing companies hire the business's workers and then *lease* them back to the business. The staff leasing company handles the burdens of payroll tax reporting, employee benefit administration, and other administrative tasks, in exchange for a fee. The client company pays the staff leasing company a fee that generally covers its expenses, plus its profit margin.

Staff Leasing Companies. The franchise tax statute defines a staff leasing company by reference to Chapter 91 of the Texas Labor Code.

Temporary Employment Services. Temporary employment services are also included in the definition of staff leasing companies. Thus, the special rules discussed in this lesson for staff leasing companies and their clients apply to temporary employment services and their clients.

Client Company. A client company is a person who contracts with a licensed staff leasing company and is assigned employees by the staff leasing company.

Client companies of staff leasing companies may include eligible payments in compensation even though the staff leasing company makes the payments.

Special Rules for Staff Leasing Company

Deductible Expenses. A staff leasing company is allowed to deduct wages and cash compensation, payroll taxes, and employee benefits only if they are incurred in connection with its own employees, officers, directors, partners or owners who are not leased employees.

Nondeductible Expenses. Staff leasing companies are not allowed to deduct expenses that have been reimbursed by a client company and excluded from revenues. Therefore, a staff leasing company may not deduct expenses incurred on behalf of the leased employees. Nondeductible expenses include wages and cash compensation, payroll taxes, and employee benefits, including workers' compensation.

Revenue Exclusions. Consistent with the allocation of deductions to the client company, a staff leasing company may exclude from revenues the payments associated with reimbursed employee expenses. The fees the staff leasing company earns are included in its revenues.

Special Rules for Client Companies

Deductible Expenses. A client company may deduct wages and cash compensation, plus benefits, associated with the leased employees. In calculating compensation, the client company may rely on information provided by the

staff leasing company. The staff leasing company is allowed to report the deductible amounts to its client companies on its invoice or on a form promulgated by the Comptroller.

Nondeductible Expenses. The client company may not deduct the expenses it pays to the staff leasing company for administrative fees and other costs. The client company may also not deduct payments for the employer portion of payroll taxes paid in connection with the leased employees.

Temporary Employment Services

Temporary employment services are also included in the definition of staff leasing companies. Thus, the special rules discussed for staff leasing companies and their clients apply to temporary employment services and their clients.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

31. Which of the following payments is **not** includible in the compensation deduction?

    a. Payments of tips reported on Form W-2.

    b. Stock options reported on Form W-2.

    c. Net distributive income reported on Form K-1.

    d. Direct labor costs reported on Form 1099.

32. Which of the following payments would be a deductible compensation expense subject to the $300,000 limitation?

    a. Workers' compensation payments that are deductible for federal tax purposes.

    b. Health care benefit payments that are deductible for federal tax purposes.

    c. Elective deferrals to certain qualified cash or deferred compensation arrangements that are deductible for federal tax purposes.

    d. The employer's share of FICA, federal unemployment taxes, state unemployment taxes, social security, and other employment taxes.

33. Which of the following is correct with respect to the compensation deduction for the Texas franchise tax?

    a. Staff leasing companies may deduct compensation paid to leased employees.

    b. Staff leasing companies' clients may deduct compensation paid to leased employees.

    c. In order to qualify for special treatment under the Texas franchise tax, staff leasing companies must receive a staff leasing fee plus a reimbursement of specified costs.

    d. In order to qualify for special treatment under the Texas margin tax, staff leasing companies must manufacture or sell goods.

34. Which of the following is **not** a requirement for a management company to exclude revenues associated with compensation paid on behalf of managed entities?

    a. A management company must be organized as a corporation, limited liability company, or other limited liability entity.

    b. A management company must qualify as a management company under Chapter 91 of the Texas Labor Code.

    c. A management company must receive reimbursement of specified costs incurred in the conduct of the active trade or business of the managed entity, including wages and cash compensation.

    d. A management company must conduct all or part of the active trade or business of another entity in exchange for a management fee.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

31. Which of the following payments is **not** includible in the compensation deduction? **(Page 131)**

    a. Payments of tips reported on Form W-2. [This answer is incorrect. This is includible in the compensation deduction per TTC Sec. 171.1013(a).]

    b. Stock options reported on Form W-2. [This answer is incorrect. This is includible in the compensation deduction. Stock awards and stock options are includible in compensation to the extent the taxable entity is eligible to deduct them for federal tax purposes.]

    c. Net distributive income reported on Form K-1. [This answer is incorrect. Net distributive income is includible in compensation deduction to the extent it is payable to a natural person per TTC Sec. 171.1013(a).]

    d. Direct labor costs reported on Form 1099. [This answer is correct. Payments to independent contractors reportable on Form 1099 are not includible in the compensation deduction.]

32. Which of the following payments would be a deductible compensation expense subject to the $320,000 limitation? **(Page 131)**

    a. Workers' compensation payments that are deductible for federal tax purposes. [This answer is incorrect. Workers compensation payments are benefits that are includible in compensation but are not subject to the $320,000 limit.]

    b. Health care benefit payments that are deductible for federal tax purposes. [This answer is incorrect. Health care benefits are includible in compensation but are not subject to the $320,000 limit.]

    c. Elective deferrals to certain qualified cash or deferred compensation arrangements that are deductible for federal tax purposes. [This answer is correct. This is part of "wages and cash compensation" which is includible in the compensation deduction and is subject to the $320,000 limit.]

    d. The employer's share of FICA, federal unemployment taxes, state unemployment taxes, social security, and other employment taxes. [This answer is incorrect. According to TAC Rule 3.589(e)(2)(B), these payments are not deductible under the compensation deduction.]

33. Which of the following is correct with respect to the compensation deduction for the Texas franchise tax? **(Page 138)**

    a. Staff leasing companies may deduct compensation paid to leased employees. [This answer is incorrect. According to TTC Sec. 171.0001(6), staff leasing companies may not deduct compensation payments for leased employees.]

    b. Staff leasing companies' clients may deduct compensation paid to leased employees. [This answer is correct. Client's of staff leasing companies may deduct compensation paid to leased employees on the client's behalf by the leasing companies.]

    c. In order to qualify for special treatment under the Texas franchise tax, staff leasing companies must receive a staff leasing fee plus a reimbursement of specified costs. [This answer is incorrect. This is a requirement for management companies not staff leasing companies.]

    d. In order to qualify for special treatment under the Texas franchise tax, staff leasing companies must manufacture or sell goods. [This answer is incorrect. This is a requirement for the cost of goods sold deduction—not the compensation deduction.]

34. Which of the following is **not** a requirement for a management company to exclude revenues associated with compensation paid on behalf of managed entities? **(Page 138)**

    a. A management company must be organized as a corporation, limited liability company, or other limited liability entity. [This answer is incorrect. This is a requirement for a management company.]

    b. A management company must qualify as a management company under Chapter 91 of the Texas Labor Code. [This answer is correct. This is not a requirement for a management company to exclude revenues. This is a requirement for Staff Leasing companies.]

    c. A management company must receive reimbursement of specified costs incurred in the conduct of the active trade or business of the managed entity, including wages and cash compensation. [This answer is incorrect. This is a requirement for management company treatment under the Texas Tax Code.]

    d. A management company must conduct all or part of the active trade or business of another entity in exchange for a management fee. [This answer is incorrect. This is a requirement for management company treatment under the Texas Tax Code.]

EXAMINATION FOR CPE CREDIT

Lesson 6 (TFTTG101)

Determine the best answer for each question below. Then mark your answer choice on the Examination for CPE Credit Answer Sheet located in the back of this workbook or by logging onto the Online Grading System.

33. A limited partnership pays wages and cash compensation of $100,000 to Employee A, $400,000 to Employee B, and $300,000 to Contractor C. It reports $450,000 of net distributive income each to Partner D and Partner E, both of whom are natural persons. What is the limited partnership's compensation deduction?

    a. $1,700,000.

    b. $1,060,000.

    c. $1,300,000.

    d. $1,000,000.

34. A single-member LLC compensates its owner for direct labor to manufacture goods for sale. According to the Comptroller's rules, how may the business deduct the cost?

    a. As a direct labor cost under the cost of goods sold deduction.

    b. As an indirect labor cost under the cost of goods sold deduction.

    c. As net distributive income paid to a natural person.

    d. As tip income reportable on Form W-2 Box 5.

35. Which of the following increases the compensation deduction, thereby decreasing margin?

    a. Net distributive income reportable to a single member LLC on Form K-1 but not paid out during the period on which margin is based.

    b. Net distributive income reportable to a single member LLC on Form K-1 and paid out during the period on which margin is based.

    c. Net distributive losses reportable to a natural on Form K-1.

    d. Net distributive income reportable to a natural person on Form K-1 but not paid out during the period on which margin is based.

36. A limited partnership pays wages and cash compensation of $100,000 to Employee A, and $400,000 to Employee B. It pays benefits of $150,000 to Employee A and $600,000 to Employee B. What is the limited partnership's compensation deduction?

    a. $1,250,000.

    b. $1,170,000.

    c. $1,150,000.

    d. $850,000.

Lesson 7: Combined Reporting

INTRODUCTION

The revised Texas franchise tax requires combined group reporting for certain related entities. Combined reporting is different from federal consolidated reporting. The combined reporting rules apply to affiliated entities that are engaged in a unitary business. To determine which entities are required to file a combined report, a return preparer must (1) identify which entities are affiliated, and (2) determine whether the entities are engaged in a unitary business. The determination of affiliation is based upon common ownership. The determination of a unitary business is a fact-intensive analysis of how the businesses operate.

Learning Objectives:

Completion of this lesson will enable you to:

- Apply the attribution rules, affiliation rules and waters edge test to identify which entities are includible in a combined group.
- Discuss the elements of unitary businesses.

Combined Groups

Combined Groups Are Taxable Entities

The definition of taxable entities subject to the franchise tax includes the combined group.

A *combined group* is defined as a group of taxable entities that are part of an affiliated group engaged in a unitary business and that are required to file a group report. Only taxable entities may be members of the combined group.

In Texas, combined reporting is compulsory as long as certain criteria are met. Affiliated entities engaged in a unitary business are required to file a combined report.

Group Level Election of COGS or Compensation

The franchise tax statute requires members of a combined group to make a single choice of deduction (cost of goods sold, compensation, or the standard 30% deduction) in computing margin. The combined group then computes an apportionment factor and applies the tax rate. The tax rate is determined based on revenues from the activities of the combined group as a whole, after intercompany eliminations.

Group Level *De Minimis* Rules

A combined group is not required to pay the franchise tax if the combined total revenues of the combined group members do not exceed the minimum threshold for taxability ($320,000 for 2008 and 2009, $1 million for 2010 and 2011, and $600,000 for 2012 onward). These amounts are determined after eliminating intercompany transactions from revenue. Regardless of whether the combined group is required to pay the tax, the group will still be required to file certain information reports for the combined group members.

Group Level EZ Computation and Tax Discounts

A combined group may use the EZ computation if the combined revenues do not exceed $10 million. For 2008 and 2009, the combined group was entitled to small business discounts ranging from 80% to 20% if the entities' combined revenues were less than $900,000. For 2010 and 2011, the small business discounts are no longer relevant because the minimum combined revenue amount is $1,000,000. For 2012 onward, the combined group will be entitled to small business discounts ranging from 40% to 20% if the entities' combined revenues are less than $900,000. These amounts are determined after eliminating intercompany transactions from revenue.

Applicable Tax Rate

The combined group revenues also determine which tax rate applies to the combined group. Most taxable entities use a tax rate of 1%. However, taxable entities with more than 50% of their revenues from retail or wholesale

business activities may qualify for the reduced rate of 1/2 of 1% (.005). For a combined group, the analysis is performed using combined group revenues after eliminating intercompany transactions.

Affiliated Groups

Common Ownership or Control

Affiliated groups are those that share more than 50% common ownership or control. An *affiliated group* is defined as a group of 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. Unlike the federal tax consolidation provisions, which only allow combination of like-kind entities, the franchise tax affiliation rules may result in the affiliation of various types of entities in the same affiliated group.

Controlling Interest

A controlling interest is defined differently for different types of entities:

Corporations. For corporations, a controlling interest is (1) more than 50% direct or indirect ownership of the total combined voting power of all classes of stock, or (2) more than 50% direct or indirect beneficial ownership in the voting stock of the corporation.

Limited Liability Companies. For limited liability companies, a controlling interest is (1) more than 50% direct or indirect ownership of the total membership interest in the LLC, or (2) more than 50 % of the direct or indirect beneficial ownership interest in the LLC membership interests.

Other Entities. For partnerships, associations, trusts, or other entities, a controlling interest is more than 50% direct or indirect interest in capital, profits, or beneficial interest in the entity.

Attribution Rules. The franchise tax statute does not provide attribution rules for determining what constitutes indirect ownership. The Comptroller's Rules attribute a lower-level entity's ownership to an upper-level entity as long as the upper-level entity holds more than 50% ownership in the lower-level entity. The Comptroller's rules also attribute one spouse's ownership interest to the other spouse, regardless of whether the interest constitutes community property or separate property.

Beneficial Ownership. In construing the definition of *affiliated groups*, the Comptroller's Rules ignore the statutory term *or owners* and treat entities as affiliated only if a single owner holds more than 50% ownership. Neither the franchise tax statute nor the Rules define what is meant by "beneficial" ownership.

Examples. The following four examples illustrating the concept of controlling interest come directly from the Comptroller's Rules.

Example 7B-1 Corporate attribution.

Corporation A owns 10% of Corporation C and 60% of Corporation B, which owns 41% of Corporation C.

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

Example 7B-2 Attribution among various types of entities.

Corporation A owns 10% of Limited Liability Company C and 15% of Corporation B, which owns 90% of Limited Liability Company C.

Corporation A does not have controlling interest in Limited Liability Company C and does not have a controlling interest in Corporation B. Corporation B has a controlling interest in Limited Liability Company C.

Example 7B-3 Attribution through a natural person.

Individual A owns 100% of 10 corporations, each of which owns 10% of Partnership B. Individual A has a controlling interest in each of the ten corporations and in Partnership B.

Example 7B-4 Indirect controlling interest.

Corporation A holds a 70% interest in Partnership B that owns 60% of Limited Liability Company C. Corporation A owns the remaining 40% of Limited Liability Company C.

Corporation A owns a controlling interest in Partnership B and a 100% controlling interest in Limited Liability Company C.

Example 7B-5 Cross-interests.

Individuals A and B each own 50% of Partnership X. Individuals A and B each also own 50% of Partnership Y. Individuals A and B are not husband and wife. Since neither individual owns more than 50% of each partnership, neither individual has a controlling interest in the partnership.

Facts and Circumstances. The Comptroller's Rules leave room for the Comptroller to apply a facts and circumstances test to determine whether a group of entities is affiliated for franchise tax reporting purposes. The Rules state that the Comptroller may consider any circumstance that tends to demonstrate whether the more than 50% direct or indirect common ownership test was met.

Certain Affiliated Entities Are Excluded. Certain entities (such as passive entities, exempt entities, or predominately foreign entities) are not includible in a combined group, even though they share common ownership with other entities.

However, the fact that one entity is not a member of a combined group does not prevent it from being affiliated. This is relevant for purposes of the affiliation tests for cost of goods sold, which require that affiliated entities use arms-length pricing, and which allow entities to treat themselves as the owners of goods if an affiliate owns the goods. This is also relevant for purposes of disallowing certain oil and gas revenues from an entity's passive revenues for purposes of determining whether it qualifies as a passive entity.

Moreover, an entity owned by an excluded entity may be includible in a combined group, even if its direct owner is not a group member.

Example 7B-6 Downstream attribution.

Top Corporation owns 60% each of (1) Corporation A, (2) Limited Liability Company B, and (3) Limited Liability Partnership C. In addition, A, B, and C each own 33% of Bottom Corporation.

Bottom Corporation is treated as an affiliate of Top Corporation because Top controls A, B, and C. A's, B's, and C's ownership in Bottom is attributed to Top because Top owns more than 50% of A, B, and C. The aggregate 99% ownership in Bottom flows through to Top under the Comptroller's attribution rules.

Example 7B-7 Downstream attribution with excluded entities.

Consider the same facts as in Example 7B-6, but Corporation A is an insurance company that pays the insurance gross premiums tax, and Limited Liability Partnership C is a passive investment partnership that earns more than 90% of its revenues from passive sources.

Even though A and C are not includible in a combined group, their ownership in Bottom Corporation is still attributed to Top Corporation under the attribution rules. Therefore, Top Corporation would still be treated as owning and controlling Bottom Corporation, even though two of the middle-tier entities are not be included in the combined group.

Top Corporation, Bottom Corporation, and Limited Liability Company B would still be potential combined group members, presuming they are engaged in a unitary business.

Family Attribution. The Comptroller's attribution rules do not require familial attribution of brothers, sisters, parents, grandparents, and other similar relationships. However, the Comptroller's Rules treat spouses as one owner for purposes of determining whether entities are affiliated. The Comptroller's stated intent is to attribute spousal ownership regardless of whether the property owned is separate or community property.

Example 7B-8 Inability to affiliate can result in double taxation of intercompany transactions.

Betty and Sue are unrelated individuals. Betty and Sue each own 50% of Service Corporation. They also own 50% of Real Estate Partnership which owns and leases property to Service Corporation.

Because Betty and Sue are unrelated individuals and neither owns more than 50% of Service Corporation or Real Estate Partnership, the entities are not considered affiliated for Texas franchise tax purposes. This means that they cannot file as a combined group.

Because they cannot file as a combined group, they are unable to eliminate the intercompany rental payments from Service Corporation to Real Estate Partnership.

Because Service Corporation is ineligible for the cost of goods sold deduction, Service Corporation may not deduct the rental payments it makes to Real Estate Partnership in computing its taxable margin. Therefore, a portion of Service Corporation's revenues are effectively taxed twice, once as revenues in Service Corporation's taxable margin and again as rental receipts in Real Estate Partnership's taxable margin.

Example 7B-9 Family attribution is not considered in determining affiliation.

Consider the same facts as in Example 7B-8, except Betty and Sue are mother and daughter.

Betty's and Sue's ownership interests are not attributed to each other. Therefore, Service Corporation and Real Estate Partnership are still not affiliated for Texas franchise tax purposes and cannot file as a combined group. The intercompany rental payments continue to be taxed twice, once as revenues in Service Corporation's taxable margin and again as rental receipts in Real Estate Partnership's taxable margin.

Example 7B-10 Spousal attribution is considered in determining affiliation.

Consider the same facts as in Example 7B-8, except Betty and her husband Tom each own 50% of Service Corporation and Real Estate partnership.

Under these facts, the Comptroller will attribute the ownership to each of the spouses, treating them as one owner. Now Service Corporation and Real Estate Partnership are treated as having 100% common ownership and are affiliated for Texas franchise tax purposes. If the businesses are considered unitary, they will be required to file a combined group report.

Presuming the businesses are unitary, they will be required to file a combined group report. Even though they are engaged in different lines of business, Service Corporation and Retail Company must make a common election to deduct either cost of goods sold, compensation, or the standard 30% deduction.

Moreover, Service Corporation and Retail Company are considered as a group, after intercompany eliminations, in determining whether the 0.5% tax rate for retailers and wholesalers will apply.

Termination of Affiliated Group Membership

Members of an affiliated group are determined annually. As ownership changes, the members of an affiliated group may change.

If an entity ceases to be a member of an affiliated group, or changes group membership during the year, that entity's margin may be divided among various combined group reports or the entity may report margin for only a

portion of the year. A particular entity could be a member of multiple combined groups during any particular taxable year.

Exceptions. The Comptroller's Rules provide for two exceptions to the normal termination of an affiliated group's membership.

Immediate Re-affiliation. The first exception applies to the sale, exchange, or other disposition of an affiliate. In this case, the affiliated group membership is not terminated if the common ownership requirements are again met immediately after the sale, exchange, or disposition. In other words, an entity will remain part of an affiliated group if the common ownership tests are met both before and after the transaction.

Re-affiliation within Two Years. The second exception allows the Comptroller to determine that an entity is part of an affiliated group if it regains affiliation status within a two-year period. Under this provision, the Comptroller may treat an affiliated group as remaining in place if the common ownership test is met again within a period not to exceed two years.

Unitary Businesses

Definition of a Unitary Business

A unitary business is defined as 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.

In determining whether a business is unitary, the Comptroller will consider any relevant factor, including whether the entities are (1) in the same line of business, (2) vertically integrated, or (3) functionally integrated.

Horizontal Integration (Same Line of Business)

A group of entities is generally considered to be in the same line of business if they engage in similar types of business activities. Examples are manufacturing, wholesaling, retail sales of tangible personal property, insurance, transportation, or finance.

Example 7C-1 Department stores.

Big Box Department Store Partnership owns a controlling interest in corporations located in Texas and various other states, which own and operate local department stores. Big Box Department Store Partnership also owns a controlling interest in Clothing Manufacturing Company, which manufactures men's and women's apparel.

Big Box Department Store Partnership provides a joint purchasing department for the corporations. It also provides monthly display advertising directions for window displays and purchases coordinated marketing via radio, television and print advertisements which are broadcast throughout the United States. Clothing Manufacturing Company supplies part, but not all, of the inventory sold in the corporate department stores.

Since these entities are engaged in the same line of business, they would likely be considered to be engaged in a unitary business.

Vertical Integration (Steps in a Process)

A group of entities is generally considered to be vertically integrated if each entity engages in one step or part of an integrated enterprise or process. Examples are the steps involved in the production of natural resources, including exploration, mining, refining, and marketing.

Example 7C-2 Oil and gas industry.

Exploration, LLP purchases geological survey data and other resources and identifies locations that may be suitable for oil and gas drilling and production. Production Company constructs oil and gas drilling rigs on the

locations identified by Exploration, LLP, and uses the equipment to raise minerals and natural resources to the earth.

Production Company uses the services of Well Servicing, LLC, to stimulate production. Well Servicing, LLC engages in well workover, fracturing acidizing, and other activities in order to stimulate production.

Once Production Company has brought the minerals to the surface, Pipeline Company transports the raw oil and gas to Refining Corporation.

Refining Corporation uses the raw materials to manufacture petroleum products and by-products for sale. Refining Corporation sells the manufactured products to Marketing Corporation, which in turn distributes the products to various entities it owns that operate gas stations throughout the state.

Bill Smith owns 100% of Exploration, LLP; Production Company; Well Servicing, LLC; Pipeline Company; Refining Corporation; Marketing Corporation; and the gas station entities. These entities will likely be considered to be engaged in a unitary business because they are vertically integrated.

Functional Integration (Strong Centralized Management)

A group of entities is generally considered to be functionally integrated if they reap benefits or flows of value from strong centralized management. Examples are authority over purchasing, financing, product line, personnel, and marketing.

Example 7C-3 Functional integration.

Christine's Cattle Company operates a ranch, where it raises heifers and steers. Christine's Cattle Company also owns a feed lot and slaughterhouse, Slice-N-Dice, LLC, which processes the cattle for further use.

Slice-N-Dice sells the hides to Tannery, LP. Tannery, processes the hides and sells them as leather to Big Tex Boot Factory, LLP. Big Tex Boot Factory uses the leather to manufacture boots, saddles, jackets, and belts, which it sells to third parties. Big Tex Boot Factory also owns and operates three subsidiaries, which sell the boots it manufactures, and other boots purchased from third parties.

Slice-N-Dice sells the rest of the cattle products to Meat Packing, Ltd. Meat Packing keeps the best cuts of meat for sale to its subsidiary, Neighborhood Butcher Block, Inc. It sells the rest of the products to third party butchers. It sells the bones and other byproducts to dog food companies for further processing. Neighborhood Butcher Block operates a chain of butcher shops in various neighborhoods located throughout Texas.

West Texas Investments, LLC, provides financial services and management services to Christine's Cattle Company; Slice-N-Dice, LLC; Tannery, LP; Big Tex Boot Factory, LLP; Meat Packing, Ltd.; and Neighborhood Butcher Block, Inc. It manages investments for each of the entities and pools their resources to effectuate risk management and generate economies of scale. It also handles the accounting and payroll aspects of the various businesses.

Even though not all of these entities are engaged in the same line of business, if they are commonly owned and controlled, they will likely be considered to be unitary. The businesses function in an integrated manner, which results in economies of scale, and flows of value among the various group members. The affiliated entities would likely be required to file a combined group report.

MeadWestvaco—No Operational Purpose Test. The *MeadWestvaco* case affirmed that the three factors for ascertaining whether there should be a unitary business, particularly when the asset of a business is another business are functional integration, centralized management and economies of scale. The Supreme Court clarified that its language regarding "operational purpose" should not be interpreted as an additional ground for apportionment.

The case in chief considered whether Illinois could constitutionally tax an apportioned share of the capital gain arising from an out-of-state corporation's sale of one of its business divisions. Mead, an Ohio corporation formed in 1864, was in the business of producing and selling paper, packaging, and school and office supplies. Mead also

owned an electronic research service, Lexis, which it had purchased in 1968 and sold in 1994. Mead did not report any of the gain from the sale on its Illinois business tax returns because it considered the proceeds to be nonbusiness income unrelated to the unitary business of Mead. The Illinois Department of Revenue audited Mead and assessed tax on the income from the sale of the electronic research service.

The U.S. Supreme Court evaluated whether Lexis was part of Mead's unitary business. Lexis had been a wholly owned subsidiary until 1980, when it merged into Mead. Lexis was subject to Mead's general oversight but a separate management team in Illinois directed its day to day business activities. Lexis and Mead maintained separate manufacturing, sales, and distribution facilities, as well as separate accounting, legal, human resources, credit and collections, purchasing, and marketing departments. Neither business was required to purchase goods or services from the other, nor did they receive discounts on purchases. In fact, Lexis purchased most of its paper from other suppliers, and neither entity was a significant customer of the other. Mead generally limited its involvement to approving Lexis' annual business plan and reviewing any significant corporate transactions (such as capital expenditures, financings, mergers and acquisitions, or joint ventures).

The trial court reasoned that Lexis and Mead could not be unitary because they were not functionally integrated or centrally managed and enjoyed no economies of scale. Nonetheless, the trial court required apportionment of the sale proceeds to Illinois because Lexis served an "operational purpose" in Mead's business, particularly in the allocation of resources. The appellate court affirmed. The Supreme Court vacated the appellate court's decision, stating that the Court did not intend its language regarding "operational purpose" to establish yet another means of identifying a unitary business. The Court remanded the case to the appellate Court for further review and declined to rule on whether the businesses were unitary.

Other Factors

The Comptroller's rules clarify that other factors may also be considered in determining whether a group of affiliated entities are engaged in a unitary business. This includes guidelines set forth in Supreme Court decisions that presume certain activities are unitary.

Example 7C-4 Other factors.

Bob Slob and Jane Neato are recently divorced from each other. Bob owns 10% of the stock in TE, Inc., Jane owns 80% of its stock, and an unrelated third party owns the other 10% of its stock. Clearly, Jane is in control of TE.

Bob also owns a 45% interest in Sub, Inc., which holds a patent on a critical process that TE uses in its very profitable business. TE also owns 45% of Sub and Bob's mother owns the other 10% of Sub. Bob's mother cannot be counted on to side with Jane in any corporate vote, and would probably vote to her detriment out of her ill will for Jane. Without the patented process, TE would not enjoy its significant market position and high profit margins. Bob's royalties from the patent are a major portion of his current income and used to discharge his child support obligations.

In this situation, it would appear that the technical definition of a combined group is not met. However, the convoluted family dynamics render it in both Bob and Jane's interest to run TE and Sub in a business-like and profitable manner despite any personal differences they may have with each other. So, in this situation, the Comptroller might want to recognize these extraordinary facts and circumstances and hold that a combined group exists even if the technical definition is not met.

Comptroller Presumptions

The Comptroller's Rules presume that all affiliated entities are presumed to be engaged in a unitary business. This appears to extend beyond the statute. It also appears to extend beyond the law set forth in other jurisdictions governing unitary taxation.

The Rules also presume that new entities are engaged in a unitary business with the entities that form or acquire them. The Rule provides that when a taxable entity acquires another entity, a presumption exists for finding a unitary relationship during the first reporting period. Any party may rebut such presumption by proving that the taxable

entities were not unitary. If such presumption is rebutted, then the taxable entities will not be considered unitary as of the date of acquisition. When a taxable entity forms another taxable entity, a unitary relationship exists as of the date of formation, unless the business is not unitary on a longer term basis. This rule appears to extend beyond the statute. It also appears to extend beyond the law set forth in other jurisdictions governing unitary taxation.

Inter-Company Pricing

The Comptroller considers a unitary business to be more likely if one entity supplies goods, services, or both, at a non-arm's-length price. The Comptroller's Rules warn that adhering to arm's-length pricing will not prevent businesses from being unitary.

Joint, Shared, or Common Activities

The Comptroller considers a unitary business to be more likely if various entities benefit from joint, shared, or common activities. Benefits may include cost-sharing, discounts, or other benefits. They may arise as a result of joint purchases, leaseholds, or other forms of joint, shared, or common activities between group members.

In determining whether affiliated entities are engaged in a unitary business, the Comptroller considers whether the joint, shared, or common activities pertain to income-producing activities. In doing so, the Comptroller considers the nature and character of each entity's operations and how they relate to each other. Considerations include such things as the entities' supply sources, the goods or services they produce or sell, the entities' labor force, and the market in which they operate. The more the joint, shared, or common activities directly relate to, are beneficial to, or are reasonably necessary for the entities' income-producing activities, the more likely the entities are to be unitary.

Included Entities

Entities that meet the affiliated entity ownership test and engage in a unitary business are required to file a combined group report. The filing of a combined report is not an election, but is required if the requisite elements of a combined group are present.

Non-Nexus Entities

Under the revised franchise tax, a combined group must include all eligible entities, even if they otherwise, on a stand-alone basis, would not have a sufficient connection with Texas to meet the constitutional nexus requirements. This means that an out-of-state entity may be subject to the tax, even if it sends no people into the state and does not rent or own any property in Texas. If the entity is commonly owned and engaged in a unitary business with an entity that has nexus in Texas, the out-of-state entity's business must be included in the combined group report.

Disregarded Entities

A combined group for Texas franchise tax purposes may include one or more entities that are disregarded for federal tax purposes. This includes partnerships and limited liability companies that are taxed as partnerships under federal law. This also includes single-member limited liability companies that are disregarded under federal law. In addition, S corporations and other pass-through entities must be included in a combined group to the extent they are affiliated with other entities engaged in a unitary business.

Excluded Entities

A combined group may not include certain entities that are otherwise affiliated and engaged in a unitary business. A combined group may desire to include certain entities if they have a significant volume of non-Texas sales or other features that would benefit the calculation of margin or apportionment. The franchise statue specifies that certain entities are not includible in the group, even if they otherwise would meet the definition of a combined group.

Exempt Entities

A combined group may not include an exempt entity. If an entity qualifies for franchise tax exemption, its business may not be included in the combined group report.

Passive Entities

Passive entities are not includible in the combined group. However, a taxable entity, including a combined group, must include its pro rata share of a passive entity's net income in calculating its total revenue. A passive entity's revenue is includible in margin, to the extent it was not generated by another taxable entity's margin.

For an entity to qualify as passive, it must be a partnership or trust, it must generate at least 90% of its revenues from passive sources, and less than 10% of its revenues must come from active sources.

Foreign Entities

Waters Edge Test

The Texas franchise tax applies a "waters-edge" test in determining which entities are includible in a combined group. Under the test, certain foreign entities may not be included in a combined group, even if they are commonly owned and engaged in a unitary business. For purposes of the waters-edge test, the term *foreign entity* refers to an entity outside the United States.

For purposes of the waters-edge test, the United States includes not only the 50 states and the District of Columbia, but also various other territories and possessions. It includes the United States territorial waters, including the seabed and subsoil of submarine areas that are adjacent to the United States territorial waters. These are the areas over which the United States has exclusive rights, under international law, with respect to exploring for or exploiting natural resources. It also includes United States possessions and territories and the Commonwealth of Puerto Rico.

The waters-edge test excludes a foreign entity from a combined report if the 80% or more of the entity's property and payroll are assigned to locations outside the United States. If the entity has no property or payroll, the test is applied to the entity's gross receipts in order to determine whether 80% of the entity's activities occur outside the United States.

Multistate Factoring Under the Multistate Tax Compact

The statute references the factoring provisions under the multistate tax compact terms set forth in Chapter 141 of the Texas Tax Code. The factoring provisions average the property factor and the payroll factor by adding them together and dividing by two.

Property Factor

In determining whether an entity is includible in a combined group, the first step is to calculate the property factor. The property factor is a ratio of the property located outside the United States divided by the entity's total property. Property is valued based on the average value of real and personal property rented or owned. The average value is determined by averaging the value of the property at the beginning and the end of the year for which the entity's margin is measured.

Property the entity owns is valued at its original cost. Property the entity leases or rents is valued at eight times the net annual rental rate. The net annual rental rate equals the amount the entity pays for renting or leasing the property less the amount the entity receives for any sub-rentals or sub-leases.

Payroll Factor

The payroll factor is calculated based on compensation paid during the year for which the entity's margin is measured. The numerator is the total amount paid to persons working outside the United States. The denominator is the total amount of compensation paid during the margin tax measurement year.

Texas considers services to be performed outside the United States if an individual performs services entirely outside the United States or if the individual performs services both inside and outside the United States, but the

services performed inside the United States are only incidental to the services performed outside the United States. A service is also considered to be performed outside the United States if some part of the service is performed outside the United States and the operations base or the place from where the service is directed or controlled is outside the United States. A service may be considered to be outside the United States if the base of operations or the place from which the service is directed or controlled is not in any location where some part of the service is performed, but the individual's residence is outside the United States.

No Property or Payroll

If an entity has no property or payroll, the denominator is one. Therefore, only the payroll or the property will be considered to determine whether the entity can be included in the combined group.

Also, if an entity has no property and no payroll, then the waters edge test is performed using gross receipts. If an entity has no property and no payroll and more than 80% of its gross receipts are apportioned to locations outside the United States, the entity is not includible in the combined group.

A foreign entity that is not allowed to be included in a combined group under the waters-edge test may still be subject to the franchise tax if it has nexus with Texas. If nexus exists, the foreign entity is required to file a separate margin tax report without the benefit of intercompany eliminations.

Combined Reporting Requirements

A combined group report is a franchise tax report that reports the business of all group members. Combined groups of taxable entities must file a combined group report in lieu of individual reports.

A combined group report includes the aggregated financial information for each member. The combined reporting allows for intercompany eliminations but does not allow one entity's financial losses to offset another entity's financial gains.

Mandatory Combined Reporting

Eligible entities are required to file combined group reports.

Taxable entities that are not included in a combined report must file a separate report if they are chartered or organized in Texas, or doing business in Texas.

Separate Public Information Reports

Even though an entity will be filing and reporting as part of combined group, each separate legal entity is still required to file its own public information report. A public information report or ownership information report must be filed for each member of the combined group.

Accounting Period

Combined group members must conform their accounting period for franchise tax reporting purposes. If two or more group members are also members of a consolidated group for federal tax purposes, they will use the federal tax consolidated group return period ending in the prior calendar year as the franchise tax accounting period. In all other situations, the reporting entity's federal tax period will determine the franchise tax accounting period.

If a member of a combined group has a different accounting year-end than the combined group's year-end, the reporting entity will calculate that member's revenue, cost of goods sold, compensation, and gross receipts using only the accounting data from the months that overlap the reporting entity's reporting period. The entity will need to prepare a pro-forma income statement, based upon federal income tax reporting method, for the period included in the group's account period to determine what amounts are reportable for Texas franchise tax purposes.

Combined Reporting of Revenues

A combined group calculates its revenues on a combined basis.

A combined group must first determine the total revenue of each of its members as if the member was an individual taxable entity. This means that entities filing consolidated federal tax returns must first remove the effects of consolidation before computing revenues.

Once the revenues are determined for each entity, those amounts are added together to determine the combined revenues. Then, the entities subtract intercompany payments to the extent they are included in revenues. The result is the combined revenue for the combined group.

Combined Reporting of Cost of Goods Sold

A combined group that elects to deduct cost of goods sold must do so on a combined group basis. All members of the combined group are limited by the election.

A combined group electing to deduct cost of goods sold must first determine the cost of goods sold for each individual member of the group on a stand-alone basis, as if each member of the combined group was a taxable entity.

Next, the group members add the cost of goods sold amounts together to arrive at a combined cost of goods sold.

Then, the combined group eliminates costs associated with transactions between members of the combined group, to the extent the associated revenues were eliminated in determining combined revenues.

The resulting cost of goods sold value is deducted from combined revenues to arrive at taxable margin, which is apportioned to Texas based upon gross receipts before the applicable rate is applied.

Arm's Length Requirement for Affiliates

The franchise tax statute imposes price restrictions on affiliated group members, which are similar to the federal transfer pricing regulations. The test applies to payments one affiliated group member makes to another affiliated group member that is not a member of the combined group. In such cases, the transactions between the affiliates may be subtracted as a cost of goods sold only if the transactions are made at arm's length.

The franchise tax statute defines *arm's length* as the standard of conduct under which entities that are not related parties and that have substantially equal bargaining power, each acting in its own interest, would negotiate or carry out a particular transaction.

Combined Reporting of Compensation

A combined group that elects to deduct compensation must do so on a combined group basis. All members of the combined group are limited by the election.

A combined group electing to deduct compensation must first determine the compensation for each individual member of the group on a stand-alone basis, as if each member of the combined group was a taxable entity.

Next, the group members add the compensation amounts together to arrive at a combined compensation. In determining combined compensation, wages and cash compensation is limited to $320,000 per person (for reports originally due in 2010 and 2011). The limit is adjusted biennially for inflation.

Then, the combined group eliminates costs associated with transactions between members of the combined group, to the extent the associated revenues were eliminated in determining combined revenues.

The resulting compensation value is deducted from combined revenues to arrive at taxable margin, which is apportioned to Texas based upon gross receipts before the applicable rate is applied.

Alternative Methods of Combined Reporting

A combined group that does not elect to deduct compensation or cost of goods sold is entitled to the 30% standard deduction. A combined group must elect a single deduction. The election may not be changed on an amended report.

A combined group is also eligible to elect the EZ computation. The EZ computation applies if the aggregate combined revenues are $10 million or less.

For reports originally due in 2008 and 2009, a combined group with aggregate combined revenues over $320,000 but less than $900,000 was eligible to claim a discount, ranging from 20% to 80%, of their computed franchise tax determined before subtracting the discount. For reports originally due in 2010 and 2011, tax discounts are not available.

Combined Apportionment

A combined group generally computes its apportionment fraction as if it were an individual taxable entity, as a ratio of Texas gross receipts to total gross receipts. The total gross receipts for apportionment purposes will generally equal the revenues for the combined group.

Non-Nexus Out-of-State Entities

In computing the combined group's Texas gross receipts, the group may exclude any Texas revenues attributable to the business activities of a group member who does not have any nexus with Texas. In general, a legal entity has no nexus, or connection, with Texas if it does not send any people into the state, for solicitation or for other purposes, and does not own or rent any real or personal property in Texas.

Example 7L-1 Texas parent and Texas sub.

Parent, LLC, owns 100% of Sub, LLC. They are engaged in a unitary business and both are located in Texas. Parent makes Texas sales of $750,000 and total sales of $1,200,000. Sub makes Texas sales of $150,000 and total sales of $300,000.

Since both Parent and Sub are located in Texas, they will include all of their Texas sales in the numerator. The apportionment fraction will be .6000 ($900,000 ÷ $1,500,000). Presuming total margin of $200,000, the taxable margin will be $200,000.

Example 7L-2 Out-of-state non-nexus parent and Texas sub.

Parent, LLC, owns 100% of Sub, LLC. They are engaged in a unitary business. Parent is located in New Mexico and has no nexus with Texas. Sub is located in Texas. Parent makes Texas sales of $750,000 and total sales of $1,200,000. Sub makes Texas sales of $150,000 and total sales of $300,000.

Since Parent is a non-nexus out-of-state entity, its Texas sales will not be included in the apportionment fraction. The apportionment fraction will be .1000 ($150,000 ÷ $1,500,000). Presuming total margin of $200,000, the taxable margin will be $20,000.

Solicitation Exemption under P.L. 86-272

The franchise tax statute specifies that Public Law 86-272 does not apply in determining whether a particular business has nexus for margin tax purposes.

Public Law 86-272 protects solicitation activities. In doing so, it prohibits a state from imposing a tax on net income where an out-of-state entity limits its activity within a state to soliciting orders for sales of tangible personal property. Public Law 86-272 defines a net income tax as any tax "imposed on, or measured by net income." The Texas Legislature has stated that the franchise tax is not intended to be an income tax under Public Law 86-272. This means that an out-of-state entity that sends persons into Texas solely for soliciting orders for sales of tangible personal property that are approved and filled from out-of-state will still be treated as having nexus in Texas for franchise tax purposes.

Anti-Abuse Provision

The franchise tax statute includes an anti-abuse provision, which prevents taxpayers from colluding with related non-nexus entities to convert Texas sales into non-Texas sales under the apportionment formula. Under this

provision, the numerator of the apportionment factor includes sales of tangible personal property that a non-nexus out-of-state entity purchases from a related entity with nexus and delivers to a purchaser in Texas without substantial modification.

Combined Credits

Credits are generally applied at the combined group level. Unless otherwise provided by law, the Comptroller has stated that credits may generally be applied against the combined tax liability of the combined group.

Combined Tax Rate

In determining whether a combined group qualifies for the 0.5% rate for wholesalers and retailers, the entire group's revenues are considered, after intercompany eliminations.

To qualify for the reduced tax rate, the combined group, as a whole, must generate more than half of its federal gross revenues from retail or wholesale trade, as defined in sections F and G of the 1987 Standard Industry Classification code handbook. In addition, more than half of the combined group's revenues must be generated by sales of products that were not manufactured by one of the group members.

Reporting Entity

The Comptroller's Rules provide that the reporting entity is the combined group's choice of an entity that is primarily responsible for filing the Texas franchise tax reports and paying the tax.

Choice of Reporting Entity

A combined group may select a reporting entity. The reporting entity will generally be the parent entity or the entity that has the most activity in Texas for the first year for which a combined report is filed. The reporting entity will be an entity subject to Texas' taxing jurisdiction.

Generally, a combined group will choose the parent entity as the reporting entity if it is part of the unitary business and has nexus with the state. Otherwise, the combined group will generally select an entity that (1) is a combined group member; (2) is subject to Texas' taxing jurisdiction; and (3) has the greatest Texas business activity during the first year that a combined report is required to be filed, as measured by the total revenue for that year.

Rights and Responsibilities

The reporting entity is responsible for timely filing the report and paying the franchise tax. The Rules consider any franchise tax elections that the reporting entity makes as binding on the combined group members as well.

The reporting entity is authorized to file refund claims, give waivers, and execute agreements on behalf of the combined group.

Notice

The Comptroller's Rules deem any refund claim, waiver given, agreement, or any other executed document to have also been provided or executed by each combined group member.

Joint and Several Liability

Although a combined group designates a primary reporting entity, the individual members of a combined group remain jointly and severally liable for the filing and reporting requirements.

Combined group members may also be held jointly and severally liable for any tax reported, plus any penalties and interest due on that tax.

Election to Include Disregarded Entity in Combined Group

The Comptroller's Rules allow a parent entity to incorporate a disregarded entity's revenues, cost of goods sold, compensation, and gross receipts as part of its franchise tax computation. If a parent entity chooses to elect the combination, the Comptroller will presume that the disregarded entity has nexus with the state. Therefore, the disregarded entity's gross receipts that are attributable to Texas would be includible in the numerator of the apportionment fraction. This election is not available if the disregarded entity is passive or otherwise exempt from the franchise tax.

Change in Reporting Entity

The Comptroller's Rules state that the reporting entity changes only when the entity is no longer subject to Texas' jurisdiction to tax or the reporting entity is no longer a member of the combined group.

There is an exception for parent entities, which can be the reporting entity of the combined group, even if they do not have nexus. When there is a change in the reporting entity resulting from a cessation of business in Texas, the combined group shall designate another qualifying entity as its reporting entity and notify the Comptroller of the designation.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

35. Which of the following is correct with respect to combined reporting?

    a. A passive entity may elect to be a member of a combined group.

    b. A combined group must choose a reporting entity that has previously been subject to the franchise tax (i.e. a corporation or LLC), if one exists in the combined group.

    c. Affiliated entities that are engaged in a unitary business may elect combined group reporting.

    d. Entities filing a combined report are limited to a single deduction election for compensation, cost of goods sold or the 30% deduction.

36. Which of the following entities are affiliated?

    a. An LLC owned 100% by a husband, and a separate corporation owned 100% by his wife.

    b. Two limited partnerships each owned 50% by individual A and 50% by unrelated individual B.

    c. Two unrelated LLCs, A and B, that each own 50% of Partnership C.

    d. A limited liability partnership owned 33% by Corporation A, 33% by Corporation B and 34% by Corporation C.

37. Which of the following entities may be included in a combined group?

    a. A taxable entity with 51% of its property and 60% of its payroll located outside the United States.

    b. A taxable entity with no property and no payroll that originates 85% of its sales from locations outside the United States.

    c. A taxable entity with 90% of its property and 90% of its payroll located outside the United States.

    d. A passive entity with 51% of its property and 60% of its payroll located outside the United States.

38. Which of the following business structures would likely be considered to be vertically integrated?

    a. Oil Rig A, Refinery B, and Gas Station C.

    b. Department Store A, Pet Store B, and Restaurant C.

39. Which of the following business structures would likely be considered to be horizontally integrated?

    a. Farm A, Dairy B, and Grocery Store C.

    b. Department Store A, Pet Store B, and Restaurant C.

    c. Farm A, Dairy B, and Restaurant C.

    d. Department Store A, Department Store B, and Department Store C.

40. A, B, C and D are affiliated. Which of the following is **not** includible in the combined group?

    a. A is a domestic limited liability company involved in operating oil and gas wells. A is owned by individuals X and Y.

    b. B is a domestic limited liability partnership receiving oil and gas royalties, delay rentals and bonus payments from A. B is owned by individuals X and Y.

    c. C is a domestic corporation involved in refining operations. C is owned by individuals X and Y.

    d. D is a domestic general partnership involved in marketing refined oil and gas products. D is owned by individuals X and Y.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

35. Which of the following is correct with respect to combined reporting? **(Page 145)**

    a. A passive entity may elect to be a member of a combined group. [This answer is incorrect. According to TTC Sec. 171.0001(7), a passive entity may not be a member of a combined group.]

    b. A combined group must choose a reporting entity that has previously been subject to the franchise tax (i.e. a corporation or LLC), if one exists in the combined group. [This answer is incorrect. A combined group chooses a reporting entity using other criteria.]

    c. Affiliated entities that are engaged in a unitary business may elect combined group reporting. [This answer is incorrect. Combined group reporting is not elective. It is compulsory for affiliated taxable entities that are engaged in a unitary business.]

    d. Entities filing a combined report are limited to a single deduction election for compensation, cost of goods sold or the 30% deduction. [This answer is correct. The combined group must make a single election. Different combined group members may not take different deductions from revenues.]

36. Which of the following entities are affiliated? **(Page 146)**

    a. An LLC owned 100% by a husband and a separate corporation owned 100% by his wife. [This answer is correct. Under the spousal attribution rules, these entities are affiliated.]

    b. Two limited partnerships each owned 50% by individual A and 50% by unrelated individual B. [This answer is incorrect. There is not more than 50% common ownership for individuals A and B.]

    c. Two unrelated LLCs, A and B, that each own 50% of Partnership C. [This answer is incorrect. There is not more than 50% common ownership for the two unrelated LLCs.]

    d. A limited liability partnership owned 33% by Corporation A, 33% by Corporation B and 34% by Corporation C. [This answer is incorrect. This answer is neither Corp. A, B or C has more than 50% common ownership.]

37. Which of the following . entities may be included in a combined group? **(Page 153)**

    a. A taxable entity with 51% of its property and 60% of its payroll located outside the United States. [This answer is correct. A "waters-edge" test is used to determine which entities are includible in a combined group. Because the foreign entities report less than 80% of the entity's property and payroll, the foreign entity can be in the combined report.]

    b. A taxable entity with no property and no payroll that originates 85% of its sales from locations outside the United States. [This answer is incorrect. This entity does not satisfy the waters-edge test, so it may not be included in the combined group.]

    c. A taxable entity with 90% of its property and 90% of its payroll located outside the United States. [This answer is incorrect. This entity does not satisfy the waters-edge test, so it may not be included in the combined group.]

    d. A passive entity with 51% of its property and 60% of its payroll located outside the United States. [This answer is incorrect. A passive entity may not be included in a combined group per TTC Sec. 171.0001(7).]

38. Which of the following business structures would likely be considered to be vertically integrated? **(Page 149)**

    a. Oil Rig A, Refinery B, and Gas Station C. [This answer is correct. According to TTC Sec. 171.0001(17)(B), These businesses are involved in steps of a process.]

    b. Department Store A, Pet Store B, and Restaurant C. [This answer is incorrect. These entities are all involved in the retail business. However, they are not involved in steps of the same process.]

39. Which of the following business structures would likely be considered to be horizontally integrated? **(Page 149)**

    a. Farm A, Dairy B, and Grocery Store C. [This answer is incorrect. These entities are involved in steps of the same process. Therefore, they would more likely be considered to be vertically integrated.]

    b. Department Store A, Pet Store B, and Restaurant C. [This answer is incorrect. These entities are all involved in the retail business. However, they are not involved in steps of the same process according to TTC Sec. 171.001(17)(B).]

    c. Farm A, Dairy B, and Restaurant C. [This answer is incorrect. These entities are involved in steps of the same process. Therefore, they would more likely be considered to be vertically integrated.]

    d. Department Store A, Department Store B, and Department Store C. [This answer is correct. These entities are involved in the same line of business.]

40. A, B, C and D are affiliated. Which of the following is **not** includible in the combined group? **(Page 145)**

    a. A is a domestic limited liability company involved in operating oil and gas wells. A is owned by individuals X and Y. [This answer is incorrect. A limited liability company is a taxable entity and therefore is includible in the combined group.]

    b. B is a domestic limited liability partnership receiving oil and gas royalties, delay rentals and bonus payments from A. B is owned by individuals X and Y. [This answer is incorrect. B does not qualify as a passive entity because it is affiliated with the operator of the oil and gas wells. B is taxable and therefore is includible in the combined group.]

    c. C is a domestic corporation involved in refining operations. C is owned by individuals X and Y. [This answer is incorrect. C is a taxable entity and therefore is includible in the combined group.]

    d. D is a domestic general partnership involved in marketing refined oil and gas products. D is owned by individuals X and Y. [This answer is correct. D is not includible in the combined group because D is not a taxable entity.]

EXAMINATION FOR CPE CREDIT

Lesson 7 (TFTTG101)

Determine the best answer for each question below. Then mark your answer choice on the Examination for CPE Credit Answer Sheet located in the back of this workbook or by logging onto the Online Grading System.

37. A LLC owns 50% of B LLC and 10% of C LLC. B LLC owns 90% of C LLC. Which of the following is correct?

    a. A is treated as owning 100% of C because B's 90% ownership of C is attributed to A.

    b. B and C are affiliated.

    c. If they are engaged in a unitary business, A, B and C will be required to file a combined report.

    d. A and C are affiliated through indirect ownership.

38. A LLC owns 60% of B LLC and 10% of C LLC. B LLC owns 90% of C LLC. B LLC is an insurance company required to file the insurance gross premiums tax. Which of the following is correct?

    a. A and C are affiliated but B is not.

    b. A and B are affiliated but C is not.

    c. If they are engaged in a unitary business, A and C will be required to file a combined report.

    d. If they are engaged in a unitary business, A, B and C will be required to file a combined report.

39. Which of the following is **not** an element of the definition of "unitary"?

    a. Flow of value.

    b. Interdependent, integrated, and interrelated.

    c. Continuity of investment.

    d. Synergy and mutual benefit.

40. Which of the following is correct with respect to the Comptroller's rules regarding unitary businesses?

    a. Adhering to arm's-length pricing will prevent businesses from being unitary.

    b. Affiliated taxable entities are presumed to be unitary.

    c. Non-nexus entities are not required to be included in the combined group report.

    d. Entities that are affiliated and engaged in a unitary business may elect to file a combined report.

GLOSSARY

Affiliated group: A group of one or more entities in which a controlling interest is owned by a common owner or owners, either corporate or non-corporate, or by one or more of the member entities.

Business Trust: A trust formed for the purpose of making a profit.

Combined group: A group of taxable entities that are part of an affiliated group engaged in a unitary business and that are required to file a group report. Only taxable entities may be members of the combined group.

Compensation: Includes wages and cash compensation plus benefits.

Goods: Tangible personal property and real property.

Heath care provider: Any taxable entity that participates as a provider of services in any one or more of the following government programs: Medicaid, Medicare, CHIP, State worker's compensation program, or TRICARE.

Location of payor rule: One of the fundamental gross receipts apportionment rules.

Net distributive income: The net amount of income, gain, deduction, or loss relating to a pass—through entity or disregarded entity reportable to the owners for the tax year of the entity. Thus, net distributive income includes losses.

Nexus: A taxable entity is subject to a state's laws based on the relative connection of its activities to that state. This connection is referred to as "nexus" or "doing business" in the state.

Production of goods: Includes construction, installation, manufacture, development, mining, extraction, improvement, creation, raising or growth.

Research and development: Includes costs incurred in connection with the development or improvement of a product.

Staff leasing companies: An arrangement by which a license holder's employees are assigned to work at a client company.

Taxable entity: Includes a combined group.

Uncompensated care: Standard charges for the healthcare services provided by a health care provider, where the provider has not received any payment for healthcare provided to the patient.

Unitary Business: (a) a single economic enterprise made up of separate parts of a single entity or (b) 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.

INDEX

A

C

G

I

N

P

R

T

TESTING INSTRUCTIONS FOR EXAMINATION FOR CPE CREDIT

Companion to PPC's Texas Franchise Tax Deskbook—Texas Franchise (Margin) Tax (TFTTG101)

1. Following these instructions is information regarding the location of the **CPE CREDIT EXAMINATION QUESTIONS** and an **EXAMINATION FOR CPE CREDIT ANSWER SHEET**. You may use the answer sheet to complete the examination consisting of multiple choice questions.

   ONLINE GRADING. Log onto our Online Grading Center at **OnlineGrading.Thomson.com** to receive instant CPE credit. Click the purchase link and a list of exams will appear. Search for an exam using wildcards. Payment for the exam is accepted over a secure site using your credit card. Once you purchase an exam, you may take the exam three times. On the third unsuccessful attempt, the system will request another payment. Once you successfully score 70% on an exam, you may print your completion certificate from the site. The site will retain your exam completion history. If you lose your certificate, you may return to the site and reprint your certificate.

   PRINT GRADING. If you prefer, you may mail or fax your completed answer sheet to the address or number below. In the print product, the answer sheets are bound with the course materials. Answer sheets may be printed from electronic products. The answer sheets are identified with the course acronym. Please ensure you use the correct answer sheet. Indicate the best answer to the exam questions by completely filling in the circle for the correct answer. The bubbled answer should correspond with the correct answer letter at the top of the circle's column and with the question number.

   Send your completed **Examination for CPE Credit Answer Sheet, Course Evaluation,** and payment to:

   Thomson Reuters
   Tax & Accounting—R&G
   TFTTG101 Self-study CPE
   36786 Treasury Center
   Chicago, IL 60694-6700

   You may fax your completed **Examination for CPE Credit Answer Sheet** and **Course Evaluation** to the Tax & Accounting business of Thomson Reuters at **(817) 252-4021**, along with your credit card information.

   Please allow a minimum of three weeks for grading.

   Note: The answer sheet has four bubbles for each question. However, not every examination question has four valid answer choices. If there are only two or three valid answer choices, "Do not select this answer choice" will appear next to the invalid answer choices on the examination.

2. If you change your answer, remove your previous mark completely. Any stray marks on the answer sheet may be misinterpreted.

3. Copies of the answer sheet are acceptable. However, each answer sheet must be accompanied by a payment of $79. Discounts apply for 3 or more courses submitted for grading at the same time by a single participant. If you complete three courses, the price for grading all three is $214 (a 5% discount on all three courses). If you complete four courses, the price for grading all four is $270 (a 10% discount on all four courses). Finally, if you complete five courses, the price for grading all five is $319 (a 15% discount on all five courses or more).

4. To receive CPE credit, completed answer sheets must be postmarked by **March 31, 2011**. CPE credit will be given for examination scores of 70% or higher. An express grading service is available for an **additional $24.95** per examination. Course results will be faxed to you by 5 p.m. CST of the business day following receipt of your examination for CPE Credit Answer Sheet.

5. Only the **Examination for CPE Credit Answer Sheet** should be submitted for grading. **DO NOT SEND YOUR SELF-STUDY COURSE MATERIALS.** Be sure to keep a completed copy for your records.

6. Please direct any questions or comments to our Customer Service department at (800) 323-8724.

EXAMINATION FOR CPE CREDIT

To enhance your learning experience, examination questions are located immediately following each lesson. Each set of examination questions can be located on the page numbers listed below. The course is designed so the participant reads the course materials, answers a series of self-study questions, and evaluates progress by comparing answers to both the correct and incorrect answers and the reasons for each. At the end of each lesson, the participant then answers the examination questions and records answers to the examination questions on either the printed **EXAMINATION FOR CPE CREDIT ANSWER SHEET** or by logging onto the Online Grading System. The **EXAMINATION FOR CPE CREDIT ANSWER SHEET** and **SELF-STUDY COURSE EVALUATION FORM** for each course are located at the end of all course materials.

EXAMINATION FOR CPE CREDIT ANSWER SHEET

Companion to PPC's Texas Franchise Tax Deskbook—Texas Franchise (Margin) Tax (TFTTG101)

Price $79

First Name: _____

Last Name: _____

Firm Name: _____

Firm Address: _____

City: _____ State /ZIP: _____

Firm Phone: _____

Firm Fax No.: _____

Firm Email: _____

Express Grading Requested: ☐ Add $24.95

Signature: _____

Credit Card Number: _____ Expiration Date: _____

Birth Month: _____ Licensing State: _____

ANSWERS:

Please indicate your answer by filling in the appropriate circle as shown: Fill in like this ● not like this ⃠ ⊗ ⊘ .

	a	b	c	d		a	b	c	d		a	b	c	d		a	b	c	d
1.	○	○	○	○	11.	○	○	○	○	21.	○	○	○	○	31.	○	○	○	○
2.	○	○	○	○	12.	○	○	○	○	22.	○	○	○	○	32.	○	○	○	○
3.	○	○	○	○	13.	○	○	○	○	23.	○	○	○	○	33.	○	○	○	○
4.	○	○	○	○	14.	○	○	○	○	24.	○	○	○	○	34.	○	○	○	○
5.	○	○	○	○	15.	○	○	○	○	25.	○	○	○	○	35.	○	○	○	○
6.	○	○	○	○	16.	○	○	○	○	26.	○	○	○	○	36.	○	○	○	○
7.	○	○	○	○	17.	○	○	○	○	27.	○	○	○	○	37.	○	○	○	○
8.	○	○	○	○	18.	○	○	○	○	28.	○	○	○	○	38.	○	○	○	○
9.	○	○	○	○	19.	○	○	○	○	29.	○	○	○	○	39.	○	○	○	○
10.	○	○	○	○	20.	○	○	○	○	30.	○	○	○	○	40.	○	○	○	○

You may complete the exam online by logging onto our online grading system at **OnlineGrading.Thomson.com**, or you may fax completed Examination for CPE Credit Answer Sheet and Course Evaluation to Thomson Reuters at (817) 252-4021, along with your credit card information.

Expiration Date: March 31, 2011

Self-study Course Evaluation

Please Print Legibly—Thank you for your feedback!

Course Title: Companion to PPC's Texas Franchise Tax Deskbook—Texas Franchise (Margin) Tax

Course Acronym: TFTTG101

Your Name (optional): _____ Date: _____

Email: _____

Please indicate your answers by filling in the appropriate circle as shown:
Fill in like this ● not like this ⊘ ⊗ ⊘.

Satisfaction Level:	Low (1) . . . to . . . High (10) 1	2	3	4	5	6	7	8	9	10
1. Rate the appropriateness of the materials for your experience level:	○	○	○	○	○	○	○	○	○	○
2. How would you rate the examination related to the course material?	○	○	○	○	○	○	○	○	○	○
3. Does the examination consist of clear and unambiguous questions and statements?	○	○	○	○	○	○	○	○	○	○
4. Were the stated learning objectives met?	○	○	○	○	○	○	○	○	○	○
5. Were the course materials accurate and useful?	○	○	○	○	○	○	○	○	○	○
6. Were the course materials relevant and did they contribute to the achievement of the learning objectives?	○	○	○	○	○	○	○	○	○	○
7. Was the time allotted to the learning activity appropriate?	○	○	○	○	○	○	○	○	○	○
8. If applicable, was the technological equipment appropriate?	○	○	○	○	○	○	○	○	○	○
9. If applicable, were handout or advance preparation materials and prerequisites satisfactory?	○	○	○	○	○	○	○	○	○	○
10. If applicable, how well did the audio/visuals contribute to the program?	○	○	○	○	○	○	○	○	○	○

Please provide any constructive criticism you may have about the course materials, such as particularly difficult parts, hard to understand areas, unclear instructions, appropriateness of subjects, educational value, and ways to make it more fun. Please be as specific as you can.
(Please print legibly):

Additional Comments:

1. What did you find **most** helpful?
2. What did you find **least** helpful?
3. What other courses or subject areas would you like for us to offer?
4. Do you work in a Corporate (C), Professional Accounting (PA), Legal (L), or Government (G) setting? _____
5. How many employees are in your company? _____
6. May we contact you for survey purposes (Y/N)? If yes, please fill out contact info at the top of the page. **Yes**/**No** ○ ○

For more information on our CPE & Training solutions, visit trainingcpe.thomson.com. Comments may be quoted or paraphrased for marketing purposes, including first initial, last name, and city/state, if provided. If you prefer we do not publish your name, write in "no" and initial here _____