

Total Revenue. Total revenue generally is determined based on federal tax return references and concepts. In determining revenue from the sale of property (e.g., the sale of real estate or securities), only the gain from such sale is included in revenue, as opposed to the sales proceeds. Each entity may need to review its methods for accounting for receipts to make sure it is not including receipts that should not be treated as such entity's revenue (e.g., deposits, customer or tenant payments to be paid or forwarded to third party vendors, funds held in trust or escrow, etc.).

Determination of Deductible Compensation. The margin tax basically allows the deduction of wages and cash compensation and benefits for each employee of the entity. The deduction for wages and cash compensation paid to employees is capped at \$300,000 per employee per year, and includes wages, salaries, stock grants and options, and net distributive income accruing to a natural person from entities treated as "pass-throughs" for federal income tax purposes, including partnerships, trusts, limited liability companies, and "S" corporations. (Wages and cash compensation means the amount entered in the Medicare wages and tip box in IRS Form W-2, subject to the \$300,000 cap). Payments to independent contractors generally are not deductible under the statute, although payments of certain commissions (e.g. to co-brokers) and payments to certain subcontractors may be deducted. In addition to the wages and cash compensation deduction, an entity may deduct "all benefits" provided to its employees. "All benefits" is not defined, but the law does state that it includes workers' compensation benefits, health care, deductible contributions to retirement plans, and contributions to employer health savings account contributions. Unlike the wages and cash compensation deduction, the benefits deduction is not subject to the \$300,000 cap.

Determination of Cost of Goods Sold. Cost of goods sold includes certain identified "direct costs" of acquiring or producing real or tangible personal property sold in a taxable entity's ordinary course of business, and certain other "related" costs. "Cost of Goods Sold" is defined in detail in the new law, rather than using federal tax or generally accepted accounting principles (GAAP) definitions of cost of goods sold. The law also provides a very detailed list of expenses that are specifically excluded.

Texas Apportionment. Multi-state businesses will determine their Texas portion of the taxable margin using the same apportionment calculation used for the previous franchise tax. The apportionment calculation is the ratio of Texas gross receipts (the numerator) to total gross receipts from the entire business (the denominator). Receipts excluded from the total revenue may not be included in gross receipts used for apportionment. A change to be noted from the previous franchise tax is that while services continue to be sourced to Texas only if performed in Texas, receipts from servicing loans secured by real property are now sourced to Texas if the real property is located in Texas.

Taxable Entities

Under the new law, businesses subject to the margin tax generally are those with state law liability protection. As a result, the base of the entities subject to the margin tax is more expansive than those entities that were subject to the previous franchise tax. Subject to certain exceptions described below, entities taxable under the margin tax regime include corporations and limited liability companies currently subject to the existing franchise tax,

and also include general partnerships and joint ventures which have at least one partner that is not a natural person, limited partnerships, professional and business associations, joint stock companies, savings-and-loan associations, banking corporations, holding companies, and other legal entities. Limited liability partnerships (LLPs) are general partnerships that elect LLP status. LLPs are not expressly taxable under the new margin tax, leaving an argument that they are not taxable if all of their partners are natural persons. The legislature clearly intended to tax LLPs and this is one of many technical corrections likely to be made by the 2007 legislature.

Non-taxable Entities

The base of taxable entities subject to the margin tax excludes:

- sole proprietorships;
- "passive investment partnerships"—limited or general partnerships that are passive entities (discussed below);
- general partnerships and joint ventures that are owned solely by natural persons;
- family limited partnerships where at least 80% of the interests are held directly or indirectly by members of the same family *and* that are passive investment partnerships (note that this exclusion is unnecessary because it is subsumed within the definition of a "passive investment partnership");
- escrows;
- grantor trusts with natural persons or charitable entities as the sole beneficiaries;
- certain trusts with natural persons or charitable entities as the sole beneficiaries that are passive entities;
- certain entities exempt from the previous franchise tax under Subchapter B of the Texas Tax Code (i.e., non-profit corporations, cooperatives, credit unions and insurance companies required to pay insurance premium taxes) (and a new section is added to Subchapter B to allow an exemption for a non-corporate entity that would qualify for one of the specific exemptions if it were a corporation such as a non-profit organization);
- estates of natural persons;
- real estate investment trusts ("REITs") but only if the REIT does not own real estate directly (other than real estate that the REIT occupies solely "for business purposes") and qualified REIT subsidiaries (as a practical matter, however, there really is very little exception for REITs); and
- real estate mortgage investment conduits ("REMICs").

Combined Reporting

Taxable entities that are part of an "affiliated group" engaged in a "unitary business" must file a combined group report. "Affiliated group" is defined as a group of one or more entities in which a "controlling" 80% or greater interest is owned by a common owner or owners, either corporate or non-corporate, or by one or more other members of the affiliated group. The 80% "controlling" interest test for a corporation refers to "direct or indirect" ownership of total combined voting power of all classes of stock or the "beneficial ownership interest in the voting stock." The 80% test for other entities applies to direct or indirect

ownership of "the capital, profits, or beneficial interest" in the entity. An affiliated group is in a "unitary business" if there is a single economic enterprise and the entities are sufficiently interdependent, integrated and interrelated to provide a synergy and mutual benefit that produces a sharing or exchange of value (e.g., common management and employees). The election to subtract cost of goods sold or employee compensation is made by the combined group and applies to all of its members.

Exceptions to the Margin Tax

Small Business Exception. Taxable entities with \$300,000 or less in total annual revenue (indexed for inflation) or that owe less than \$1,000 under the tax are not required to pay the tax. This doubles the small business exemption from the previous franchise tax for taxable entities with gross receipts of \$150,000 or less in a given tax year.

Passive Entities. "Passive entities" are excluded from the definition of "taxable entity." A passive entity is generally defined as a general or limited partnership or trust, other than a business trust, that both (i) derives at least 90% of its federal gross income from passive income, and (ii) does not receive more than 10% of its federal gross income from conducting an active trade or business. Importantly, a limited liability company does not fall under the definition of a passive entity.

Passive income includes but is not limited to, dividends, interest, distributive shares of partnership income, gains from the sale of real property, and royalties. Passive income also includes royalties, bonuses or delay rental income from mineral properties and income from other mineral interests not operated directly or by an affiliate.

Rent income is not considered passive income.

Generally, a business is considered to have conducted active business if the entity's activities include operations that earn income and if the entity performs active management and operational functions. A royalty interest or non-operating working interest in a mineral right is not considered "active business."

Choice of Entity

The enactment of the margin tax will change the analysis for choice of entity decisions. Under the previous franchise tax, limited partnerships were favorable entities because they were not subject to the franchise tax.

- **Limited Liability Company.** Generally, subject to the comments below, the LLC will be the most attractive entity under the margin tax regime. Under the federal "Check the Box" regulations, it can be taxed for federal income tax purposes as a corporation or a partnership.
- **Limited Partnership.** In certain situations however, limited partnerships may still be favorable. Entities that are engaged in "passive investment" income activities (see above) may still want to consider being organized as limited partnerships in order to

qualify as an exempt "passive entity". For example, an entity owning securities, mineral interests or real estate in Texas most often should be a limited partnership. Although rent is not passive income, the gain from the sale of real estate is passive income. Therefore, limited partnerships should continue to be the preferred vehicle for real estate ownership. From a planning standpoint, where real estate has been rented, the timing of a sale (or the timing of the gain from a sale via the use of the installment method) may be critical if it will cause the entity's income for a year to be 90% passive, and thus not taxable for the year.

- **General Partnership.** A general partnership will also be an attractive entity in certain circumstances. General partnerships owned entirely by natural persons will not be subject to the margin tax. The margin tax will be imposed on a general partnership which has an entity as a partner. However, one major downside is that under common law, all partners in a general partnership generally have joint and several liability for all of the debts and obligations of the partnership.
- **Family Limited Partnership.** Family limited partnerships where at least 80% of the interests are held directly or indirectly by members of the same family *and* that are passive investment partnerships are not taxable entities under the margin tax regime.
- **Keep Existing Entity Structure in Tact.** The margin tax takes effect on January 1, 2008 and for calendar year taxpayers the margin tax will apply to entity income commencing January 1, 2007, and will be payable annually commencing May 1, 2008. The May 2007 franchise tax payment will be based on the franchise tax as it existed prior to enactment of the new margin tax. For fiscal year taxpayers, the margin tax computations cannot apply to business activity before June 1, 2006. For this reason, businesses operating as entities that will be taxable under the margin tax, but which are not subject to the previous franchise tax, such as limited partnerships, should retain their status at least through 2006.



MAKE SURE YOUR OFFICE LEASES ARE IN ORDER

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As the Special Session of the Texas Legislature gets into full swing, it's imperative your leases are up to date and properly address tax issues that could affect the amount of money you get from the leases. The Special Session began April 17 and lasts for 30 days, and chances are good we will not know the specific outcome until after it ends. However, you need to be prepared since it is possible that a new margin tax will replace the current state franchise tax.

The margin tax has been proposed by the Texas Tax Reform Commission, appointed by Governor Perry and led by former Comptroller John Sharp. The margin tax is gaining traction as a viable option to members of the Legislature and has been endorsed by many top business organizations in the state. Currently, one in 16 businesses pay franchise taxes – the new proposal would double that to where about one in eight would pay the margin tax.

Though the results will not be known until late May at the earliest, make sure your operating expense clauses allow you to pass through various tax increases. While some leases afford owners flexibility in this area, others are quite restrictive. Landlords and owners need to review their leases as soon as possible to make any necessary changes to reflect the current environment.

Specifically, the Texas Tax Reform Commission is proposing to reduce school ad valorem maintenance and operations taxes by 50 cents to \$1, and impose a margin tax that would apply to all forms of Texas businesses other than sole proprietorships. In general, the margin tax would tax a business' total revenue apportioned to Texas, and allow the business to deduct either the cost of goods sold or compensation costs (wages, salaries and benefits). The resulting margin would then be taxed at 1 percent (.5 percent for retailers and wholesalers).

Currently, most commercial leases allow the landlord to pass ad valorem taxes or escalations through to the tenant as an operating cost of the property. If the commercial lease does not allow the landlord to pass through the margin tax, then the building owner will take a financial hit because the margin tax is being

substituted for the ad valorem tax. Most commercial leases state that a franchise tax, income tax or a wide variety of other non-ad valorem taxes may not be passed through to the tenant, although some leases will say unless such tax is assessed in lieu of an ad valorem tax.

In order to maintain the same economic relationship between landlord and tenant under a commercial lease, it is important that your lease allow for a tax substituted for an ad valorem tax to qualify for the pass-through. We are currently seeking to develop legislative intent evidencing that the margin tax is as a substitute for a portion of school property taxes. Going forward, landlords should be aware of their lease language and provide for flexible tax substitution provisions.

Important items for you to consider are:

- Some ownership groups may not have language in their lease that allows a substitute business tax to be passed through to the tenant in lieu of a property tax. Even if they do, it could be weak language that may not cover the needs of the owner.
- The above situation is probably more prevalent in regional owners or in a situation where a lease is very old (having been renewed a number of times) and does not have state of the art language. National institutional owners may have already covered this situation in the lease due to a history with other states.
- The possibility of a school property tax reduction will decrease income from some owners who have tenant leases that are "triple net." When the school property tax goes down, the tenant pays less and the management fee may be less. Additionally, both the owner and the management company may pay a business tax that it did not pay before.

Owners that have a lease with a base year or expense stop also should carefully analyze the terms so they can properly address the various situations that might exist. Finally, management companies should carefully review their management contracts because a new business tax will be an added cost.

The Special Session promises to be a busy one, and taxes will be the main focus. Take steps now to ensure your house – well, building in this case --- is in order.