

Texas Margin Tax

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Beginning this year, business entities will be subject to the new Texas Margin Tax. This tax will replace the Texas Franchise Tax. While it is not clear that the new tax will hold up to constitutional challenges, anyone who may be affected should be concerned about the possible impact. This tax will be due and payable on May 15, 2008, and based on 2007 financial results.

Who will it affect?

Most businesses operating as either a limited liability company, limited partnership, corporation including S Corps, professional associations, and certain business trusts are among the taxable entities. Businesses operating as sole proprietorships or general partnerships will not be taxable.

Passive entities are not subject to the tax if they meet two requirements. First, they must be either a general partnership, limited partnership or a trust. A business trust will not qualify. Second, at least 90% of the gross income must be passive: interest, dividends, capital gains, etc. Two notable items included in passive income are capital gains from selling real estate and non-operated working interest income. One item not considered passive is rental income.

How is the tax computed?

Tax is based on the federal tax returns as filed or as they should have been filed. The tax is imposed on either taxable margin (as defined) or gross revenues (if elected). In simple terms the taxable margin is gross revenues less (1) cost of goods sold or (2) compensation and benefits. You can choose which is more advantageous each year. Both cost of goods sold and compensation and benefits have certain additional qualifications, which are too numerous to cover in this short article. As another alternative you can compute taxable margin as 70% of gross revenues. Entities with gross receipts under \$900,000 have a reduced tax rate schedule.

The margin tax is 1% of the computed taxable margin. So as a simple example, a partnership with \$1,000,000 in gross rental income would compute its tax as \$7,000 (\$1,000,000 times 70% times 1%).

An entity can elect to compute its margin tax as .575% of gross revenues. Applying this election to the example above would result in margin tax of \$5,750 (\$1,000,000 times .575%). This special election is only available if gross revenues are no more than \$10 million.

Combined reporting and other odd-ball considerations

Entities that are part of an affiliated group engaged in a unitary business will file a combined report. Texas has a specific definition of unitary business. For anyone with entities that could be affected this will require careful attention.

Retailers and wholesalers will pay tax at the rate of .5% of taxable margin.

Contractors, lawyers, medical professionals, management companies, and oil and gas operators, among others, have special preferences which will help mitigate their tax liability. Note that we did not include CPAs in this list.

We will be looking at the impact of this new tax on our clients and ourselves. Should you have any specific questions or concerns, please contact us.