



January 8, 2008

Re: Texas Margin Tax implementation issues

Dear Clients and Friends:

Texas House Bill 3 was passed into law during 2006 implementing the new Texas Margin Tax. Since our last update on this issue, the Texas Legislature has passed technical corrections bill HB 3928 in 2007 which makes a number of revisions to the Margin Tax. Although the revisions included in HB 3928 helped clarify certain points, others were addressed in the rules recently issued by the Texas Comptroller.

To recap, the Margin Tax has a few key aspects which differ from the former Franchise Tax:

- Most entities conducting business in Texas are subject to the tax (with very limited exceptions)
- Tax rate of 1% (0.5% for Retailers and Wholesalers) of the Taxable Margin
- Taxable Margin is limited to a maximum of 70% of Gross Receipts
- Deduction for Compensation and Benefits or Cost of Goods Sold
- \$300,000 per person compensation limit (excluding benefits)
- Single factor (gross receipts) multi-state apportionment
- Repeal of all Texas Franchise Tax credits
- Special rules for tiered partnerships
- One time credit to use prior Texas Franchise loss carryovers
- Mandatory combined filing for entities under common control who operate unitary businesses
- Denial of COGS or compensation deduction for undocumented workers

A number of these items are of significant importance in determining the tax to be paid and will require analysis before or during preparation of the 2008 Margin Tax returns. The following items will be of importance to many of our clients:

### **Combined Reporting**

Taxable entities which are under common control and part of a group operating unitary businesses must file on a combined basis. Many clients operate multi-level structures under common control, such as the LP/LLC structure common in Texas. It is our expectation that many of our clients will be required to file combined. We encourage you to review your accounting procedures and systems to ensure that adequate financial information can be derived for generating the combined filing.

Barker Viggato, LLP  
Certified Public Accountants

17300 Dallas Parkway, Suite 3035 Dallas, Texas 75248 main 972-789-1313 fax 972-789-1315

Certain items such as total revenue and the cost of good sold or compensation deduction are determined on a separate company basis. The combined group must determine on a collective basis whether it will elect to use the cost of good sold deduction or the compensation deduction. Therefore, it is important to understand which entities will be part of the combined group and the financial attributes of those entities. In certain instances, a pro-forma federal return will have to be prepared on a combined basis in order to provide the information necessary to file the Texas return on a combined basis.

### **Passive Business exception**

Certain entities which are "passive entities" are not considered taxable entities for Margin Tax purposes. Passive entities are partnerships or certain trusts who's gross federal income consists of 90% or more of certain defined income types, such as dividends, interest, capital gains, distributive shares of partnership income, capital gains from real property and securities, royalties and others. Notably absent are Section 1231 gains on business property, which are taxed as capital gains for federal tax purposes. Also notable, passive income does not include rents. Although a passive entity is not a taxable entity for margin tax, passive entities will have to file reports and demonstrate their passive status. Therefore, most entities should expect to file annual reports for the Margin Tax.

### **Small Business Exclusions**

In addition to the exclusion for taxable entities with total revenues of less than \$300,000, HB 3928 implemented a multi-tier tax discount for small business entities with total revenue greater than \$300,000 but less than \$900,000. Again, this will likely require reporting on the applicable forms on an annual basis.

### **Temporary Tax Credit for business loss carryforward**

For entities which have a Texas business loss carryover from the 2007 report year, a temporary credit will be available to offset the Margin Tax. However, entities must report the credit on their first tax report due in 2008. **Therefore, all entities expecting to use a credit should plan on filing the credit request form by May 15, 2008.**

The preparation of your 2008 Margin Tax return(s) may require work on some of the following items:

- Determine whether common controlled businesses exist and unitary status of those businesses
- Determine separate company attributes for combined filing
- Preparation of pro-forma federal returns for combined filing entities
- Determine whether cost of good sold or compensation deduction is more favorable
- Determine whether the entity is eligible for the passive or small business exceptions
- Analyze the detail cost of goods sold or compensation items for exclusions
- Analyze non-combined tiered partnership activity for appropriate exclusions
- Determine availability of temporary credit for business loss carryforward

Although we have kept abreast of the recent Margin Tax activity with the Comptroller and Legislature, the Comptroller's delayed issuance of the final regulations shortens our window for preparing each client's analysis during the early months of 2008. The Margin Tax is driven off of Federal Tax return items, and therefore federal business tax returns must be completed prior to the preparation of the Margin Tax returns.

If we can provide any advance assistance to analyze your company's Margin Tax position, please call our office to schedule a review meeting. We look forward to helping you achieve a smooth transition to the Margin Tax system.

Sincerely,

Barker Viggato, LLP