BILL ANALYSIS

C.S.H.B. 3
By: Keffer, Jim
Ways & Means
Committee Report (Substituted)

BACKGROUND AND PURPOSE

The Texas Supreme Court held in Neeley v. West Orange-Cove CISD, that the state school finance system relies on revenues derived from a tax that, in effect, is a state property tax prohibited by the Texas Constitution. The court required the legislature to correct the constitutional violation by June 1, 2006. Since many Texas businesses that receive liability protection from the State do not pay the franchise tax, C.S.H.B. 3 raises state revenue by amending Chapter 171, Tax Code, to close the loopholes in the current franchise tax by extending coverage to certain active businesses. At the same time, it broadens the tax base and lowers the rate.

RULEMAKING AUTHORITY

It is the committee's opinion that rulemaking authority is expressly granted to the comptroller of public accounts in SECTION 1, SECTION 3, and SECTION 15 of the bill.

ANALYSIS

DEFINITIONS

New Section 171.0001, Tax Code, as added by SECTION 1 of the bill, defines new terms, including "affiliated group," "combined group," "controlling interest," "retail trade," "wholesale trade," and "unitary business."

The Internal Revenue Code definition is updated to reflect the 1986 code in effect for the federal tax year beginning January 1, 2006.

New Section 171.0002, Tax Code, as added by SECTION 1 of the bill, defines a taxable entity. A taxable entity includes a partnership, corporation, banking corporation, savings and loan association, limited liability company, business trust, professional association, business association, joint venture, joint stock company, holding company, or other legal entity. The term includes a combined group. This section also provides that a joint venture does not include joint operating or co-ownership arrangements meeting the requirements of Treasury Regulation Section 1.761-2(a)(3) that elect out of federal partnership treatment as provided by Section 761(a), Internal Revenue Code.

Taxable entity does not include:

1. sole proprietorships;
2. general partnerships owned entirely by natural persons;
3. certain passive entities; and
4. certain entities currently exempt from the franchise tax.

In addition, several other types of entities are excluded from the definition, including grantor trusts, estates of natural persons, escrows, passive investment partnerships, family limited partnerships where at least 80 percent of the interests are held by members of the same family and that are passive investment partnerships, certain non-business passive entity trusts, real estate investment trusts (REITs), but only if the REIT does not own real estate directly (other than real estate occupied for business purposes), and real estate mortgage investment conduits (REMICs).

New Section 171.0003, Tax Code, defines a "passive entity". A "passive entity" is a general or limited partnership or trust, other than a business trust, where at least 90 percent of federal gross income is from investments, including dividends, interest, distributive shares of partnership income, capital gains, and royalties. A passive entity also cannot receive more than 10 percent of its federal gross income from conducting an active trade or business. The bill also creates an active trade or business test to determine whether a passive entity is a taxable entity.

RATES

As provided in Section 171.002, Tax Code, as amended by SECTION 1 of the bill, the tax rate is one percent per year of privilege period of taxable margin, except that the rate for taxable entities primarily engaged in retail or wholesale trade is 0.5 percent per year of privilege period of taxable margin. This section also set out a test for determining whether a taxable entity is primarily engaged in retail or wholesale trade.

EXEMPTIONS

A taxable entity with $300,000 or less in total revenue is exempt from the tax. Under new Section 171.006, Tax Code, as added by SECTION 1 of the bill, the exemption would be indexed to an inflation index every two years beginning in 2009 on January 1 of each odd-numbered year. The Comptroller may adopt rules to make the determination required by Sec. 171.006.

SECTION 2 of the bill extends current franchise tax exemptions in Subchapter B, Chapter 171, Tax Code, for corporations to other qualified noncorporate entities.

BASIC TAX COMPUTATION

The basic formula that a taxable entity uses to calculate the amount that the rate of the tax applies to is to start with its total revenue and choose to deduct either employee compensation, including health, retirement, and workers' compensation benefits, or cost of goods sold, computed in a manner similar to that used for federal income tax purposes. This amount is capped at 70 percent of the taxable entity's total revenue.

Total revenue is determined under Section 171.1011, Tax Code, as added by SECTION 3 of the bill in a number of ways. For instance, for a corporation, total revenue equals line 1c plus lines 4-10 on Internal Revenue Service (IRS) Form 1120 and subtracting other specified amounts. For partnerships, total revenue equals line 1c plus lines 4-7 on IRS Form 1065, plus lines 2-11 on IRS Form 1065, Schedule K and subtracting other specified amounts. The total revenue for a non corporation or partnership is determined in a manner substantially equivalent to the amount for subdivision (1) or (2) determined by rules that the comptroller shall adopt. The comptroller shall also adopt rules to accomplish the legislative intent prescribed by Section 171.1011 (a) or (b). The comptroller shall adopt rules governing the computation of the actual cost to a health care provider of any uncompensated care provided under Section 171.1011(n)(2) and the audit requirements related to the computation of those costs.

Certain exclusions from total revenue are allowed.

Cost of goods sold is determined under Section 171.1012, Tax Code, as added by SECTION 3 of the bill. The term "goods" is defined as real or tangible personal property sold in the ordinary course of business and does not include services sold.

Cost of goods sold includes all direct costs of acquiring or producing goods, including the cost of labor and materials. It also includes indirect overhead costs related to the goods, but not to exceed four percent of the taxable entity's total indirect overhead costs. Cost of goods sold does not include selling, distribution, outbound transportation, and advertising costs, to name a few, nor does it include interest, income taxes, and officers' compensation. If the taxable entity is a lending institution, the entity may subtract as a cost of goods sold an amount equal to interest expense.

Compensation is determined under Section 171.1013, Tax Code, as added by SECTION 3 of the bill. The deduction for wages and cash compensation (excluding benefits) is capped at $300,000 per employee (including officers, directors, owners, and partners) and includes wages, salaries, stock options, and net distributive income from entities treated as S corporations and partnerships for federal income tax purposes, but only if the person receiving the distribution is a natural person. The $300,000 cap would be indexed to an inflation index every two years in the same manner used for the small business exemption. The compensation deduction also includes the cost of health, retirement, and workers' compensation benefits.

COMBINED REPORTING

Combined reporting and affiliated groups are provided for under Section 171.1014, Tax Code, as added by SECTION 3 of the bill. Taxable entities that are part of an affiliated group engaged in a unitary business must file a combined group report. Entities with 80 percent or more of property and payroll assigned to locations outside the U.S. would not be included in the combined report. The combined group would be considered a single taxable entity and must elect the same deduction from total revenue.

Special procedures govern how a combined group determines its total revenue, cost of goods sold, and compensation.

APPORTIONMENT

Multistate businesses would determine their Texas portion of the tax base using the same apportionment calculation currently used for franchise tax. The apportionment calculation is the ratio of Texas gross receipts to total gross receipts from the entire business.

Receipts excluded from total revenue may not be included in either the receipts of the taxable entity from its business done in Texas or from its entire business. Special apportionment procedures apply to a combined group.

CONFORMING CHANGES

SECTIONS 4-13 of the bill make conforming changes to Chapter 171, Tax Code, needed to replace the current franchise tax with the reformed tax. For example, the term "corporation" is changed to "taxable entity" throughout the bill, references to the current tax on either earned surplus or taxable capital are deleted, and certain provisions such as forfeiture of the right to transact business in the state that currently apply only to corporations are extended to all taxable entities.

CREDITS

SECTION 14 of the bill allows a corporation that has any unused tax credits that accrued under Section 171.111, Tax Code (temporary credit on net taxable earned surplus), repealed by the bill, and that the corporation accumulated before the effective date of the bill to claim those unused credits as if Section 171.111, Tax Code, continued in effect.

SECTION 15 of the bill repeals all existing franchise tax credits: Subchapter L (wages paid to Texas Department of Criminal Justice work program participants), Subchapter M (wages paid to certain children committed to Texas Youth Commission), Subchapter N (establishing day-care center or purchasing child-care services), Subchapter O (certain research and development activities), Subchapter P (certain job creation activities), Subchapter Q (certain capital investments), Subchapter R (contributions to before and after school programs), Subchapter S (credits limitation), Subchapter T (wages paid to persons with certain disabilities), and Subchapter U (title insurance holding companies).

Taxable entities with unused prior credits that have already been earned may continue to apply those credits for a certain period of time depending on the type of credit, as if the former law were continued in effect. The Comptroller shall adopt rules to administer SECTION 15.

SECTION 16 of the bill would allow written agreements between the Texas Department of Economic Development and taxpayers effective before June 1, 2006, concerning franchise tax credits to continue. Taxpayers would be allowed to accrue and claim the credits in the manner provided by the agreement for the specified duration.

NOT AN INCOME TAX

SECTION 17 of the bill specifies that Chapter 171, as amended by the bill, is not an income tax and Pub. L. No. 86-272 does not apply to the tax.

TRANSITION PROVISIONS

SECTION 18 of the bill provides that the first annual return and payment under the reformed franchise tax would be due on May 15, 2008, for the reporting period beginning on January 1, 2007, and ending on December 31, 2007. Certain exceptions for reporting periods are allowed for taxpayers that have accounting periods that do not correspond to the calendar year.

SECTION 19 of the bill requires certain large taxable entities to file an information report with the comptroller by February 15, 2007, including the amount of revenue the reformed franchise tax would have generated in fiscal 2006 if the new law had been in effect.

APPEAL

SECTION 20 of the bill requires that a suit brought by a taxable entity contending that the reformed franchise tax is unconstitutional must be brought in a district court in Travis County. The judgment of the district court may be reviewed only by direct appeal to the supreme court.

APPROPRIATION

SECTION 21 of the bill appropriates $2 million out of the general revenue fund to the comptroller of public accounts for the biennium ending August 31, 2007, to implement the tax changes made by the bill and for audit and enforcement activities.

SECTION 22 of the bill provides that, except as provided by SECTION 23 of the bill, the bill takes effect January 1, 2008.

Those sections of the bill that refer to Section 23 take effect June 1, 2006, if the bill receives the necessary vote to take immediate effect, or September 1, 2006, if it does not.

EFFECTIVE DATE

The bill takes effect January 1, 2008, except that a SECTION of the bill that provides that it takes effect as provided by SECTION 23 that takes effect June 1, 2006, if the bill receives the necessary vote to take immediate effect. If the bill does not receive the necessary vote for immediate effect that SECTION takes effect September 1, 2006.

COMPARISON OF ORIGINAL TO SUBSTITUTE

The substitute varies from the original in the following ways:

- makes changes in relation to the definition of passive entity in Section 171.0003, Tax Code;
- adds a new Section 171.1011(n-1), Tax Code, requiring the comptroller of public accounts to adopt rules relating to the computation and requirements of certain health care costs that are subtracted from a health care provider's total revenue;
- makes clarifying changes in Section 171.1012(i), Tax Code, in relation to the computation of certain cost of goods sold;
- makes clarifying changes in relation to the definition of "wages and cash compensation" in Section 171.1013(a), Tax Code;
- makes changes in relation to apportioning margin for receipts derived from transactions between individual members of a combined group in Section 171.1055(b), Tax Code;

- provides that the written agreement referenced in Section 16 of the bill is an agreement between the taxpayer and the Texas Department of Economic Development or its successor;
- makes changes in relation to the exclusion of certain flow-through funds from total revenue in Section 171.1011(f).
- adds a new Section 171.1011(g-3) to specify the funds which a taxable entity that provides legal services is required to exclude from its revenue; and
- makes grammatical and citation corrections throughout the original bill.