

BILL ANALYSIS

C.S.H.B. 3928
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Ways & Means
Committee Report (Substituted)

BACKGROUND AND PURPOSE

During the 79th Legislature, 3rd Called Session, 2006, the Legislature passed House Bill No. 3 to restructure the state's franchise tax to expand the tax to include newly taxed entities and change how the tax is calculated. Under the revised franchise tax (effective January 1, 2008, and applying to all tax returns filed on or after that date), also commonly known as the "margin tax", most partnerships - except general partnerships of natural persons - associations, business trusts, limited liability companies, and corporations must pay a tax based on total revenue, less the taxpayer's choice of either cost of goods sold or compensation. The resulting "taxable margin" may not exceed 70% of total revenue, is apportioned to Texas using gross receipts, and is taxed at a 1% tax rate or at 0.5% for wholesalers and retailers.

While the first annual payment of the revised franchise tax is not due until May of 2008, a number of issues have been identified that require correction, clarification, or revision. CSHB 3928 makes changes to the revised franchise tax.

RULEMAKING AUTHORITY

It is the committee's opinion that rulemaking authority is expressly granted to the comptroller in SECTION 11 of this bill.

ANALYSIS

The bill amends Section 171.0001, Tax Code, as effective January 1, 2008, to clarify or alter several definitions. The bill changes the definition of the Internal Revenue Code to that which existed on January 1, 2007. The definition of "controlling interest" expands the 80 percent ownership test for limited liability companies to apply to membership as well as beneficial ownership interest. The definition of "lending institution" is amended to include an entity that is regulated by the Commodity Futures Trading Commission or the Office of Thrift Supervision; is licensed by, registered with, or otherwise regulated by the Department of Savings and Mortgage Lending; or is a "broker" or "dealer" as defined by the Securities Exchange Act of 1934 at 15 U.S.C. Section 78c. The bill also adds definitions of "natural person" and "security", and restructures the definition of "unitary business".

The bill amends Section 171.0002, Tax Code, as effective January 1, 2008, to clarify the definition of "taxable entity" such that limited liability partnerships are taxable entities, and that "taxable entity" does not include a general partnership the direct ownership of which is entirely composed of natural persons and the liability of which is not limited under a statute of this state or another state, including by registration as a limited liability partnership. The bill strikes references to "family limited partnerships" and other specific types of entities that would already be excluded under the passive entity provisions; and, to clarify that nonprofit self insurance trusts and certain other trusts are not taxable entities. Also, the bill adds that an entity formed under the statutes of a foreign country that limit its liability and that can file as a sole proprietorship for federal tax purposes is not exempt from the revised franchise tax.

The bill amends Section 171.0003(a), Tax Code, as effective January 1, 2008, to add that capital gains from the sale of real property that does not produce income and is not used in the production of income, other than income described by Paragraph (D) of that subsection, gains from the sale of commodities traded on a commodities exchange, and gains from the sale of securities are included in the 90 percent income test for passive entities.

The bill amends Section 171.0004(e), Tax Code, as effective January 1, 2008, to clarify that the act of holding a seat on a board of directors does not by itself constitute conduct of an active trade or business.

The bill amends Section 171.001, Tax Code, as effective January 1, 2008, by adding Subsection (c) to clarify that the tax imposed under Section 171.001 or 171.0011 is not imposed on an entity if, during the period on which the report is based, the entity qualifies as a passive entity as defined by Section 171.0003.

The bill amends Sections 171.0011(a) and (b), Tax Code, as effective January 1, 2008, to delete an incorrect reference, to add a reference to clarify that the exit tax (the "additional tax") does not apply to an entity that qualifies as a passive entity, and to add a reference to net taxable earned surplus for determining the period on which the additional tax is calculated.

The bill amends Sections 171.002(a), (b), and (c), Tax Code, as effective January 1, 2008, to provide that the revised franchise tax rate is not based per year of privilege period. Also, the bill provides that an entity may not be considered a wholesaler or retailer for the purpose of being eligible for the 0.5 percent tax rate if the entity provides retail or wholesale utilities, including telecommunication services, electricity, "or" (rather than "and") gas.

The bill amends Section 171.002(d), Tax Code, as effective January 1, 2008, to increase the no-tax-due threshold from \$300,000 in total revenue to \$600,000 in total revenue or the amount determined under Section 171.006 per 12-month period on which margin is based.

The bill changes the heading to Section 171.006, Tax Code, as effective January 1, 2008, from "ADJUSTMENT OF ELIGIBILITY FOR EXEMPTION AND COMPENSATION DEDUCTION" to "ADJUSTMENT OF ELIGIBILITY FOR NO TAX DUE AND COMPENSATION DEDUCTION".

The bill amends Section 171.006(b), Tax Code, as effective January 1, 2008, to change the timing of the adjustments to the no-tax-due threshold and the compensation deduction from odd-numbered years beginning in 2009 to even-numbered years beginning in 2010.

The bill amends Section 171.101(d), Tax Code, as effective January 1, 2008, to require a taxable entity to notify the comptroller of its election of deduction not later than the due date of the annual report, and to prohibit a change of the election by filing an amended report.

The bill amends Section 171.1011(b) and (c), Tax Code, as effective January 1, 2008, to change the amounts included in calculating total revenue from the amounts "entered" on the federal return to the amounts "reportable" as income on the federal return. The bill changes the provisions excluding net distributive income from total revenue for certain entities. The bill corrects incorrect references to lines of the Internal Revenue Service forms used for determining the total revenue of a partnership subject to the revised franchise tax to ensure that guaranteed payments are not counted twice, and to include new references to lines of the Internal Revenue Services forms to provide that partnerships include their gross, rather than net, rental income and include certain farm income in calculating total revenue.

The bill amends Section 171.1011(b), Tax Code, as effective January 1, 2008, and adds a new Subsection (t) to provide that the Comptroller shall adopt rules as necessary to accomplish the legislative intent of Section 171.1011, rather than just subsections (a) and (b) of 171.1011.

The bill amends Section 171.1011(d), Tax Code, as effective January 1, 2008, to clarify that any taxable entity, and not only a corporation, that is part of a federal consolidated group must calculate its total revenue as if it had filed a separate return for federal income tax purposes.

The bill amends Section 171.1011(e), Tax Code, as effective January 1, 2008, to extend the requirement that the total revenue of a taxable entity include certain net income of a passive entity to apply to any passive entity.

The bill amends Section 171.1011(g-3), Tax Code, as effective January 1, 2008, to clarify the amounts that a taxable entity that provides legal services shall exclude from total revenue by moving, within the subsection, references to amounts previously included in total revenue.

The bill amends Sections 171.1011(n) and (o), Tax Code, as effective January 1, 2008, to clarify the amounts that a taxable entity that is a healthcare provider shall exclude from total revenue by moving, within the subsections, references to amounts previously included in total revenue.

The bill amends Section 171.1011(l), Tax Code, as effective January 1, 2008, is amended to replace “and” with “or” in order to clarify that "sales commission" means any form of compensation paid to a person for engaging in an act for which a license is required by Chapter 1101, Occupations Code; or compensation paid to a sales representative by a principal in an amount 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 on Internal Revenue Service Form 1099-MISC.

The bill amends Section 171.1012(a)(3)(A), Tax Code, as effective January 1, 2008, to clarify that live and prerecorded television and radio programs are tangible personal property, that the enumerated programs and recordings are tangible personal property without regard to the means or methods of distribution or the medium in which the property is embodied. Also, a change is made such that this property is tangible personal property without regard to whether the creator of the property is also the creator of the creative content of the property.

The bill amends Section 171.1012(c), Tax Code, as effective January 1, 2008, to limit the amount of depreciation, depletion, and amortization included in cost of goods sold to the amount reported on the federal tax return on which the revised franchise tax report is based.

The bill amends Section 171.1012(g), Tax Code, as effective January 1, 2008, to permit a taxable entity that is subject to Section 263A, 460, or 471, Internal Revenue Code, to expense costs includible in cost of goods sold or to capitalize those costs in the same manner and to the same extent the costs are capitalized on its federal income tax return, to require a taxable entity that elects to capitalize costs to capitalize each cost that it capitalized on its federal income tax return; to prohibit a taxable entity that elects to capitalize a cost and later elects to begin expensing that cost from deducting any cost in ending inventory from a previous report; to prohibit a taxable entity that elects to expense costs from subtracting as a cost of goods sold a cost incurred before the first day of the period on which the report is based; and to prohibit a taxable entity that elects to expense a cost of goods sold and later elects to capitalize that cost of goods sold from capitalizing a cost expensed on a previous report.

The bill amends Section 171.1012(h), Tax Code, as effective January 1, 2008, to require a taxable entity to determine its cost of goods sold, with some exceptions, in accordance with the methods used on the federal income tax return on which the revised franchise tax report is based.

The bill amends Section 171.1012(k), Tax Code, as effective January 1, 2008, to prohibit an entity primarily engaged in an activity described by category 5932 of the 1987 Standard Industrial Classification Manual published by the federal Office of Management and Budget, from subtracting interest expense as a cost of goods sold.

The bill amends Section 171.1013(a), Tax Code, as effective January 1, 2008, to clarify that the definition of “wages and cash compensation” includes net distributive income paid to a natural person by a limited liability company treated as a sole proprietorship for federal income tax purposes.

The bill amends Section 171.1013(b), Tax Code, as effective January 1, 2008, to clarify that the cost of a benefit is includible in compensation only to the extent it is deductible for federal income tax purposes.

The bill amends Section 171.1013(c), Tax Code, as effective January 1, 2008, to clarify that the \$300,000 limitation on the amount of wages and cash compensation includible in compensation, or the amount determined under Section 171.006, is limited per 12-month period on which margin is based. Also, language is added such that if a person is paid by more than one entity of

a combined group, the combined group may not subtract in relation to that person a total of more than \$300,000, or the amount determined under Section 171.006, per 12-month period on which margin is based.

The bill amends Sections 171.1014(b), (d) and (f), Tax Code, as effective January 1, 2008, to clarify that a combined group is a single taxable entity for purposes of the no-tax-due threshold under Section 171.002(d), that the taxable margin of the combined group may not exceed 70 percent of the combined group's total revenue under Section 171.101(a)(1)(A), and that the requirement that each member of a combined group determine compensation as if it were a separate entity is subject to the limitation in Section 171.1013(c).

The bill amends Section 171.1014, Tax Code, as effective January 1, 2008, by adding Subsection (d-1) to allow a member of a combined group to claim as cost of goods sold those costs that qualify under Section 171.1012 if the goods for which the costs are incurred are owned by another member of the combined group.

The bill amends Section 171.1014, Tax Code, as effective January 1, 2008, by adding Subsection (h) to require each taxable entity that is part of a combined group to include its activities for the same period used by the combined group in determining margin and apportionment.

The bill amends Section 171.1014, Tax Code, as effective January 1, 2008, by adding Subsection (i) to make each member of a combined group jointly and severally liable for the tax of the combined group.

The bill amends Section 171.1015, Tax Code, as effective January 1, 2008, to correct the transposed terms for "upper tier" and "lower tier" entities and to delete a statement that relieves an upper [sic] tier partnership from liability for the tax.

The bill amends Section 171.1055(b), Tax Code, as effective January 1, 2008, to clarify that the exception for receipts derived from certain sales of tangible personal property applies to receipts "ultimately" derived from such sales and to such property resold without "substantial" modification, and to define "receipts ultimately derived from the sale" as the amount paid for tangible personal property by a third-party purchaser.

The bill amends Section 171.106, Tax Code, as effective January 1, 2008, by adding Subsection (f) to provide that, notwithstanding Section 171.1055, if a loan or security is treated as inventory of the seller for federal income tax purposes, the gross proceeds of the sale of that loan or security are considered gross receipts.

The bill amends Section 171.111(a), Tax Code, as effective January 1, 2008, to change the time that a taxable entity must notify the comptroller in writing of its intent to take a credit for a business loss carryforward from not later than March 1, 2007 to the first revised franchise tax report originally due on or after January 1, 2008. Also, language is changed so that a taxable entity may claim the credit for not more than 20 consecutive privilege periods beginning with the first report originally due under this chapter on or after January 1, 2008 rather than after January 1, 2007.

The bill amends Section 171.111(b), Tax Code, as effective January 1, 2008, to allow a taxable entity to claim its accumulated business loss under the old franchise tax as a credit against the revised franchise tax at the earned surplus rate of 4.5 percent. The loss is claimable at 2.25 percent for reports originally due on or after January 1, 2008, and before January 1, 2018; and 7.75 percent for reports originally due on or after January 1, 2018, and before September 1, 2027.

The bill amends Section 171.111(c), Tax Code, as effective January 1, 2008, to delete the requirement that a taxable entity that notifies the comptroller of its intent to preserve its right to take a credit allowed by this section shall submit with its notice of intent a statement of the amount determined under Subsection (b)(1), and to revise the information that the comptroller may request a taxable entity to provide in connection with a business loss carryforward credit.

The bill amends Section 171.111(d), Tax Code, as effective January 1, 2008, to prohibit any conveyance, assignment, or transfer of a business loss carryforward credit and to revoke the right of a taxable entity to claim the credit if the entity changes combined groups after June 30, 2007.

The bill amends Section 171.111, Tax Code, as effective January 1, 2008, by adding Subsection (d-1) to prohibit a taxable entity, other than a combined group, from claiming a business loss carryforward credit unless the taxable entity was subject to the franchise tax on May 1, 2006; and to permit a taxable entity that is a combined group to claim the credit for each member entity that was subject to the franchise tax on May 1, 2006.

The bill amends Section 171.111, Tax Code, as effective January 1, 2008, by adding Subsection (d-2) to provide that the amount of business loss carryforward credit claimed on a report, including any unused credit carried forward, may not exceed the amount of revised franchise tax due for the report and that unused credits may not be carried forward to reports originally due on or after September 1, 2027.

The bill amends Section 171.111(e), Tax Code, as effective January 1, 2008, to change the expiration date of Section 171.111 from September 1, 2026 to September 1, 2027.

The bill amends Section 171.1121(b), Tax Code, as effective January 1, 2008, to clarify that a taxable entity must use the same method to apportion margin that they used in calculating margin.

The bill amends Section 171.1532(b), Tax Code, as effective January 1, 2008, to add a reference to net taxable earned surplus for reporting purposes.

The bill amends Section 171.201(a), Tax Code, as effective January 1, 2008, to make changes to the information on an initial report a taxable entity shall file with the comptroller.

The bill amends Section 171.203(a), (b), (d) and (e), Tax Code, as effective January 1, 2008, to make conforming changes to the franchise tax information report for the revised franchise tax, specifically by adding "limited liability company" to each occurrence of "corporation."

The bill amends Section 171.204, Tax Code, as by adding a new subsection (c) to permit the Comptroller to require an entity that claims it is not subject to the revised franchised tax to file information necessary to verify that claim.

The bill amends Subchapter G, Chapter 171, Tax Code, by adding a new Section 171.3015 to state that the comptroller may, for the same reasons and using the same procedures the comptroller uses in relation to the forfeiture of a corporation's charter or certificate of authority, forfeit the certificate or registration of a taxable entity.

The bill amends Section 171.309, Tax Code, to extend the secretary of state's authority to forfeit a corporation's charter or certificate of authority to forfeit the certificate, charter or registration of a taxable entity. Furthermore, it strikes language removing one of the conditions under which the secretary of state may forfeit the charter or certificate of authority of a corporation.

The bill amends the transition language in Section 17 of H.B. 3, 79th Legislature, 3rd Called Session, to delete an inaccurate reference to the repeal of Section 171.111, which was not actually repealed, and to clarify the reference to unused credits as those "established" rather than "accrued."

The bill amends the transition language in Sections 18(b) through (f) of H.B. 3, 79th Legislature, 3rd Called Session, to clarify the reference to unused economic development credits as those "established" rather than "accrued."

The bill amends the transition language in Section 22(b) of H.B. 3, 79th Legislature, 3rd Called Session, to add clarity to the provision and to delete the imposition of the franchise tax on an entity subject to the franchise tax anytime during 2007 that ceases to be subject to the franchise tax after June 30, 2007 and before January 1, 2008, because this provision is duplicative of the additional tax imposed by Section 171.0011, as effective until January 1, 2008.

The bill amends the transition language in Section 22 of H.B. 3, 79th Legislature, 3rd Called Session, by adding Subsections (b-1) and (b-2) to require an entity to file a report and to pay the revised franchise tax for the period that the entity does business in this state after June 30, 2007 and before January 1, 2008, if the entity is not subject to the old franchise tax during that period, the entity ceases to do business in this state prior to January 1, 2008, and the entity would be subject to the revised franchise tax if it were doing business in this state on January 1, 2008.

The bill amends the transition language in Section 22 of H.B. 3, 79th Legislature, 3rd Called Session, by adding Subsection (g) to require, except as provided by Subsections (b-1) and (b-2) of this section, an entity becoming subject to the revised franchise tax that is part of a combined group report, for purposes of determining margin and apportionment, to include in the combined report its activity for the same period used by the combined group.

The bill states that Section 30 of the bill, which contains the amendments to Section 22, H.B. 3, 79th Legislature, 3rd Called Session, takes effect immediately if the Act receives a vote of two-thirds of all the members elected to each house and takes effect on September 1, 2007 if the Act does not receive a two-thirds vote of all the members elected to each house.

The bill amends the transition language in Sections 23(b) and (f) of H.B. 3, 79th Legislature, 3rd Called Session, to eliminate the requirement that taxpayers file an information return in 2008 and to delete the requirement that taxpayers report maintenance and operations property taxes paid for the 2006 and 2007 school years.

The bill repeals the following provisions of the Tax Code:

- (1) Section 171.0011(e), as effective January 1, 2008;
- (2) Section 171.1014(g), as effective January 1, 2008; and
- (3) Section 171.2035, as effective January 1, 2008.

The bill states that the Act is effective January 1, 2008, except as otherwise provided, and applies only to reports due on or after that date.

EFFECTIVE DATE

This Act takes effect January 1, 2008, except that Section 30 takes effect immediately if this Act receives a vote of two-thirds of all the members elected to each house, as provided by Section 39, Article III, Texas Constitution. If this Act does not receive the vote necessary for immediate effect, Section 30 takes effect September 1, 2007.

COMPARISON OF ORIGINAL TO SUBSTITUTE

The substitute amends the definition of "lending institution" in a different manner than the original bill.

The substitute amends Section 171.0003(a), Tax Code, as effective January 1, 2008, to add that capital gains from the sale of real property that does not produce income and is not used in the production of income, other than income described by Paragraph (D), gains from the sale of commodities traded on a commodities exchange, and gains from the sale of securities are included in the 90 percent income test for passive entities. This language was not added in the original bill.

The substitute amends Sections 171.0011(a), Tax Code, as effective January 1, 2008, to delete an incorrect reference and to add a reference to clarify that the exit tax (the "additional tax") does not apply to an entity that qualifies as a passive entity. These changes were not made in the original bill.

The substitute increases the no-tax-due threshold from \$300,000 in total revenue to \$600,000 in total revenue, while the original bill did not address this change.

The substitute amends Section 171.006, Tax Code, as effective January 1, 2008, to change the timing of the adjustments to the no-tax-due threshold and the compensation deduction from odd-

numbered years beginning in 2009 to even-numbered years beginning in 2010. The original bill did not address this change.

The substitute includes passive entities in the provisions in Section 171.1011(c)(1)(B)(iii) and (c)(2)(B)(iii) that exclude net distributive income from total revenue and changes the singular to the plural in these provisions.

The substitute corrects incorrect references to lines of the Internal Revenue Service forms used for determining the total revenue of a partnership subject to the revised franchise tax to include new references to lines of the Internal Revenue Service forms to provide that partnerships include their gross, rather than net, rental income and include certain farm income in calculating total revenue. This language was not included in the original bill.

The bill amends Section 171.1011(e), Tax Code, as effective January 1, 2008, to extend the requirement that the total revenue of a taxable entity include certain net income of a passive entity to apply to any passive entity. The language was not included in the original bill.

The original bill deleted a provision that expressly included in costs described in Section 171.1012(c)(9) "all research or experimental expenditures described by Section 174, Internal Revenue Code." The substitute does not delete this provision, thus restoring the language originally enacted in House Bill No. 3 (79th Legislature, 3rd Called Session, 2006).

The substitute amends Section 171.1055(b), Tax Code, as effective January 1, 2008, to clarify that the exception for receipts derived from certain sales of tangible personal property applies to receipts "ultimately" derived from such sales and to such property resold without "substantial" modification, and to define "receipts ultimately derived from the sale" as the amount paid for tangible personal property by a third-party purchaser. The original bill did not make this clarification.

The substitute amends Section 171.106, Tax Code, as effective January 1, 2008, by adding Subsection (f) to provide that, notwithstanding Section 171.1055, if a loan or security is treated as inventory of the seller for federal income tax purposes, the gross proceeds of the sale of that loan or security are considered gross receipts. This language was not included in the original bill.

Both the original bill and the substitute amend the business loss carryforward credit in Section 171.111, Tax Code, as effective January 1, 2008. The differences between the original bill and the substitute in the amendment of Section 171.111 are:

- Under the substitute, 2.25 percent of the loss is claimable on each report originally due on or after January 1, 2008, and before January 1, 2018; and 7.75 percent of the loss is claimable on each report originally due on or after January 1, 2018, and before September 1, 2027. Under the original bill, 10 percent of the loss was claimable on each report originally due on or after January 1, 2008 and before September 1, 2017.
- Under the substitute, the loss is claimable at the earned surplus rate of 4.5 percent. Under the original bill, the loss was claimable at the revised franchise tax rate of either 0.5 percent or 1 percent.
- The substitute amends Section 171.111(d) Tax Code, as effective January 1, 2008, to prohibit any conveyance, assignment, or transfer of a business loss carryforward credit and to revoke the right of a taxable to claim the credit if the entity changes combined groups after June 30, 2007. The original bill did not amend Section 171.111(d).
- The substitute amends Section 171.111, Tax Code, as effective January 1, 2008, by adding Subsection (d-1) to prohibit a taxable entity, other than a combined group, from claiming a business loss carryforward credit unless the taxable entity was subject to the franchise tax on May 1, 2006; and to permit a taxable entity that is a combined group to claim the credit for each member entity that was subject to the franchise tax on May 1, 2006. Subsection (d-1) as added by the original bill would

have permitted only those entities subject to the old franchise tax to use a business loss carryforward credit against the revised franchise tax and contained no reference to a combined group.

- The substitute amends Section 171.111, Tax Code, as effective January 1, 2008, by adding Subsection (d-2) to provide that the amount of business loss carryforward credit claimed on a report, including any unused credit carried forward, may not exceed the amount of revised franchise tax due for the report and that unused credits may not be carried forward to reports originally due on or after September 1, 2027. The original bill did not include this provision.
- Under the substitute, Section 171.111 expires September 21, 2027. Under the original bill, Section 171.111 expires September 1, 2017.

In the original bill, Subsection (g) that was added to Section 22, Chapter 1, Acts of the 79th Legislature, 3rd Called Session, 2006, excepted Subsection (b)(1), while the substitute instead excepts Subsections (b-1) and (b-2).

The original bill repealed Section 171.0003(a-1), Tax Code, as effective January 1, 2008, while the substitute does not repeal this section. The substitute repeals Sections 171.1014(g), Tax Code, as effective January 1, 2008, and 171.2035, Tax Code, as effective January 1, 2008, while original bill did not repeal these two sections.