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Tax Reform in Texas: Was it the Perfect Storm?

Karey Barton
Principal

December 15, 2008

Agenda

- The background:
  - What was the emphasis driving tax reform?
  - How did the process work?
- The basics:
  - Who is subject to the tax?
  - When is it due?
  - How is it calculated?
- Tax Impacts
- Future Legislative Actions

The Long Tax Reform Road

- Driving factors for tax reform include:
  - Increasing reliance on local Property Taxes.
    - State share of school funding continued to decrease.
  - "Voluntary" status of Franchise Tax.
    - Growth in Franchise Tax receipts was slower than all other state taxes over last decade.
  - Tax system that did not mirror state's economy.

Tax System – State Economy

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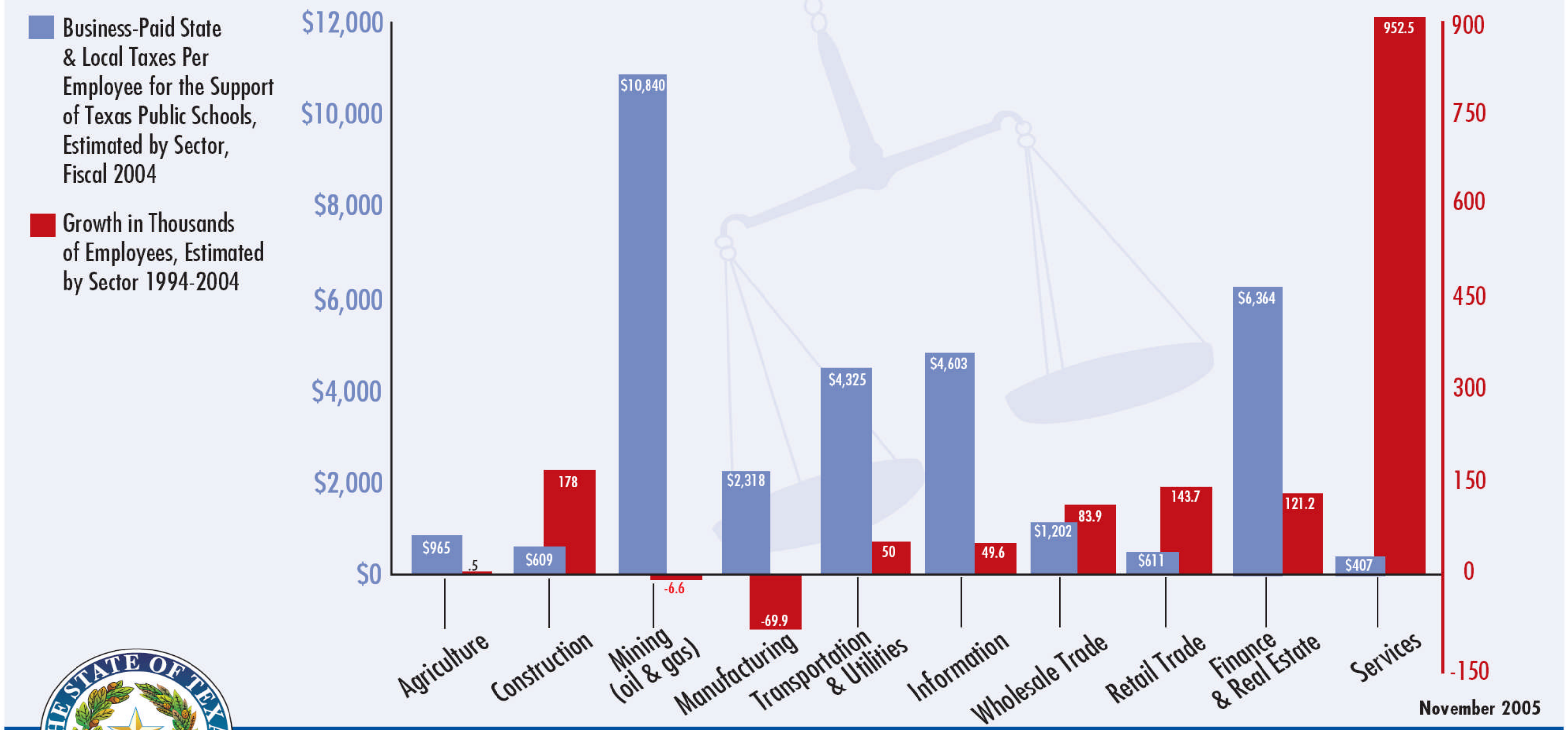
Business-Paid State & Local Taxes Per Employee and Growth in Thousands of Employees



November 2005

THE STATE OF TEXAS

Texas Tax Reform Commission

Data Sources: Texas Comptroller's Office, Texas Taxpayers and Research Association

The Long Tax Reform Road

- Previous Attempts:
  - Attempts prior to adoption of “revised” Franchise Tax included two regular sessions and three special sessions.
  - Timeline of attempts runs from 1986 to 2005.
    - Sales Tax – broaden base or tax all services (1986, 1996, 2003, & 2005)
    - Business Tax
      - Proposed BAT/VAT in 1991 & 1997
      - Modified Franchise Tax base in 1991 – earned surplus
      - Proposed payroll and gross receipts in 2005
      - Proposed modifications to Franchise Tax in 2005
      - Modified Franchise Tax base and reporting basis in 2006 – margin tax base and combined reporting
    - Property Tax
      - Split Rolls in 1993 & 1997

Beginning of Perfect Storm

- West Orange Cove Litigation:
  - School districts challenged State on school finance structure
  - Supreme Court decision issued on November 2005.
    - Most recent decision over the last two decades.
    - State prevailed on all but one issue.
      - Statewide Property Tax.
      - June 1, 2006 deadline to address.

Second Part of Perfect Storm

- Texas Tax Reform Commission:
  - Created by Governor Perry in September 2005
    - Named former Comptroller John Sharp as Chair
    - Named 23 additional members of the Commission in November 2005.
  - Commission held 18 meeting
  - Commission presented plan to Governor on March 29, 2006
  - The Commission's plan was endorsed by more than 20 major business and trade organizations and Chambers of Commerce.

Culmination of a Perfect Storm

- Business and Chamber of Commerce support significant property tax rate reduction.

- School reforms were put on back burner.
  - Reforms were not added to legislation until after passage from the House.

- Politically viable plan included:
  - Net tax cut.
  - No sales tax.

Part of a Package Deal

- Property Tax Relief:
  - HB 1 Property Tax rate reduction.
  - HB 2 Dedication of Revenue for Property Tax rate cuts.

- Funding for Property Tax Relief:
  - HB 3 “Revised” Franchise Tax.
  - HB 4 “Liar’s Affidavit” Motor Vehicle Sales Tax.
  - HB 5 $1/pack increase in Cigarette Tax and increase in other tobacco products taxes.

- Net Tax Cut:
  - Surplus/future revenue growth.

Revenue Impact

- "Revised" Franchise Tax estimated to generate about $6 billion
  - Estimated to increase revenue base by $3 billion
  - Actual collections approximately $1.5 billion lower than estimate.

- Tobacco Taxes estimated to generate about $700 million
  - Actual collections higher than estimate

- Motor Vehicle Sales Tax change estimated to generate about $65 million

Property Tax Rate Reduction

- Total legislative package estimated at $15.7 billion net tax reduction over 3 years.
  - Reduction in school maintenance and operations (M&O) tax rates phased-in over 2 years.
    - First year, 2006, M&O rate reduced by $.17.
    - Second year, 2007, M&O rate reduced by additional $.33 for a total reduction of $.50.
  - Truth-in-taxation provisions are strengthened.
    - Maximum M&O rate that a school district can impose without voter approval in 2007 is:
      - The lesser of $1.04 or the effective tax rate plus $.04.

The Basics of the "Revised" Franchise Tax

- Broader Base and Lower Rate:
  - Applies to a broader range of business types.
  - The Capital and Earned Surplus Tax Bases are replaced with a Margin Tax Base.
  - The Tax Rates are changed to 1% and .5% for qualifying retailers and wholesalers.

- Timing – Reports due on or after January 1, 2008.

Taxable Entities

- Entities with liability protection include:
  - Limited liability partnerships.
  - Limited partnerships.
  - Business trusts.
  - Corporations.
  - Limited liability companies.
  - Professional associations.
  - Professional corporations.

Nontaxable Entities

- Certain entities are NOT subject to the tax, including:
  - Entities currently exempt from franchise tax.
  - Entities that qualify as passive.
  - Escrows.
  - Estates of natural persons.
  - Grantor trusts that qualify.
  - REITs that qualify.
  - REMICs.
  - Sole proprietorships and general partnerships owned by natural persons.
  - Taxable entities that owe less than $1,000 in tax.
  - Taxable entities with $300,000 or less in total revenue.

Exempt Entities

- The following entities may be exempt from the tax:
  - Entity subject to insurance premium taxes.
  - Entity organized for the exclusive purpose of promoting the public interest of any county, city, town, or other area within the state.
  - Certain nonprofit organizations:
    - Charitable.
    - Educational.
    - Home Owner’s Association.
    - Religious.

Passive Entities

- General, limited partnership, or non-business trust.
- Meets 90% passive income test.
  - 90% of income must be passive income.
  - Types of Passive income: dividends, mineral royalties, Limited Liability Corporation (LLC) income, interest, distributive shares of partnership income, net capital gains from sales of real property, and net gains from the sales of securities.
- No more than 10% of gross income from conducting active trade or business.
- Rental income not considered passive income.

Small Business Provision

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- Scaled tax liability discount schedule for small businesses (House Bill 3928):
  - 100% discount for taxable entities with ***$300,000 or less*** in total revenue.
  - 80% discount for taxable entities with more than ***$300,000 but less than $400,000*** in total revenue.
  - 60% discount for taxable entities with ***$400,000 or more but less than $500,000*** in total revenue.
  - 40% discount for taxable entities with ***$500,000 or more but less than $700,000*** in total revenue.
  - 20% discount for taxable entities with ***$700,000 or more but less than $900,000*** in total revenue.

When is the Tax Due?

- Generally, the Margin Tax is effective for reports due on or after January 1, 2008.
  - First report due May 15, 2008.
  - Transition provisions for entities ceasing to do business.
    - Affected entities include:
      - Entities not previously subject to franchise tax.
      - Doing business after June 30, 2007, but not after January 1, 2008.
    - Entities must pay “Exit Tax.”

How is the Tax Calculated?

- Taxable Margin Calculation:

Lesser of 70% of TOTAL REVENUE *or* TOTAL REVENUE less either Cost of Goods Sold or Compensation	×	APPORTIONMENT FACTOR	×	TAX RATE

- The election to deduct either Cost of Goods Sold (COGS) or Compensation is done on an annual basis and is irrevocable.

Tax Rates

- General rule:
  - 1% tax rate for all entities.
- Exception:
  - .5% tax rate for entities primarily engaged in retail and wholesale trade (includes restaurants).
- Primarily engaged in retail and wholesale trade if:
  - Total revenue from retail and wholesale trade is greater than total revenue from non-retail and wholesale trade activities.
  - Less than 50% of the total revenue from retail and wholesale trade activities comes from the sale of products produced by the entity or an affiliated entity.
  - The entity does not provide retail or wholesale utilities such as telecommunications, electric, or gas.

EZ Tax

- A taxable entity with $10 million or less in total revenue may choose an alternative calculation to determine tax liability.

Total Revenue	×	**Apportionment Factor**	×	**0.575% Tax Rate**

- – Taxable entity choosing the EZ tax calculation may not take any credits authorized by the Margin Tax.
- – Taxable entity choosing the EZ tax calculation is eligible for the small business scaled discount schedule.

Total Revenue

- Amounts reportable as income on Federal Income Tax returns:
  - Gross receipts or sales, less returns and allowances.
  - Dividends.
  - Interest.
  - Gross rents.
  - Gross royalties.
  - Net capital gains.
  - Other income:
    - Ordinary income from trade or business activities of a partnership, LLC, or S-Corporation.

Total Revenue

- Specific allowable subtractions from total revenue:
  - Bad debt.
  - Foreign royalties and dividends.
  - Net distributive income from partnerships, LLCs, and S-Corporations (unless the income is from a passive entity).
  - Allowable deductions from Form 1120, Schedule C (dividends received deduction).
  - Income items from disregarded entities.
  - Dividends and interest from federal obligations.

- Specific situational and industry adjustments

Cost of Goods Sold

- Statutorily defined:
  - Similar to federal definition.

- Cost of Goods Sold:
  - Deduction generally can only be taken by entities selling or producing goods it owns.

- Goods:
  - Includes tangible personal property and real property.

Cost of Goods Sold

- COGS includes costs related to acquiring or producing goods.
  - Direct costs:
    - Labor directly related to production and acquisition of goods
    - Material costs (incorporated, consumed and acquired)
    - Production equipment costs
    - Research and Development cost related to production of goods
    - Utility costs consumed in production.
  - Indirect costs:
    - Limits indirect and administrative overhead costs that are allocable to the acquisition or production of goods to 4% of total indirect and administrative overhead costs.

Specific Industry Provisions

- Certain expenses for mining industry, such as depletion or geological costs can be included in COGS.

- Interest expense is COGS for lending institutions.
  - Regulated entities making loans to the public.
  - Excludes entities primarily engaged in activities described by the 1987 Standard Industrial Classification Manual, Category 5932 (Rule 3.588).

Specific Industry Provisions

- COGS deductions can be taken by certain rental or leasing businesses.
  - Entities renting or leasing motor vehicles.
  - Entities renting or leasing heavy construction equipment.
    - Rule 3.588 defines:
      - Self-propelled, self-powered, or pull-type.
      - Weighs more than 3,000 pounds.
      - Intended for use in construction.
  - Entities renting or leasing railcar rolling stock.

Cost of Goods Sold: Ineligible Costs

- Equipment costs not directly related to production:
  - Selling costs:
    - Employee expenses.
    - Sales commissions paid to third parties.
  - Advertising costs.
  - Bidding costs (successful or otherwise).
  - Interest costs.
  - Income taxes.
  - Officers' compensation.
  - Undocumented worker's compensation.

Compensation

- Compensation is defined as wages and salaries and employee benefits.
  - Wages (Medicare wages and tips box on W-2), plus:
    - Distributions to a natural person from entities treated as partnerships and S-Corporations.
    - Federal tax deductible stock awards and options.
    - Limited to $300,000 per employee.
  - Benefits (federal tax deductible benefits not subject to $300,000 cap):
    - Health care expenses.
    - Retirement expenses.
    - Worker's compensation expenses.
- Undocumented worker's compensation cannot be deducted.

Compensation

- Compensation deduction.
  - Compensation does not include:
    - Payments to independent contractors on Form 1099.
    - Anything excluded from revenue.
    - Employer's share of payroll tax.
    - Compensation paid to employee directly associated with operation of a facility located on military property.
    - Wages or cash paid to undocumented workers.
  - Benefits do not include:
    - Wages and cash compensation.
    - Discounts on the entity's merchandise or services.
    - Payroll taxes.
    - Working condition amounts provided to perform job (e.g., company car, education, and travel).

Apportionment

- Limited changes.
  - Current apportionment rules and policies are meant to apply to Margin Tax.
  - Single gross receipts factor remains the standard.
- No throwback rule.
  - Not a net income tax per statute.

Unitary Combined Reporting

- Taxable entities in a unitary affiliated group must file a combined report.
  - An affiliated group is a group of one or more entities owned by common owner(s).
    - Controlling interest is more than 50% ownership.
  - Water’s edge unitary combined reporting is required.
    - Excludes a taxable entity that conducts business outside of the United States and has 80% or more of its property and payroll outside the United States.
      - If the entity does not have property or payroll, then it is excluded if 80% or more of its gross receipts are outside the United States.

Unitary Combined Reporting

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- All members of the combined unitary group must make the same election of COGS or compensation.
  - Each group member determines total revenue, COGS, and compensation as if filing separately.
    - Inter-entity COGS, compensation, and total revenue are eliminated.
    - Combined margin is pre-apportionment.

Apportionment

- Joyce rule for apportionment of a combined group:
  - Texas sales in the apportionment numerator include only those sales made by entities with nexus in Texas.

- Finnegan rule for information only (House Bill 3928):
  - The combined unitary group must report its Texas sales of the non-nexus members of the combined group.
  - No tax due based on Finnegan.

Unity Specifics

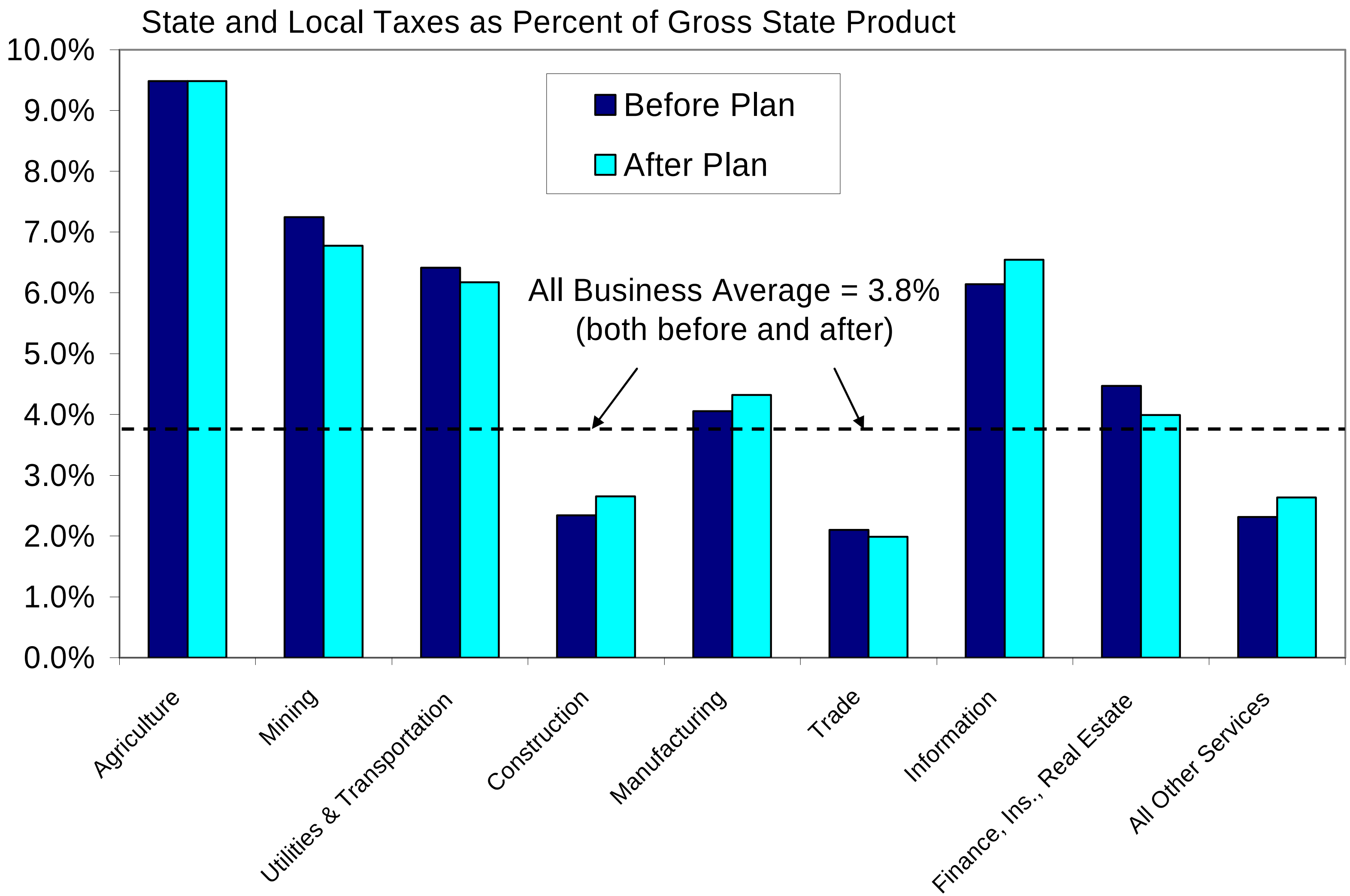
- To be unitary, entities must be sufficiently:
  - Interdependent.
  - Integrated.
  - Interrelated.

- Activities of the entities to be analyzed to determine if they are:
  - Entities in the same general line of business.
  - Steps in a vertically or horizontally structured process.
  - Functionally integrated (strong centralized management).
    - Authority of purchasing, financing, personnel, and marketing.

Unity: Texas Style

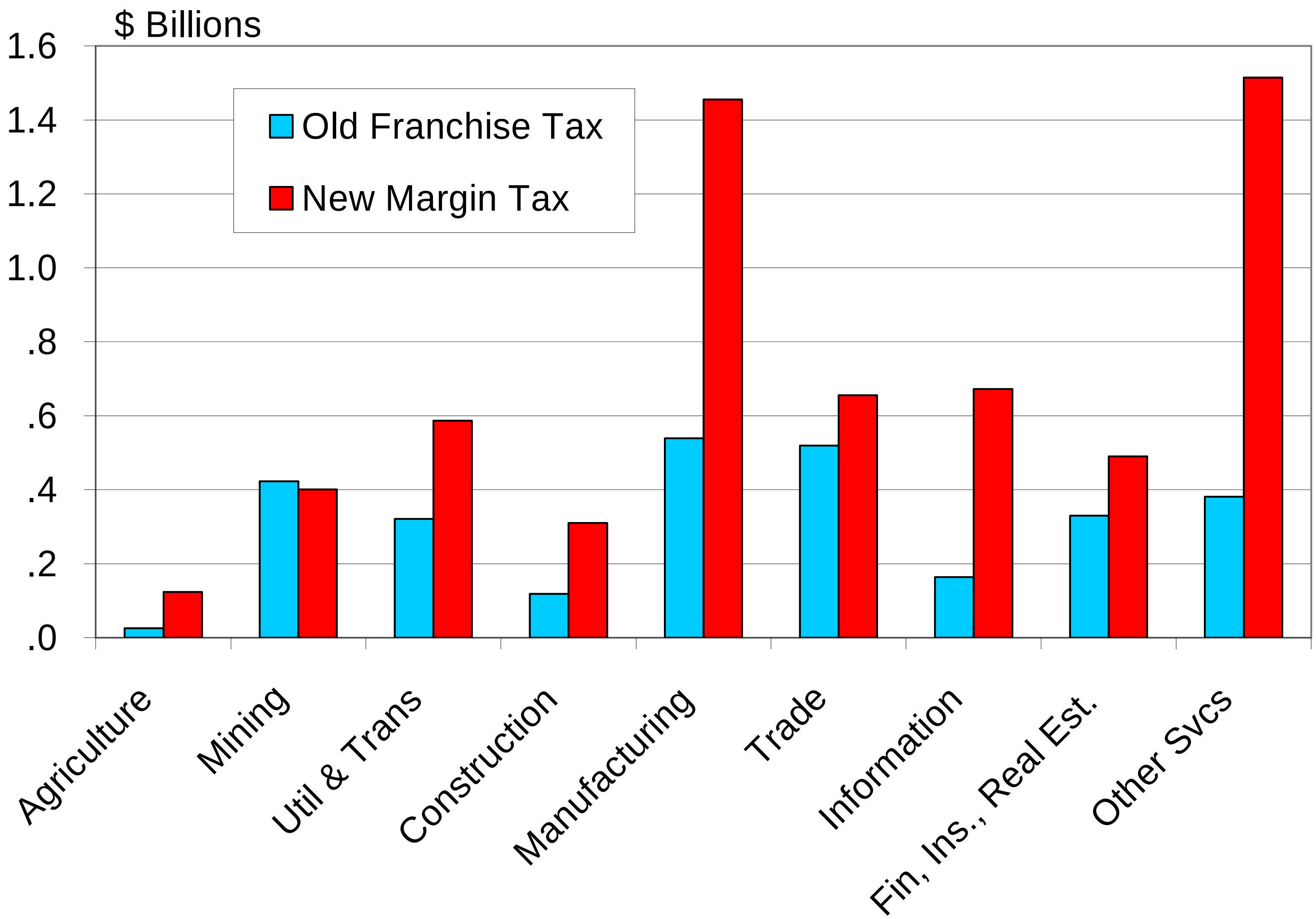
- Texas Unitary Groups may include non-corporate entities.
  - LLCs.
  - Partnerships.
  - Trusts, etc.
  - Taxpayers must analyze more business relationships for Texas than for other states to determine unity.

Overall Package Impact by Industry



Source: Texas Taxpayers and Research Association

New Margin Vs Old Franchise Tax



Source: Texas Taxpayers and Research Association

Impacts and Issues

- Capital intensive service industries
  - Telecommunications
  - Transportation – Trucking
- Mixed Business entities
  - Service and Retail
  - Manufacturing and Service
- Taxpayers with non-profitable years still owe tax
- Size of the Texas Franchise Tax
- Small Businesses
- Taxpayer Compliance burdens and State administration

Future Legislative changes

- Potential legislative changes to be considered during the 2009 legislative session:
  - Apportionment:
    - Which standard will be used for unitary combined reports?
      - Joyce or Finnegan.
      - Certain legislative leaders believe Joyce method is a “loophole.”
      - Information from Finnegan reporting requirement.
  - Special deductions for certain industries
  - Deductibility of 1099 payments.

Questions?