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HOW THE NEW TEXAS MARGIN TAX WILL AFFECT MEDICAL PRACTICES

Sweeping changes have been made to the Texas franchise tax which will have a significant impact on virtually every medical practice in the state. The franchise tax, which previously applied only to corporations and limited liability companies ("LLCs"), now will apply to nearly all types of entities conducting business within the state, including professional associations and limited partnerships, but excluding general partnerships owned entirely by individuals, "passive entities," and certain other types of entities. This article examines how the new tax rules operate, and considers potential impacts on existing business structures common in medical practices.

How the New Tax is Computed

In General. The new tax is imposed on the entity's modified gross revenue or "margin" and consequently is commonly referred to as the "Margin Tax." Margin is the lesser of (a) 70% of an entity's total revenue or (b) the taxable entity's total revenue less (at the taxpayer's election) either cost of goods sold or compensation. Total revenue means the entity's gross revenues from its federal income tax return, with certain adjustments. Receipts generally do not include amounts received from pass-through entities, including S corporations and partnerships (which are now taxable entities) in order to avoid double taxation. The existing tax on capital and earned surplus is eliminated.

Cost of goods sold is subject to a number of special rules, and includes the cost of real or tangible personal property sold, plus a very limited overhead allowance, but not the cost of intangible property or services. The alternative deduction of compensation permits a business to deduct all employee wages and net distributive income to individual partners or S corporation shareholders, subject to a maximum per individual of \$300,000 plus benefits (including deductible retirement payments). Payments to independent contractors who are not employees are not deductible as compensation, nor are payments to undocumented workers.

Margin is then apportioned to Texas using a single factor formula equal to the ratio of gross receipts from business done in Texas to gross receipts from the entire business. The apportioned amount, less any special deductions, is referred to as the entity's "taxable margin."

The tax rate is generally 1% of taxable margin, except that taxable entities primarily engaged in retail or wholesale trade pay a tax of 1/2% of taxable margin. No tax is due if the computed tax would be under \$1,000 or if the entity's total revenue from its entire business is \$300,000 or less. Businesses that fail to file returns and pay tax can lose their right to do business in Texas.

The new tax applies to returns due on or after January 1, 2008. However, because the Texas franchise tax is generally based on the taxable margin earned during the preceding taxable year, receipts in 2006 and 2007 can be subject to the new tax. In addition, entities desiring to claim a credit against the new tax for NOL carryovers created under the existing franchise tax must notify the Comptroller by March 1, 2007 (it is expected that the Comptroller will extend this deadline to September 1, 2007).

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Combined Reporting. Taxable entities that are part of an affiliated group (80% of each entity has common ownership) and are engaged in a "unitary business" are treated as a single combined taxable entity under the new law. Entities are generally treated as comprising a unitary business where their activities are in the same general line of business or are steps in a vertically structured enterprise and where they are functionally integrated through strong central management.

Special Rules for Health Care Industry. Certain special rules apply to Health Care Providers and Health Care Institutions. Health Care Providers are not taxed on payments from Medicare, Medicaid, CHIP, workers' compensation or Tri-Care Health System Program ("Governmental Insurance"). Similarly, Health Care Institutions such as hospitals, EMS providers, nursing homes and hospices are taxed on only half of any Governmental Insurance received.

Wholesale and retail pharmacies and suppliers of medical, dental, and hospital equipment generally will be treated as wholesale or retail trades and subject to the 1/2% rate. The remainder of medical businesses, including doctors' practices, dental practices, nursing care, hospitals and laboratories generally will be subject to the 1% rate.

Typically, medical practices other than pharmacies or medical supply companies will not have a significant amount of costs of goods sold and therefore will elect to deduct compensation. Because compensation is limited to \$300,000 per individual (plus benefits), the tax impact can be roughly estimated at 1% of receipts less deductible compensation. Viewed in another way, the tax is roughly equal to 1% of overhead, including rent, insurance, and payments to vendors plus compensation in excess of \$300,000. In no event, however, will the tax exceed .7% of taxable receipts (1% rate x 70% of taxable receipts).

Impacts on Existing Business Structures

Existing business structures may have unexpected consequences under the Margin Tax. For example, a partnership in which the partners are professional associations or PAs will not be able to deduct the \$300,000 compensation to each partner because that deduction applies only to compensation or profits of individual partners. In addition, entities that are disregarded entities for federal tax purposes may nevertheless be subject to the Margin Tax. Finally, a single business may have been divided between several different entities, such as a limited partnership owning a medical office building, which is leased to the practice itself, operated as a PA, with a related medical supply business held in another entity. Under the combined entity rule, these entities may be treated as a single entity for Margin Tax purposes, with "internal" payments ignored. If so, whether that entity qualifies for the 1/2 percent rate for retail trade and whether it should elect to deduct cost of goods sold or compensation will be determined on a combined basis. In other circumstances, the related business entities might not be eligible to file a combined report (for example, due to lack of 80% overlapping ownership), and payments between the entities might give rise to double taxation. For example, rent paid by the practice group to a related real estate holding company might not be deductible by the practice group but might be taxable margin to the real estate holding company.

The new tax is complicated and, as might be expected of such a sweeping change, presents a multitude of uncertainties and questions in its application. The Comptroller is in the process of preparing regulations and guidelines on the

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new tax and it is expected there also may be legislative corrections and changes. It would be advisable for medical businesses to analyze the likely impact of the new tax on their existing business structures as early as possible and consider whether there may be planning opportunities to pursue or pitfalls to avoid. Because of the effective date, restructurings completed before January 1, 2007 may offer additional tax savings. Strasburger will be glad to assist its clients in navigating through the uncertain waters of this new tax structure.