

IF YOU HAVE QUESTIONS REGARDING THIS MATTER, PLEASE CONTACT:



Daniel L. Butcher
Managing Partner - Dallas
901 Main Street, Suite 4400
Dallas, Texas 75202-3794
214.651.4640
dan.butcher@strasburger.com



Farley P. Katz
Partner - San Antonio
300 Convent Street, Suite 900
San Antonio, Texas 8205-3715
210.250.6007
farley.katz@strasburger.com



James R. Browne
Partner - Dallas
901 Main Street, Suite 4400
Dallas, Texas 75202-3794
214.651.4640
jim.browne@strasburger.com

Taxes & Estates Group

Luke Bailey	Jack Kinnebrew
Jack Dugan	Michael McClelland
Brad Fletcher*	Charles Muller
Jason Forshee	John Round
Drake Frazier	Dani Smith

*Not licensed to practice law in the state of Texas.

SUMMARY OF NEW TEXAS BUSINESS ENTITY OR “MARGIN” TAX

The state legislature has passed and the Governor has signed into law the most sweeping revision of the franchise tax since it was expanded to reach earned surplus in 1991.

The new franchise tax will apply to most business entities that do business or are organized in Texas, including corporations, partnerships, professional associations, etc., but not general partnerships owned entirely by individuals, “passive entities,” and certain passive family limited partnerships. 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.

The tax base will be the entity or combined entity’s modified gross revenue or “taxable margin” that is apportioned to Texas. Taxable margin is the lesser of 70% of an entity’s total revenue or 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. 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, but not the cost of intangible property or services. The alternative deduction of compensation permits a business to deduct all wages, benefits and partnership net distributive income to individuals, subject to a maximum \$300,000 per individual.

Taxable margin is apportioned to Texas using a single factor formula equal to gross receipts from business done in Texas over all gross receipts.

The tax rate is one-percent of taxable margin, except for taxable entities primarily engaged in retail or wholesale trade (including restaurants) which pay a tax of one-half percent. No tax is due if the computed tax would be under \$1,000 or if the entity’s total business revenue 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, since the tax is generally based on the taxable margin using the federal income tax return filed in the preceding year, income 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.

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. Special rules apply to various types of businesses, including banks, law firms, health care providers, employee leasing companies, and certain businesses with foreign income.

It would be advisable for businesses to analyze the likely impact of the new tax on their existing business structure as early as possible and consider whether there may be planning opportunities to pursue or pitfalls to avoid. Strasburger will be glad to assist its clients in navigating through the uncertain waters of this new tax structure.

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