Texas Margin Tax Rules
Part II

Charles D. Pulman, J.D., LL.M., CPA
Partner, Meadows, Collier, Reed, Cousins & Blau, L.L.P.
Dallas, Texas

Thomas G. Hineman, J.D., LLM
Partner, Meadows, Collier, Reed, Cousins & Blau, L.L.P.
Dallas, Texas

In 2006, the Texas Legislature passed and the Governor signed into law House Bill 3, which substantially revises the Texas franchise tax by expanding the types of businesses that are subject to the tax, expanding the tax base, lowering the tax rate, and eliminating a number of credit provisions previously included in Chapter 171 of the Texas Tax Code. Notably, HB 3 subjects partnerships to the new Texas franchise tax (a.k.a. the "Margin Tax"), exempts "passive" entities, and introduces combined reporting for certain affiliated entities. The new tax becomes effective in 2008 based upon activity in 2007. The prior franchise tax by comparison was imposed on corporations and limited liability companies and was the greater of 0.25% of an entity's taxable capital (adjusted GAAP net worth) or 4.5% of taxable earned surplus (adjusted federal taxable income plus officer and director compensation).

The 2007 Texas Legislature passed a technical corrections bill, HB 3928, which made a number of revisions to the new Margin Tax. HB 3928 was signed into law by Governor Perry.

The Texas Comptroller of Public Accounts ("Comptroller") issued on December 11, 2007, the final set of Rules ("Rules") implementing the Texas Margin Tax, which were published on December 28, 2007, in the Texas Register, Volume 32, Number 52, Pages 9879-10118. Several organizations, including the State Bar of Texas, Section of Taxation ("SBT") and the Texas Society of Certified Public Accountants ("TSCPA"), submitted comments to the proposed rules that were issued on August 27, 2007 ("Proposed Rules"). The comments of these organizations and the Comptroller's response can be found in the Rules as published in the Texas Register. The Rules, as codified, are found at 34, Texas Administrative Code, Part 1, Chapter 3, Subchapter V, Franchise Tax, Rules, §3.581 et. seq. The Rules can be found at:

http://www.sos.state.tx.us/texreg/archive/December282007/adopted/34.PUBLIC%20FINANCE.html#258.

In January 2008, the Comptroller issued, in draft form, the tax forms and instructions ("Draft Instructions"). As of the writing of this article, final forms and instructions have not been issued.

The purpose of this article is to present those provisions of the Rules that are different from or clarify the Margin Tax statute, as amended, or that are not contained in the Margin Tax statute, as amended. Provisions in the Rules that are the same as the Margin Tax statute, as amended, are omitted from this article. Statements preceded by the word "Comment" are comments of the authors of this article. This article does not present or discuss the Margin Tax statute as a whole or every provision of the Rules. This article is written on the assumption that the reader is familiar generally with the Margin Tax statute.

The Margin Tax, as amended by HB 3928, was discussed in an article contained in Summer 2007, Volume 26, No. 2 edition of the Petroleum Accounting and Financial Management Journal.

The information included in this article is intended to be general in nature and should not be relied upon without seeking individual legal advice.

All references to "Code Section" or "IRC" are to the Internal Revenue Code of 1986, as amended.

References in this article to "***" signify that portions of the particular Rule have been omitted from this article.

Summary of Rules and Implemented Sections.

The following is a chart showing the number of each Rule, the title of each Rule and the corresponding sections of the Margin Tax statute, as amended, that are implemented by that Rule.

Rule	Title	Implemented Section
3.581	Taxable and Non-Taxable Entities	171.0002
3.582	Passive Entities	171.0003
3.583	Exemptions	171.0002 & 171.088
3.584	Reports and Payments	171.002, .0021, .101, .1016, .151, .152, .1532, .154, .201, .202, .203, .212
3.585	Annual Reports Extensions	171.202
3.586	Nexus	171.001, 171.106
3.587	Total Revenue	171.1011
3.588	Costs of Goods Sold	171.1012
3.589	Compensation	171.1011, 171.1013
3.590	Combined Reporting	171.0001, .0002, .002, .101, .1011, .1014, .1016, .103, .105, .1055, .0021
3.591	Apportionment	171.103, .1055, .106, .1121
3.592	Additional Tax	171.0011
3.593	Franchise Tax Credits	171, Subchapter Q-1
3.594	Business Loss Carryforwards	171.111
3.595	Transition	H.B. 3, §22; H.B. 3928, §35

Rule 3.581 – Taxable and Non-Taxable Entities
Implements Tax Code Section 171.0002

Rule 3.581 sets forth guidelines to determine the taxability of legal entities under the Tax Code, Chapter 171. This Section applies only to franchise tax reports due on or after January 1, 2008 and defines words and terms, provides a detailed list of entities that are taxable and not taxable, and addresses the taxability of a single member limited liability company ("SMLLC").

Subsection (b) of this Section sets forth definitions of terms and words. This subsection reads as follows:

(b) Definitions

(1) Banking Corporation. Each state, national, domestic, or foreign bank, whether organized under the laws of this state, another state, or another country, or under federal law, including a limited banking association organized under Finance Code, Title 3, Subtitle A, and each bank organized under §25(a), Federal Reserve Act (12 U.S.C. §§611-631) (edge corporations), but does not include a bank holding company as that term is defined by Bank Holding Company Act of 1956, §2, (12 U.S.C. §1841).

(2) Business Trust. An entity as defined by Treasury Regulation Section 301.7701-4(b).

(3) Corporation. An entity formed pursuant to Business Corporation Act; Non-Profit Corporation Act; Professional Corporation Act; Business Organizations Code, Title 2 or 7, or equivalent statute of Texas or another jurisdiction.

4) Escrow. Legal arrangement whereby an asset is delivered to a third party to be held in trust or otherwise pending a contingency or the fulfillment of a condition or conditions in a contract.

(5) Estate of Natural Person. An entity as defined by Internal Revenue Code §7701(a)(30)(D), excluding estate taxable as business entity under Treasury Regulation §301.7701-4(b). An estate of a natural person shall include a trust that makes an election under Internal Revenue Code, §645 to be treated and taxed as part of an estate for federal income tax purposes.

(6) General Partnership. A partnership described in Revised Partnership Act (Art. 6132b-1.01 et. seq.) or Business Organizations Code, Title 4, Chap. 152, or equivalent statute in another jurisdiction.

(7) Grantor Trust. A trust as defined by Internal Revenue Code §671 and §7701(a)(30)(E), excluding a trust taxable as a business entity pursuant to Treasury Regulation §301.7701-4(b).

(8) Holding Company. Entity that confines its activities to owning stock in, and supervising management of, other companies.

(9) Joint Stock Company. A common-law unincorporated business enterprise of natural persons possessing common capital with

ownership interests represented by shares of stock.

(10) Joint Venture. A partnership engaged in the joint prosecution of a particular transaction for mutual profit.

(11) Limited Liability Company. An entity formed pursuant to Limited Liability Company Act, Article 1528n, or Business Organizations Code, Title 3 or 7, or an equivalent statute in another jurisdiction.

(12) Limited Liability Partnership. A partnership registered pursuant to Revised Partnership Act, Article 6132b-3.08, or Business Organizations Code, Title 4, Chapters 152 and 153, Subchapter H, or an equivalent statute in another jurisdiction.

(13) Limited Partnership. A partnership formed pursuant to Revised Partnership Act, Article 6132a-1 or Business Organizations Code, Title 4, Chapter 153, or an equivalent statute in another jurisdiction.

(14) Natural Person. A human being or the estate of a human being. The term does not include a purely legal entity given recognition as the possessor of rights, privileges, and responsibilities, such as a corporation, limited liability company, partnership, or trust.

(15) Partnership. A relationship referred to in Business Organizations Code, §152.051, and Revised Partnership Act, Article 6132b-2.02.

(16) Passive Entity. A general or limited partnership or trust other than a business trust that meets the qualifications in Tax Code, §171.0003. See also §3.582 of this title (relating to Margin: Passive Entities).

(17) Professional Association. An entity organized under Professional Association Act, Article 1528e, or Business Organizations Code, Title 7, Chapter 302, or an equivalent statute in another jurisdiction.

(18) Qualified REIT Subsidiary. An entity defined by Internal Revenue Code §856(i)(2).

(19) Real Estate Investment Trust or REIT. An entity as defined by Internal Revenue Code §856.

(20) Real Estate Mortgage Investment Conduit or REMIC. An entity as defined by Internal Revenue Code §860D.

(21) Savings and Loan Association. A savings and loan association or savings bank, whether organized under the laws of this state, another state, or another country, or under federal law.

(22) Self-Insurance Trust. A trust created and operated according to

the provisions of Insurance Code, Chapter 2212, or a predecessor statute.

(23) Sole Proprietorship. A natural person carrying on business, if the business is not formed in a manner that limits the liability of the owner. It does not include other entities treated as sole proprietorships for federal income tax purposes, unless by statute the form of entity does not afford limited liability protection to the owner and it does not include single member limited liability companies.

Subsection (c) of this Section sets forth a list of taxable entities that includes an additional provision for joint ventures as follows:

(c) Taxable entities include:

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(10) joint ventures, except joint operating or co-ownership arrangements meeting the requirements of Treasury Regulation 1.761-2(a)(3) that elect out of federal partnership treatment as provided by Internal Revenue Code §761(a).

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Subsection (d) of this Section sets forth a list of excluded entities, which generally tracks the statute with the following variations:

(d) Nontaxable entities. The following entities are specifically excluded from the definition of taxable entities for purposes of imposition of the franchise tax:

(1) sole proprietorships (does not include single member limited liability companies);

(2) general partnerships where direct ownership is composed entirely of natural persons, and the liability of those persons is not limited (e.g., by registration as a limited liability partnership) under a statute of this state or another state;

(3) passive entities, as determined on a year to year basis (also see §3.582 of this title);

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(8) REITs or qualified REIT subsidiaries provided that:

(A) the REIT holds interests in limited partnerships or other

entities that are taxable entities and directly hold real estate; and

(B) the REIT does not directly hold real estate, other than real estate it occupies for business purposes; or

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Subsection (e) of this Section sets forth the treatment of a SMLLC as follows:

(e) Single Member Limited Liability Company. An entity treated as a sole proprietorship for federal tax purposes is not a sole proprietorship for the purposes of this rule if it is formed in a manner that limits the liability of its owners or members.

Comment: A Single Member LLC under subsection (e) is not limited to an entity whose limitation of liability is afforded by statute as in subsection (d)(2) above for general partnerships or as provided in §171.0002(d).

Rule 3.582
Passive Entities. Implements Tax Code Section 171.0003

Section 171.0002(b)(3) excludes from the definition of a "taxable entity" a passive entity as defined in Section 171.0003. Under the terms of Section 171.003, an entity qualifies as a passive entity only if:

(a) the entity is a general or limited partnership or a trust, other than a business trust;

(b) during the period on which margin is based, the entity's federal *gross income* consists of at least 90 percent of the following income:

- Dividends, interest, foreign currency exchange gain, periodic and non-periodic payments with respect to notional principal contracts, option premiums, cash settlement or termination payments with respect to a financial instrument, and income from a limited liability company.

- Distributive shares of partnership income to the extent that those distributive shares of income are greater than zero;

- Capital gains from the sale of real property, gains from the sale of commodities traded on a commodities exchange and gains from the sale of securities; and

- Royalties, bonuses, or delay rental income from mineral properties and income from other non-operating mineral interests; and

(c) The entity does not receive more than 10 percent of its federal *gross income* from conducting an active trade or business.

Rule 3.582 establishes guidelines to determine the qualification of an entity as passive under Tax Code, Section 171. This Section applies only to franchise tax reports due on or after January 1. This Section defines words and terms; lists the types of entities that may qualify as passive entities and the types of income that qualify as passive income; lists certain income that is not considered passive; provides that a passive entity may not receive more than 10% of its federal gross income from conducting an active trade or business; lists activities that do not constitute an active trade or business; and establishes the reporting requirements for the passive entity.

Subsection (b) of this Section sets forth definitions. Terms defined in this Subsection and not contained in the Margin Tax statute or that are different from or clarify those stated in the statute are the following:

(b) Definitions:

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(2) Business Trust. An entity as defined by Internal Revenue Code, Treasury Regulation, §301.7701-4(b).

(3) Federal Gross Income. Gross Income as defined in Internal Revenue Code Section 61(a).

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(6) Net Capital Gains. Net capital gains as defined under the Internal Revenue Code.

(7) Net Gains. Net gains as defined under the Internal Revenue Code.

(8) Non-Controlling Interest. For the purposes of this section only, a less than 50% interest that is held by an investor, either directly or indirectly, in an investee.

(9) Security:

(A) an instrument defined by Internal Revenue Code, §475(c)(2), where the holder of the instrument has a non-controlling interest in the issuer/investee;

(B) an instrument described by Internal Revenue Code, §475 (e)(2)(B), (C), (D);

(C) an interest in a partnership where the investor has a non-controlling interest in the investee;

(D) an interest in a limited liability company where the investor has a non-controlling interest in the investee; or

(E) a beneficial interest in a trust where the investor has a non-controlling interest in the investee.

Comment:

- The Rules add the word "net" to "capital gains", "gains from the sale of commodities traded on a commodities exchange"; and "gains from the sale of securities," contrary to the language of the statute. The Rules require offsetting capital losses against capital gains, and likewise for losses from the sale of certain commodities or securities, which would reduce the amount of such gains that can be included in the "Passive Income" 90% test.
- The Comptroller rejected suggestions of the SBT and TSCPA that the word "net" be deleted, which word is not contained in the Margin Tax statute. The Comptroller instead takes the position that the determination as a passive entity is based on an entity's federal gross income and that net capital gains and net gains are included in federal gross income. However, it should be noted that for purposes of the 25% omission test of IRC §6501(e) the IRS takes the position that capital losses are *not* netted against capital gains in arriving at "gross income" as stated in the federal income tax return, but rather are a deduction *from* gross income in arriving at net income. See, CCA 200609024.
- The Rules provide that gains from the sale of a security, which can be included in the computation of passive income, is limited to gains from the sale of a "non-controlling interest" in a security, which means a less than 50% interest. Once again, this qualification is not contained in the Margin Tax statute and poses a potentially

significant restriction on the inclusion of gains from the sale of securities in the passive income computation. The Comptroller's position is that a reasonable interpretation of the statute implies that a controlling interest cannot be considered passive.

- The SBT had suggested adding clarifying language that a stock sale treated as an asset sale for federal income tax purposes pursuant to a §338(h)(10) election still be treated as a sale of securities for purposes of the Passive Entity exception. However, the Comptroller declined to make this clarification as passive income is derived from lines on the federal income tax return and therefore it is implicit that the Comptroller would follow federal law for those underlying items as stated in the Tax Code §171.1011(b). Rule 3.591(e)(7) also continues the prior rule, for apportionment purposes, that a stock sale subject to a §338(h)(10) election is treated as a sale of assets for Texas franchise tax purposes and the purchaser of the target's stock is considered the purchaser of the assets.

The wording of subsection (c) of the Rules is as follows:

(c) <u>Qualifications as a Passive Entity</u>.

(1) To qualify as a passive entity, the entity must be one of the following for the entire period on which the tax is based:

(A) general partnership;

(B) limited partnership;

(C) limited liability partnership; or

(D) trust, other than a business trust, and

Comment: The Rules clarify that a limited liability partnership is a type of general partnership that can qualify as a "passive entity."

(2) At least 90% of an entity's federal gross income for the period on which margin is based must consist of the following sources of income:

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(C) net capital gains from the sale of real property, net gains from the sale of commodities traded on a commodities exchange, and net gains from the sale of securities; and

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Comment : As noted above, (c)(2)(C) limits gains which are considered passive to "net" gains. The Comptroller's explanation for this change from the wording of the statute is that "net" gains, as opposed to "gains" are included in federal gross income. The Comptroller reasons that if gains were allowed, passive income could exceed federal gross income. The Comptroller further asserts that the "net" qualifier makes the numerator and denominator of the federal gross income ratio consistent.

Subsection (g) of this Section sets forth the reporting requirements for a passive entity. Those requirements are stated as follows:

> (g) Reporting Requirement for a Passive Entity. If an entity meets all of the qualifications of a passive entity for the reporting period, the entity will owe no tax; however, the entity must file information to verify that the passive entity qualifications are met each year.

Comment: No guidance is given as to the information required or the date the information is to be submitted.

Rule 3.583 – Exemptions
Implements Tax Code Sections 171.0002 and 171.088

Rule 3.583 extends to the entities other than corporations certain specific exemptions from franchise tax available to corporations, provided the entity qualifies for the exemption in the same manner and under the same conditions as a corporation. This Section applies only to franchise tax reports due on or after January 1, 2008. This Section explains how to apply for a franchise tax exemption and identifies the information that must accompany the application; describes the possible actions that the Comptroller will take after consideration of the application; describes qualifications necessary to qualify for exemption as: an entity subject to insurance premium taxes, an entity promoting the public interest, a religious organization, a charitable organization, an educational organization and a homeowner's association; addresses the effects of a revocation, withdrawal or loss of an exemption and the notification responsibilities of the affected entity; provides an entity that is exempt from federal income tax under one of certain specified paragraphs of Internal Revenue Code § 501(c), establishes its exempt status by providing a copy of a current exemption letter from the Internal Revenue Service to the comptroller; describes the essential attributes of a solar energy device to qualify for exemption under Tax Code, Section 171.056; provides that an entity engaged solely in the business of recycling sludge, as defined in the Health & Safety Code, is exempt; identifies certain entities that may apply for a

provisional or temporary exemption and describes the information that must accompany the application; addresses the requirements necessary for an entity to qualify for the trade show exemption and provides for notification requirements in certain circumstances; and provides that an entity organized under 12 U.S.C. Section 2071, or an agricultural credit association regulated by the Farm Credit Administration is exempt from franchise tax.

Subsection (b) of this Section sets forth the manner of applying for the exemption by an entity that is not a corporation but whose activities would qualify it for a specific exemption under the Tax Code if it were a corporation. This subsection generally provides as follows:

(b) Application. Must apply for exemption if entity has not previously established exemption from franchise tax.

(1) Furnish sufficient evidence to establish exempt status; entity has burden; denial if any doubts;

(2) Must submit:

(A) written request using Comptroller forms;

(B) detailed statement of past and current activities and future plans;

(C) organizational documents if not on file with the Secretary of State;

(D) additional information requested by Comptroller.

Comment: The Rules clarify that currently exempt entities are not required to reapply for exemption.

Subsection (c) of this Section sets forth the actions to be taken by the Comptroller upon receipt of the application. This subsection generally provides as follows:

(c) Comptroller Action. Review and notify applicant:

(1) if granted, exemption effective from first date eligible;

(2) if denied or revoked, may contest by filing all reports due, and paying all tax, penalty and interest and requesting refund hearing or file written protest and filing suit or request redetermination hearing if deficiency.

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Subsection (d) of this Section sets out the entities that are qualified for exemption. This subsection, which is quite detailed, generally provides as follows:

(d) Qualification for Exemption.

(1) Entity subject to insurance premium taxes.

(2) Entity organized exclusively for promoting the public interest of county, city, town or other area within the state.

(3) Nonprofit entity as religious organization – organized group; regular meetings for religious worship services; established congregation; also qualify if exempt under IRC §501(c).

(4) Nonprofit entity organized purely for public charity or exempt under IRC §501(c).

(5) Nonprofit entity as educational organization or exempt under IRC §501(c).

(6) Nonprofit entity as homeowners' association of residential condominium or residential real estate development. Collective resident owners of individual lots, residences or units must control at least 51% of votes and voting control not held by single individual or family or by one or more developers, declarants, banks, investors, or other similar parties.

Subsection (e) of this Section sets forth the consequences of revocation, withdrawal or loss of exemptions. This subsection generally provides as follows:

(e) Revocation, Withdrawal, or Loss of Exemptions.

(1) If no longer qualify, required to notify Comptroller in writing.

(2) Revocation, withdrawal or loss of federal income tax exemption terminates franchise tax exemption; must notify Comptroller within 30 days of change of status.

(3) Electric cooperative entity that is exempt and later participates in joint powers agency loses franchise tax exception; must notify comptroller within 30 days.

Subsection (f) of this Section sets forth the consequences of a nonprofit organization being exempt under certain sections of §501(c) of the Internal Revenue Code. This subsection provides as follows:

> (f) Federal Exemption. A nonprofit organization that has been exempted from the federal income tax under the provisions of Internal Revenue Code, §501(c)(2), (3), (4), (5), (6), (7), (8), (9), (10), (16), (19) or (25), establishes its exempt status by furnishing to the comptroller a copy of a current exemption letter from the IRS.

Subsection (g) of this Section sets forth the definition of the term "solar energy device." This subsection provides as follows:

> (g) Solar Energy Device. For purposes of Tax Code, §171.056, the term "solar energy device" includes, but is not limited to:
>
> (1) devices used in the conversion of solar thermal energy into electrical or mechanical power;
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> (2) devices used in the photovoltaic (solar cell) generation of electricity;
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> (3) systems used in the heating of water and the heating and cooling of structures by use of solar collectors to gather the sun's energy; and
>
> (4) heat pumps used as an integral part of a system designed to make the best combined use of solar energy and conventional heating.

Subsection (h) of this Section sets forth the exemption for certain types of recycling operations. This subsection provides as follows:

> (h) Exemption for Recycling Operation. An entity engaged solely in the business of recycling sludge as defined by Health and Safety Code, Chapter 361, Solid Waste Disposal Act, §361.003, is exempt from franchise tax.

Subsection (i) of this Section provides provisional exemptions which are as follows:

> (i) Provisional Exemptions.
>
> (1) If established with the Comptroller, the following entities may be granted a temporary exemption from franchise tax:
>
> (A) a nonprofit entity that has applied for exemption from federal income tax under Internal Revenue Code, §501(c)(3),

(4), (5), (6), (7), (8), (9), (10), (16), or (19); and

(B) an entity that has applied for exemption from federal income tax under Internal Revenue Code, §501(c)(2) or (25), if the entity or entities for which it holds title to property is either exempt from or not subject to the franchise tax.

(2) To obtain a temporary franchise tax exemption with the Comptroller, an entity that has applied for but has not yet received a letter of exemption from the IRS must timely file with the comptroller:

(A) a copy of the application for recognition of exemption that has been filed with the IRS; and

(B) a copy of:

(i) a written notice from the IRS stating that the application for recognition of exemption has been received; or

(ii) a receipt as proof that the application has been sent to the IRS by means of the United States Postal Service, other carrier, or hand delivery to the IRS.

(3) Paragraphs (2)(A) and (2)(B)(ii) of this subsection, apply only if the organization has filed its application for recognition of exemption during the 14th or 15th month after its beginning date. Beginning date means:

(A) for an entity organized under the laws of this state, the date on which the entity's certificate of formation or other similar document takes effect; and

(B) for a foreign entity, the date on which the entity begins doing business in this state.

(4) If the information required in paragraphs (2)(A) and (2)(B)(i) of this subsection is provided in a timely manner, a 90-day provisional franchise tax exemption will be granted.

(5) An entity qualifying under paragraphs (2)(A) and (2)(B)(ii) of

this subsection, will be granted a 90-day provisional exemption with the condition that a copy of the notice required in paragraph (2)(B)(i) of this subsection be provided to the comptroller within 30 days from the date of the letter notifying the entity of the provisional exemption. If the IRS notification is not provided within the 30-day period, the provisional exemption will be canceled. An entity whose provisional exemption is canceled will be subject to all tax, penalty, and interest that has accrued since the entity's beginning date.

(6) The information necessary for obtaining a temporary franchise tax exemption will be considered to be provided to the comptroller in a timely manner if:

(A) the application or recognition of exemption is provided to the IRS within their timely filing guidelines; and

(B) the information required in paragraphs (2)(A) and (2)(B)(i) or (2)(B)(ii) of this subsection, is postmarked within 15 months after the day that is the last day of a calendar month and that is nearest to the entity's beginning date.

(7) Before the expiration of the 90-day provisional exemption, the entity must provide the comptroller a copy of the letter from the IRS showing that the decision on the federal exemption is still pending or stating that the federal exemption is either granted or denied.

(8) If the comptroller is notified as required in paragraph (7) of this subsection, that the decision on the federal exemption is still pending, an extension of the provisional exemption may be considered.

(9) If the information in paragraph (7) of this subsection, is not provided as required, the provisional exemption may be canceled. If the provisional exemption is canceled, the entity will be responsible for all franchise tax reports and payments that have become due since its beginning date, and penalty and interest will be based on the original due date of each report.

(10) An entity that provides the comptroller a copy of the letter from the IRS stating that the federal exemption has been granted will be considered for franchise tax exemption under subsection (e) of this section.

(11) If the federal exemption is denied by the IRS, the entity is

responsible for all franchise tax reports and payments that have become due since its beginning date and interest will be based on the original due date of each report. Late filing and payment penalties will be waived for any reports and payments postmarked within 90 days after the date of the final denial of the federal exemption. The penalty waiver process will begin when the entity submits a written request for penalty waiver and a copy of the letter denying the federal exemption when filing reports and payment.

Subsection (j) of this Section sets forth the requirements for exemption for certain foreign entities that participate in trade shows in Texas. This subsection provides as follows:

(j) Trade Show Exemption. See Tax Code, §171.084, for the requirements for exemption for certain foreign entities that participate in trade shows in Texas.

(1) Notification to Comptroller. Entities need not apply for an exemption under Tax Code, §171.084.

(A) If a foreign entity has obtained a registration or has already notified the comptroller that it is doing business in Texas, the entity must notify the comptroller in writing by the due date of the first report for which the entity is exempt that the report and payment are not due because the entity is exempt under Tax Code, §171.084. After such notification, the entity must notify the comptroller in writing only when the organization no longer qualifies for exemption.

(B) If a foreign entity has not obtained a registration or otherwise qualified to do business in the state, if applicable, and if the entity has not notified the comptroller that it is doing business in Texas, the entity must notify the comptroller in writing only when the entity no longer qualifies for exemption under Tax Code, §171.084. There is no need to apply for exemption as long as the entity qualifies for the exemption.

(2) Solicitation Periods. If the solicitation of orders is conducted during more than five periods during the business period upon which tax is based as set out in Tax Code, §171.1532, the entity does not qualify for exemption.

(A) An entity with its fiscal year ending December 31, 2008, that filed a 2008 annual report, will not have to file and pay a 2009

annual report if it did not solicit orders for more than five periods during 2008.

(B) Example. ***

(3) One Hundred Twenty Hours. A solicitation period may not exceed 120 consecutive hours. If the solicitation or orders is conducted during a single period of more than 120 consecutive hours, the entity does not qualify for exemption. For example, an entity that meets the other requirements of Tax Code, §171.084, will meet the 120 hours requirement if the solicitation occurs Monday-Friday, but will not meet the 120 hours requirement if the solicitation occurs Monday-Saturday. If none of the solicitation limits prescribed in this subsection are exceeded, an entity may qualify for the exemption even if it leases space at a wholesale center for the entire period upon which the tax is based.

Subsection (k) of this Section addresses the exemption for agricultural credit associations. This subsection provides as follows:

(k) An entity organized under 12 U.S.C. §2071, or an agricultural credit association regulated by the Farm Credit Administration is exempt from franchise tax.

Rule 3.584 – Reports and Payments
Implements Tax Code §171.002, .0021, .101, .1016, .151, .152, .1532, .154, .201, .202, .203, and .212

Rule 3.584 establishes guidelines for the filing of reports and payments under Tax Code, Chapter 171. This Section applies only to franchise tax reports due on or after January 1, 2008. This Section details the filing requirements for non-taxable entities; details the types of franchise tax reports due, due dates and the accounting dates to be used on the reports; details the calculation of margin and the criteria for use of the 0.5% tax rate, as well as providing qualifications for the no-tax-due threshold, the discount and the EZ Computation; sets forth the method of calculating the penalty and interest on delinquent taxes; provides details on filing amended reports; addresses the examination of an entity's records during a comptroller audit; addresses the payment of an estimated liability; and provides requirements on filing a public information report or an ownership information report.

Subsection (b) of this Section sets forth the notification requirements for nontaxable entities. This subsection provides as follows:

(b) Nontaxable Entities.

(1) If a taxable entity has notified the comptroller that it is doing business in Texas, the entity must notify the comptroller in writing by the due date of the first report for which the entity qualifies as a nontaxable entity that the report and payment are not due because the entity qualifies as a nontaxable entity. After such notification, the entity must notify the comptroller in writing only when the entity no longer qualifies as a nontaxable entity.

(2) If a nontaxable entity has not notified the comptroller that it is doing business in Texas, the nontaxable entity must notify the comptroller in writing only when the entity no longer qualifies as a nontaxable entity.

Subsection (c) of this Section sets forth the reporting requirements for taxable entities. The provisions of this subsection dealing with initial and annual reports are as follows:

(c) Reports and Due Dates.

(1) Each taxable entity subject to the franchise tax levied by Tax Code, 171.001, must file an initial franchise tax report, and thereafter an annual franchise tax report, and at the same time must pay the franchise tax and any applicable penalties and interest due by the taxable entity. It is the responsibility of a receiver to file franchise tax reports and pay the franchise tax of a taxable entity in receivership. A debtor in possession or the appointed trustee or receiver of a taxable entity in reorganization or arrangement proceedings under the Bankruptcy Act is responsible for filing franchise tax reports and paying the franchise tax pursuant to the plan of reorganization or arrangement.

Comment: The Rules revised language of the Proposed Rules which would have required reporting and payment of the franchise tax before the priority of payment had been determined under the Bankruptcy Code. Under the Rules, the payment obligation is tied to the terms of the plan.

(A) "Beginning Date" Means:

(i) for a taxable entity chartered or organized in this state, the date on which the taxable entity's charter or organization takes effect; and

(ii) for a foreign taxable entity, the date on which the taxable entity begins doing business in this state.

(B) Initial Report. Both the initial report and payment of the tax due, if any, are due no later than 89 days after the first anniversary date of the beginning date. The initial franchise tax report and payment are for the privilege periods beginning on the beginning date and ending on December 31 following the first anniversary of the beginning date. For example, if a Texas taxable entity is chartered on June 1, 2008, the payment due with the initial report will be for the privilege periods from June 1, 2008—December 31, 2009. In addition, when the first anniversary occurs during the period from October 4 - December 31, the tax paid with the initial report is for an additional privilege period beginning on January 1 following the first anniversary and ending on the following December 31. For example, if a Texas taxable entity is chartered on November 1, 2008, the payment due with the initial report will be for the privilege periods from November 1, 2008—December 31, 2010. The taxable margin computed on the initial report is based on the business done during the period beginning on the beginning date and ending on the last accounting period ending date for federal income tax purposes that is at least 60 days before the original due date of the initial report, or, if there is no such ending date, then ending on the day that is the last day of the calendar month nearest to the end of the taxable entity's first year of business. If the period used to compute business done for purposes of the initial report differs from the taxable entity's last accounting period for federal income tax purposes, then the taxable entity's total revenue for purposes of the initial report shall be computed as if the taxable entity had reported its federal taxable income on an Internal Revenue Service form covering the period used to compute business done for purposes of the initial report.

(C) Annual report. The annual franchise tax report must be filed and the tax paid no later than May 15 of each year. The annual tax is paid for the privilege period of the calendar year in which the report is due. The taxable margin computed on an annual report is based on the business done during the period beginning with the day after the last date upon which tax was computed under Tax Code, Chapter 171 on a previous report, and ending with the last accounting period ending date for federal income tax purposes ending in the calendar year before the calendar year in which the report is originally due, or, if there is no such ending date, then ending on December 31 of the calendar year before the calendar year in which the report is originally due. A taxable entity that uses a 52-53 week accounting year end and has an accounting year ending the first four days of January of the year in which the annual report is originally due may use the preceding December 31 as the date through which taxable

margin is computed. If the period used to compute business done for purposes of the annual report differs from the taxable entity's last accounting period for federal income tax purposes, then the taxable entity's total revenue for purposes of the annual report shall be computed as if the taxable entity had reported its federal taxable income on an Internal Revenue Service form covering the period used to compute business done for purposes of the annual report.

***

Comment: The period upon which margin is computed under subsections (B) and (C) may not coincide with the period reported on the federal income tax return. The Rules add clarification to subsections (B) and (C) that, in that instance, the total revenue will not be taken from a "form" as filed with the Internal Revenue Service, but rather from a hypothetical form based on the same period as the Margin Tax accounting period.

***

(H) Combined Reporting. Taxable entities that are part of an affiliated group engaged in a unitary business must file a combined report in lieu of individual reports, except that a public information report or ownership information report must be filed for each member of the combined group with nexus. A newly created taxable entity that is a member of a combined group is not required to report data on a separate initial report, and a combined group that would not otherwise be required to file an initial report shall not be required to file an initial report solely because a newly-created entity has become a member of the combined group. See §3.590 of this title (relating to Margin: Combined Reporting), for rules on filing a combined report.

Comment: The Rules add clarifying language that a newly created entity which is a member of a combined group does not file an initial report and the fact that a newly formed entity joins a combined group does not require the combined group to file an initial report.

(d) Calculation of Margin.

(1) Calculation. A taxable entity must make an annual election to deduct cost of goods sold or compensation by the due date of its return. If an election is not made by the due date of the return, the taxable entity's margin will be calculated as indicated in subparagraph (c) of this paragraph. This election may not be amended. A taxable entity's margin equals the least of three calculations:

(A) Total revenue minus cost of goods sold;

(B) Total revenue minus compensation; or

(C) Total revenue times 70%.

Comment: The Rules clarify that an election for cost of goods sold or compensation must be made by the due date of the return. If no election is made by the due date of the return, or if the extension of the return is not valid, the taxpayer is precluded from using either cost of goods sold or compensation and is limited to 70% of total revenue.

Subsection (e) of this Section addresses the penalties and interest on delinquent taxes, including when a deficiency determination is final and the determination amount due, when a redetermination petition is due and a decision thereon becomes final and the amount due, when a jeopardy determination is final and the amount due, and when penalties and interest may be waived.

Subsection (f) of this Section sets forth the requirements for filing an amended report. Provisions in this subsection are as follows:

> (f) Amended Reports. In filing an amended report, the taxable entity must type or print on the report, immediately above the taxable entity name, the phrase "Amended Report." The report should be forwarded with a cover letter of explanation, with enclosures necessary to support the amendment. Applicable penalties and interest must be reported and paid along with any additional amount of tax shown to be due on the amended report.
>
>> (1) A taxable entity may file an amended report for the purpose of correcting a mathematical or other error in a report or for the purpose of supporting a claim for refund. An amended report may not be filed to change between a cost of goods sold deduction and a compensation deduction.
>>
>> (2) A taxable entity that has been audited by the Internal Revenue Service must file an amended franchise tax report within 120 days after the Revenue Agent's Report (RAR) is final, if the RAR results in changes to taxable margin reported for franchise tax purposes. An RAR is final when all administrative appeals with the Internal Revenue Service have been exhausted or waived. An administrative appeal with the Internal Revenue Service does not include an action or proceeding in the United States Tax Court or any other federal court.

(3) A taxable entity whose taxable margin is changed as a result of an audit or other adjustment by a competent authority other than the Internal Revenue Service must file an amended franchise tax report within 120 days after the adjustment is final. An adjustment is final when all administrative or other appeals have been exhausted or waived. For the purposes of this section, a competent authority includes, but is not limited to, the United States Tax Court, United States District Courts, United States Courts of Appeals, and United States Supreme Court.

(4) A taxable entity must file an amended franchise tax report within 120 days after the taxable entity files an amended federal income tax return that changes the taxable entity's taxable margin. A taxable entity is considered to have filed an amended federal income tax return if the taxable entity is a member of an affiliated group during a period in which an amended consolidated federal income tax return is filed.

(5) A final determination resulting from an Internal Revenue Service administrative proceeding (including an audit), or a judicial proceeding arising from an administrative proceeding, that affects the amount of franchise tax liability must be reported to the comptroller before the expiration of 120 days after the day on which the determination becomes final. See Tax Code, §111.206.

(6) Because the 10% penalty provided for in Tax Code, §171.212 only applies to deficiencies, failure to file an amended return in which a refund would result will not cause a 10% penalty to be imposed.

Comment: Subparagraphs 2 through 6 may require multiple amended return filings during the course of an IRS proceeding. The Rules require that an amended return be filed after IRS administrative appeals have been exhausted or waived despite a challenge to the IRS adjustment in federal court.

Subsection (g) of this Section sets forth what and whom may be examined during an audit. This subsection provides as follows:

(g) Comptroller Audit. During the course of an audit or other examination of a taxable entity's franchise tax account, the comptroller may examine financial statements, working papers, registers, memoranda, contracts, corporate minutes, and any other business papers used in connection with its accounting system. In connection with the examination, the

comptroller may also examine any of the taxable entity's officers or employees under oath.

Subsection (h) of this Section addresses a determination issued for an estimated tax liability. This subsection provides as follows:

(h) Payment of Determination. The payment of a determination issued to a taxable entity for an estimated tax liability shall not satisfy the reporting requirements set forth in Tax Code, Chapter 171, Subchapter E, concerning reports and records.

Subsection (i) of this Section addresses the requirements for filing an information report. While this subsection generally follows the statute, subsection (i)(3), dealing with forfeiture of corporate or business privileges, provides as follows:

(i) Information Report.

***

(3) Failure to file or sign a public information report or ownership information report shall result in the forfeiture of corporate or business privileges as provided by Tax Code, §171.251 and §171.2515. If the corporate or business privileges are forfeited, each officer or director of the taxable entity may be liable for each debt of the taxable entity that is created or incurred in Texas after the date on which the report is due and before the corporate or business privileges are revived, as provided by Tax Code, §171.255.

(4) The provisions of paragraph (3) of this subsection, concerning forfeiture of corporate privileges do not apply to a banking taxable entity or a savings and loan association, as defined in Tax Code, §171.001.

***

(6) Taxable entities that are members of a combined group and do not have nexus to Texas are not required to file an ownership information report or public information report.

Comment: Subparagraph (6) was added in the Rules to clarify that the requirement for filing an ownership information report or public information report only applies to members of a combined group with nexus to Texas.

***

Rule 3.585 – Annual Report Extensions
Implements Tax Code Section 171.202

Rule 3.585 establishes guidelines for requesting extensions under Tax Code, Chapter 171. This Section applies to franchise tax reports originally due on or after January 1, 2008. This Section provides guidance for an extension to November 15; provides that an extension will not be granted by paying 100% of the tax paid in the previous year if no report was filed for the previous year, or due in the previous year; provides guidance for calculating penalty and interest; provides guidance for extensions for taxpayers required to file by electronic funds transfer; and states that no additional extensions will be granted other than those provided in this Section.

Subsection (c) of this Section provides for extensions to November 15. This subsection provides as follows:

> (c) Extension to November 15. Except for a taxable entity which has been notified by the comptroller that it is required to make its franchise tax payments by electronic funds transfer (see subsections (d), (f), and (g) of this section), a taxable entity will be granted an extension to file an annual report on or before the next November 15, if the taxable entity:
>
> (1) requests the extension on or before May 15;
>
> (2) requests the extension on a form provided by the comptroller; and
>
> (3) remits with the extension request:
>
> (A) 90% or more of the amount of tax reported as due on the report filed on or before November 15; or
>
> (B) 100% of the tax reported as due for the previous calendar year on the report due in the previous calendar year and filed on or before May 14 of the year for which the extension is requested. A combined group may only use this 100% option if the combined group has lost a member or if the members of the combined group are the same as they were on the last day of the period upon which the report due in the previous calendar year was based.

Subsection (d) of this Section addresses the consequences if no previous report was due or timely filed. This subsection provides as follows:

> (d) No Previous Report. An extension shall not be granted under subsections (c)(3)(B) or (f)(3)(B) of this section, if no report was due in the previous calendar year or the report due in the previous calendar year is not filed on or before May 14 of the year for which the extension is requested.

Comment: If no report was due or was not filed timely, the extension can only be met by paying at least 90% of the tax that will be due for the current year. Thus, if the 90% test is used and is not ultimately satisfied based on the actual amount of tax due, the extension is not valid and any elections made with the purported extension will not be valid.

Subsection (e) of this Section provides for the calculation of penalty and interest. This subsection provides as follows:

> (e) Penalty and Interest. Penalty and interest, except for a taxable entity which has been notified by the Comptroller that it is required to make its franchise tax payments by electronic funds transfer (see subsection (h) of this section), will be calculated as though the following were due dates.
>
>> (1) If a taxable entity is granted an extension and pays, on or before May 15, at least 100% of the tax reported as due for the previous calendar year on the report due in the previous calendar year and filed on or before May 14 of the year for which the extension is requested, then November 15 will be the due date for any additional tax due.
>>
>> (2) If a taxable entity is granted an extension and pays on or before May 15, 90% or more of the tax which will be reported as due on or before November 15, then November 15 will be the due date for any additional tax due.
>>
>> (3) If a taxable entity, on or before May 15, requests an extension but does not qualify for an extension under paragraphs (1) or (2) of this subsection, then May 15 is the due date for 90% of the tax finally determined to be due and November 15 is the due date for 10% of the tax finally determined to be due.

Subsection (f) of this Section addresses extensions for a taxable entity required to makes its franchise tax payments by electronic funds transfer. This subsection provides as follows:

(f) Required Electronic Funds Transfer Extension to August 15. A taxable entity which has been notified by the comptroller that it is required to make its franchise tax payments by electronic funds transfer (see §3.9 of this title (relating to Electronic Filing of Returns and Reports; Electronic Transfer of Certain Payments by Certain Taxpayers)) will be granted an extension to file an annual report on or before the next August 15, if the taxable entity:

(1) requests the extension on or before May 15;

(2) requests the extension on a form provided by the comptroller; and

(3) remits with the extension request:

(A) 90% or more of the amount of tax reported as due on the report filed on or before November 15; or

(B) 100% of the tax reported as due for the previous calendar year on the report due in the previous calendar year and filed on or before May 14 of the year for which the extension is requested. A combined group may only use this 100% option if the combined group has lost a member or if the members of the combined group are the same as they were on the last day of the period upon which the report due in the previous calendar year was based.

Subsection (g) of this Section addresses an extension to November 15 for taxable entities granted an extension under subparagraph (f). This subsection provides as follows:

(g) Required Electronic Funds Transfer Extension to November 15. A taxable entity granted an extension under subsection (f) of this section, will be granted an extension to file an annual report on or before the next November 15, if the taxable entity:

(1) requests the extension on or before August 15;

(2) requests the extension on a form provided by the comptroller; and

(3) remits with the request the difference between the amount paid previously for the current reporting period and 100% of the amount of tax reported as due on the report filed on or before November 15.

Subsection (h) of this Section applies to the calculation of penalty and interest with regard to taxable entities required to make franchise tax payments by electronic funds transfer. This subsection provides as follows:

> (h) Required Electronic Funds Transfer Penalty and Interest. Penalty and interest will be calculated as though the following were due dates.
>
> > (1) If a taxable entity is granted an extension until August 15 and pays, on or before May 15, at least 100% of the tax reported as due for the previous calendar year on the report due in the previous calendar year and filed on or before May 14 of the year for which the extension is requested, then August 15 will be the due date for any additional tax due. However, if the taxable entity requests, on or before August 15, an extension until November 15, and remits, on or before August 15, 99% of the amount reported as due on or before November 15, then November 15 will be the due date for any additional tax due.
> >
> > (2) If a taxable entity is granted an extension until August 15 and pays, on or before May 15, 90% or more of the tax which will be reported as due on or before August 15, then August 15 will be the due date for any additional tax due. However, if the taxable entity requests, on or before August 15, an extension until November 15, and remits, on or before August 15, 99% of the amount reported as due on or before November 15, then November 15 will be the due date for any additional tax due.
> >
> > (3) If a taxable entity, on or before May 15, requests an extension until August 15, but does not qualify for an extension under paragraphs (1) or (2) of this subsection, then May 15 is the due date for 90% of the tax finally determined to be due. August 15 is the due date for the remaining 10% of the tax finally determined to be due. However, if the taxable entity requests, on or before August 15, an extension until November 15, and remits on or before August 15 at least 99% of the amount reported as due on or before November 15, then May 15 is the due date for 90% of the amount reported as due on or before November 15, August 15 is the due date for 90% of the amount reported as due on or before November 15, and November 15 is the due date for any additional tax due.

Subsection (i) of this Section provides that no additional extensions will be granted for annual franchise tax reports pursuant to Tax Code, Section 111.057.

(i) No Additional Extensions. No additional extensions will be granted for annual franchise tax reports pursuant to Tax Code, §111.057.

Rule 3.586—Nexus
Implements Tax Code Sections 171.001 and 171.106

Rule 3.586 establishes guidelines for determining nexus under Tax Code, Chapter 171. This Section applies only to franchise tax reports due on or after January 1, 2008. This Section provides that Texas will find nexus to the limits of the United States Constitution; provides a non-exclusive list of common activities which will subject a taxable entity to Texas franchise tax; and states that Public Law 86-272 does not apply to the franchise tax.

Subsection (c) of this Section sets forth a list of activities, which are not exclusive, that would subject a taxable entity to the Texas franchise tax. Most of the items in this Rule are in Rule 3.546 under the prior law. This subsection, which is substantially the same as under prior law, reads as follows:

(c) Some specific activities which subject a taxable entity to Texas franchise tax include, but are not limited to, the following:

(1) Advertising: entering Texas to purchase, place, or display advertising when the advertising is for the benefit of another and in the ordinary course of business (e.g., the foreign taxable entity makes signs and brings them into Texas, sets them up, and maintains them);

(2) Consignments: having consigned goods in Texas;

(3) Contracting: performance of a contract in Texas regardless of whether the taxable entity brings its own employees into the state, hires local labor, or subcontracts with another;

(4) Delivering: delivering into Texas items it has sold;

(5) Employees or Representatives: having employees or representatives doing the business of the taxable entity;

(6) Federal Enclaves: doing business in any area within Texas, even if the area is leased by, owned by, ceded to, or under the control of the federal government;

(7) Franchisors: entering into one or more contracts with persons, corporations, or other business entities located in Texas, by which:

> (A) the franchisee is granted the right to engage in the business of offering, selling, or distributing goods or services under a marketing plan or system prescribed in substantial part by the franchisor; and
>
> (B) the operation of a franchisee's business pursuant to such plan is substantially associated with the franchisor's trademark, service mark, trade name, logotype, advertising, or other commercial symbol designating the franchisor or its affiliate;

(8) Holding Companies: maintaining a place of business in Texas or managing, directing, and/or performing services in Texas for subsidiaries or investee entities;

(9) Inventory: having an inventory in Texas or having spot inventory for the convenient delivery to customers, even if the bulk of orders are filled from out of state;

(10) Leasing: leasing tangible personal property which is used in Texas;

(11) Loan Production Activities: soliciting sales contracts or loans, gathering financial data, making credit checks, collecting accounts, repossessing property or performing other financial activities in Texas through employees, independent contractors, or agents, regardless of whether they reside in Texas;

(12) Partners:

> (A) acting as a general partner in a general partnership which is doing business in Texas;
>
> (B) acting as a general partner in a limited partnership which is doing business in Texas (a foreign taxable entity which is a limited partner in a limited partnership is not doing business in Texas, if that is the limited partner's only connection with Texas);

(13) Place of Business: maintaining a place of business in Texas;

(14) Processing: assembling, processing, manufacturing, or storing goods in Texas;

(15) Real Estate: holding, acquiring, leasing, or disposing of any property located in Texas;

(16) Services: including, but not limited to the following:

> (A) providing any service in Texas, regardless of whether the employees, independent contractors, agents, or other representatives performing the services reside in Texas;
>
> (B) maintaining or repairing property located in Texas whether under warranty or by separate contract;
>
> (C) installing, erecting, or modifying property in Texas;
>
> (D) conducting training classes, seminars or lectures in Texas;
>
> (E) providing any kind of technical assistance in Texas, including, but not limited to, engineering services; or
>
> (F) investigating, handling or otherwise assisting in resolving customer complaints in Texas;

(17) Shipment: sending materials to Texas to be stored awaiting orders for their shipment;

(18) Shows and Performances: the staging of or participating in shows, theatrical performances, sporting events, or other events within Texas;

(19) Solicitation: having employees, independent contractors, agents, or other representatives in Texas, regardless of whether they reside in Texas, to promote or induce sales of the foreign taxable entity's goods or services;

(20) Telephone Listing: having a telephone number that is answered in Texas; or

(21) Transportation:

> (A) carrying passengers or freight (any personal property including oil and gas transmitted by pipeline) from one point in Texas to another point within the state, if pickup and delivery, regardless of origination or ultimate destination, occurs within Texas; or

(B) having facilities and/or employees, independent contractors, agents, or other representatives in Texas, regardless of whether they reside in Texas:

(i) for storage, delivery, or shipment of goods;

(ii) for servicing, maintaining, or repair of vehicles, trailers, containers, and other equipment;

(iii) for coordinating and directing the transportation of passengers or freight; or

(iv) for doing any other business of the taxable entity.

Rule 3.587 – Total Revenue
Implements Tax Code Section 171.1011

Rule 3.587 establishes guidelines for determining total revenue. This Section applies only to franchise tax reports due on or after January 1, 2008. This Section defines certain words and terms; provides general rules used in the calculation of total revenue; details the line items from federal income tax forms that each type of entity will use in determining total revenue and also details certain subtractions from total revenue; and details items that are excluded from total revenue.

Subsection (b) of this Section sets forth the definition of certain words and terms, which include the following terms that are either not included in the statute or are slightly different from or clarify the statute:

(b) Definitions.

(1) Actual Costs of Uncompensated Care. The amount determined by either (A) or (B) of this paragraph where total charges means all amounts for health care services, including uncompensated care and compensation includes amounts determined under Tax Code, §171.1013, regardless of whether the taxable entity elects to subtract compensation. See §3.589 of this title (relating to Margin: Compensation).

(A) Uncompensated care divided by total charges multiplied by operating expenses. If this method is used to determine uncompensated care, a corresponding adjustment must be made in determining compensation by the ratio of uncompensated care divided by total charges.

(B) Uncompensated care divided by total charges multiplied by the result of total operating expenses less compensation.

***

(7) Net Distributive Income. The net amount of income, gain, deduction, or loss relating to a pass-through entity or disregarded entity reportable to the owners for the tax year of the entity.

***

(10) Product. Services, tangible personal property, and intangible property.

(11) Sales Commission.

(A) any form of compensation paid to a person for engaging in an act for which a license is required by Occupations Code, Chapter 1101; or

(B) 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 (or would have been reported if the amount had met the Internal Revenue Service minimum reporting requirement).

***

(12) Security. The meaning assigned by Internal Revenue Code, §475(c)(2), and includes instruments described by Internal Revenue Code, §475(e)(2) (B), (C), and (D).

***

(14) Tiered Partnership Arrangement. An ownership structure in which any of the interests in one taxable entity treated as a partnership or an S corporation for federal income tax purposes (a "lower tier entity") are owned by one or more taxable entities (an "upper tier entity").

(15) Uncompensated Care. Standard charges for the health care services provided by a health care provider, where the provider has not received any payment for health care provided to the patient.

***

Subsection (c) of this Section sets forth general rules for reporting total revenue. Provisions of this subsection that are not contained in the statute or are different from or clarify what is contained in this statute are as follows:

(c) General Rules for Reporting Total Revenue.

***

(3) Federal Consolidated Group. A taxable entity that is part of a federal

consolidated group or is a disregarded entity shall compute its total revenue as if it had filed a separate return for federal income tax purposes; provided, however, that a disregarded entity may combine its revenue, cost of goods sold, compensation and gross revenue with its parent as provided by §3.590(d)(6) of this title (relating to Margin: Combined Reporting). Further information on combined entities can be found in §3.590 of this title (relating to Margin: Combined Reporting).

(4) Passive Entity. A taxable entity will include its share of net distributive income from a passive entity, but only to the extent the net income of the passive entity was not generated by any other taxable entity.

(5) Exclusions from Total Revenue. For any amount that is excluded from total revenue, the related costs may not be included in the determination of cost of goods sold (see §3.588 of this title (relating to Margin: Costs of Goods Sold)) or the determination of compensation (see §3.589 of this title (relating to Margin: Compensation)).

(6) Contract Services. Except as provided by subsection (e)(2) of this section, a payment received under an ordinary contract for the provision of services in the ordinary course of business may not be excluded from the calculation of total revenue.

(7) Payments to Affiliated Group Members. If the taxable entity belongs to an affiliated group, the taxable entity may not exclude from the calculation of total revenue any payments described by subsection (e)(1)–(6) of this section that are made to entities that are members of the affiliated group.

(8) Lower Tier Entities. A lower tier entity in a tiered partnership arrangement may exclude from total revenue any revenue reported to an upper tier entity subject to the following paragraphs:

(A) The lower tier entity must submit a report to the comptroller showing the amount of total revenue that each upper tier entity should include with the upper tier entity's own taxable margin calculation, according to the ownership interest of the upper tier entity.

(B) This paragraph does not apply to that percentage of the total revenue attributable to an upper tier entity by a lower tier entity if the upper tier entity is not subject to the tax under this chapter. In this case, the lower tier entity is liable for the tax on its taxable margin.

(C) The no tax due thresholds, discounts and the E-Z Computation

do not apply to an upper tier entity if, before the attribution of any total revenue by a lower tier entity to an upper tier entity under this section, the lower tier entity does not meet the criteria. See §3.584(d)(6) of this title (relating to Margin: Reports and Payments).

(D) Total revenue reported from a lower tier entity to an upper tier entity under the provisions of Tax Code, §171.1015(b) is not a distribution from a partnership.

(9) Allocated Revenue. Revenue that Texas cannot tax because the activities generating that item of revenue do not have sufficient unitary connection with the entity's other activities conducted in Texas under the United States Constitution is not included in total revenue.

Comment: Although SBT and TSCPA requested that subsection (c)(5) address timing differences in expense and revenue recognition and include examples, the Comptroller stated that timing difference issues will be addressed on a case-by-case basis. Subsection (c)(8) of this Rule was amended from the Proposed Rules to eliminate double-taxation of the same revenue.

Subsection (d) of this Section sets forth the line items on 2006 Internal Revenue Service forms that are to be used in calculating margin for several types of entities. The provisions of this subsection that are new or are slightly different from or clarify the statute are as follows:

(d) Reporting Total Revenue. The line items in this subsection refer to line items on the 2006 Internal Revenue Service forms. In computing total revenue for a subsequent report year, total revenue should be based on the equivalent line numbers from the corresponding federal report and computed based on the Internal Revenue Code of 1986 in effect for the federal tax year beginning on January 1, 2007.

(1) Corporations. For the purpose of computing its taxable margin, the total revenue of a taxable entity treated as a corporation for federal income tax purposes is computed by:

***

(B) subtracting, to the extent included in the calculation under subparagraph (A) of this paragraph:

***

(ii) foreign royalties and foreign dividends, including amounts determined under Internal Revenue Code, §78 or §951-964;

(iii) net distributive income from a taxable entity treated as a partnership or as an S corporation for federal income tax

purposes, except as provided by subsection (c)(4) of this section.

***

(2) S Corporations. For the purpose of computing its taxable margin, the total revenue of a taxable entity treated as an S corporation for federal income tax purposes is computed by:

(A) adding:

(i) the amount reportable as income on line 1c, Internal Revenue Service Form 1120S;

(ii) the amounts reportable as income on lines 4 and 5, Internal Revenue Service Form 1120S; and

(iii) the amounts reportable as income on lines 3a and 4 through 10, Internal Revenue Service Form 1120S, Schedule K;

(iv) the amounts reportable as income on line 17, Internal Revenue Service Form 8825;

(v) any total revenue reported by a lower tier entity as includable in the taxable entity's total revenue under Tax Code, §171.1015(b); and

(B) subtracting, to the extent included in the calculation under subparagraph (A) of this paragraph:

(i) bad debt expensed for federal income tax purposes that corresponds to items of gross receipts included for the current reporting period or a past reporting period;

(ii) foreign royalties and foreign dividends, including amounts determined under Internal Revenue Code, §78 or §951-964;

(iii) net distributive income from a taxable entity treated as a partnership or as an S corporation for federal income tax purposes, except as provided by subsection (c)(4) of this section;

(iv) items of income attributable to an entity that is a disregarded entity for federal income tax purposes; and

(v) other amounts authorized by subsection (e) of this section.

(3) Partnerships. For the purpose of computing its taxable margin, the total revenue of a taxable entity treated as a partnership for federal income tax purposes is computed by:

***

(B) subtracting to the extent included in the calculation under subparagraph (A) of this paragraph;

***

(ii) foreign royalties and foreign dividends, including amounts determined under Internal Revenue Code, §78 or §951-964;

***

(4) Trusts. For the purpose of computing its taxable margin, the total revenue of a taxable entity treated as a trust for federal income tax purposes is computed by:

(A) adding:

(i) the amount reportable as income on lines 1, 2a, 3,4,7, and 8 of Internal Revenue Service Form 1041;

(ii) the amount reportable as income on lines 3, 4, 32, and 37 of Internal Revenue Service Form 1040; Schedule E; and

(iii) the amounts reportable as income on line 11, plus line 2 or line 45, Internal Revenue Service Form 1040, Schedule F; and

(iv) any total revenue reported by a lower tier entity as includable in the taxable entity's total revenue under Tax Code, §171.1015(b); and

(B) subtracting, to the extent included in the calculation under subparagraph (A) of this paragraph:

(i) bad debt expensed for federal income tax purposes that corresponds to items of gross receipts included for the current reporting period or a past reporting period;

(ii) foreign royalties and foreign dividends, including amounts determined under Internal Revenue Code, §78 or §951-964;

(iii) net distributive income from a taxable entity treated as a partnership or as an S corporation for federal income tax purposes, except as provided by subsection (c)(4) of this section;

(iv) items of income attributable to an entity that is a disregarded entity for federal income tax purposes; and

(v) other amounts authorized by subsection (e) of this section.

(5) Single Member Limited Liability Company (LLC) Filing as a Sole Proprietorship. For the purpose of computing its taxable margin, the total revenue of a taxable entity registered as a single member limited liability company and filing as a sole proprietorship for federal income tax purposes is computed by:

(A) adding:

(i) the amount reportable as income on line 3 of Internal Revenue Service, Form 1040, Schedule C;

(ii) the amount reportable as income on line 17, Internal Revenue Service Form 4797, to the extent that it relates to the LLC;

(iii) ordinary income or loss from partnerships, S corporations, estates and trusts, Internal Revenue Service Form 1040, Schedule E, to the extent that it relates to the LLC;

(iv) the amount reportable as income on line 16 of Internal Revenue Service Form 1040, Schedule D, to the extent that it relates to the LLC;

(v) the amounts reportable as income on lines 3 and 4, Internal Revenue Service Form 1040, Schedule E, to the extent that it relates to the LLC;

(vi) the amounts reportable as income on line 11, plus line 2 or line 45, Internal Revenue Service Form 1040, Schedule F, to the extent that it relates to the LLC;

(vii) the amount reportable as income on line 6 of Internal Revenue Service Form 1040, Schedule C, that has not already been included in this subparagraph; and

(viii) any total revenue reported by a lower tier entity as includable in the taxable entity's total revenue under Tax Code, §171.1015(b); and

(B) subtracting, to the extent included in the calculation under subparagraph (A) of this paragraph:

(i) bad debt expensed for federal income tax purposes that corresponds to items of gross receipts included for the current reporting period or a past reporting period;

(ii) foreign royalties and foreign dividends, including amounts determined under Internal Revenue Code, §78 or §951-964;

(iii) net distributive income from a taxable entity treated as a partnership or as an S corporation for federal income tax purposes, except as provided by subsection (c)(4) of this section;

(iv) items of income attributable to an entity that is a disregarded entity for federal income tax purposes; and

(v) other amounts authorized by subsection (e) of this section.

(6) Other Taxable Entities. For a taxable entity other than a taxable entity treated for federal income tax purposes as a corporation, S corporation, partnership, trust, or single member limited liability company filing as a sole proprietorship, the total revenue will be an amount determined in a manner substantially equivalent to the amount calculated for the entities listed in this subsection.

Subsection (e) of this Section sets forth the exclusions from total revenue. This subsection provides, in part, as follows:

(e) Exclusions from Total Revenue. Except as otherwise provided in this section and only to the extent included in the calculation of total revenue under subsection (d)((1)-(6) of this section, the following items shall be excluded from total revenue:

(1) Flow-through funds mandated by law. Flow-through funds that are mandated by law or fiduciary duty to be distributed to other entities or persons, including taxes collected from a third party by the taxable entity and remitted by the taxable entity to a taxing authority;

(2) Flow-through Funds Mandated by Contract. Flow-through funds that are mandated by contract to be distributed to other entities or persons, limited to:

***

(10) Health care provider. A taxable entity that is a health care provider shall exclude:

(A) the total amount of payments received (not to include any co-payments or deductibles received from the patient):

(i) under the Medicaid program, Medicare program, Indigent Health Care and Treatment Act (Health and Safety Code, Chapter 61), and Children's Health Insurance Program (CHIP), including any plans under these programs;

(ii) for professional services provided in relation to a workers' compensation claim under Labor Code, Title 5;

(iii) for professional services provided to a beneficiary rendered under the TRICARE military health system, including any plans under this program;

(iv) from a third-party agent or administrator for revenue earned under clauses (i) –(iii) of this subparagraph; and

***

Comment: Subparagraphs (e)(1) and (2), dealing with "flow-through funds," generated many comments from several organizations for clarification or amendment. Generally, the Comptroller declined to provide guidance on what a "flow-through fund" is. For example, the Comptroller declined to provide examples of the types of taxes excludable under subsection (e)(1), but stated that "the determination of excludible taxes will be based on specific facts and circumstances."

Rule 3.588 – Cost of Goods Sold
Implements Tax Code Section 171.1012

Rule 3.588 establishes guidelines for computing cost of goods sold under Tax Code, Chapter 171. This Section only applies to franchise tax reports originally due on or after January 1, 2008. This Section defines certain words and terms; provides general rules for computing cost of goods sold; details the direct costs includable in cost of goods sold; details additional costs includable in cost of goods sold; addresses indirect and administrative overhead costs includable in cost of goods sold; and addresses those costs not includable in cost of goods sold.

Subsection (b) of this Section sets forth the definition of words and terms used in this Section. Words or terms defined in this subsection that are not contained in the statute or that are slightly different from or that clarify those contained in the statute are as follows:

(b) Definitions.

***

(2) Computer Program. A series of instructions that are coded for acceptance or use by a computer system and that are designed to permit the computer system to process data and provide results and information. The series of instructions may be contained in or on magnetic tapes, printed instructions, or other tangible or electronic media.

***

(4) Heavy Construction Equipment – Self-propelled, self-powered, or pull-type equipment that weighs at least 3,000 pounds and is intended to be used for construction. The term does not include a motor vehicle required to be titled and registered.

***

(6) Principal Business Activity. The activity in which a taxable entity derives the largest percentage of its "total revenue."

(7) Production. Construction, manufacture, installation occurring during the manufacturing or construction process, development, mining, extraction, improvement, creation, raising, or growth.

***

Subsection (c) of this Section provides general rules for determining cost of goods sold. These rules generally follow the statute with the exception of the following:

(c) General Rules for Determining Cost of Goods Sold.

***

(2) Capitalization or Expensing of Certain Costs. A taxable entity that is allowed a subtraction by this section for a cost of goods sold and that is subject to Internal Revenue Code, §§263A, 460, or 471 (including a taxable entity subject to §471 that elects to use LIFO under §472), may:

(A) Capitalize those costs in the same manner and to the same extent that the taxable entity capitalized those costs on its federal income tax return, except for those costs excluded under subsection (g) of this section, or in accordance with subsections (d), (e), and (f) of this section. **A taxable entity that elects to capitalize costs on its first report due on or after January 1, 2008, may not include any costs incurred prior to the accounting period upon which the report is based**.

(i) If the taxable entity elects to capitalize those costs, it must capitalize each cost allowed under this section that it capitalized on its federal income tax return.

(ii) If the taxable entity later elects to begin expensing those costs allowed under this section as a cost of goods sold, the entity may not deduct any cost in ending inventory from a previous report.

Comment: Shortly after issuance of this Rule and substantial protest from many organizations, the Comptroller announced on January 11, 2008, that they had reconsidered the sentence in bold above and that beginning inventory may be fairly valued and not be limited to a value of zero. This Rule has not yet been amended to reflect that position.

(B) Expense those costs, except for those costs excluded under subsection (g) of this section, or in accordance with subsections (d), (e), and (f) of this section.

(i) If the taxable entity elects to expense those costs allowed under this section as a cost of good sold, costs incurred before the first day of the period on which the report is based may not be subtracted as a cost of goods sold.

(ii) If the taxable entity later elects to begin capitalizing those costs allowed under this section as a cost of goods sold, costs expensed on a previous report and costs incurred prior to the accounting period upon which the report is based may not be capitalized.

(3) Exclusions from Total Revenue. Costs related to revenue that has been excluded from total revenue (see §3.587 of this title (relating to Margin: Total Revenue)) may not be included in the determination of cost of goods sold. Costs must be allocated between included and excluded revenue on a reasonable basis.

***

(6) Mixed Transactions. If a transaction contains elements of both a sale of tangible personal property and a service, a taxable entity may only subtract as cost of goods sold the costs otherwise allowed by this section in relation to the tangible personal property sold.

***

(8) Rentals and Leases. Notwithstanding any other provision of this section, the following taxable entities may subtract as cost of goods sold the costs otherwise allowed by this section in relation to tangible personal property that the entity rents or leases in the ordinary course of business of the entity:

(A) a motor vehicle rental company that remits a tax on gross receipts imposed under Tax Code, §152.026 or a motor vehicle leasing company;

(B) a heavy construction equipment rental or leasing company; and

(C) a railcar rolling stock rental or leasing company.

***

(10) Restaurants. Entities engaged in activities described in Major Group 58 of the Standard Industrial Classification Manual may deduct for cost of goods sold only those expenses allowed under subsection (d), (e) and (f) of this section, that relate to the production of food. Any costs related to both the production of food and to other activities must be allocated to production on a reasonable basis.

Subsection (d) of this Section sets forth direct costs that are included in cost of goods sold. While this list of direct costs generally tracks the statute, the following items are either new or modified or clarify the definition in the statute:

(d) Cost of Goods Sold. The cost of goods sold includes all direct costs of acquiring or producing the goods, including:

(1) labor costs including W-2 wages, IRS Form 1099 wages, temporary labor, payroll taxes and benefits;

***

(3) cost of materials that are consumed in the course of performing production activities;

***

(6) depreciation, depletion, and amortization, reported on the federal income tax return on which the report under this chapter is based, to the extent associated with and necessary for the production of goods, including recovery described by Internal Revenue Code, §197, and property described in Internal Revenue Code, §179;

(7) the cost of renting or leasing equipment, facilities, or real property used for the production of the goods, including pollution control equipment and intangible drilling and dry hole costs;

***

Comment: The Comptroller declined to include bonus depreciation in subsection (d)(6).

Subsection (e) of this Section sets forth additional costs that can be treated as cost of goods sold. While this provision generally tracks the statute, the following item is slightly different than the statute:

(e) Additional Costs. In addition to the amounts includable under

subsection (d) of this section, the cost of goods sold includes the following costs in relation to the taxable entity's goods;

***

(4) if the property is held for future production, preproduction direct costs allocable to the property, including storage and handling costs, as provided by subsection (d)(4) and (5) of this section;

***

Subsection (f) of this Section sets out the provisions dealing with the treatment of indirect or administrative overhead costs. This subsection generally tracks the statute with the following modification:

(f) Indirect or Administrative Overhead Costs. A taxable entity may subtract as a cost of goods sold indirect or administrative overhead costs that it can demonstrate are allocable to the acquisition or production of goods. This amount may not exceed 4.0% of total indirect or administrative overhead cost.

***

(2) Any costs already subtracted under subsection (d) or (e) of this section, may not be subtracted under this subsection.

(3) Any costs excluded under subsection (g) of this section, may not be subtracted under this subsection.

Subsection (g) of this Section sets forth the types of costs that are not included in costs of goods sold. This subsection generally tracks the statute with the exception of the following provision which is new:

(g) Costs Not Included. The cost of goods sold does not include the following costs in relation to the taxable entity's goods:

***

(15) costs funded by a partnership contribution, to the extent that the contributing taxable entity made the cost of goods sold deduction under subsection (d)(13) of this section.

Comment: The Draft Instructions contain an interesting comment about the relationship between COGS for Margin Tax purposes and for federal income tax purposes. The Draft Instructions state there is no relationship as COGS "is a calculated amount specific for franchise tax."

Rule 3.589 – Compensation
Implements Tax Code §171.1011 and §171.1013

This Section establishes guidelines for computing compensation under Tax Code, Chapter 171. This Section only applies to franchise tax reports due on or after January 1, 2008. This Section defines words and terms; provides for general rules used in the calculation of compensation; provides for exclusions from total compensation; provides general rules used in the calculation of benefits; sets forth general rules for staff leasing companies; sets forth general rules for management companies; and provides rules applicable for small employers.

Subsection (b) of this Section provides definitions of certain words and terms. While this subsection generally tracks the statute, the following provisions are either new or slightly different from or clarify the statute:

> (b) Definitions. The following words and terms, when used in this section, shall have the following meanings, unless the context clearly indicates otherwise.
>
> ***
>
> (3) Management Company. A corporation, limited liability company or other limited liability entity that conducts all or part of the active trade or business of another entity (the managed entity) in exchange for:
>
> ***
>
> (B) reimbursement of specified costs incurred in the conduct of the active trade or business of the managed entity.
>
> ***
>
> (5) Net Distributive Income. The net amount of income, gain, deduction, or loss relating to a pass-through entity or disregarded entity reportable to the owners for the tax year of the entity.
>
> (6) Small Employer. An entity defined in Insurance Code, §1501.002.
>
> ***
>
> (9) Wages and Cash Compensation.
>
> ***
>
> (B) the amount of net distributive income, regardless of whether cash or property pertaining to such income is actually distributed, from one of the following entities to partners or owners during the accounting period but only if the person receiving the amount is a natural person.

Comment: The Draft Instructions clarify that net distributive income is determined regardless of whether an actual distribution was made to the partner or owner.

***

Subsection (d) of this Section sets forth items that are excluded from compensation. This subsection reads as follows:

(d) Compensation – Excluded Items. Compensation does not include:

(1) payments to independent contractors on Forms 1099;

(2) exclusions from revenue. See §3.587 of this title (relating to Margin: Total Revenue). Compensation related to any amount excluded from total revenue may not be included in the determination of compensation. The compensation related to an amount excluded from revenue must be determined on a reasonable basis;

(3) an employer's share of payroll taxes;

(4) wages or cash compensation paid to an employee whose primary employment is directly associated with the operation of a facility that is located on property owned or leased by the federal government, and managed or operated primarily to house members of the armed forces of the United States. See §3.587 of this title; and

(5) wages or cash compensation paid to undocumented workers.

Subsection (e) of this Section sets forth the deductibility of benefits from compensation. While this subsection includes provisions in the statute, a substantial portion of this subsection is new and is, therefore, repeated in its entirety as follows:

(e) Benefits. A taxable entity is allowed to subtract the cost of all benefits to the extent deductible for federal income tax purposes that it provides to its officers, directors, owners, partners, and employees.

(1) The term "benefits" includes employer contributions made to:

(A) employees' health savings accounts;

(B) health care (for example, this would include contributions to the cost of health insurance);

(C) retirement; and

(D) workers' compensation.

(2) The term "benefits" does not include the following:

(A) amounts included in the definition of wages and cash compensation;

(B) discounts on the price of the taxable entity's merchandise or services sold to the taxpayer's employees, officers, or directors, partners, or owners that are not available to other customers;

(C) payroll taxes. (For example, "payroll taxes" would include payments to state and federal unemployment compensation funds and payments under the Federal Insurance Contributions Act, Chapter 21 of Subtitle C of the Internal Revenue Code, §3101-3128, the Railroad Retirement Tax Act, Chapter 22 of Subtitle C of the Internal Revenue Code, §3201-3233); and

(D) working condition amounts provided so employees can perform their jobs. (Examples of working condition benefits include an employee's use of a company car for business, job-related education provided to an employee, and travel reimbursement).

(3) The cost of benefits does not include the amount paid by an employee.

Comment: Subsections (2) and (3) above are not in the statute.

Subsection (h) of this Section sets forth the provisions dealing with a small employer providing health care benefits for the first time. While this subsection generally tracks the statute, this subsection provides a definition for the term "provide" as follows:

(h) Small Employers. This subsection applies to a taxable entity that is a small employer and that has not provided health care benefits to any of its employees in the calendar year preceding the beginning date of its reporting period. Subject to Tax Code, §171.1014, a taxable entity to which this subsection applies that elects to subtract compensation for the purpose of computing its taxable margin under Tax Code, §171.101, may subtract the following health care benefits:

***

(4) The term "provide" does not include amounts paid by the employee, officer, director, etc.

Rule 3.590 – Combined Reporting
Implements Tax Code §171.0001, .0002, .002, .101, .1011, .1014, .1016, .103, .105, .1055, and .0021

Section 171.1014 of the Tax Code provides rules for combined reporting of Affiliated Groups Engaged in a Unitary Business. Under the combined reporting rules the combined group is a single taxable entity for purposes of application of the Margin Tax. However, total revenue of each of the members is initially determined as if it were an individual taxable entity. The resulting total revenue of each of the members is then added together and any portion of total revenue of a member received from another member of the combined group is then deducted in arriving at the total revenue of the combined group. The combined group must make a group-wide election to either subtract cost of goods sold or compensation.

The Tax Code defines "Unitary Business" as a single economic enterprise that is made up of separate parts of a single entity or of a commonly controlled group of entities that are sufficiently interdependent, integrated, and interrelated through their activities so as to provide a *synergy and mutual benefit that produces a sharing or exchange of value among them and a significant flow of value to the separate parts.*

Rule 3.590 establishes guidelines for combined reporting under Tax Code, Chapter 171. This Section only applies to franchise tax reports due on or after January 1, 2008. This Section defines certain words and terms; provides for mandatory combined reporting; sets forth general rules for determining combined taxable margin and apportionment; provides general rules describing the reporting entity's responsibilities; provides general rules for determining the accounting period of a combined group; addresses the liability for tax, interest and penalty of the combined group and its members; provides general rules for the calculation of credits; and provides general rules for calculating the tax rate.

Subsection (b) of this Section sets forth terms that are included in the statute, as well as new or clarifying terms as follows:

(b) Definitions. The following words and terms, when used in this section, shall have the following meanings, unless the context clearly indicates otherwise.

(1) Affiliated Group. Entities in which a controlling interest is owned by a common owner, either corporate or noncorporate, or by one or more of the member entities.

Comment: Interestingly, the definition of "Affiliated Group" in Tax Code §171.0001(1) refers to "Entities in which a controlling interest is owned by a common owner *or owners…*" It is understood that the Comptroller intentionally left out the phrase "or owners" for purposes of the definition of "Affiliated Group" in the Rules. Assume that individuals A, B and C each own 1/3 of entities X and Y. Their ownership as common owners in X and Y will apparently not be aggregated under the Rules in applying the 50% control test, discussed below (unless two of the individuals are husband and wife). Under the definition in the Rules it would appear that X and Y would not be part of an affiliated group as no "common owner" has a controlling interest when tested alone.

(2) Combined Group. Taxable entities that are part of an affiliated group engaged in a unitary business and that are required to file a combined group report under Tax Code, §171.1014.

***

(C) A combined group must include eligible entities even if those entities do not have nexus as described in §3.586 of this title (relating to Margin: Nexus).

(D) Eligible pass-through entities (including partnerships), limited liability companies taxed as partnerships under federal law, limited liability companies that are disregarded under federal law, and S corporations must be included in a combined group.

Comment: The word "Eligible" was added in the Rules to clarify that inclusion of pass-through entities in a combined group is limited to entities that satisfy the criteria for combined reporting.

(E) Insurance companies that pay gross premiums tax are not included in a combined group.

(F) Passive entities are not included in the combined group; however, the pro rata share of net income from a passive entity shall be included in total revenue to the extent it was not generated by the margin of another taxable entity.

(3) Combined Group Report. A report that includes the business of all members of the combined group.

(4) Controlling Interest.

(A) Controlling interest means:

(i) for a corporation, either more than 50%, owned

directly or indirectly, of the total combined voting power of all classes of stock of the corporation, or more than 50% owned directly or indirectly, of the beneficial ownership interest in the voting stock of the corporation;

(ii) for a partnership, association, trust or other entity other than a limited liability company, more than 50%, owned directly or indirectly, of the capital, profits, or beneficial interest in the partnership, association, trust, or other entity;

(iii) for a limited liability company, either more than 50%, owned directly or indirectly, of the total membership interest of the limited liability company or more than 50%, owned directly or indirectly, of the beneficial ownership interest in the membership interest of the limited liability company.

Comment: The test is a 50% threshold; note also that in the case of a partnership the test is satisfied if there is a more than 50% interest in capital, profits *or* beneficial interest. This could potentially lead to a conflict whereby a partnership may be includable in two different combined groups if a taxable entity in one group owns more than 50% of the capital interest in the partnership and another taxable entity in a different group owns more than 50% of the profits interest in the partnership. However, the Rules add subsection (F), below, to deal with those situations where a taxable entity could be included in more than one group.

***

(B) Examples are as follows:

(i) Corporation A owns 10% of Corporation C and 60% of Corporation B, which owns 41% of Corporation C. Corporation A has a controlling interest in Corporation B and a controlling interest in Corporation C of 51% of stock ownership because it has control of the stock owned by Corporation B.

(ii) Corporation A owns 10% of Limited Liability Company C and 15% of Corporation B, which owns 90% of Limited Liability Company C. Corporation A does not have controlling interest in Limited Liability Company C and does not have a controlling interest in Corporation B. Corporation B has a controlling interest in Limited Liability Company C.

(iii) Individual A owns 100% of 10 corporations, each of which owns 10% of Partnership B. Individual A has a controlling interest in each of the ten corporations and in Partnership B.

(iv) corporation A holds a 70% interest in Partnership B that owns 60% of Limited Liability Company C. Corporation A owns the remaining 40% of Limited Liability Company C. Corporation A owns a controlling interest in Partnership B and a 100% controlling interest in Limited Liability Company C.

Comment: The Rules clarify that the Comptroller is taking the position that if a taxable entity owns more than 50% of another taxable entity, which in turn owns an interest in a third tier entity, then it is deemed to own all of the interest in the third tier entity that is owned by the second tier entity, rather than prorating based on the upper tier entity's percentage interest in the second tier entity.

(v) Corporation A owns 10% of Limited Liability Company C and 45% of Corporation B, which owns 90% of Limited Liability Company C. Corporation A would hold a 10% interest in Limited Liability Company C which would not constitute a controlling interest. Corporation B has a controlling interest in Limited Liability Company C.

Comment: This example was added in the Rules to further clarify that an upper tier entity which owns less than 50% of a lower tier entity is not attributed any ownership in any entities owned by that lower tier entity.

(vi) Partnership P is owned by Limited Liability Company A, Limited Liability Company B and Limited Liability Company C. Three unrelated individuals each wholly own one of the limited liability companies. None of the limited liability companies owns more than 50% of Partnership P. There is no controlling interest.

Comment: This example was apparently added in the Rules to clarify that where separate, unrelated individuals each own an LLC and those LLCs collectively own an interest in a partnership, the ownership of the unrelated individuals will not be combined to determine control.

(C) In addition to the foregoing tests, the comptroller may consider any other circumstance that tends to demonstrate that the more than 50% direct or indirect common ownership test was met or was not met.

Comment: The Comptroller rejected suggestions by the TSCPA and Texas Oil and Gas Association (TxOGA) that this provision be deleted as being overly vague. The Comptroller gave as justification for this broad provision the necessity to address extraordinary situations not contemplated by the statutes (citing Tax Code §171.0001(8) which defines a "controlling interest").

> (D) Membership in an affiliated group shall be treated as terminated in any year, or fraction thereof, in which the conditions listed in this paragraph are not met, except as follows:
>
> > (i) when an affiliate is sold, exchanged, or otherwise disposed of, the membership in an affiliated group shall not be terminated if the requirements of this paragraph are again met immediately after the sale, exchange, or disposition.
> >
> > (ii) The comptroller may treat the affiliated group as remaining in place if the conditions of this paragraph are again met within a period not to exceed two years.

Comment: This raises interesting questions as to how the group is to report in the interim between termination of the group and reconstitution within two years. For instance, assume that Partnership A owns a 51% interest in the capital and profits of LLC B and that they are treated as a combined group. On December 31, 2008 it disposes of a 10% interest in LLC B which terminates the combined group. On December 1, 2010 Partnership A reacquires the 10% interest in LLC B once again bringing its total ownership to 51%. Presumably, Partnership A and LLC B would report as separate taxable entities for their 2009 Margin Tax report. Upon once again becoming part of a combined group within two years will they be required to file an amended return for 2009 as a combined group?

> (E) Except as otherwise provided, an entity is owned when a controlling interest is directly held or the interest is constructively owned. An individual constructively owns stock that is owned by his or her spouse.

Comment: In an initial draft of the Proposed Rules, an individual was treated as owning a taxable entity owned directly or indirectly by or for his "family", which was defined to include his or her brothers and sisters (whether by the whole or half blood), spouse, ancestors, and lineal descendants. That provision was deleted from the Proposed Rules as published. However, the Rules add a narrow constructive ownership rule which is apparently limited to

attribution to a person's spouse. It is not clear why the definition only refers to stock, as opposed to a more broader reference to any interest in a taxable entity.

> (F) If an entity is a member of more than one affiliated group, the entity is treated as a member of the affiliated group (or part thereof) with respect to which it has a unitary relationship. If the entity has a unitary relationship with more than one of those affiliated groups, it shall elect to be treated as a member of only one group. The election shall remain in effect until the unitary business relationship between the entity and the other members ceases, or unless revoked with approval of the comptroller.

(5) Reporting Entity. The combined group's choice of an entity that is**:**

(A) the parent entity, if it is part of the unitary business, or

(B) the entity that:

(i) is included within the combined group;

(ii) is subject to Texas' taxing jurisdiction; and

(iii) has the greatest Texas business activity during the first period upon which the first report is based, as measured by the Texas receipts after eliminations for that period.

(6) Unitary Business. A single economic enterprise that is made up of separate parts of a single entity or of a commonly controlled group of entities that are sufficiently interdependent, integrated, and interrelated through their activities so as to provide a synergy and mutual benefit that produces a sharing or exchange of value among them and a significant flow of value to the separate parts. In determining whether a unitary business exists, the comptroller shall consider any relevant factor, including:

(A) whether:

(i) activities of the group members are in the same general line, such as manufacturing, wholesaling, retailing of tangible personal property, transportation, or finance;

Comment: The word "insurance" is omitted, while it is included in the statute.

(ii) The activities of the group members are steps in a vertically structured enterprise or process, such as the steps involved in the

production of natural resources, including exploration, mining refining, and marketing; or

(iii) The members are functionally integrated through the exercise of strong centralized management, such as authority over purchasing, financing, product line, personnel, and marketing.

(B) Other Factors. In addition, the comptroller may consider other factors that may be applicable, including guidelines in Supreme Court decisions that presume activities are unitary. All affiliated entities are presumed to be engaged in a unitary business.

Comment: Read literally, the provision that the Comptroller "may consider…guidelines in Supreme Court decisions *that presume activities are unitary*" (emphasis added) could be read to mean that the Comptroller need not consider Supreme Court decisions that do not presume activities are unitary. However, such a position, if intended, would appear to be untenable. This portion of subsection (B) above is not in the statute; §171.0001(17).

The last sentence of subsection (B) is also not in the statute; §171.0001(17). There does not appear to be any basis either in the Tax Code, or Supreme Court decisions, for a blanket presumption that all affiliated entities are presumed to be engaged in a unitary business. Indeed, in *F.W. Woolworth Co., v. Taxation and Revenue Department of the State of New Mexico,* 458 U.S. 354 (1982), the Court observed that although the parent company had the potential to operate the subsidiaries as integrated divisions of a single unitary business, that potential was not significant if the subsidiaries in fact comprise discrete business operations. Id at 362.

(C) New Entities. When a taxable entity acquires another entity, a presumption exists for finding a unitary relationship during the first reporting period. Any party may rebut such presumption by proving that the taxable entities were not unitary. If such presumption is rebutted, then the taxable entities shall not be considered unitary as of the date of acquisition. When a taxable entity forms another taxable entity, a unitary relationship exists as of the date of formation unless the business is not unitary on a longer term basis. An acquired entity is required to file a report for the period prior to acquisition.

Comment: Again, this presumption appears to go beyond the scope of the language of the Texas Tax Code and existing definitions of unitary business in other states or case law.

(D) Non-Arm's Length Prices. Goods or services or both are supplied at non-arm's length prices between or among entities. Existence of

arm's-length pricing between entities, however, does not indicate lack of unity.

(E) Existence of Benefits from Joint, Shared or Common Activity. A discount, cost-saving or other benefit can be shown to result from joint purchases, leaseholds, or other forms of joint, shared or common activities between or among entities.

(F) Relationships of Joint, Shared or Common Activity to Income-Producing Operations. In determining whether a joint, shared, or common activity is indicative of a unitary relationship, consideration shall be given to the nature and character of the basic operations of each entity. Such consideration shall include, but not be limited to, the entity's sources of supply, its goods or services produced or sold, its labor force, and market to determine whether the joint, shared, or common activity is directly beneficial to, related to, or reasonably necessary to the income-producing activities of the unitary business.

(G) Holding Entities. The tests for a unitary business established by this section apply in determining whether a holding entity is included or excluded from a unitary business.

Comment: The unitary business definition adopted by the Tax Code, and expanded by the Rules, is based in part on case law, including a number of Supreme Court cases, which have used the unitary business principal as a means of determining which of the taxed enterprise's activities in the taxing jurisdiction form one part, and then apportioning the total income of that unitary business between the taxing jurisdiction and the rest of the world. See *Container Corporation of America,* 463 U.S. 159 (1983)*; F.W. Woolworth Co., supra; Allied-Signal, Inc. v. Director, Division of Taxation,* 504 U.S. 768 (1992). While the Margin Tax definition of unitary business is based in part on concepts developed through case law, the definition adopted by the Tax Code differs from other definitions of unitary business and liberally applies a series of presumptions in favor of classification of two or more entities as part of a unitary business.

(7) United States: The 50 states and the district of Columbia. It also includes the territorial waters of the United States and the seabed and subsoil of those submarine areas that are adjacent to the territorial waters of the United states and over which the United States has exclusive rights, in accordance with international law, with respect to the exploration for or exploitation of natural resources. It also includes the possessions and territories of the United States and the Commonwealth of Puerto Rico.

Subsection (c) of this Section deals with the obligation for combined reporting. This subsection reads as follows:

> (c) Mandatory Combined Reporting. A combined group shall file a combined group report. A taxable entity that is not included in a combined report must file a separate report if it is doing business in Texas or is chartered or organized in Texas.

Subsection (d) of this Section sets forth guidelines for determining combined taxable margin and apportionment. The provisions of this subsection that are either new or clarify the statute are as follows:

> (d) Determination of Combined Taxable Margin and Apportionment.
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> ***
>
> (3) Combined Compensation. The combined group may not subtract in relation to a person, more than $300,000 or the amount determined under Tax Code, §171.006, per 12-month period on which margin is based. A combined group that elects to subtract compensation shall determine that amount by:
>
> ***
>
> (4) Combined groups are eligible to elect to use the 70% of revenue calculation pursuant to Tax Code, §171.101 or E-Z Computation pursuant to Tax Code, §171.1016. See §3.584 of this title (relating to Margin: Reports and Payments.)
>
> (5) Combined Apportionment.
>
> ***
>
> (B) Except as provided in subparagraph (D) of this paragraph, gross receipts from business done in this state of taxable entities without nexus individually in Texas are excluded from the numerator. For example, sales of tangible personal property shipped into Texas by a member that does not have nexus individually are excluded from the numerator but are included in the denominator.
>
> ***
>
> (D) Receipts derived from transactions between members of a combined group that are excluded under Tax Code, §171.1014(c)(3), may not be included in the numerator or denominator of the apportionment factor. However, the numerator of the apportionment factor will include certain sales of tangible personal property made to third party purchasers if the

tangible personal property is ultimately delivered to a purchaser in Texas without substantial modification. See Tax Code, §171.1055(b). For example, drop shipments made from a Texas location to a Texas purchaser would be included in Texas receipts based on the amount billed to the third party purchaser if the seller is a member of the combined group and the seller does not have nexus.

(6) When reporting revenue, cost of goods sold, compensation and gross receipts for a disregarded entity, that information may be included with the parent; in that event, both entities are presumed to have nexus.

Subsection (e) of this Section sets forth the responsibilities of a reporting entity. This subsection reads as follows:

(e) Reporting Entity.

(1) Responsibilities of the Reporting Entity.

(A) Access to Records. In addition to the information required to be included in the combined group report, upon request of the comptroller, the reporting entity shall provide access to the tax, financial, and nonfinancial records of entities that do and do not have Texas nexus.

(B) Filing. The reporting entity shall file a combined group report on behalf of the combined group together with all reports and schedules required by the comptroller. Any elections required by the combined group are binding on all members of the group.

(C) Payment. The reporting entity shall timely remit to the comptroller the Texas franchise tax imposed on the combined group.

(D) Authority. The reporting entity may file refund claims, give waivers and execute agreements on behalf of the combined group. Any refund claim, waiver given, agreement or any document executed, shall be considered as having also been given or executed by such combined group member.

(2) Notices. Notices mailed to the reporting entity shall be deemed to have been mailed to each of the taxable entities in the combined group.

(3) Change in the Reporting Entity. The reporting entity shall change only when the entity (other than the parent) is no longer subject to

Texas' jurisdiction to tax or the reporting entity is no longer a member of the combined group, at which time the combined group shall designate another entity that qualifies as its reporting entity and notify the comptroller of the designation.

Subsection (f) of this Section sets forth the rules for the accounting period of the combined group. This subsection reads as follows:

(f) Accounting Period of the Combined Group.

(1) The combined group's accounting period is determined as follows:

(A) if two or more members of a combined group file a federal consolidated return, the group's accounting period is the federal taxable period of the federal consolidated group;

(B) in all other instances, the accounting period is the federal taxable period of the reporting entity.

(2) Members with Different Accounting Periods. If the federal taxable period of a member differs from the federal taxable period of the combined group, the reporting entity will determine the portion of that member's revenue, cost of goods sold, compensation, etc. to be included by preparing a separate income statement prepared from the books and records for the months included in the group's accounting period.

Subsection (i) of this Section sets forth the rules for the application of credits to a combined group. This subsection reads as follows:

(i) For a combined group, the revenue from each retail and wholesale trade activity of each of the members of the combined group shall be aggregated for purposes of determining whether the combined group is engaged in retail or wholesale trade. The determination of whether a combined group is engaged in a retail or wholesale trade activity shall be made after eliminations.

Rule 3.591 – Apportionment
Implements Tax Code §171.103, .1055, .106, and .1121

The apportionment rules remain largely unchanged under the Margin Tax. One change, however, apportions receipts from the servicing of loans secured by real property to the location of the collateral real property that secures the loan. Also the throwback rule has been eliminated. The Margin Tax keeps the "Joyce Rule" which only includes in the numerator of the apportionment

formula gross receipts of taxable entities with nexus to Texas whereas gross receipts of all taxable entities which are members of a combined group are included in the denominator.

Rule 3.591 establishes guidelines for the apportionment of the Margin Tax. This Section applies only to franchise tax reports originally due on or after January 1, 2008. This Section defines certain words and terms; gives the apportionment formula and provides two exceptions to the formula; provides general rules for reporting gross receipts; addresses the treatment of specific items of revenue in the computation of gross receipts; and provides guidance in the determination of gross receipts for natural gas production.

Subsection (b) of this Section sets forth the definition of certain words and terms. Words and terms as defined in this Subsection that are not contained in the statute or that differ from or clarify the statute are as follows:

> (b) Definitions. The following words and terms, when used in this section, shall have the following meanings, unless the context clearly indicates otherwise.
>
> > ***
> >
> > (4) Gross Receipts. The amount determined as total revenue under §3.587 of this title (relating to Margin: Total Revenue), except for a taxable entity taking a deduction for uncompensated care or pro bono services or an entity for which subsection (e)(16) of this section, applies.
> >
> > ***

Subsection (c) of this Section sets forth the apportionment formula and reads in part as follows:

> (c) Apportionment Formula. A taxable entity's margin is apportioned to this state to determine the amount of franchise tax due by multiplying the taxable entity's margin by a fraction, the numerator of which is the taxable entity's gross receipts from business done in this state and the denominator of which is the taxable entity's gross receipts from its entire business except as provided by this subsection.
>
> > (1) Taxable entities that have margin that is derived, directly or indirectly from the sale of services to or on behalf of a regulated investment company as defined by IRC, §851(a), should refer to Tax Code, §171.106(b), relating to the apportionment of gross receipts from services for regulated investment companies.
> >
> > ***

Comment: In the statute, services are limited to "management, distribution or administrative."

Subsection (e) of this Section sets forth the treatment of specific items and the computation of gross receipts. Subsection (e) reads as follows:

(e) Treatment of specific items in the computation of gross receipts.

(1) Bad Debt Recoveries. Bad debt recoveries are gross receipts.

(2) Capital Assets and Investments. Except as provided by paragraph (16) of this subsection, net gains and losses from sales of investments and capital assets must be added to determine the total gross receipts from such transactions. If both Texas and out-of-state sales have occurred, then a separate calculation of net gains and losses on Texas sales must be made. If the combination of net gains and losses results in a net loss, the taxable entity should net the loss against other receipts, but not below zero. In no instance shall the apportionment factor be greater than 1. Net gain on sales of intangibles held as capital assets or investments is apportioned to the location of the payor. Examples of intangibles include, but are not limited to, stocks, bonds, commodities, futures contracts, patents copyrights, licenses, trademarks, franchises, goodwill, and general receivable rights.

***

(5) Debt Forgiveness. If a creditor releases any part of a debt, then the amount that the creditor forgives is a gross receipt that is apportioned to the legal domicile of the creditor.

(6) Debt Retirement. Revenues from the retirement of a taxable entity's own indebtedness, such as through the taxable entity's purchase of its own bonds at a discount, are gross receipts that are apportioned to the taxable entity's legal domicile. The indebtedness is treated as an investment in the determination of the amount of gross receipts.

(7) Deemed Sales of Assets Under Internal Revenue Code, §338. Amounts that are deemed to have been received by the target taxable entity are treated as sales of assets by the target taxable entity, and are apportioned according to rules that otherwise apply to sales of such assets under Tax Code, Chapter 171, or this section. For the purposes of this paragraph, the purchaser of the target's stock is considered the purchaser of the assets.

(8) Dividends and/or Interest.

(A) Dividends that are recognized as a reduction of the taxpayer's basis in stock of a taxable entity for federal income tax purposes are not gross receipts. Dividends that exceed the taxpayer's basis for federal income tax purposes that are recognized as a capital gain are treated as dividends for apportionment purposes.

(B) The following are excluded from Texas receipts and receipts everywhere:

(i) dividends from a subsidiary, associate, or affiliated taxable entity that does not transact a substantial portion of its business or regularly maintain a substantial portion of its assets in the United States;

(ii) schedule C special deductions that are excluded from total revenues;

(iii) dividends and/or interest on federal obligations that are excluded from total revenue;

(iv) interest that is exempt from federal income tax.

(C) Dividends and/or interest that are received from a corporation or other sources are apportioned to the legal domicile of the payor.

(D) Dividends and/or interest that are received from a national bank are apportioned to Texas if the bank's principal place of business is located in Texas. Dividends and/or interest that are received from a bank that is organized under the Texas Banking Code are apportioned to Texas.

(E) A banking corporation may exclude from its Texas gross receipts interest that is earned on federal funds and interest that is earned on securities that are sold under an agreement to repurchase and that are held in a correspondent bank that is domiciled in Texas, but the banking corporation must include the interest in its gross receipts everywhere.

(9) Exchanges of Property. Exchanges of property are included in gross receipts to the extent that the exchange is recognized as a taxable transaction for federal income tax purposes. Such exchange must be included in receipts based on the gross exchange value, unless otherwise required under this section.

***

(11) Insurance Proceeds.

(A) Business interruption insurance proceeds are gross receipts when the proceeds are intended to replace lost profits. Such receipts are apportioned to the legal domicile of the payor of the proceeds.

(B) Revenues from fire and casualty insurance proceeds are apportioned to the location of the damaged or destroyed property.

(12) Internet Access Fee. A fee that is charged to obtain access to the World Wide Web in Texas is a Texas gross receipt.

(13) Leases and Subleases.

(A) Revenue from the lease or sublease (or rental or subrental) of real property are apportioned to the location of the property.

(B) Revenues from the lease or sublease (or rental or subrental) of tangible personal property are apportioned to the location of the property. If the property is used both inside and outside Texas, then lease payments are apportioned based on the number of days that the tangible personal property was used in Texas divided by the number of days that the tangible personal property was used everywhere. If the amount of revenue that is due under the lease is based on mileage, then the lease payments are apportioned based on the number of miles in Texas divided by the number of miles everywhere.

(C) If a lump sum is charged for leased or subleased (or rental or subrental) property that is located both inside and outside Texas, then the allocation of such revenue is based on the rental value of each item of property.

(D) Revenues from the lease or sublease (or rental or subrental) of a vessel that engages in commerce are apportioned to Texas based on the number of days that the vessel is engaged in commerce in Texas waters divided by the number of days that the vessel is engaged in commerce everywhere.

(E) If a lease, sublease, rental, or subrental of real property or tangible personal property is treated as a sale for federal income tax purposes, then the receipts from the transaction are apportioned in the same manner as a sale. Any portion of the payments that the contracting parties designate as interest is interest receipts.

(14) Litigation Awards. Revenues that are realized from litigation

awards are gross receipts that are apportioned to the legal domicile of the payor of the proceeds; however, if the litigation awards are intended to replace receipts for which another apportionment rule is provided in this section, then the apportionment must be made in accordance with that rule. For example, if taxable entity sues a Delaware corporation to recover on a sale of goods delivered to a Texas location, then a judgment for the amount of that sale would not convert the receipts from Texas receipts to Delaware receipts. See subsection (f) of this section, for the apportionment of receipts from judgments, compromises, or settlements that relate to natural gas production.

(15) Loan Servicing of Real Property. Receipts from the servicing of loans secured by real property are apportioned to the location of the collateral real property that secures the loan being serviced.

(16) Loans and Securities. 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.

(17) Membership or Enrollment Fees Paid for Access to Benefits. Membership or enrollment fees paid for access to benefits should be considered gross receipts from the sale of an intangible asset and are apportioned to the legal domicile of the payor.

(18) Mixed Transactions. If a transaction involves elements of both a sale of tangible personal property and a service, but no documentation exists to show separate charges for the sale and service elements, then the comptroller may determine the amounts that are allocable to each element based on fair values or on any available evidence.

(19) Net Distributive Income. The net distributive income from a passive entity that is included in total revenue is apportioned to the principal place of business of the passive entity.

***

(23) Real Property. Revenues from the sale, lease, rental, sublease, or subrental of real property, including mineral interests, are apportioned to the location of the property. Royalties from mineral interests are considered revenue from real property.

Comment: The Rules add the reference to mineral interests and royalties to the apportionment rule for real property.

(24) Sales Taxes. State or local sales taxes that are imposed on the

customer, but are collected by a seller are not gross receipts of the seller. However, discounts that a seller is allowed to take in remittance of the collected sales tax are gross receipts to the seller.

(25) Securities. Receipts from the sale of securities are apportioned based on the location of the payor. If securities are sold through an exchange, and the buyer cannot be identified, then 7.9% of the revenue is a Texas receipt.

Comment: According to the Comptroller, the increase from 6.5% to 7.9% was intentional and was based on the increase in the Texas population.

(26) Services. Receipts from a service are apportioned to the location where the service is performed. If services are performed both inside and outside Texas, then such receipts are Texas receipts on the basis of the fair value of the services that are rendered in Texas.

(A) Taxable entities that have margin that is derived, directly or indirectly, from the sale of services to or on behalf of a regulated investment company should refer to Tax Code, §171.106(b), for information on apportionment of such margin.

(B) Taxable entities that have margin that is derived, directly or indirectly, from the sale of management, administration, or investment services to an employee retirement plan as defined in subsection (b)(3) of this section, should refer to the Tax Code, §171.106(c), for information on apportionment of such margin.

(C) Receipts from services that a defense readjustment project performs in a defense economic readjustment zone are not Texas receipts.

(27) Services Procurement. Revenues for the procurement of services are apportioned to the place where the service procurement is performed.

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(30) Telephone Companies.

(A) Revenues from telephone calls that both originate and terminate in Texas are Texas receipts.

(B) Revenues from telephone calls that originate in Texas but terminate outside of Texas or that originate outside of Texas but terminate in Texas are excluded from Texas receipts;

(C) Revenues from telecommunication services other than those services in subparagraph (A) or (B) of this paragraph are Texas receipts if the services are performed in Texas. For example, a telephone company that provides a long distance carrier access to the telephone company's local exchange network in Texas is performing a service in Texas. Any fee that the telephone company charges the long distance carrier for access to the local exchange network in Texas is a Texas receipt regardless of whether the access is related to an interstate call. A fee that is charged to obtain access to a local exchange network in Texas and that is based on the duration of an interstate telephone call may be excluded from Texas receipts.

(31) Texas Waters. Revenue from transactions that occur in Texas waters are Texas receipts. Texas waters are considered to extend to 10.359 statute miles, or nine nautical miles, from the Texas coastline.

***

Subsection (f) of this Section sets forth the apportionment of revenue from natural gas production. Subsection (f) reads as follows:

(f) Natural Gas Production.

(1) Revenues that a gas producer realizes from the contract price of gas that the gas producer produces and that the purchaser takes pursuant to the terms of sales are gross receipts and are apportioned to Texas, if the gas is delivered in Texas.

(2) Revenues that a gas producer realizes from a purchaser's payment under a sale or purchase contract for gas to be produced even if no gas is produced and delivered to the purchaser, are gross receipts and are apportioned to the legal domicile of the payor.

(3) Revenues that a gas producer realizes from a purchaser's payments to terminate a gas purchase contract are gross receipts and are apportioned to the legal domicile of the payor.

(4) Revenues that a gas producer realizes from a contract amendment that relates to the price of the gas sold are gross receipts from the sales of gas and are apportioned to Texas if delivery is made to a location in Texas. Revenues that the gas producer realizes from a contract amendment that relates to a provision other than the price of gas sold are gross receipts and are apportioned to the legal domicile of the payor.

(5) Revenues that a gas producer realizes from litigation awards for a breach of contract, reimbursements for litigation-related expenses (e.g., documented attorney's fees or court costs), or interest (upon which the parties have agreed, that the records of the producer reflects, or in an amount that a court has ordered) are gross receipts and are apportioned to the legal domicile of the payor.

(6) Revenues that a gas producer realizes from a judgment, compromise, or settlement relating to the recovery of a contract price of gas produced are gross receipts and are apportioned to Texas to the extent the contract specified delivery to a location in Texas. Revenues that a gas producer realizes from a judgment, compromise, or settlement that relates to several claims or causes of action shall be prorated based upon the documented amounts due under the contract for each claim or cause of action according to the records of the producer. For example, a settlement sum of $100,000 for a pricing dispute of $25,000 and for failure to pay for gas not taken in the amount of $225,000, would result in receipts of $10,000 from gas sales (100,000 X 25,000/250,000) and receipts from other business of $90,000 (100,000 X 225,000/250,000). Records of the producer shall include, but are not limited to the following: contracts, settlement agreements, accounting records and entries, court pleadings and worksheets, including calculations reflecting settlement amounts.

Rule 3.592 – Additional Tax
Implements Tax Code §171.0011

The Margin Tax Rules continue the requirement that an "additional tax" (sometimes referred to as the "exit tax") is due upon a taxable entity ceasing to be subject to Texas Margin Tax.

This Section establishes guidelines for computing additional tax under Tax Code, Chapter 171 and is effective for reports originally due on or after January 1, 2008. This Section also provides the due date; provides the rate of tax and the period upon which the additional tax is based; and refers to other sections for additional information.

Subsection (a) of this Section addresses the effective date of this Section. Although this subsection is similar to the applicable statute, this subsection uses nexus as the standard. This subsection reads as follows:

(a) Effective Date. For reports originally due on or after January 1, 2008, the additional tax imposed by Tax Code, §171.0011, applies to a taxable entity which no longer has sufficient nexus with Texas to be subject to the

franchise tax. All provisions of Tax Code, Chapter 171, apply to the additional tax, unless they conflict with a provision in Tax Code, §171.0011.

Comment: The portion of original H.B. 3 stating that the additional tax is not imposed on a taxable entity that qualifies as a passive entity was repealed by H.B. 3928.

Subsection (b) of this Section states when the final report and additional tax are due and addresses the need to make an estimated return and payment. This subsection reads as follows:

(b) Due Date. A final report and payment of the additional tax are due within 60 days after the taxable entity no longer has sufficient nexus with Texas to be subject to the franchise tax. However, an estimated return and payment may need to be filed and paid before a taxable entity will receive clearance from the comptroller to terminate, dissolve, merge, or withdraw. As long as the proper amount is paid and an amended return, if needed, is filed within 60 days after the taxable entity terminates, dissolves, merges, or withdraws, then no penalty or interest will be assessed.

Subsection (c) of this Section addresses the rate of tax and the taxable margin in the same manner as the statute. This subsection, however, refers to nexus as the standard by which the additional tax will be imposed.

(c) Rate and Business Based On. The additional tax rate is determined by Tax Code, §171.002 and is applied to taxable margin for the period from the date after the last day for which tax under Tax Code, Chapter 171, was based on a previous report through the date the taxable entity no longer has sufficient nexus with Texas to be subject to the franchise tax.

(d) Passive Entities. See §3.582 of this title (relating to Margin: Passive Entities) and Tax Code §171.001(c). A passive entity must file a final report when the entity is no longer subject to the tax. If the entity has been a passive entity since the last report filed, no tax would be due with the report.

Comment: This provision was changed in the Rules to clarify the reporting requirements when a passive entity is no longer subject to tax.

(e) Combined Reports. §3.590 of this title (relating to Margin: Combined Reporting). An entity that is part of a combined report must file a final report when the entity is no longer subject to the tax to tell the comptroller the name of the reporting entity. No financial data

would be included on the report, unless the entity becoming no longer subject to the tax is the reporting entity.

Comment: This provision was also changed in the Rules to clarify the reporting requirements when a member of a combined group is no longer subject to the tax.

Rule 3.593 – Franchise Tax Credits
Implements Tax Code Chapter 171, Subchapter Q—1

This Section establishes guidelines for the computation of franchise tax credits under Tax Code, Chapter 171. This Section applies to franchise tax reports originally due on or after January 1, 2008. This Section defines certain words and terms; details the requirement that a credit schedule must be filed; details the tax limitations for the credits; details the carryforward and report limitation for the research and development credit; details the carryforward and report limitation for the jobs creation credits; details the installment, carryforward and report limitation for the investment credit; and relates to an investment credit for certain enterprise projects and details the calculation of the credit and the limitations.

Comment: This Rule is not discussed in this article.

Rule 3.594 – Temporary Credit for Business Loss Carryforwards
Implements Tax Code §171.111

This Section establishes guidelines for calculating the temporary credit. This Section applies to franchise tax reports originally due on or after January 1, 2008. This Section defines certain words and terms; outlines the entities eligible to take this credit; provides notice requirements; provides for the election of the credit; describes the calculation of the credit; and changes the preservation date from September 1, 2007 to May 15, 2008.

Subsection (b) of this Section contains the following defined terms:

(b) Definitions. The following words and terms, when used in this section, shall have the following meanings, unless the context clearly indicates otherwise.

(1) Business Loss. Any negative amount of earned surplus after apportionment and allocation but before any deductions for solar energy devices under Tax Code, §171.107, clean coal project under Tax Code, §171.108, or investment in an enterprise zone under Tax Code, §171.1015. Business losses must have been used to offset any

positive amount of earned surplus even in years when no tax was due.

(2) Business Loss Carryforward. Unused and unexpired amounts of business losses created on the 2003 and subsequent franchise tax report years.

Subsection (c) of this Section sets forth the eligibility tests. While this subsection tracks the statute, a new provision dealing with combined groups is as follows:

(c) Eligibility.

***

(3) If a member of a combined group changes combined groups after June 30, 2007, the business loss carryforward of that member will no longer be included in the temporary credit calculation of the group and the related share of any temporary credit carried over from a previous year is lost to the group. There is no proration for a partial year. In addition, the business loss carryforward does not follow the member to a separately filed report or another combined group. If a member merges into another member of the group, that member's business loss carryforward will remain with the group. If the member dissolves, terminates, or otherwise leaves the group, the business loss carryover of that member is no longer eligible for use. If the combined group adds a new member or members, the credit of the existing members will remain intact, but no credit is allowed for the new member(s).

(4) Example. Corporation A, corporation B, corporation C and corporation D are members of a combined group. They have business loss carryforwards of $2,000,000, $2,000,000, $2,000,000, and $4,000,000 respectively. In 2008, the combined group's credit will be $10,000,000 x 2.25% x 4.5% equaling $10,125. The combined group's tax due before the credit is $9,000 which results in a carryover of $1,025. During 2008, corporation D leaves the group. On the 2009 report, the combined group is entitled to a credit of $6,000,000 x 2.25% x 4.5% equaling $5,075. In addition, the group only has $615 of the carryover credit. They lost the 40% that was related to corporation D. However, if corporation D had merged into corporation C during 2008 instead of leaving the group, the combined group's credit will remain $10,125 for 2009 and there will still be a $1,025 carryover from 2008.

***

Subsection (d) of this Section sets forth the notice of intent requirement. This subsection, which changes the preservation date from September 1, 2007, to May 15, 2008, provides as follows:

(d) Notice Requirements.

(1) A notice of intent to preserve the right to claim the temporary credit for business loss carryforwards must be submitted to the comptroller with the first report due from a taxable entity after January 1, 2008, on a form prescribed by the comptroller. The postmark date (or meter-mark date, if there is no postmark) on the envelope in which the form is received determines the date of filing.

(2) The taxable entity must submit with the notice of intent the amount of business loss that is being carried forward.

(3) After the initial preservation, the taxpayer may change the amount preserved only as the result of an Internal Revenue Service audit. The taxpayer must notify the comptroller in writing of the change within 120 days after the Internal Revenue Service audit is final.

(4) If, upon audit by the comptroller, an adjustment is made to the business loss carryforward used on reports prior to 2008, then no notice is required and the amount of business loss carryforwards that were preserved and subsequently taken will be adjusted accordingly. The taxable entity will be liable for any additional tax, penalty, and interest due for years in which the credit was improperly claimed.

(5) No other changes to the amount preserved will be allowed except as provided by subsections (d)(3) and (d)(4) of this section.

Subsection (e) of this Section sets forth the rules for electing the credit. This subsection reads as follows:

(e) Electing the Credit. The election to claim the credit shall be made on each report originally due on or after January 1, 2008 and before September 1, 2027.

(1) A taxable entity elects the credit by:

(A) properly taking the credit on a report filed on or before the original due date; or

(B) electing the credit on a timely filed extension request and properly taking the credit on the report filed on or before the extended due date on the report.

(2) If an election to take the credit is not made on or before the original due date of the report as indicated in paragraph (1) of this subsection, the credit for that year is lost for that year and cannot be carried over to a subsequent year.

(3) A taxable entity that uses the E-Z Computation to report and pay its franchise tax may not elect to take the business loss carryforward credit in that year. The unused credit may not be carried over to subsequent years.

Rule 3.595 – Transition

This Section establishes guidelines for computing tax liability during the transition period under Tax Code, §171. This Section provides for effective date; provides guidance to entities previously subject to the franchise tax, such as corporations and limited liability companies; and provides guidance to newly-taxable entities, such as limited partnerships, professional associations and others.

Subsection (b) of this Section applies to entities previously subject to the franchise tax. Subsection (b) provides as follows:

(b) Types of Entities Previously Subject to Franchise Tax. If an entity is a type of entity that would have been subject to the franchise tax immediately before the passage of House Bill 3, 79th Legislature, 3rd Called Session, 2006, then the margin calculation, as opposed to the taxable capital and earned surplus calculations, should be used for reports originally due on or after January 1, 2008. If an entity is part of a combined group, then the entity will be included in a combined report due in 2008, even if the entity becomes no longer subject to the franchise tax in 2007.

(1) Unless the entity is part of a combined group, if an initial report is due in 2008 or later and the entity becomes no longer subject to the franchise tax on or before November 1, 2007, then the initial report based on margin will be based on the beginning date through the date the entity became no longer subject to the franchise tax and no final report will be due.

(2) If an entity was required to file a report based on earned surplus, then the first report due based on margin should be based on a period beginning on the day after the last date used to calculate earned surplus.

(3) If an entity filed a report based on taxable capital, but was not subject to the earned surplus component, then the first report due based on margin should be based on a period beginning on the day after the last date used to calculate taxable capital.

(4) Except as provided in paragraph (1) of this subsection, if the entity becomes no longer subject to the earned surplus component of the tax on or before November 1, 2007, then the entity will owe a final report based on taxable earned surplus, unless the entity is part of a combined group.

Subsection (c) of this Section applies to entities becoming subject to franchise tax under H.B. 3. This subsection reads as follows:

(c) Types of entities becoming subject to the franchise tax under House Bill 3, 79th Legislature, 3rd Called Session, 2006.

(1) Margin or gross receipts occurring before June 1, 2006, may not be considered for purposes of determining taxable margin or for apportionment purposes.

(2) Extensions for 2008 annual reports will not be granted based on 100% of the tax reported as due in the previous calendar year, including combined reports which include at least one entity becoming subject to the franchise tax under House Bill 3, 79th Legislature, 3rd Called Session, 2006.

(3) If the entity becomes no longer subject to the franchise tax before July 1, 2007, then it will not owe franchise tax and the entity will not be included in a combined report. The entity may become "no longer subject to the franchise tax" by terminating its existence. A dissolution, merger out of existence or liquidation is considered a termination. A conversion is not considered a termination. A partnership is considered terminated only if no part of any business, financial operation, or venture of the partnership continues to be carried on by any of its partners in a partnership. For a merger or consolidation of two or more partnerships, the resulting partnership is considered the continuation of any merging or consolidating partnership whose members own an interest of more than 50% in the capital and profits of the resulting partnership. For a division of a partnership into two or more partnerships, the resulting partnerships, other than any resulting partnership the members of which had an interest of 50% or less in the capital and profits of the prior partnership, are considered a continuation of the prior partnership.

Comment: Partnerships were given a limited window of opportunity to avoid Margin Tax with respect to total revenue for the period prior to July 1, 2007 by liquidating or merging out of existence prior to that date. No exit tax was imposed in that event. Of course, revenue of the successor entity for the period subsequent to such a merger, to the extent that it is a taxable entity, is includible in computation of the Margin Tax applicable to that entity. Many partnerships took advantage of this opportunity to merge into an LLC or corporation prior to July 1, 2007. The Comptroller has taken the position that conversion of a partnership prior to July 1, 2007 would not qualify for this limited exception.

(See http://www.window.state.tx.us/taxinfo/franchise/tranfaq.html)

(4) An entity doing business in this state at any time after June 30, 2007, and before January 1, 2008, but not on January 1, 2008, shall file a final report based on margin as provided in subsection (b)(2) of this Section, of Section 35 of House Bill 3928, 80th Legislature, 2007. The final report is due on the 60th day after the date the entity becomes no longer subject to the franchise tax. The entity will not be included in a combined report.

(5) An entity subject to the franchise tax on January 1, 2008, for which January 1, 2008, is not the beginning date, shall file an annual report due May 15, 2008, based on the period or periods:

(A) if the entity has an accounting period that ends on or after January 1, 2007, and before June 1, 2007:

(i) beginning the later of:

(I) June 1, 2006; or

(II) the date the entity was organized in this state, or if a foreign entity, the date it began doing business in this state; and

(ii) ending on the date that accounting period ends in 2007;

(B) if the entity has an accounting period that ends on or after June 1, 2007, and before December 31, 2007:

(i) beginning on the date that accounting period begins; and

(ii) ending on the date that accounting period ends in 2007; and

(C) if the entity has an accounting period that ends on December 31, 2007, or if the entity does not have an accounting period that ends in 2007:

(i) beginning the later of:

(I) January 1, 2007; or

(II) the date the entity was organized in this state or, if a foreign entity, the date it began doing business in this state; and

(ii) ending on December 31, 2007.