Tax Information from the Texas Comptroller of Public Accounts

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House Bill 3: Revised Franchise Tax Overview

Overview

The Texas Legislature passed House Bill (HB) 3 during the 79th 3rd Called Session in 2006. The bill amends Texas Tax Code Chapter 171 to revise the existing franchise tax by changing the tax base, lowering the rate and extending coverage to active businesses receiving state law liability protection.

Changes made by HB 3 are effective for franchise tax reports originally due on or after January 1, 2008.

Entities Subject to Tax

The tax applies to partnerships (general, limited and limited liability), corporations, limited liability companies, business trusts, professional associations, business associations, joint ventures and other legal entities with statutory liability protection, except for:

- sole proprietorships;
- general partnerships directly owned by natural persons;
- entities exempt under Subchapter B of Chapter 171;
- certain unincorporated passive entities;
- grantor trusts, estates of natural persons and escrows;
- passive investment partnerships;
- certain family limited partnerships;
- real estate mortgage investment conduits (REMICs) and certain real estate investment trusts (REITs); and
- certain non-business passive entity trusts.

Margin

The revised tax base is the taxable entity's margin. Margin equals the lesser of three calculations: total revenue minus cost of goods sold; total revenue minus compensation; or total revenue times 70 percent.

Total revenue is determined based on federal income tax reporting. Exclusions from revenue include:

- physicians' revenues from Medicaid, Medicare, Children's Health Insurance Program (CHIP), workers' compensation claims and TRICARE, and actual costs for uncompensated care;
- health care institutions exclude 50 percent of revenues from Medicaid, Medicare, CHIP, workers' compensation claims and TRICARE, and actual costs for uncompensated care;
- dividends and interest from federal obligations, Schedule C dividends, foreign royalties and dividends under Section 78 and Sections 951-964;
- certain flow-through funds; and
- attorney's cost of providing pro bono legal services, limited to $500 per case.

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Cost of goods sold is traditionally defined, but excludes officer compensation and includes some specific items for certain industries and up to 4 percent of overhead costs.

Taxable entities only selling services are not eligible for the cost of goods sold deduction. However, motor vehicle and heavy construction equipment rental or leasing may use cost of goods sold.

Payments for undocumented workers are not deductible.

Compensation and benefits include:

- W-2 wages and cash compensation paid to officers, directors, owners, partners and employees (including owner or partner distributions to natural persons), limited to $300,000 per person; and
- benefits provided to all personnel, including workers' compensation, health care and retirement benefits to the extent deductible for federal income tax purposes.

Payments for undocumented workers are not deductible.

Apportionment

Margin is apportioned to Texas in essentially the same manner as prescribed by current law.

Tax Rate

The tax rate is 0.5 percent for entities primarily engaged in retail and wholesale trades as well as those businesses under Major Group 58 of the 1987 SIC code (eating and drinking establishments). The rate is 1 percent for all other taxable entities.

No Tax Due

Taxable entities with revenues of $300,000 or less will owe no tax. Taxable entities with tax due of less than $1,000 will owe no tax. However, all taxable entities, including those that will owe no tax, must file a return.

Combined Reporting

Taxable entities that are part of an affiliated group engaged in a unitary business must file a combined group report without regard to the $300,000 limitation on revenue. Members of a combined group must use the same method to compute margin.

Questions?

Email us at **margin.tax@cpa.state.tx.us**.