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Texas Margin Tax Update: Potential Opportunities

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Four years ago, the Texas Legislature replaced the franchise tax with a new business tax commonly known as the "margin tax." The Texas comptroller has published very little administrative guidance interpreting the new tax laws. This lack of guidance provides planning opportunities for taxpayers.

Margin Tax—Overview

The margin tax revised and expanded the franchise tax by changing the tax base, lowering the rate and extending coverage to all active businesses receiving state law liability protection. Under the margin tax, limited partnerships became subject to business tax for the first time.

The margin tax levies a tax of up to 1 percent on a taxable entity's "taxable margin," which is an amount equal to either (a) the taxable entity's total revenue minus cost of goods sold (COGS), or (b) the taxable entity's total revenue minus aggregate wages and compensation. Taxable margin is capped at 70 percent of total revenue.

The margin tax includes several exemptions and limitations. For example, taxable entities with total revenue of less than $1 million are exempt from tax through fiscal year 2011. Thereafter, taxable entities with total revenue of less than $300,000 will remain exempt and those taxable entities with total revenue of $300,000-$1 million will benefit from a graduated system of deductions.

The margin tax introduced "combined reporting" to Texas. Entities that share more than 50 percent common ownership and are engaged in a "unitary business" must calculate their margin tax liability on a combined basis as if they were a single taxpayer.

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Potential Opportunities

The lack of administrative guidance provides the opportunity for taxpayers to take aggressive, but not unreasonable, positions because they will not be constrained by unfavorable interpretive precedent. Potential opportunities include the following:

Claiming the 0.5 percent tax rate. The margin tax provides a 0.5 percent tax rate to taxpayers primarily engaged in "retail or wholesale trade" and a 1.0 percent tax rate to all others. To be considered primarily engaged in a retail or wholesale trade, more than 50 percent of the taxpayer's total revenue must be derived from activities described in Division G or F of the 1987 Standard Industrial Classification Manual published by the federal Office of Management and Budget. If the types of activities your business conducts are arguably described in these divisions of the SIC Manual—and more than 50 percent of your total revenue is derived through these activities—then consider claiming the lower tax rate. (See also discussion regarding combined group reporting, below.)

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Maximize the benefit from using the COGS method. As defined for margin tax purposes, COGS includes all "direct costs" of acquiring or producing goods, as well as certain additional "indirect costs" and other adjustments. Neither the margin tax statutes nor the limited administrative guidance available provide a standard of differentiating between direct and indirect costs. While the comptroller's published administrative rules identify specific items that must be included in each of these categories, the lack of comprehensive guidance in this area provides taxpayers with some flexibility to make their own interpretations of which other items should be included in the taxpayer's COGS calculation. Note, however, that the margin tax statutes do make clear that a taxpayer must have COGS to use the COGS method. If you are primarily providing professional services, it is unlikely that you will be able utilize the COGS method because your COGS, if any, will probably be less than your aggregate wages and compensation. (See also discussion regarding combined group reporting, below.

Calculating tax liability for a combined group. The margin tax requires affiliated entities engaged in a "unitary business" to file their margin tax as a combined group. While the tax statutes make clear that "affiliated" entities share more than 50 percent common ownership, there is little guidance regarding whether two or more such entities should be considered engaged in a unitary business. Because members of the same combined group must calculate their combined tax liability using the same method (i.e., using either the COGS method or the aggregate wages plus compensation method) and the same tax rate, taxpayers with both service and manufacturing and / or retailing lines of business conducted through separate entities may want to consider whether those business lines are sufficiently distinct to avoid including them in a combined group, if calculating margin tax liability on a separate basis provides a lower overall tax burden.

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