Taxing of Partnerships and Combined Reporting in Texas

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FRANCHISE TAX REVISION

Prior to the revision:

- Only corporations and limited liability companies (LLCs) were subject to the franchise tax.
- Single-entity reporting was required.
- Corporations reduced their franchise tax liability considerably by reorganizing into a limited partnership structure with a 99.9% limited partner and 0.1% corporate general partner.
- A non-Texas limited partner was not considered to be doing business in Texas.

FRANCHISE TAX REVISION

Revision:

- Effective for reports due in 2008.
- Widened the tax base to include partnerships, trusts, and other legal entities.
- Further expanded the tax base by requiring combined reporting.

TAXABLE ENTITIES

- Include partnerships, limited liability partnerships, corporations, LLCs, business trusts, and *other legal entities.*
- Partnerships are taxed at the entity level and not as a pass-through entity.
- Each entity is taxed regardless of federal treatment.
- A single member LLC cannot be treated as a sole proprietor or a disregarded entity for franchise tax purposes.
- Any entity that is formed in a manner that limits its liability is taxed.

NONTAXABLE ENTITIES

Taxable entities do NOT include:

- a sole proprietorship,
- a general partnership directly owned by natural persons,
- a passive entity, as defined in Tax Code Section 171.0003, and
- an entity exempt from franchise tax under Subchapter B.

NONTAXABLE ENTITIES

Taxable entities also do NOT include:

- certain grantor trusts,
- the estate of a natural person,
- an escrow,
- certain REITs,
- a REMIC,
- a nonprofit self-insurance trust,
- a trust qualified under IRC Section 401(a),
- a trust exempt under IRC Section 501(c)(9), and
- an unincorporated entity organized as a political committee.

TOTAL REVENUE REPORTING

- For corporations, total revenue amounts are pulled from income line items on IRS Form 1120.

- For partnerships, total revenue amounts are pulled from various IRS forms such as the partnership's Form 1065; Form 1065, Schedule K, and Form 8825, if applicable.

- There is no double taxation of pass-through entity income.
  - An entity may subtract from total revenue, to the extent included, the Net Distributive Income from a taxable entity treated as a pass-through entity for federal income tax purposes. See Section 171.1011(c).

COMBINED REPORTING

- A combined group consists of entities in which
  - a controlling interest is owned and
  - the entities are engaged in a unitary business.
- The combined group is a single taxable entity for purposes of the franchise tax.
- All members are jointly and severally liable for the combined tax due.

COMBINED REPORTING

- A combined group does not include:
  - Entities that conduct business outside the United States (80/20 rule)
  - Passive entities
  - Exempt entities

COMBINED REPORTING

Controlling Interest

- Corporations – more than 50 percent, owned directly or indirectly, of
  - the total combined voting power of all classes of stock or
  - the beneficial ownership interest in the voting stock.

COMBINED REPORTING

Controlling Interest

- Partnerships – more than 50 percent owned, directly or indirectly, of the
  - capital,
  - profits, or
  - beneficial interest in the partnership.

COMBINED REPORTING

Controlling Interest

- Partnerships
  - Three possibilities for control means more than one partner can "control" the partnership.
  - The partnership may belong to more than one combined group but may only file with one combined group.
  - See Rule 3.590(b)(4)(F) – the unitary relationship controls in this circumstance.

COMBINED REPORTING

Unitary Business

- A single economic enterprise that is made up of separate parts 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.

COMBINED REPORTING

Unitary Business

- Factors the Comptroller considers are whether
  - the members activities are in the same general line of business;
  - the members activities are in a vertically structured enterprise or process; or
  - the members are functionally integrated through the exercise of strong centralized management.
- The Comptroller may also consider other relevant factors.

COMBINED REPORTING

Unitary Business

All affiliated entities are presumed to be engaged in a unitary business.

- The presumption may be rebutted.
- See Rule 3.590(b)(6)(B).

COMBINED REPORTING

Determining Combined Taxable Margin

Combined Total Revenue

- determine the total revenue for each member of the group as if the member were an individual taxable entity,
- add the total revenues of the members together, and
- subtract items of total revenue received from a member of the combined group.

COMBINED REPORTING

Determining Combined Taxable Margin

Combined Cost of Goods Sold

- determine the cost of goods sold for each member of the group as if the member were an individual taxable entity,
- add the cost of goods sold amounts of the members together, and
- subtract any amounts paid from one member of the group to another member, but only to the extent the corresponding item of total revenue was subtracted.

COMBINED REPORTING

Determining Combined Taxable Margin

Combined Compensation

- determine the compensation for each member of the group as if the member were an individual taxable entity,
- add the compensation amounts of each member together, and
- subtract any compensation amounts paid from one member of the combined group to another member of the combined group but only to the extent the corresponding item of total revenue was subtracted.

COMBINED REPORTING

Determining Combined Taxable Margin

Combined Apportionment

- Joyce method of apportionment
  - the Texas gross receipts of a member without nexus individually are excluded from the numerator of the apportionment factor but included in the denominator.
- There is no throwback provision.

INCOME SHIFTING

Income Shifting

- Joyce method of apportionment
- Shifting receipts to a no-nexus entity is not allowed under Tax Code Section 171.1055(b).
- Economic nexus decreases the number of “no-nexus” members.

INCOME SHIFTING

- Putting all passive income into a separate entity
    - NDI from a passive entity is taxed under Tax Code Section 171.1011(e)
    - unless the passive entity's net income was generated by a taxable entity.

INCOME SHIFTING

- Tiered Partnership Provision
  - “Tiered partnership arrangement" - Interests in a federal pass-through entity ("lower tier entity") are owned by one or more "upper tier entities.
  - The upper tier entity may include in calculating its own taxable margin the total revenue of a lower tier entity.
  - The upper tier entity must be subject to the franchise tax.

PARTNERSHIP REPORTING ISSUES

Federal Tax Disconnects

Depletion

- For federal tax, a partnership is not allowed to take a deduction for depletion related to oil & gas wells.
- For franchise tax purposes, the Comptroller allows partnerships to claim the depletion as COGS.
- See STAR Document 201011554L.

PARTNERSHIP REPORTING ISSUES

Federal Tax Disconnects

Capital Gains Reporting

- Capital gains from sale of leasehold interests are included in total revenue of the partnership.
- Even though the gains are passed through to the partner and included at the partner level for federal tax.
- See *Hibernia Energy, LLC and Ryan, LLC as Assignee v. Hegar,* No. 03-21-00527 in the Third Court of Appeals.

Questions?