

**ADVISING BUSINESS OWNERS
ABOUT THE MARGIN TAX AND THE
TEXAS BUSINESS ORGANIZATIONS CODE**

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ADVISING BUSINESS OWNERS ABOUT THE MARGIN TAX AND THE TBOC

I. WHAT IS THE CONNECTION BETWEEN THE MARGIN TAX AND THE TBOC?

This paper originated in the daily rigors of my practice, as the Texas Legislature enacted the new Texas Business Organizations Code (“TBOC”) in the 78th Legislature’s Regular Session (House Bill 1156, Tex. Leg. R.S. 2003) (“House Bill 1156”), followed by the “Margin Tax” enacted in the 79th Legislature’s Third Called Session (House Bill 3, Tex. Leg. 3rd C.S. 2006) (“House Bill 3”). The Margin Tax (herein so called) is formally known as the state franchise tax imposed by Chapter 171 of the Texas Tax Code. As discussed in this paper, the new Margin Tax scheme of taxation is substantially different than the former franchise tax scheme. In comparing and contrasting these two schemes, for purposes of clarity, this paper will use the term “Margin Tax” to refer to the franchise tax scheme applicable to calendar year taxpayers beginning on January 1, 2007, and to accrual basis taxpayers beginning as early as June 1, 2006, and will refer to the former version of the state franchise tax as the “Franchise Tax.”²

For the 78th, 79th and 80th Legislatures I have been a member of the Real Estate Legislative Affairs Committee (“RELACs”), which is a standing committee of the State Bar of Texas’ Real Estate, Probate and Trust Law Section. I Chaired RELACs for the 79th and 80th Legislatures, which provided me with a “bird’s eye” view of these statutory changes.

In today’s environment, it is necessary to consider the Margin Tax in order to determine what entities to form (or to refrain from forming), and to then comply with the TBOC in forming those entities, or in converting entities governed by the pre-TBOC codes. A Margin Tax analysis may also lead one to decide to terminate existing entities. Since a Margin Tax analysis usually precedes entity formation, conversion and/or termination, this paper will address the Margin Tax first,

¹The TBOC was amended by House Bill 1319 (Tex. Leg. R.S. 2005), and by House Bill 1737 (Tex. Leg. R.S. 2007) (“House Bill 1737”). This paper will cite to “TBOC Section __”, to refer to the TBOC as amended through House Bill 1737, which is not codified as of the date of publication.

²For statutory reference purposes, the Margin Tax references are to the Margin Tax as enacted by House Bill 3 and amended by House Bill 3928 (Tex. Leg. R.S. 2007) (“House Bill 3928”), which is not codified as of the date of publication.

followed by the TBOC. This paper assumes the reader has a working knowledge of the basics of the TBOC and, to a lesser extent the Margin Tax and Franchise Tax.

The author is not a tax attorney, and so the Margin Tax portion of this paper is not an explanation or analysis of the mechanics of the Margin Tax, nor does it deal with how to calculate the amount of Margin Tax due. This paper provides a planning perspective mainly focused on choice of entity planning and overall business ownership structuring. In fact, it is the author’s normal practice to specifically allocate to a client or the client’s CPA the responsibility to calculate Margin Tax, including choosing whether to use the “Cost of Goods Sold,” “Compensation,” or the new “E-Z” formula.

II. THE MARGIN TAX

A. FRANCHISE TAX PLANNING

Under prior law, the state Franchise Tax was assessed, or not assessed, based on: (1) the type of entity; and (2) the amount of annual revenues. Most significantly, limited partnerships were exempt from being assessed Franchise Tax, whereas corporations and limited liability companies were subject to the Franchise Tax.³ Taxable business entities could earn up to \$150,000 before generating Franchise Tax liability⁴. In practice the Franchise Tax code separately tested the revenues of each entity, so that one owner receiving \$400,000 in annual revenues could avoid Franchise Tax liability by creating two entities, with each booking less than \$150,000 in annual revenues. Franchise Tax planning therefore consisted mostly of determining if the business income stream would be greater than the minimum taxable threshold, and if so, structuring the business into multiple entities or organizing it as a limited partnership.

Some businesses were practically precluded from operating as a limited partnership. Examples of these businesses include Dell Computers, Southwestern Bell, and Southwest Airlines. In order for these entities to minimize their Franchise Tax liability, other strategies were developed by planners, such as the “Geoffrey Sub”, where intellectual property was spun out into a limited partnership and large royalty payments were made to the limited partnership, and the “Delaware Sub”, where the business would form a Texas limited partnership

³Texas Tax Code Section 171.001(a) (2006)

⁴Texas Tax Code Section 171.002 (2006)

subsidiary to receive and book all Texas income, then distribute it to the Delaware corporation beyond the reach of the Franchise Tax. These are two examples of planning techniques; this is by no means an exhaustive list of the various strategies employed by businesses under the Franchise Tax system.

All of these prior planning techniques must be re-evaluated because the Margin Tax is very different than the Franchise Tax. Few of these Franchise Tax planning techniques work the same under the Margin Tax. The Margin Tax drafters were clearly aware of the loopholes exploited by planning professionals⁵, and the Margin Tax successfully closed most of those loopholes. Nevertheless, the identification and exploitation of loopholes is a time honored tradition of the legal profession, and so the Margin Tax merely sets us on a different course with different challenges.

B. ETHICS AT THE OUTSET: ADVISING CLIENTS ABOUT THE CONSTITUTIONALITY ISSUES OF THE NEW MARGIN TAX

Because the new Margin Tax calculates tax liability based in part on an entity's income, and since it subjects certain general partnerships and all limited partnerships to tax liability, there are concerns as to whether the Margin Tax is constitutional in view of TEXAS CONSTITUTION ARTICLE 8, SECTION 24(a), which provides:

A general law enacted by the legislature that imposes a tax on the net incomes of natural persons, including a person's share of partnership and unincorporated association income, must provide that the portion of the law imposing the tax not take effect until approved by a majority of the registered voters voting in a statewide referendum held on the question of imposing the tax. The referendum must specify the rate of the tax that will apply to taxable income as defined by law.

In connection with certifying the appropriation in House Bill 3, then-Comptroller Carolyn Strayhorn handwrote on the bill:

....I believe portions of the tax enacted by this bill constitute a personal income

⁵The Margin Tax statute was based in large part on the official report of the Texas Tax Commission, which report noted the various schemes used by planners to avoid or minimize Franchise Tax liability.

tax and are unconstitutional.

CKS

I have included a copy of her certification as Exhibit A.⁶

House Bill 3, Section 24, contemplated such a challenge to the Margin Tax, and it provides in relevant part as follows:

- (a) The supreme court has exclusive and original jurisdiction over a challenge to the constitutionality of this Act or any part of this Act and may issue injunctive or declaratory relief in connection with the challenge.
- (b) The supreme court shall rule on a challenge filed under this section on or before the 120th day after the date the challenge is filed.

To the best of the author's knowledge as of June 15, 2007, no challenge to the Margin Tax has been filed or decided. The first Margin Tax filings are not due until May, 2008, and this author expects such a challenge to be filed (although I have no specific information supporting this expectation) once taxpayers determine the amount of Margin Tax they must pay.⁷

As a result, at the outset of undertaking to advise any client about the Margin Tax, practitioners must consider the effect a court ruling declaring the Margin Tax unconstitutional would have on any advice given based on the Margin Tax statute. For this reason, before analyzing a business structure, or prior to formation of new business entities based on Margin Tax analysis, practitioners are cautioned to specifically advise clients that the Margin Tax may be ruled unconstitutional.

However, as a matter of practice, the old maxim "plan based on the law as presently enacted, not as it might someday be" applies here. As a result, generally, this author thinks the wiser practice is to assume the Margin Tax is constitutional, and plan accordingly, until the Texas Supreme Court decides otherwise, with one caveat. In order to "hedge" the bet that the Margin Tax is constitutional, this author still tends to consider using

⁶Readers should also be aware that Comptroller Strayhorn made this notation while running her election campaign for Texas Governor, running as in Independent candidate against Governor Rick Perry, under whose "leadership" the Margin Tax was passed.

⁷The author does not intend the reader to place hope in a Texas Supreme Court decision holding the Margin Tax unconstitutional.

limited partnerships as the entity of choice for businesses that generate or are anticipated to generate \$150,000 or more in annual revenues. By doing so, the client would benefit from any court ruling against the Margin Tax, while suffering only the increased administrative costs associated with filing the initial entity and ongoing maintenance expenses during the Margin Tax period.

C. MARGIN TAX PLANNING

Margin Tax planning is materially and substantially different from Franchise Tax planning. The form of limited liability entity is now generally irrelevant, and the ability to use multiple entities with common ownership to reduce any one entity’s annual revenues below the taxable threshold has been eliminated. These concerns have been replaced with a focus on: (1) the type of income generated; (2) the total revenues earned by an affiliated group of business entities; and (3) the ability to structure business income in non-taxable relationships. This paper follows the general process I use in evaluating business operations in the Margin Tax context. My process is to first construct the best possible business structure, present that to the client, and then make practical compromises and other bows to specific client realities as the particular circumstances of each case dictate.

1. CHARACTERIZATION OF INCOME

One analysis under the Margin Tax that is similar to the Franchise Tax is the focus on entities. Under the Margin Tax, in certain circumstances the form of entity may make the difference between income being taxed or being exempt from tax. The general rule of entity taxation under the Margin Tax is that all entities that provide limited liability protection for its owners are taxable entities.⁸ These entities are then specifically exempt from paying Margin Tax.⁹

- (1) a sole proprietorship;
- (2) a general partnership:
 - (A) the direct ownership of which is entirely composed of natural persons; and
 - (B) the liability of which is not limited under a statute of this state or another

- state, including by registration as a limited liability partnership;
- (3) a passive entity (defined below);
- (4) an entity that is exempt from taxation listed under Texas Tax Code Chapter 171, Subchapter B (there are few changes to this Subchapter enacted by the Margin Tax; most of these are special-purpose entities);
- (5) an entity that is a grantor trust as defined by Sections 671 and 7701(a)(30)(E), Internal Revenue Code, all of the grantors and beneficiaries of which are natural persons or charitable entities as described in Section 501(c)(3), Internal Revenue Code, excluding a trust taxable as a business entity pursuant to Treasury Regulation Section 301.7701-4(b);
- (6) an entity that is an estate of a natural person as defined by Section 7701(a)(30)(D), Internal Revenue Code, excluding an estate taxable as a business entity pursuant to Treasury Regulation Section 301.7701-4(b);
- (7) an entity that is an escrow;
- (8) an entity that is a real estate investment trust (“REIT”) as defined by Section 856, Internal Revenue Code, and its “qualified REIT subsidiary” entities as defined by Section 856(i)(2), Internal Revenue Code, provided that:
 - (A) a REIT with any amount of its assets in direct holdings of real estate, other than real estate it occupies for business purposes, as opposed to holding interests in limited partnerships or other entities that directly hold the real estate, is a taxable entity; and
 - (B) a limited partnership or other entity that directly holds the real estate as described in Paragraph (A) is not exempt, without regard to whether a REIT holds an interest in it;
- (9) an entity that is a real estate mortgage investment conduit (“REMIC”), as defined by Section 860D, Internal Revenue Code;
- (10) an entity that is a nonprofit self-insurance trust created under Chapter 2212, Insurance Code, or a predecessor statute;
- (11) an entity that is a trust qualified under Section 401(a), Internal Revenue Code; or
- (12) an entity that is a trust or other entity that is exempt under Section 501(c)(9), Internal Revenue Code.

Additionally, the Margin Tax has a minimum revenue threshold. An entity is exempt from paying Margin Tax for years in which:

⁸Texas Tax Code Section 171.0002(a) lists the following entity types specifically as “taxable entities:” “partnership, limited liability partnership, corporation, banking corporation, savings and loan association, limited liability company, business trust, professional association, business association, joint venture, joint stock company, holding company, or other legal entity.”

⁹Texas Tax Code Section 171.0002(b) and (c)

- (1) the taxable entity's Margin Tax liability for the given year is less than \$1,000.00; or
- (2) the amount of the taxable entity's total revenue from its entire business is \$300,000 or less.¹⁰

As you will note, the Margin Tax is still generally defined in terms of the form of entity, as was the former Franchise Tax.

The Margin Tax introduces a new entity exempt from Margin Tax liability: a "passive entity." This is not a type of entity (the TBOC does not have any provisions instructing one on how to form a passive entity), but rather an entity that receives a certain type of income. A "passive entity" is defined in Margin Tax Section 171.0003 as:

- (1) the entity is a general or limited partnership or a trust, other than a business trust;
- (2) during the period on which margin is based, the entity's federal gross income consists of at least 90 percent of the following income:
 - (A) dividends, interest, foreign currency exchange gain, periodic and nonperiodic 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;
 - (B) distributive shares of partnership income to the extent that those distributive shares of income are greater than zero;
 - (C) 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
 - (D) royalties, bonuses, or delay rental income from mineral properties and income from other nonoperating mineral interests; and
- (3) the entity does not receive more than 10 percent of its federal gross income from conducting an active trade or business.

Note that an entity must pass all three prongs of the test in order to avoid Margin Tax liability. Also note that in the 90%/10% income split (90% or more in "passive income" and no more than 10% from an "active trade or

business"), one is not exclusive of the other. In practice, the definition of "active trade or business" may recapture some income that would otherwise be passive income. An entity can pass the second element and fail the third test, thereby failing to be a "passive entity."

The first prong of this test is the most obvious. Only general partnerships, limited partnerships, and trusts other than business trusts need apply. Limited liability companies, corporations, limited liability partnerships, and the various professional entities cannot, under any circumstances, qualify as a "passive entity" and thus avoid Margin Tax liability.

The second prong of this test looks at the character of the income received by the first-prong qualified entity form. It also introduces the concept of "combined group" which is discussed in Section 2 below ("Aggregation Rules"). The Aggregation Rules must be applied before applying this second prong.

Under the second prong of this test, an entity's federal gross income must be 90% or more of the specified types of income; provided, however, that the following types of income are specifically defined as not "passive income:" (1) rent; and (2) income received by a nonoperator from mineral properties under a joint operating agreement if the nonoperator is a member of an affiliated group and another member of that group is the operator under the same joint operating agreement.¹¹ As practitioners apply the second prong of the "passive entity" test, these 2 types of income should not be included as "passive income."

The third prong of the "passive entity" test also looks at the character of an entity's income. To qualify as a "passive entity", that entity can receive up to, but not more than, 10% of its federal gross income from conducting an "active trade or business." This is a newly defined term in the Margin Tax.

An entity conducts an "active trade or business" if it meets this two part test: (1) the activities being carried on by the entity include one or more active operations that form a part of the process of earning income or profit; and (2) the entity performs active management and operational functions.¹² Also, an entity conducts an active trade or business if assets, including royalties, patents, trademarks, and other intangible assets, held by the entity are used in the active trade or

¹¹Texas Tax Code Section 171.0003(b)

¹²Texas Tax Code Section 171.0004(b)

¹⁰Texas Tax Code Section 171.002(d)

business of one or more related entities.⁶ However:

- (1) the ownership of a royalty interest or a nonoperating working interest in mineral rights does not constitute conduct of an active trade or business;
- (2) payment of compensation to employees or independent contractors for financial or legal services reasonably necessary for the operation of the entity does not constitute conduct of an active trade or business; and
- (3) holding a seat on the board of directors of an entity does not by itself constitute conduct of an active trade or business.⁸

It is hoped that the Comptroller will promulgate rules to better explain this definition. The entity must pass both parts of the test to be conducting an active trade or business.

Note that this three prong test must be applied for every taxable year. A general partnership, limited partnership or trust other than an business trust, seeking to be a “passive entity,” must identify its “passive income” and income from “conducting an active trade or business” each calendar year. It is possible, in theory, for an entity to meet these income character criteria in some calendar years, and fail to meet them in other years. If there is any chance an entity may meet these income criteria in any year, it may be the safest advice to use a general partnership, limited partnership or trust other than an business trust to receive that income. As a result, in Margin Tax planning, it is more important than under the Franchise Tax to understand and discuss a client’s future business operations.

I begin my Margin Tax analyses with the identification of “passive income” streams, income streams from “conducting an active trade or business,” and then consider all other income streams in a separate, third category, because these are the foundational elements of Margin Tax planning. At this stage of the process, I ignore the client’s current business structure (or lack thereof for new operations), in order to be able to develop an “ideal” arrangement.

I conclude this first step of Margin Tax planning by analyzing whether the client’s businesses allows for the creation of “passive entities.” Under the Margin Tax, a planner may determine how many different

passive entities to form or use based on the client’s asset protection, structure simplification, or other non-tax goals.

The next four steps in Margin Tax analysis planning (aggregation, apportionment, tax rate and choice of formula) require an understanding of the income stream(s) in each of these three income categories, and some initial application of the “passive entity” rules. If the planner is able to direct income streams into one or more “passive entities,” then for those “passive entities” the planner does not have to consider aggregation, apportionment, tax rate or choice of formula.

2. AGGREGATION RULES

The next step in Margin Tax planning is to consider and apply the “aggregation” rules. At the outset, it should be noted that these aggregation rules are some of the most complex and confusing portions of the new Margin Tax.

There are four new terms important in the aggregation rules: “affiliated group”, “controlling interest”, “unitary business” and “combined group.” Generally, the Margin Tax identifies business entities in a “combined group” and then treats the “combined group” as one entity for purposes of apportionment, tax rate, and choice of formula. As you will realize in applying these aggregation rules, clients (and their planners) will want to avoid including entities in a “combined group” whenever possible.

A “combined group” is comprised of “taxable entities that are part of an affiliated group engaged in a unitary business.”⁹ Note that passive entities are excluded from “combined groups” because they are not “taxable entities.” This definition should be applied in the order of its drafting: (1) taxable entities vs. non-taxable (e.g. passive) entities; (2) in an affiliated group; (3) engaged in a unitary business. Entities may be excluded from a combined group at each of these three levels. A planner’s goal is to maximize the entities (and level of income) excluded.

An “affiliated group” is “a group of one or more entities in which a controlling interest is owned by a common owner or owners, either corporate or non-corporate, or by one or more of the member entities.”¹⁰ The term “controlling interest” as used in this section has

⁶Texas Tax Code Section 171.0004(d)

⁸Texas Tax Code Section 171.0004(e)

⁹Texas Tax Code Section 171.0001(7)

¹⁰Texas Tax Code Section 171.0001(1)

a fairly technical definition¹¹ in what appears to be an attempt to not create any loopholes. It is separately defined for corporations, limited liability companies, and partnerships and similar associations. The general intent of the Margin Tax is to define as “affiliated” those entities that have 50% or more of common ownership.

This definition destroys the ability of one individual to escape Margin Tax liability by simply creating several different entities and splitting income among them. The “affiliated” definition looks to the ultimate individual owner(s) of each entity, and in practice “aggregates” all commonly owned entities together into one single entity. Note that this is an objective test. An individual either owns more than 50% of the entity, as a matter of mathematical calculation, or not.

Finally, the planner must consider what is, in the author’s opinion, the most challenging definition in the entire Margin Tax statute. A “unitary business” is:

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 whether:

- (A) the activities of the group members are in the same general line, such as manufacturing, wholesaling, retailing of tangible personal property, insurance, transportation, or finance;
- (B) 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
- (C) the members are functionally integrated

through the exercise of strong centralized management, such as authority over purchasing, financing, product line, personnel, and marketing.¹²

This is overall a very subjective set of tests. Subsection (A) defines a “unitary business” by horizontal relationships, while Subsection (B) defines them by vertical relationships. These are relatively understandable. Subsection (C), however, may be quite problematic.

The three sub-parts are connected with “or”, meaning businesses may be “unitary” if they fit within any one of these three descriptions (A) through (C).¹³ Also, note that these three subparts are stated as a directive to the Comptroller for determination. This language raises the question of how much reliance a planner should place on them in advising a client on whether to consider certain entities as being members of a “unitary business.”

A client will feel the effect of having multiple entities considered as members of a “combined group” in the apportionment, tax rate and calculation formula sections of the Margin Tax. The combined group is a single taxable entity for purposes of the application of the Margin Tax.¹⁴ This means that:

- (1) a combined group must file a combined group Margin Tax return in lieu of individual returns of each member;¹⁵
- (2) the combined group must add together the total revenue of each individual member and report the “aggregated” total income as its total revenue, eliminating revenue received by one member of the combined group from another member of the combined group (so that it is not double-taxed);¹⁶

¹²Texas Tax Code Section 171.0001(17)

¹³Practitioners may expect the Comptroller to promulgate a questionnaire form for each filing entity to complete and return to the Comptroller, with questions designed to help the Comptroller determine whether or not an entity is part of a unitary business.

¹⁴Texas Tax Code Section 171.1014(b)

¹⁵Texas Tax Code Section 171.1014(a)

¹⁶Texas Tax Code Section 171.1014(c)

¹¹New Texas Tax Code Section 171.0001(8). The amendment to this section enacted by House Bill 3928 lowered the common ownership threshold from 80% or more common ownership to 50% or more common ownership, thus “catching” more entities within its definition.

- (3) in effect, the combined group’s total revenue is tested for the minimum taxable threshold, and for the new small business discount (see Section 7 below);
- (4) the combined group can only make one election to subtract either cost of goods sold or compensation, and that one election must be applied to all of its members;¹⁷
- (5) in effect, the same tax rate applies to all members of a combined group, even if some of the members qualify for a lower tax rate; and¹⁸
- (6) each member of the combined group is jointly and severally liable for the entire Margin Tax liability of the combined group.¹⁹

Basically, a combined group has to recognize and report all of the income from all of its members, but it is limited to using only one set of deductions. All members must use the same Margin Tax calculation formula. These provisions are expected to significantly increase the amount of Margin Tax due for a combined group as compared to the Margin Tax due if it were calculated on a separate per-entity basis, and this is a very significant change from Franchise Tax planning.

3. APPORTIONMENT

After aggregating entities into a combined group, if required, the planner must “apportion” income to Texas for entities that generate income both within and without Texas. Even if your clients do not have operations or businesses outside of Texas, this apportionment topic may interest you because it creates some opportunities to exempt income from the Margin Tax.

The Franchise Tax also had an apportionment component, so this part of the Margin Tax is best characterized as a tweaked Franchise Tax provision. Practitioners should note at the outset that apportionment calculations are based on the federal income tax concept of “gross receipts”, which is different than “total revenue” and other new Margin Tax definitions.

Apportionment is ultimately a fraction, the

numerator of which is a taxable entity’s gross receipts apportioned to Texas, and the denominator of which is the taxable entity’s total gross receipts. The Margin Tax defines the numerator as the sum of the taxable entity’s receipts from:

- (1) each sale of tangible personal property if the property is delivered or shipped to a buyer in this state regardless of the FOB point or another condition of the sale;
- (2) each service performed in this state, except that receipts derived from servicing loans secured by real property are in this state if the real property is located in this state;
- (3) each rental of property situated in this state;
- (4) the use of a patent, copyright, trademark, franchise, or license in this state;
- (5) each sale of real property located in this state, including royalties from oil, gas, or other mineral interests; and
- (6) other business done in this state.²⁰

If the “taxable entity” is a “combined group” due to the aggregation rules discussed above, the “combined group” excludes from this numerator gross receipts of any entity that does not have a nexus with Texas for the purpose of taxation.²¹

The denominator of this apportionment fraction is the sum of the taxable entity’s receipts from:

- (1) each sale of the taxable entity's tangible personal property;
- (2) each service, rental, or royalty; and
- (3) other business.²²

A planner’s goal in apportionment is to cause the fraction to be as close to zero (0) as possible. In application, a combined group may have an advantage here because it can eliminate from the numerator all of the gross receipts of any member entity that does not have sufficient contacts with Texas to subject it to income tax, but all of that member entity’s gross receipts is still included in the denominator.

Booking revenue in or to a state other than Texas is available in theory under the Margin Tax, as it was under the Franchise Tax. In fact, it may be a more viable

¹⁷Texas Tax Code Section 171.1014(d)

¹⁸Texas Tax Code Section 171.002(a) and (b); 171.1014(b)

¹⁹Texas Tax Code Section 171.1014(i)

²⁰Texas Tax Code Section 171.103(a)

²¹Texas Tax Code Section 171.005(c)

²²Texas Tax Code Section 171.105(a)

option because the Margin Tax eliminates the former so-called “throwback” rule.²³ To use this strategy, an individual would form one or more entities in states other than Texas that did not have this type of taxation scheme, such as Delaware or Nevada. The entity/entities would then book as much revenue as possible as “non-Texas revenue.”²⁴

4. TAX RATES

The Margin Tax has two different applicable tax rates. The default rate is one percent (1%) of “taxable margin,” whereas for those taxable entities primarily engaged in retail or wholesale trade, the rate is one-half percent (0.5%) of “taxable margin.”²⁵ A taxable entity is primarily engaged in retail or wholesale trade only if:

- (1) the total revenue from its activities in retail or wholesale trade is greater than the total revenue from its activities in trades other than the retail and wholesale trades;
- (2) except as provided by Subsection (c-1)²⁶, less than 50 percent of the total revenue from activities in retail or wholesale trade comes from the sale of products it produces or products produced by an entity that is part of an affiliated group to which the taxable entity also belongs; and

²³In *Home Interiors & Gifts, Inc., v. Strayhorn*, 175 S.W.3d 856 (Tex. App.—Austin 2005, pet. filed), the State of Texas suffered an adverse decision on its throwback rule, which may have contributed to the decision to delete it from the Margin Tax. Generally, the deleted provision apportioned to Texas receipts from the sale of tangible property shipped from Texas into a state in which the seller had insufficient contacts to be subject to state income tax.

²⁴As originally passed, the Margin Tax allowed combined groups the option to include “passive entities” that would otherwise have been included in the combined group, via Texas Tax Code Section 171.1014(g). A combined group would have considered including a passive entity in order to affect its apportionment fraction. However House Bill 3928 eliminated this subsection and with it, this planning strategy.

²⁵Texas Tax Code Section 171.002(a) and (b)

²⁶Subsection (c-1) provides that “Subsection (c)(2) does not apply to activities in a retail trade described by Major Group 58 of the Standard Industrial Classification Manual published by the federal Office of Management and Budget.”

- (3) the taxable entity does not provide retail or wholesale utilities, including telecommunications services, electricity, or gas.²⁷

The determination of whether an entity is primarily engaged in retail or wholesale trade must be made every tax period (e.g. every calendar year for calendar year taxpayers). It is therefore possible for a taxable entity to pay Margin Tax at 1% of taxable margin in some years, and 0.5% of taxable margin in other years.

From a planning perspective, the lower 0.5% rate is clearly more advantageous than the 1.0% rate. Combined groups as determined by the Margin Tax scheme may offer some planning opportunities regarding the applicable tax rate, if a client’s operations allow the planner to intentionally create a combined group that meets the test for the lower rate, thus shielding some income from the higher rate.

5. THE CALCULATION FORMULA

The intricacies of the Margin Tax calculation formulas have already generated, and will continue to yield, entire papers dedicated solely to that topic, and such is beyond the scope of this paper. The basic calculation is as set out in Exhibit B. Within that calculation is an option to use one of three formulas that determine the lowest amount of tax due. Although the idea of paying the “lesser of” three options sounds appealing, a taxable entity may have to perform three different calculations, with three different formulas, to determine and select the formula that will produce the lowest tax burden.

The “taxable margin” of a taxable entity, to which the margin tax rate is applied (1.0% or 0.5% as discussed above) is the lesser of:

- (1) 70 percent of the “taxable entity’s” “total revenue from its entire business;” or
- (2) the “taxable entity’s” “total revenue from its entire business;” less “cost of goods sold;” or
- (3) the “taxable entity’s” “total revenue from its entire business;” less “compensation.”

The first formula is merely designed to prevent any taxable entity from subjecting more than 70 percent of its total revenue to the applicable margins tax rate. The second and third formulas include terms (in quotes)

²⁷Texas Tax Code Section 171.002(c)

defined elsewhere in the new statute.

For some entities, the choice between using the “cost of goods sold” or the “compensation” formula will likely be obvious (e.g. services-based entities do not produce a “good”), whereas some entities may require planners to actually calculate the estimated tax using each formula. As stated previously, the author’s practice is to specifically allocate to the client’s CPA the task of calculating taxable margin, and assuming I am not alone, I predict this new Margin Tax scheme will keep our CPA friends quite busy for the foreseeable future.

6. NEW ALTERNATIVE “E-Z” FORMULA

A taxable entity with less than \$10 million of “total revenue” (note this defined term) may choose to calculate and pay an alternative tax. The formula is indeed simpler than the “cost of good sold” or “compensation” options:

(Apportioned Total Revenue x 0.575%) x the
new small business discount (see next section)

An entity choosing the E-Z alternative cannot apply tax credits or make any other adjustments. Since all taxable entities must determine “apportioned total revenue”, the “E-Z formula may be quickly applied. Some clients may decide to pay this E-Z alternative tax, even if higher than a full COGS or Compensation calculation, to save professional fees and thereby achieve an overall savings. Also remember this election is available each year, regardless of the taxable entity’s election in prior years.

7. NEW SMALL BUSINESS DISCOUNTS

House Bill 3928 implemented a new set of discounts for “small businesses.” These discounts are determined on a “taxable entity” basis. Since a combined group is multiple taxable entities treated as one “taxable entity”, the premium for keeping income out of combined groups has already increased before the Margin Tax even became effective.

The effect of this Texas Tax Code Section 171.0021 is shown on Exhibit B, in the “Small Business Discount” line item near the bottom of the calculation.

D. TRANSITION RULES

The Margin Tax has several important transition provisions of which practitioners should be aware, three of which are dealt with below, namely net operating losses, the effective date of the Margin Tax, and the anti-abuse rules.

1. NET OPERATING LOSSES

The Margin Tax treats a business’s net operating losses (“NOLs”) as “temporary credits.” Only entities subject to the Franchise Tax may take NOLs as temporary credits under the Margin Tax. The statute allows a taxpayer to make this election only once, and it cannot be conveyed, assigned or transferred to another entity. Taxpayers must notify the Comptroller in writing of their intent to use NOLs as temporary credits on the first report originally due on or after January 1, 2008 (meaning May 15, 2008).²⁸ A taxable entity loses the right to claim the credit if the entity changes “combined groups” after June 30, 2007.²⁹

The Margin Tax includes a formula that calculates the maximum amount a taxpayer may deduct in any given year, and that formula changes.³⁰ The credit is generally calculated based on business loss carryforwards at a 4.5% rate; 2.25% of the credit is available for each of the first 10 years and 7.75% of the credit is available for the following 10 years. The credit cannot result in a refund.

2. EFFECTIVE DATE AND REPORTING

The Margin Tax applies to calendar year taxpayers from and after January 1, 2007; for accrual basis taxpayers, the Margin Tax begins to apply at the beginning of their first federal income tax year that commences on or after June 1, 2006. All “taxable entities” should therefore be subject to the Margin Tax no later than January 1, 2007. The earliest tax year completely subject to the Margin Tax is June 1, 2006 through May 31, 2007, for taxpayers whose tax year begins June 1.

The Margin Tax bills did not change the deadlines to file reports and pay taxes, found in current Texas Tax Code Sections 171.151 and 171.152. However, the first Margin Tax return is not due until May 15, 2008.³¹ Since a calendar year taxpayer normally files tax returns 90 days after the end of the reporting period (i.e. March 30), it appears that the Margin Tax drafters graciously allowed most taxpayers an extra 45 days to complete and file the first Margin Tax return. The filing of subsequent Margin Tax returns beginning in 2009 appear to return to the March 30 date.

²⁸House Bill 3, Section 22

²⁹Texas Tax Code Section 171.111(d)

³⁰Texas Tax Code Section 171.111(b)

³¹House Bill 3, Section 22

3. ANTI-ABUSE RULES

The first Margin Tax bill, House Bill 3, contained some interesting “anti-abuse” rules. These were materially amended by House Bill 3928. The Margin Tax drafters were apparently concerned that entities and persons who were not taxed by the Franchise Tax but will be taxed by the Margin Tax scheme would try to reorganize to avoid Margin Tax liability. One wonders whether they thought they did their job “too good” or whether they feared being beaten right out of the gate by their nemesis, tax planners.

An entity that does business in Texas after June 30, 2007, and that ceases doing business in Texas between June 30, 2007, and January 1, 2008, that did not pay Franchise Tax but would have to pay Margin Tax but for ceasing to do business in Texas, must still file a final report and pay an additional tax through the date it no longer became subject to Margins Tax.³² This appears to be a material change from the “anti-abuse” rules in House Bill 3.

E. COMPTROLLER RULES INTERPRETING AND SUPPLEMENTING THE MARGIN TAX STATUTE

The Margin Tax expressly and repeatedly directs the Comptroller to promulgate administrative rules to interpret, clarify, and implement various sections of the Margin Tax. Interested taxpayers will have significant opportunities for meaningful input into this process. However, there is no set deadline by which rules must be promulgated, and it is possible that practitioners may have to advise taxpayers regarding the first Margin Tax report due on May 15, 2008, without any additional rules from the Comptroller.

F. ADVISING BUSINESS OWNERS ABOUT THE MARGIN TAX

The TBOC, as discussed below, has a “phase in” time period and does not affect all businesses until January 1, 2010. In contrast, the Margin Tax began to apply to all Texas businesses in 2007 and the first return with payment is due May 15, 2008. This gives practitioners more options for advising clients about the TBOC, while it becomes more important to educate clients about the Margin Tax now (as opposed to later).

1. CHOICE OF ENTITY

The Margin Tax certainly has changed the traditional Franchise Tax’s choice of preferred entity. In the author’s opinion, the Margin Tax does not allow for the simplistic approaches and decision trees that

practitioners developed for the Franchise Tax. It is not possible to designate any one entity as the “entity of choice” in Margin Tax planning. The choice of entity analysis must be applied for each client on a fact-specific basis. In fact, the “combined group” rules discussed above are expected to have very unique and individualized effect.

Furthermore, since many of the tests required by the Margin Tax must be applied each year, the “best entity” in one year may not be the best for the next year. As we develop more experience with the Margin Tax, we may find that it has a higher sensitivity to the transactions in which our clients participate, such that transactions (both current and future) may trigger the need for Margin Tax analysis and a change in structure. There are still some advantages to using limited partnerships in certain circumstances that are unique to limited partnerships, but gone are the days when practitioners could advise clients to operate businesses and place assets in limited partnerships, and ignore the Franchise Tax.

2. PLANNING STRATEGIES

The Margin Tax appears to have successfully closed some (perhaps rising to the level of “many”) loopholes that practitioners had developed under the Franchise Tax. However, depending on individual circumstances and facts, some opportunities still exist to minimize or eliminate Margin Tax liability for clients. The following is a short, non-all-inclusive summary list of potential strategies practitioners may consider to reduce or eliminate Margin Tax liability, some of which have been previously discussed in this paper:

- (1) shield “passive income” from Margin Tax by segregating it from non-passive income;
- (2) do not flow “passive income” through a passive entity into a non-passive taxable entity;
- (3) structure intentionally affiliated entities to subject more income to the lower retail/wholesale tax rate;
- (4) other than strategy #3, as a general rule of thumb, avoid “combined groups” whenever possible;
- (5) break affiliations among taxable entities using different rights of ownership, particularly for “combined groups” comprised of some taxable entities that need to use the “COGS” formula, and others that need to use the “Compensation” formula, in order to minimize the overall tax

³²House Bill 3928, Section 35

burden;

- (6) avoid “taxable entity” status by having parties “contract” to do business together in ways that do not rise to the level of “general partnership”;
- (7) form entities in states other than Texas with more favorable state and local taxation (e.g. Nevada or Delaware) that contract together to do business in Texas;
- (8) pay management fees to parent entities formed in states other than Texas (and which do not have a “nexus” with Texas) to shift Margin Taxable income out of Texas;
- (9) sell entities instead of assets to eliminate Margin Tax on the gain recognized by the seller;
- (10) move assets outside taxable entities, and otherwise consider assets owned by individuals outside taxable entities, such as good will, and maximize the sales price portion allocated to those assets;
- (11) move assets whose sale will generate “passive income” into a separate “passive entity” prior to sale;
- (12) passive entities may own non-passive entities, but non-passive entities should not own passive entities;
- (13) watch mineral interests carefully and apply the specific mineral interest rules on a case-by-case basis;
- (14) in situations where it is possible that an entity may be considered part of a “combined group”, the entities in that combined group should consider entering into a written agreement apportioning the Margin Tax among the members of the combined group, with each affected entity’s governing authority approving the entity’s execution of that document. These affected entities should also indemnify each other for their apportioned Margin Tax liability, since the Margin Tax statute now imposes the tax liability among all combined group members jointly and severally.
- (15) At a minimum, an entity’s formation documents should include a specific requirement that its owners must timely provide the entity with information sufficient to allow the entity to

determine whether it is a member of a “combined group” and, if so, to also provide information necessary to allow the entity to compute its Margin Tax liability. Note that the obligation must be enforceable against the owner(s) of the entity, and so it must be included in an entity document signed by the owners, and not by only the entity’s governing authority.

Some or all of these ideas may be eliminated once the Comptroller issues rules to interpret, clarify and implement the Margin Tax. Please check my law firm’s website (www.mctexlaw.com) for updates and other helpful information.

III. THE TBOC

The TBOC was adopted by the 78th Legislature in 2003, so by now practitioners are likely familiar with its “hub and spoke” structure, and its long section of new defined terms. This paper will not attempt to introduce the reader to the TBOC, but will instead focus on how to implement the TBOC in practice and into client business structures, with particular focus on common filings to implement a new structure upon completion of a Margin Tax analysis.

The three most common actions required to implement a new business structure for a client are: (1) forming new entities; (2) converting existing entities; and (3) terminating existing entities. Obviously, beginning a new business will often only require forming new entities.

From the present until January 1, 2010, Texas practitioners are in the TBOC’s transition period. Entities formed prior to January 1, 2006, continue to be governed by the “Prior Codes” (herein so called), such as the Texas Business Corporation Act (“TBCA”), Texas Limited Liability Company Act (“TLLCA”), and Texas Revised Limited Partnership Act (“TRLPA”), and others as applicable depending on the type of entity. On January 1, 2010, all of these Prior Codes will be automatically repealed, and all business entities will be governed by the TBOC from and after January 1, 2010.³³ All new entities formed from and after January 1, 2006, are governed by the TBOC.³⁴

Generally, during this transition period any entity may choose to be governed by the TBOC instead

³³TBOC Section 402.005

³⁴TBOC Section 402.001(a)

of the Prior Codes by filing an election to adopt the TBOC.³⁵ In the context of Margin Tax planning or otherwise forming new entities for business owners, it may be advisable to consider whether existing business entities affiliated with the owner and governed by the Prior Codes should adopt the TBOC prior to January 1, 2010. This issue is addressed in Subsection D below.

A. FORMING NEW ENTITIES

Forming new entities is one of the easier tasks to accomplish under the TBOC. The formation document filed with the Secretary of State for any type of entity formed under the TBOC is titled a “Certificate of Formation.” Generally, the TBOC has standardized several provisions of these Certificates among the different types of entities. The Secretary of State has promulgated basic statutorily-prescribed “Certificate of Formation” forms for most types of entities, and these may be found at:

http://www.sos.state.tx.us/corp/forms_boc.shtml

Under the Prior Codes different practitioners have developed different entity organizational forms that include provisions in addition to the statutory minimum, and this practice should continue under the TBOC. This is where the art of crafting a particular form to a distinct set of circumstances meets the science of the code provisions, which is inherently the “practice of law.”

From the author’s perspective, the Legislature has historically shown a propensity to change, from time to time, various default rules applicable to matters such as preemptive rights, cumulative voting, and indemnification, and so many organizational document forms specifically address these and other matters. While it is hoped the TBOC will put an end to such legislative “flip-flops”, there are no assurances this will occur, and so it may be the wiser practice to continue to include specific provisions on these issues, and others based on individual experience, in updated TBOC-compliant forms. TBOC changes affect the entire “set” of entity formation documents, including the certificate of formation, bylaws/company agreement/ limited partnership agreement, organizational consents of the governing body, and form of ownership certificate.

B. CONVERTING “OLD” ENTITIES

A “conversion” is simply one entity changing its form of organization, for example where “Widget Corporation”, a Texas corporation, becomes “Widget, LLC”, a Texas LLC. The legal effect of a conversion is

set forth in TBOC Section 10.106. The entity continues to exist without interruption in the new organizational entity form, and all rights, titles and interests to all property owned by the entity continues to be owned by the entity in its new form, subject to any existing liens or other encumbrances. The new form of entity retains all tax characteristics (such as elections to be taxed as an S corporation or partnership), and the employer identification number of the old entity form as well.

As compared to mergers, conversions are relatively modern additions to our entity codes. Some states other than Texas do not allow for conversions, or only allow certain types of entities to convert into other specified types of entities. These statutes can be very limiting.³⁶ Conversions have in many instances replaced mergers as the vehicle used to change the form of an entity. It remains to be seen whether the Margin Tax will increase the use of the merger process in order to obtain different state tax characteristics than conversions would achieve. Although this paper does not discuss mergers in detail, practitioners should remember that they remain available as necessary to implement one or more of the Margin Tax planning strategies listed in II.F.2. above.

During the Franchise Tax era, many entities converted from corporations or LLCs to limited partnerships (and, in the realm of professional services entities, to professional associations) to eliminate Franchise Tax liability. In the new Margin Tax era, practitioners may see entities that were formed as, or converted to, limited partnerships solely to avoid Franchise Tax, but which are now subject to Margin Tax, convert from limited partnerships to LLCs or corporations, to eliminate the need to maintain bank accounts, prepare financial statements, and file federal income tax reports for both the limited partnership and the general partner. This may include formally terminating the general partner entity (terminations are discussed below). Furthermore, in the appropriate circumstance, Texas entities may want to convert to an out-of-state entity.

I have attached as Exhibit C a form of “Articles of Conversion” that converts a Texas corporation governed by the TBCA to a Texas LLC governed by the TBOC, which includes as its exhibit the Certificate of Formation of the converted entity. Conversion of an entity governed by a Prior Code also requires a “Plan of

³⁵TBOC Sections 402.003 & 402.004

³⁶Of course, other states continue to modernize their entity codes as has Texas, so over time this limitation may be resolved.

Conversion” that complies with the applicable Prior Code. I have attached as Exhibit D a simple Plan of Conversion coordinated with Exhibit C that does not change the percentage of ownership of the affected entity. It complies with the TBCA. Note that the Certificate of Formation attached to the Articles of Conversion is a TBOC compliant form. By statute, converted entities are governed by the TBOC.³⁷

If the entity to be converted is governed by the TBOC before its conversion, then the Plan of Conversion must comply with TBOC Sections 10.103 and 10.104, instead of a Prior Code, and the document filed with the Secretary of State is termed a “Certificate of Conversion” which must comply with TBOC Section 10.154. This section has been materially amended by House Bill 1737, which takes effect September 1, 2007. Multiple forms for a TBOC-compliant Certificate of Conversion, specific to the entity converted, are posted for download on the Secretary of State’s website.

C. TERMINATING ENTITIES

The TBOC made significant changes in the area of entity termination as compared to the Prior Codes. Generally, the TBOC has more generous provisions that permit survival and reinstatement of an entity after termination for various purposes. Once a decision is made to terminate an entity, the client should consider filing an Early Adoption of the TBOC (discussed below in section D) prior to commencing the termination process. A non-inclusive list of some of the changes to the termination process made by the TBOC follows:

- (1) The reinstatement provisions after entity termination are generally more flexible.
- (2) Limited partnerships are included in the winding up and termination provisions of TBOC Chapter 13, which includes, for all TBOC entities, the new ability to reinstate a voluntarily terminated entity within three years following termination (TBOC Section 11.202), extending the period from 120 days to 3 years for for-profit corporations. There is also a 3 year limitation on liability for existing claims, and a short claims resolution provision.
- (3) The TBOC permits an entity to cancel a decision to terminate the entity upon a vote of the owners. Practitioners should note that LLCs should specify the vote required to revoke a voluntary winding up or to cancel an agreed event

requiring winding up because if the LLC does not specify otherwise, the vote required is a majority of owners in numbers, not percentage, (TBOC Section 101.552).

- (4) The failure to pay franchise tax (i.e. Margin Tax) has been removed from the TBOC as grounds for involuntary termination of the entity. This merely eliminates the redundancy, because the Secretary of State has this power pursuant to Texas Tax Code Section 11.251.
- (5) The confusing references to “dissolution” as part of the process of termination and winding up have been eliminated.
- (6) The operations of an entity may be continued for a limited period of time as necessary to avoid an unreasonable loss of property or business.
- (7) For LLCs and corporations, the members or shareholders, in addition to the entity, may apply for court-supervised winding up of the entity (TBOC Section 11.054).
- (8) An event requiring the winding up of an entity because of the expiration of the entity’s specified period of duration may be canceled by amending the entity’s governing documents within 3 years after such expiration (TBOC Section 11.152(b)). The entity’s reinstatement is retroactive if made within this three year window. Reinstatement has no effect on the personal liability of the directors/members or officers.
- (9) An event of termination in an entity’s governing documents requiring a winding up and termination of the entity may be cancelled by the appropriate action within one year of the event (TBOC Sections 11.152, 21.502, and 22.302).
- (10) The Secretary of State, upon receipt of a proper certificate of reinstatement, can reinstate an involuntarily terminated entity at any time; there is no time limit (TBOC Section 11.253).
- (11) The TBOC provides a new ability to reinstate a voluntarily terminated entity within 3 years following a termination (TBOC Section 11.202). Note that this extends the period for for-profit corporations from 120 days under the Prior Code to 3 years.

³⁷TBOC Section 402.001(a)

It is therefore very advantageous for a

terminating entity to file an Early Adoption of the Business Organizations Code before commencing the termination process. Upon concluding the termination, an entity must file a Certificate of Termination with the Secretary of State. Forms for a Certificate of Termination are posted for download on the Secretary of State's website.

D. EARLY ADOPTION OF THE TBOC

Entities may elect to be governed by the TBOC earlier than January 1, 2010. Domestic entities do so by filing an "Early Adoption of the Business Organizations Code by an Existing Domestic Entity." This form has been promulgated by the Secretary of State and is available for download at:

<http://www.sos.state.tx.us/corp/forms/808.pdf>

Practitioners may be retained to advise an existing entity about making this election. In the author's opinion, the answer depends on the facts and circumstances of each situation; there is no "absolute" right answer. This section sets forth below some of the considerations practitioners may consider in assisting a client decide whether to elect to be governed by the TBOC earlier than January 1, 2010.

1. WHO IS THE CLIENT?

At the outset, practitioners should identify the "client." The client may be the entity, the majority owner, a "sweat equity" owner/operator, the money investor-owner, one or more officers, or the governing board, among others. The Prior Codes govern the acts, contracts and transactions of the entity and its governing officials and owners that occur prior to the TBOC becoming applicable to the entity. The TBOC may affect these different stakeholders differently.

It is beyond the scope of this paper to compare the TBOC to the Prior Codes and analyze the differences between them. An excellent source of comparison data may be found in the "*Chart Listing Changes From Existing Law Effected by Business Organizations Code*" posted May 23, 2005, on the website of the Business Law Section of the State Bar of Texas:

<http://www.texasbusinesslaw.org/>

A review of this chart may help practitioners understand how certain changes between the Prior Codes and the TBOC will affect the different stakeholders.

2. TIMING MATTERS

This title, "Timing Matters", is a complete sentence. Once an entity decides to adopt the TBOC

prior to January 1, 2010, practitioners should carefully choose the date the Early Adoption of the Business Organizations Code becomes effective, and determine exactly when the TBOC becomes applicable to an entity or a particular transaction, as shown by these examples:

- (1) The TBOC applies to meetings of owners, members or governing persons held, and to any actions by written consent that take effect, on or after the date the entity is governed by the TBOC.³⁸ In practice, if a meeting is called for a date before the TBOC election is effective, the Prior Codes apply to the meeting, regardless of any postponement or adjournment.
- (2) Mergers, conversions, interest exchanges and sales of assets are also affected by the sequence of approval, TBOC election, and transaction consummation. Generally, the TBOC applies to these transactions if the entity is governed by the TBOC before the transaction is consummated. However, if a required approval of the owners and members of the entity was given before the TBOC applied to the entity, or if the required approval was given at a meeting originally called for a date before the TBOC applied to the entity (even if the meeting was postponed to a date after the TBOC applied to the entity), then the Prior Codes apply to the transaction.³⁹
- (3) Timing issues are also implicated in the termination of an entity. As discussed above, in many instances a client may prefer that the TBOC apply to its termination. However, any voluntary winding up and termination proceeding initiated before the date the entity is governed by the TBOC will be governed instead by the Prior Codes.
- (4) Indemnification is an area of particular interest in the context of timing, because once an entity is governed by the TBOC, TBOC Chapter 8 (governing any proposed indemnification by a domestic entity) will apply regardless of whether the events on which the indemnification is based occurred before or after the TBOC's application to the entity.⁴⁰ The entity's governing documents will not be construed to limit the

³⁸TBOC Section 402.008 and 402.009

³⁹TBOC Chapter 10

⁴⁰TBOC Section 402.007

permissive indemnification authorized by Chapter 8 unless the limiting provision is intended to limit or restrict permissive indemnification under applicable law.

This is a non-inclusive list of determinations showing how technical this issue can become. For those clients and practitioners interested in simplicity and clarity, the most opportune time for an entity to file an Early Adoption of the Business Organizations Code is when the entity is engaged in no other significant activity. As many of us know, it is practically difficult to persuade a client or potential client to incur legal fees with no specific stimulus. As a result, practitioners may find themselves sorting through the transition rules to make lemonade out of a client’s lemon-choice of timing. However, a Margin Tax analysis may prove to be the motivation to expand the review to include TBOC adoption issues.

E. ADVISING BUSINESS OWNERS ABOUT THE TBOC

There are several different options available to practitioners in advising business owners about the TBOC. One initial decision is whether to proactively notify clients about the TBOC, and if so, to decide on the substance of the communication, or whether to allow the natural course of events to present opportunities to discuss the TBOC with the client. Once a client becomes knowledgeable about the TBOC, the client will likely ask the lawyer whether or not to file an early adoption. This section sets out some thoughts in deciding how to answer that inquiry.

1. REASONS TO FILE AN EARLY ELECTION

- (1) Dealing with the termination of an entity, whether a voluntary termination or an involuntary termination, is easier because the entity has more options under the TBOC (discussed more fully in Section C above). Entity clients that do not regularly and timely pay their franchise tax, causing the occasional forfeiture of the entity’s privileges, should consider electing to be governed by the TBOC at the earliest possible date.
- (2) TBOC Section 6.002(a) permits TBOC entities to hold meetings via electronic or Internet communication so long as the equipment used permits the participants to communicate with all other participants.

- (3) Limited partnerships may have officers (TBOC Section 3.103).
- (4) The TBOC resolves ambiguities and inconsistencies caused by linkage of TLLCA 8.12 (Applicability of Other Statutes) to TBCA Art. 7.12 (Limited Survival After Dissolution).
- (5) The TBOC does not prohibit the use of a limited partner’s name in the limited partnership’s name.
- (6) TBOC permits removal of officers with or without cause as a default rule (omits requirement that removal be in “best interest” of the entity, TBOC Section 3.104).
- (7) Under the TBOC, limited partnerships have 1 year (rather than 90 days) to appoint a new general partner to continue LP after withdrawal of a general partner.

In the author’s experience, clients are generally not interested in these sorts of details. In conversations with clients about the TBOC, the author’s experience has been that clients most want to ensure the lawyer is knowledgeable about and comfortable with the TBOC.

If a client goes through a Margin Tax analysis, and that analysis results in one or more entities becoming subject to the TBOC, then for the sake of uniformity the client should strongly consider adopting the TBOC for all of the client’s entities, for administrative consistency, which should result in lower legal fees.

2. REASONS NOT TO FILE AN EARLY ELECTION

Notwithstanding the issues listed above favoring an early adoption of the TBOC, there are valid reasons for a client to decide not to file an early adoption of the TBOC:

- (1) It takes time and effort to undertake the analysis and make the decision, with the client incurring out of pocket expenses for the professional time and effort.
- (2) Clients incur costs to have drafted and filed any amendments to the entity’s governing documents required by the TBOC.
- (3) The TBOC’s provisions have not been tested in

the courts.⁴¹

- (4) All entities will be governed by the TBOC on January 1, 2010 by client inaction, which is very inexpensive.

It is the author's experience that clients are very interested in these financial issues. The filing fee to file an Early Adoption of the Business Organizations Code by an Existing Domestic Entity is \$15.00 for all domestic entities other than cooperative associations and non-profit corporations, in which case the filing fee is \$5.00. Practitioners may want to consider determining a set fee to draft and file an Early Adoption statement.

IV. CONCLUSION

One of the goals of the drafters of the TBOC was to influence businesses to formally organize in Texas as the "headquarter state" for their business organization, by enacting a code attractive to businesses. In the author's opinion, these individuals and groups have succeeded in providing a modern and flexible state entities code that sets a high standard for the other states to match. Unfortunately, one of the effects of the Margin Tax may be to chase certain businesses out of Texas as they attempt to avoid this new functional business income tax and the administrative costs required for its computation.

The Margin Tax introduces to state and local tax planning the opportunity for taxable entities and their professional advisors to apply sophisticated (as well as not so sophisticated) strategies similar to the level historically available for federal income tax planning. However, this opportunity comes with potentially high administrative costs, particularly in the next few years as professionals deal with uncertainties and ambiguities of the new Margin Tax scheme. The administrative planning expenses may be reduced or contained by a negotiated common understanding between client and practitioner of the scope of the practitioner's review and

analysis, and this should be documented in writing to include the scope as well as the limitations. Individuals and entities seeking to implement planning for the Margin Tax must design and execute the plan prior to the expiration of the first taxable time period, which may end as early as May 31, 2007, or as late as December 31, 2007.

This paper has expounded on some ideas available to planners as they implement Margin Tax planning. The TBOC offers practitioners dealing with Texas entities great latitude in moving from a client's current business structure to a new business structure modified to minimize the impact of the Margin Tax. However, in order to take full advantage of the TBOC, entities must first elect early adoption of the TBOC.

V. CREDITS

Because I am not a tax lawyer, I have had to rely more extensively than normal on the thoughts and ideas of tax-savvy colleagues such as Daniel G. Baucum, Dallas, Law Offices of Daniel Baucum, who continues to be kind enough to discuss this paper and other Margin Tax topics with me. Since the enactment of the TBOC I have used and relied on the many CLE papers written by Daryl B. Robertson and George W. Coleman, both in the Dallas office of Hunton & Williams, and Professor Elizabeth Miller, Waco, Baylor School of Law. The Texas Business Law Foundation has spent countless hours drafting the TBOC and supporting its enactment, and subsequently enacting helpful technical amendments as well as protecting the TBOC from poor legislation.

EXHIBITS

Exhibit A	Strayhorn Notation
Exhibit B	Margin Tax Calculation Formula
Exhibit C	Articles of Conversion
Exhibit D	Plan of Conversion

⁴¹Nevertheless, we are beginning to see state cases that cite the TBOC: (1) *Willis v. Donnelly*, 199 S.W.3d 262 (Tex. 2006), confirming that the strict standards of TBCA Article 2.21 were carried forward into TBOC Sections 21.223-21.236; (2) *Pye's Auto Sales v. Gulf States Finance Co.*, 2006 S.W. 3d (LWC-4001), 2006 WL 1428922 (Tex. App.-Houston [1st Dist.] 2006) (same issue); (3) *Bates v. De Tournillon*, 2006 S.W.3d (LWC-1053), 2006 WL 265474 (Tex. App.-Amarillo 2006) (same issue); *A.P. McMaster v. Davidson*, 2005 S.W.3d (LWC-6437), 2005 WL 2000789 (Tex. App.-Corpus Christi 2005) (court confirmed that certain TBOC provisions were carried over from the TLLCA with no substantive change).

EXHIBIT A
STRAYHORN NOTATION

H.B. No. 3

I certify that the amounts appropriated in the herein H.B. No. 3, 3rd Called Session of the 79th Legislature, are within amounts estimated to be available in the affected fund.

Certified 5/5/2006

Carole Keeton Strayhorn
Comptroller of Public Accounts

APPROVED: _____

Date

Governor

*I am certifying the appropriation in this bill as required by the Constitution because it is within available revenue, but I believe portions of the tax enacted by this bill constitute a personal income tax and are unconstitutional.
CKS*

EXHIBIT B

EXHIBIT B
MARGIN TAX CALCULATION FORMULA

TOTAL REVENUE FROM ENTIRE BUSINESS _____
 This includes all revenue from all
 taxable entities in a combined group (Aggregation)

LESS either:

Cost of Goods Sold (COGS) OR

Compensation (limited to \$300,000 per person
 plus Employee Benefits) _____ (_____)

SUBTOTAL 1 (GROSS MARGIN): _____
 Note that Gross Margin cannot exceed 70% of Total Revenue

MULTIPLIED BY APPORTIONMENT FRACTION: X _____

SUBTOTAL 2 (TAXABLE MARGIN): _____

MULTIPLIED BY APPLICABLE TAX RATE: _____
 0.5% for wholesale and retail
 1.0% for all others

SUBTOTAL 3 (GROSS TAX DUE): _____

LESS SMALL BUSINESS DISCOUNT: _____ (_____)

If TOTAL REVENUE <u>FROM ENTIRE BUSINESS is:</u> \$300,000.01-\$399,999.99 \$400,000.00-\$499,999.99 \$500,000.00-\$699,999.99 \$700,000.00-\$899,999.99	then insert the result of <u>this calculation:</u> 80% x Subtotal 3 60% x Subtotal 3 40% x Subtotal 3 20% x Subtotal 3
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TAX PAYABLE: _____

EXHIBIT C
ARTICLES OF CONVERSION
ARTICLES OF CONVERSION
OF
WIDGET, INC.

ARTICLE ONE

The name of the converting entity is “Widget, Inc.” (the “Converting Entity”), File No. 0000000000. The Converting Entity is a Texas corporation, duly incorporated on [date of incorporation]. The Converting Entity’s address is: [converted entity’s address].

ARTICLE TWO

A plan of conversion has been approved. The organizational form of the converted entity shall be a Texas limited liability company. The name of the converted entity shall be “Widget, LLC” (the “Converted Entity”). The Converted Entity is being created pursuant to the plan of conversion so adopted. The Converted Entity shall be responsible for the payment of all fees and franchise taxes of the Converting Entity. The Converted Entity will be obligated to pay such fees and franchise taxes of the Converting Entity if the same are not timely paid by the Converting Entity.

ARTICLE THREE

The executed plan of conversion is on file at the current principal place of business of the Converting Entity, [converting entity’s address], and an executed plan of conversion will be on file, from and after the conversion, at the principal place of business of the Converted Entity, at [converted entity’s address].

ARTICLE FOUR

A copy of the plan of conversion will be furnished by the Converting Entity (prior to the conversion) or the Converted Entity (after the conversion), on written request and without cost, to any shareholder of the Converting Entity or Converted Entity.

ARTICLE FIVE

The number of shares outstanding in the Converting Entity is [number, spelled out] (numeric) and consists of only one class of common stock.

ARTICLE SIX

All outstanding shares of stock were voted in favor of the conversion plan; no outstanding shares of stock were voted against the conversion plan.

ARTICLE SEVEN

The conversion of the Converting Entity shall become effective immediately and automatically upon the issuance of a certificate of conversion by the Secretary of State of the State of Texas.

IN WITNESS WHEREOF, the undersigned duly authorized representative of the Converting Entity has executed these Articles of Conversion for the purposes herein expressed on July 20, 2007.

[name of authorized person]

[title]

CERTIFICATE OF FORMATION
Limited Liability Company
of
Widget, LLC

ARTICLE 1

The filing entity being formed is a limited liability company. The name of the entity is Widget, LLC (the “Company”).

ARTICLE 2

- A. The initial registered agent is an individual resident of the State of Texas, whose name is [Name].
- B. The business address of the registered agent and the registered office address of the Company is [address].

ARTICLE 3

The Company will have managers. The name and address of the initial managers are set forth below:

[list name and address of each manager]

ARTICLE 4

The purpose for which the Company is formed is for the transaction of any and all lawful purposes for which a limited liability company may be organized under the Texas Business Organizations Code.

ARTICLE 5

- A. No member shall have the right to cumulate his or her votes in an election of managers or for any other matter(s) to be voted upon by the members of the Company.
- B. No member shall have a preemptive right to acquire any interests, units or securities of any kind, whether now or hereafter authorized, which may at any time be issued, sold or offered for sale by the Company.
- C. The Company shall indemnify its officers and managers and may, in the discretion of the board of managers, indemnify their delegates, and the Company’s other employees and agents, to the fullest extent permitted under Title 1, Chapter 8 of the Texas Business Organizations Code and decisional law if any such person was or is a party, or is threatened to be made a party, to any threatened, pending or completed action, suit or proceeding, whether civil, criminal, administrative, arbitrative, or investigative, by reason of the fact that such person is or was a manager, officer, employee or agent of the Company, or is or was serving at the request of the Company as a director, officer, member, manager, partner, venturer, proprietor, trustee, employee or agent of another limited liability company, corporation,

partnership, joint venture, trust, or other enterprise, against expenses (including attorneys' fees), judgments, fines and amounts paid in settlement actually and reasonably incurred by such person in connection with such action, suit or proceeding. Such right of indemnification shall not be deemed exclusive of any other rights to which such person may be entitled under any bylaws, agreement, vote of members, or otherwise. Any repeal or amendment of this Article shall operate prospectively only and shall not adversely affect any right to receive indemnification existing at the time of such repeal or amendment.

D. The membership interests in the Company are personal property and may be represented by certificates in a form approved and adopted by the Company's members. The membership interests of the Company are subject to substantial restrictions on transfer as set forth in the Company Agreement of the Company, which Company Agreement will be kept with the records of the Company.

ARTICLE 6

The Company, which is a converted entity, is being created pursuant to a plan of conversion. The name, address, prior form of organization, date of incorporation, and the jurisdiction of the converting entity is as follows: [list converting entity's name, address, prior form of organization, date of incorporation, and jurisdiction].

ARTICLE 7

This document becomes effective when the document is filed by the Secretary of State.

ARTICLE 8

A. The name and address of the organizer is:

[name and address]

B. The undersigned signs this document subject to the penalties imposed by law for the submission of a materially false or fraudulent instrument.

IN WITNESS WHEREOF, I have signed this document on [date].

[name of authorized party signatory]
Organizer [or other title]

**EXHIBIT D
PLAN OF CONVERSION**

WIDGET, INC.

PLAN OF CONVERSION

**ARTICLE ONE
BACKGROUND FACTS**

1.1. Widget, Inc. (the “Converting Entity”), is a Texas corporation duly incorporated on [date of incorporation], pursuant to the Texas Business Corporations Act (the “TBCA”), and whose Charter Number assigned by the Secretary of State of Texas is 0000000000.

1.2. The Converting Entity desires to convert its form of organization from a Texas corporation to a Texas limited liability company and organize pursuant to the Texas Business Organizations Code (“TBOC”).

1.3. The Converting Entity has issued a total of [number of shares actually issued] (numeric) shares of common stock, and those [numeric] shares were issued to the following persons:

Owner	(number of shares owned)
Owner	(number of shares owned)
Owner	(number of shares owned)
[continue as necessary; list every owner]	

1.4. The Converting Entity’s shares of stock consist of only one class of common stock.

1.5. The name of the entity after conversion will be “Widget, LLC” (the “Converted Entity”).

1.6. This Plan of Conversion is submitted to the Converting Entity’s Directors and Shareholders for adoption and approval.

**ARTICLE 2
THE CONVERSION**

2.1. The Converted Entity shall be a Texas limited liability company.

2.2. Each shareholder of the Converting Entity will own an equity interest in and be a member of the Converted Entity.

2.3. No shareholder of the Converting Entity will, as a result of the conversion, become personally liable, without that respective shareholder’s consent, for the liabilities or obligations of the Converted Entity.

2.4. The Converted Entity shall be formed and organized pursuant to this Plan of Conversion.

2.5. The form of the Certificate of Formation of the Converted Entity to be filed with the Secretary of State of Texas upon the effectiveness of this Plan of Conversion is attached hereto as Exhibit A.

2.6. After conversion, the Converted Entity shall adopt a Company Agreement, which shall supercede and replace the Converting Entity’s Bylaws, and shall also adopt organizational minutes of its Managers and Members pursuant to the TBOC.

ARTICLE 3
EFFECT OF CONVERSION

3.1. The Converting Entity is continuing its existence in the organizational form of the Converted Entity. The Converting Entity shall continue to exist, without interruption, but in the organizational form of the Converted Entity rather than its prior organizational form.

3.2. All rights, title, and interests to all real estate and other property owned by the Converting Entity shall continue to be owned by the Converted Entity in its new organizational form without reversion or impairment, without further act or deed, and without any transfer or assignment having occurred, but subject to any existing liens or other encumbrances thereon.

3.3. All liabilities and obligations of the Converting Entity shall continue to be liabilities and obligations of the Converted Entity in its new organizational form without impairment or diminution by reason of the conversion.

3.4. All rights of creditors or other parties with respect to or against the prior interest holders or other owners of the Converting Entity in their capacities as such in existence as of the effective time of the conversion will continue in existence as to those liabilities and obligations and may be pursued by such creditors and obligees as if the conversion had not occurred.

3.5. A proceeding by or against the Converting Entity or by or against any of the Converting Entity's interest holders or owners in their capacities as such may be continued by or against the Converted Entity in its new organizational form and by or against the prior interest holders or owners, as the case may be, without any need for substitution of parties.

3.6. If, after the effectiveness of the conversion, a member of the Converted Entity would be liable under applicable law, in such capacity, for the debts or obligations of the Converted Entity, such member of the Converted Entity shall be liable for the debts and obligations of the Converting Entity that existed before the conversion takes effect only to the extent that such member: (a) agreed in writing to be liable for such debts or obligations; or (b) was liable under applicable law, prior to the effectiveness of the conversion, for such debts or obligations; or (c) by becoming a member of the Converted Entity, becomes liable under applicable law for existing debts and obligations of the Converted Entity.

ARTICLE 4
OWNERSHIP

4.1. Shares of stock in the Converting Entity shall be converted into Membership Interests in the Converted Entity at ratio of 1:1.

4.2. The shares of stock in the Converting Entity, all of which are to be converted into membership units in the Converted Entity as provided herein, shall be converted automatically upon the effectiveness of this Plan of Conversion and the the Converted Entity shall issue new certificates evidencing each owner's membership interests in the Converted Entity. Upon issuance of membership interest certificates to an owner, the stock certificates of the Converting Entity owned by that owner shall automatically be canceled and of no further effect. The former holders of shares of stock in the Converting Entity shall be entitled only to the rights provided in this Plan of Conversion.

ARTICLE 5
EFFECTIVENESS OF CONVERSION

5.1. This Plan of Conversion shall be effective upon: (1) adoption by the Converting Entity's Board of Directors of a resolution approving it and recommending its adoption by the Converting Entity's shareholders; and (2) approval and adoption of this Plan of Conversion by the Converting Entity's shareholders. The Secretary of the Converting Entity shall certify the effectiveness of this Plan of Conversion below.

CERTIFICATION

THE UNDERSIGNED, IN HER CAPACITY AS SECRETARY OF THE CONVERTING ENTITY, HEREBY CERTIFIES THAT: (1) THE BOARD OF DIRECTORS OF THE CONVERTING ENTITY ADOPTED A RESOLUTION APPROVING THIS PLAN OF CONVERSION AND RECOMMENDING ITS ADOPTION BY THE CONVERTING ENTITY'S SHAREHOLDERS; AND (2) THE CONVERTING ENTITY'S SHAREHOLDERS APPROVED AND ADOPTED THIS PLAN OF CONVERSION; EFFECTIVE ON [DATE].

[name of authorized person]
[title], Widget, Inc.