

THE LAW OFFICE OF RUTH BROCK

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A note from Ruth and Lee Ann.....

With all of the changes recently enacted by the Texas Legislature effecting business entities, we felt it was necessary to bring to your attention some of the more important legislation that may impact you, your entity, and the way you conduct business.

We have prepared this newsletter with you in mind and hope that you find it not only informative but also relevant to your business. We welcome your thoughts and comments.



Ruth Brock



Lee Ann Strunk

Say Good-bye to the Texas “Franchise Tax” and Hello to the New Texas “Margin Tax”

Who is subject to the Texas Franchise Tax (TFT)? Under current law, corporations and LLCs are subject to the TFT but not Partnerships or Professional Associations.

How is the Texas Franchise Tax computed? In a nutshell, the tax is equal to the greater of (a) 0.25% of the entity’s “taxable capital” (generally, the owners’ equity) and (b) 4.5% of its “net taxable earned surplus” (generally, a 4.5% income tax at the entity level). Currently, a corporation or an LLC is not required to pay TFT for a given year if the amount of the entity’s gross receipts from its entire business is less than \$150,000.

All of this is about to change with the enactment of the “Margin Tax” earlier this year by the Texas Legislature.

Who is subject to the Margin Tax? Generally, the Margin Tax is imposed on all businesses enjoying protection from liability. All partnerships will be subject to the Margin Tax *except* for general partnerships (the direct ownership of which is entirely composed of natural persons), general or limited partnerships meeting the definition of a “passive entity”, and family limited partnerships which are “passive entities” and held 80% by family members. The definition of “passive entities” is extensive and certain requirements must be met to be considered a passive entity for Margin Tax purposes. Sole proprietorships, “passive entities”, and entities exempt from taxation under subchapter B of Chapter 171 of the *Texas Tax Code* are also exempt from the Margin Tax.

How will the Margin Tax be reported? The Margin Tax will require entities conducting business in Texas to file on a unitary and combined basis (“combined reporting”). An affiliated group of entities in a “unitary business” (all affiliates with a common owner) will file a combined return that includes all taxable entities within the group.

When does the Margin Tax take effect? The Margin Tax is effective January 1, 2007 and applies to business conducted after that date. In May 2008, entities that are calendar year taxpayers will pay Margin Tax based on business conducted in calendar year 2007. However, fiscal year taxpaying entities that began their fiscal year after May 31, 2006 may be subject to the Margin Tax now.

How is the Margin Tax computed? Generally, the Margin Tax is a “modified gross receipts” tax. The tax is based on a “taxable entity’s” gross receipts in Texas after deductions for either (a) compensation or (b) cost of goods sold. The tax rate is 1% for all taxpayers, except some retail and wholesale businesses will pay a 0.5% rate. The tax base for the Margin Tax may not exceed 70% of a business’s total revenue.

The full impact of the Margin Tax is still being determined, and it is expected that the Texas Legislature will make changes when it reconvenes in January 2007. In the meantime, we recommend that you stay in close contact with your CPA, counselors, and advisors to stay abreast of developments with the new Margin Tax law.

Does The New “Texas Business Organizations Code” Affect Your Entity?

What is the Texas Business Organizations Code (TBOC)? The TBOC incorporates and replaces former law contained in numerous separate Texas statutes. The TBOC provides considerable flexibility to organizations in establishing their capital structures, affecting business combination transactions, and governing their internal affairs. The drafters have eliminated outdated provisions in the law as well as modernized, simplified, and standardized filings and other procedures.

What is the effective date of the TBOC? The TBOC became effective January 1, 2006. It applies to all domestic entities organized in Texas *on or after* that date. Entities formed *prior* to January 1, 2006 will continue to be governed by the law in effect at the time the entity was formed unless such entities make an election to be governed by the TBOC. However, effective January 1, 2010, all entities will be governed by the TBOC.

Should an entity formed prior to January 1, 2006 elect to be governed by the TBOC before January 1, 2010?

The answer depends upon a thorough review of each entity. Most changes brought about by the TBOC were non-substantive. However, a few of the more substantive changes are as follows. The TBOC ...

- provides greater flexibility for conducting meetings by current and future electronic formats;
- permits the removal of officers with or without cause;
- provides for appointment of officers without regard to entity form;
- allows officers and directors to rely on opinions, reports, and statements given by certain people in the execution of their duties;
- applies new terminology to common provisions used by

multiple entities;

- permits governing persons of domestic entities other than limited partnerships to have the right to inspect the entity’s books and records in connection with their duties;
- allows limited partnerships to use the name of a limited partner in the name of the limited partnership;
- creates numerous default provisions which may be adopted by a limited partnership or limited liability company;
- requires limited liability partnerships to register under the TBOC when their current registrations expire;
- extends permissible period to name a new general partner of a limited partnership following withdrawal or removal of the general partner to one year (allowing continued operation as a limited partnership for a like period);
- prevents deemed merger or conversion treatment on sale of entity assets;
- provides simpler winding up procedures for an entity and allows owner approval for cancellation of certain events requiring winding up;
- provides greater flexibility for all entities for reinstatement following entity termination;
- allows limited liability companies to be formed for non-profit purposes;
- provides more procedural and substantive changes with regard to non-profits than any other type of entity;
- provides for the perpetual duration of an entity unless otherwise specified in the entity’s certificate of formation.

These are just some of the changes brought about by the TBOC. The full impact of the TBOC on all Texas entities is still emerging, and we recommend that you stay in close contact with your counselors and advisors to help ensure your entity’s compliance with the changing face of the law.

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