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# Texas Franchise Tax

Overview and Updates

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# Agenda

- What is the Texas Margin Tax & Why Does it Exist
- High level calculation of Tax Margin
- COGs Deduction
- 2024 Changes
- 2024 Court Cases

# Texas Franchise Tax

**If it looks like a duck, walks like a duck, quacks like a duck... it is an income tax?**



# Texas Franchise Tax

- Texas Franchise Tax is calculated by reducing gross receipts by allowed exclusions and deductions (i.e. Margin Tax)
- The calculated margin is apportioned based on a ratio of Texas gross receipt divided by total gross receipts then multiplying the applicable tax rate.
- PL 86-272 limits a state from imposing a net *income* tax on income derived within a state from interstate commerce if the only business activity adheres to strict limitations
- Under Texas Administrative Code Rule 3.586(i) - Public Law 86-272 does not apply to the Texas *franchise* tax.
- However, for ASC 740 purposes, Texas Franchise is considered an income tax.

Texas Constitution Article  
8 Sec. 24-a. INDIVIDUAL  
INCOME TAX PROHIBITED.  
The legislature may not  
impose a tax on the net  
incomes of individuals,  
including an individual's  
share of partnership and  
unincorporated  
association income



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# Calculation

- Calculating Franchise Tax
  - Total Revenue (based on applicable federal tax form)
    - ✓ Based on Internal Revenue Code in effect for the federal tax year beginning on January 1, 2007, not including any changes made by federal law after that date, and any regulations adopted under that code applicable to that period (Tx. Tax Code 171.0001)
  - Less Exclusions
    - ✓ Bad Debt, Foreign Dividends, Net Distributive Income, Revenue from DREs (not treated as DREs for franchise tax), Flow Through Funds...
  - Less the greatest of:
    - ✓ 30% of revenue
    - ✓ COGS (as determined under Texas rules)
    - ✓ Includes a 4% indirect expense allocation or administration cost
    - ✓ Compensation
    - ✓ \$1,000,000
- Alternative – EZ Method for entities with \$20 million or less in annualized revenue

# COGs Deduction

- Cost of goods sold includes all direct costs of acquiring or producing the goods (Not the same as federal cogs)
- Only available if taxpayer sells real or tangible personal property in the ordinary course of business
- Expenses qualifying for COGs can be found under Tex. Tax Code 171.1012
- **Note :** Tex. Tax Code 171.1012(i) states that the COGs deduction is available to an entity furnishing labor or materials to a project for the construction, improvement, remodeling, repair, or industrial maintenance (as the term "maintenance" is defined in 34 T.A.C. Section 3.357) of real property is considered to be an owner of that labor or materials and may include the costs, as allowed by this section, in the computation of cost of goods sold

# 2024 Changes Still Relevant for 2025

- No tax due filing threshold increased to \$2,470,000 (annualized)
  - A combined groups total revenue is used to determine a no tax due filing
- No tax due report eliminated (Form 05-163)
  - Public Information Report(05-102) and Ownership Information Report (05-167) Still Required
- Texas entities with zero gross receipts need to still file EZ computation form or Long Form and report \$0 on Texas gross receipts line. Still need to file PIR or OIR



# Court Cases - Nustar

- NUSTAR ENERGY, L.P., Appellant v. Glenn HEGAR, Comptroller of Public Accounts of the State of Texas; and Ken Paxton, Attorney General of the State of Texas, Appellees
  - **Notes from Case:** NuStar has several business lines including the sale of bunker fuel. Fuel was sold to foreign vessels who did not consume the tangible property in Texas. Federal laws prohibits the use of bunker fuel within 200 nautical miles of the Texas coast. Texas waters only extend nine nautical miles from the coast; therefore, any use of the fuel is not in Texas.

# Court Cases - Nustar

- Texas Tax Code 171.103(a)(1) - Subject to Section 171.1055, in apportioning margin, the gross receipts of a taxable entity from its business done in this state is 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
- NuStar's position
  - ✓ Buyer is foreign and not a Texas entity
  - ✓ Tangible property not used in Texas ("place of market")
- Comptroller's position
  - ✓ Gross receipts should be apportioned to Texas if the tangible personal property was used in Texas, no matter where the property was ultimately used. ("place of delivery")
- Texas Court of Appeals agreed with Comptroller and the case is currently with the Texas Supreme Court
- Items to note
  - ✓ It is prudent to review sales contracts for state tax applicability

## Court Cases - Hibernia

- Hibernia Energy, LLC and Ryan LLC, As Assignee v. Glenn Hegar, Comptroller of Public Accounts of the State of Texas and Ken Paxton, Attorney General of the State of Texas.
  - **Notes from Case:** Hibernia is a limited liability company (classified as a partnership for federal tax purposes) that acquired leasehold interests in several oil-and-gas properties. In 2012 and 2014, Hibernia sold its leasehold interests and reported to the Comptroller on its corresponding franchise-tax reports. Gains were reported on line 11 of form 1065. Hibernia filed a request for a total tax refund for the two tax years at issue.

# Court Cases - Hibernia

- Franchise tax total revenue is calculated using lines 1, 3a, 5, 6, 7, 8, 9a, 10, and 11 of Federal form 1065
- Hibernia's position
  - ✓ The company is not a taxpayer for federal tax purposes. The gains and losses for the sale of oil and gas leaseholds could not be determined at the partnership level because the adjustments are tracked at the partner level (e.g. intangible drilling costs elections).
- Comptroller's position
  - ✓ Comptroller's position - Line 11 on the federal partnership tax return is included as gross receipts for Texas franchise tax purposes.
- Texas Court of Appeals sided with Comptroller. Texas Supreme Court declined to review.

# Private Letter Rulings – PLRPLR20230712120955 (July 24, 2024)

- PLR Facts:

- Taxpayer provides direct on-site consulting and supervision services for completions, workovers, and contract lease operators on oil and gas drilling and workover rigs.
- Supervisions is either provided by the owners or subcontracted consultants. Subcontracted services are listed in the taxpayer's contracts with customers.
- When work is completed by subcontractor, taxpayer is limited to receiving expense sheets and issuing required payments.

- Analysis

- Under Section 171.1011(g)(3), revenue can be excluded from franchise tax that are subcontractor payments made under contract to provide services, labor, or material in connection with design, construction, remodeling, remediation, or repair of improvements on real property.

# Private Letter Rulings – PLRPLR20230712120955 (July 24, 2024)

- Ruling

- Taxpayer may exclude from total revenue subcontracting payments for services related to completions and workovers of oil and gas drilling and workover rigs

- Additional notes

- The PLR cited Gulf Copper V. Comptroller
- This case affirmed work on rigs and drill sites can be considered work on real property and therefore a COGs deduction is allowed under Texas tax code section 171.1012



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## Q&A



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# Citings

- NUSTAR ENERGY, L.P., Appellant v. Glenn HEGAR, Comptroller of Public Accounts of the State of Texas; and Ken Paxton, Attorney General of the State of Texas, Appellees
- Hibernia Energy, LLC and Ryan LLC, As Assignee v. Glenn Hegar, Comptroller of Public Accounts of the State of Texas and Ken Paxton, Attorney General of the State of Texas.
- Private Letter Ruling No. PLR20230712120955 (July 24, 2024)