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The Real Estate Industry and the effect of the new Texas Margin Tax

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As many taxpayers are aware, we have a new Margin Tax in Texas, which replaces the Franchise tax. The tax was passed into law in June 2006 and was followed by a technical corrections act in June 2007. The purpose of this article is to provide a brief explanation of the new tax, and to discuss the effect it will have on various aspects of the real estate industry.

The Texas Margin Tax – Calculation

The calculation appears to be simple; however it can be very complex. Basically, it is a 1% tax on the lesser of: 70% of a taxable entity's total revenue or total revenue less either cost of goods sold for manufacturers and wholesalers/retailers or total revenue less employee compensation and benefits for all other industries. The resulting margin tax base is apportioned based upon Texas sourcing rules. The rate is ½% for entities primarily engaged in retail or wholesale business.

The intent of the law is to tax all entity types that offer liability protection to their owners. Sole proprietorships, general partnerships with only individuals as partners, passive income entities, certain grantor trusts and estates, real estate investment trusts with restricted holdings, qualified charities, and real estate mortgage investment conduits are not taxable entities; almost all other business entities are taxable.

For entities with less than \$10 million in total gross receipts, there is some relief available via an alternative EZ tax, which is a tax on .575% on total receipts. Additionally, small businesses with less than \$300,000 in gross receipts are exempt from the tax, with a phase-in of the tax rate up to \$900,000 in gross receipts. Note that entities in the same line of business with 50% or more common owners are grouped together on a unitary basis for the new Margin

Tax and must all use the same method for calculating the tax. Thus the gross receipts test will be applied to the combined group, rather than individual entities.

Real Estate Impact

The law affects each facet of the real estate industry in a variety of ways. For operators of commercial properties, the law, as originally enacted, offered those who operated their properties through limited partnerships the ability to pay the tax based on net rental income. This was corrected in the 2007 legislative session. Owners of rental property cannot deduct depreciation and interest, typically the two largest deductions on any property, nor any other expense other than employee compensation. The result is that most commercial landlords will pay the tax on 70% of gross rents.

There is also an interesting twist on the treatment of capital gains from the sale of real property. If a partnership meets the definition of a passive income entity, the capital gain is considered passive and not subject to tax. Note that rental income is not deemed passive income and therefore cannot exceed 10% of total income on an annual basis to retain the passive income entity status and avoid the tax. For a partnership which simply owns land, the criteria are fairly easy to meet.

A commercial operator with rental income may not be able to meet these criteria. To illustrate, the capital gain on a building generating \$1,200,000 in annual gross rents and which has a fair market value of \$10,000,000 will be subject to the tax. However, if the building is sold in mid-January, when the rental income is only \$50,000, the rental income will be less than 10% of the total gross receipts and the gain on the sale may be excluded from the tax. In the future, this may cause a flurry of early-year sales of real property.

Alternatively, the owner may sell the interest in the entity, rather than the property. This can have favorable tax results based upon Texas sourcing/apportionment rules.

REITs are exempt from the margin tax to the extent the REIT owns the property directly. Any underlying partnerships owned by the REITs which actually own the properties will be subject to the tax.

Real Estate Brokers will be able to exclude from revenue the commissions paid to non-employees (and virtually all real estate agents are non-employees under Federal statute) in calculating gross receipts to the extent those commissions were included as revenue. They will then be able to deduct compensation paid to employees, up to \$300,000 per employee, or 30% of gross receipts.

Texas Margin Tax – What's Next?

This new law is precisely that--New Law. And with any new legislation, there are many unanswered questions and undefined areas which the Comptroller's office and the courts will have to decide and define in future years. This will be an exciting time to be in the tax consulting business, but it may be an expensive time for taxpayers.

The above is merely a general summary of the margin tax and its effect on the real estate industry and is not meant to be all-inclusive for either the real estate industry or tax issues in general. Taxpayers are encouraged to consult their tax advisors to determine the effect on their business.

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