TEXAS MARGIN TAX CHANGES EXPECTED IN THE 2017 TEXAS LEGISLATIVE SESSION AND PLANNING CONSIDERATIONS UNDER EXISTING TEXAS TAX LAWS

STEVEN D. MOORE, *Austin*
Jackson Walker, LLP

State Bar of Texas
15TH ANNUAL
CHOICE, GOVERNANCE & ACQUISITION OF ENTITIES
May 19, 2017
San Antonio

CHAPTER 3

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Practice Areas

- Tax
- Family Office
- Public-Private Partnerships
- Aircraft Ownership and Operation
- Energy Tax
- Tax Controversy and Litigation
- International
- Tax-Exempt Organizations
- Tax: International
- State and Local

Education

B.B.A., *with high honors*, The University of Texas at Austin

J.D., *with honors*, The University of Texas School of Law

- Order of the Coif, Top 10%

Bar Admissions

Texas, 1989

Recognition

- *The Best Lawyers in America,* 2015, 2016

Biography

Recognized for his depth of expertise in state tax matters, Steve is one of the state's leading attorneys for guidance on the Texas margin tax and he frequently speaks on this topic, with ongoing commitments for presentations to Texas State Bar and University of Texas CLE programs.

Steve Moore's state tax practice includes planning and controversy work on (i) sales tax, (ii) Texas franchise (aka "margin") tax, (iii) ad valorem tax including Chapter 312 property tax abatements; (iv) Chapter 313 property tax value limitation agreements, and (v) insurance premium and retaliatory tax. Steve is dedicated, from a value-driven perspective, to helping his clients fully comply with and control state tax exposure.

Steve advises multi-state businesses, and regularly provides tax strategy advice relating to business mergers, acquisitions, and divestitures. An effective negotiator, Steve works to reach successful and economically viable resolutions to Texas sales, franchise, property, motor vehicle, and insurance premium tax audits. To this end, he handles administrative hearings before the Texas Comptroller of Public Accounts and works with the firm's litigation group to prosecute judicial resolution of Texas tax cases.

Spotlight

Steve's article "Nexus and State Tax Due Diligence" was published in the Summer 2012 edition of *Texas Journal of Business Law*. He has made numerous speaking presentations to major CLE programs across Texas dealing with various state tax and corporate topics, including "The New Texas Margin Tax."

Career Highlights

- 2015 negotiations of valuable tax abatement agreements in major metropolitan cities and counties for Fortune 100 and other clients' expansions representing $100s of millions in new Texas investments.
- Travis County District Court victory establishing renewable energy construction company's right to Texas franchise tax exemption under Section 171.056 of the Texas Tax Code.
- SALT work in large business acquisitions and sales to navigate (i) Texas franchise tax results, (ii) preservation of state and local incentives, (iii) nexus concerns, (iv) transfer taxes, (v) occasional sale exemptions, and (vi) successor liability.
- Energy project acquisition and development advice to maximize benefits from state and local tax incentives including Chapter 312 and Chapter 313 abatement work.
- Ongoing representation of major investors, lenders, and developers of billions of dollars on Texas renewable energy projects as lead and local counsel and provide due diligence on state tax incentives and other aspects of such projects.
- 2015 successful audit defense of retaliatory tax assessment against non-Texas life insurer resulting in allowance of foreign state's investment credits.
- Numerous aircraft acquisitions, sales, and ongoing operations modeled to achieve best-available state sales, use, and property tax treatment.
- Planning and compliance with respect to Texas sales tax on services, including bundled "data processing" transactions.
- Non-lobby monitoring and advising on pending and proposed Texas tax legislation and policy.

Community

- KMFA FM 89.5
  - Board of Trustees
  - Chairman of the Board, 2005-2013
- STEM-focused Austin Technology Council Community Foundation, Board Member, 2011-2016

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POWERPOINT PRESENTATION

Texas Margin Tax Changes Expected in the 2017 Texas Legislative Session and Planning Considerations Under Existing Texas Tax Laws

TexasBar CLE

Choice, Governance & Acquisition of Entities

May 19, 2017

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Overview & Objectives

1. Texas Franchise Tax Legislative and Judicial Update
2. SALT 101
3. Common M&A considerations – successor liability, gains/losses, other traps, etc.
4. Case Studies

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Texas Franchise Tax Legislation

SB 17 (2017 Reg. Session)

If a biennium revenue certification by the Texas Comptroller exceeds the certification for prior biennium by > 5%, then ½ of such excess must be used to reduce the franchise tax rate proportionately, but not below 0%.

[See also HB 28]

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HB 3345 (2017 Reg. Session)

Texas Comptroller Technical Corrections Bill that clarifies or removes "interest income by a person in the business of making loans to the general public" from the definition of passive source of income.

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HB 4002 (2017 Reg. Session)

Texas Comptroller Technical Corrections Bill that clarifies or removes "installation" from the cost of production included in the "cost of goods sold" deduction.

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Texas Franchise Tax Judicial Update

MTC 3-Factor Apportionment Still Pending

Graphic Packaging Corp. v. Hegar, 2015 BL 239686, No. 03-14-00197-CV (Tex. Ct. App. July 28, 2015) (*pet pending as of April 25, 2017*) (affirming a district court's ruling that a taxpayer may not use the three-factor formula in chapter 141 of the Texas Tax Code and the Multistate Tax Compact for franchise tax purposes, but, instead, must use the single-factor formula in Texas Tax Code §171.106).

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IRS Asset Allocation Used For Texas Apportionment

When a taxpayer sells a business it is deemed to have elected to use the same methods that the taxable entity used in filing its federal income tax return, so the same allocation of the sales price to specific assets that the seller used for federal tax purposes should be used for apportioning the gross receipts for franchise tax. Tex. Comptroller Letter 201607948L (July 22, 2016) (citing Tex. Admin. Code tit. 34, § 3.591(d)(4)).

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Texas "Unitary" Test Requires Strong Centralized Management

In Texas Comptroller Hearing 111,577; Accession No. 201501708H (Oct. 22, 2015), the Administrative Law Judge found that the Texas Tax Code requires "strong" centralized management and that two commonly owned entities in two separate lines of business (oriental rug cleaning vs. small business marketing) that shared administrative functions did not amount to strong centralized management given that both entities operated independently with respect to the critical function of delivering their services.

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Certain Seismic Reports Can Be COGS for Oil and Gas Producer

Hegar v. CGG Veritas Servs. (U.S.), Cause No. 03-14-00713-CV (Tex. Ct. App. Mar. 9, 2016)(*pet. withdrawn*) (affirming a trial court's ruling that a taxpayer's activities constituted "labor furnished to a project for the construction of real property" and therefore qualifying it as "labor and materials" in Tex. Tax Code Ann. § 171.1012(i) for COGS computation where company provided essential and direct services for oil and gas exploration project).

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Labor to Install Parts On Customer-Owned Vehicles ≠ COGS

In *Autohaus LP v. Hegar*, No. D-1-GN-13-000989 (Tex. Ct. App. 2017) the Austin Court of Appeals confirms that the cost of goods sold deduction in Section 171.1012 of the Texas Tax Code is only available with respect to goods that the taxpayer "owns," and that labor charges to install a product into a customer-owned good are "services" and are not included in the cost of goods sold deduction."

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SALT 101

"Transacting Business" for Registration

Selected Safe Harbors:

- Defending or prosecuting a suit
- Board meeting
- Maintaining a bank account
- Holding a security interest in real estate
- Transacting business in interstate commerce
- Owning, without more, real or personal property in this state

TBOC 9.251

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Which Entities Must Register

- Corporation
- Limited partnership
- Limited liability company
- Business trust
- REIT
- Coop…

≠ General partnership

TBOC 9.001(a)(1)

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Nexus =

"Sufficient contact with or activity within [a] state, as determined by state and federal law."

[to subject a person or entity to state taxation and compliance]

34 TAC § 3.286(a)(5)

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"Doing Business" for State Tax Nexus Purposes

- Performing a contract in Texas (even if you use independent contractors)
- Deliver items using seller's vehicle to Texas buyer
- Having employees or representatives in Texas
- Having a franchisee in Texas
- Acting as GP not LP
- Any real estate in Texas
- Providing any service in Texas

34 TAC § 3.586(c)

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Public Law 86-272

- Federal law exception to physical presence nexus
  - Only applies to state income tax ≠ sales tax
  - Only applies to sales of tangible personal property ≠ services
- If only activity is in-state solicitation of sales of TPP, then income tax not allowed

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COMMOM M&A SALT CONSIDERATIONS

Premise – Representation 1

"Seller is qualified to do business in each state in which either the ownership or use of the properties owned or used by it or the nature of the activities conducted by it require such qualification."

Common Sources: Loan Covenant
Asset Purchase Agreement
Opinion Letter

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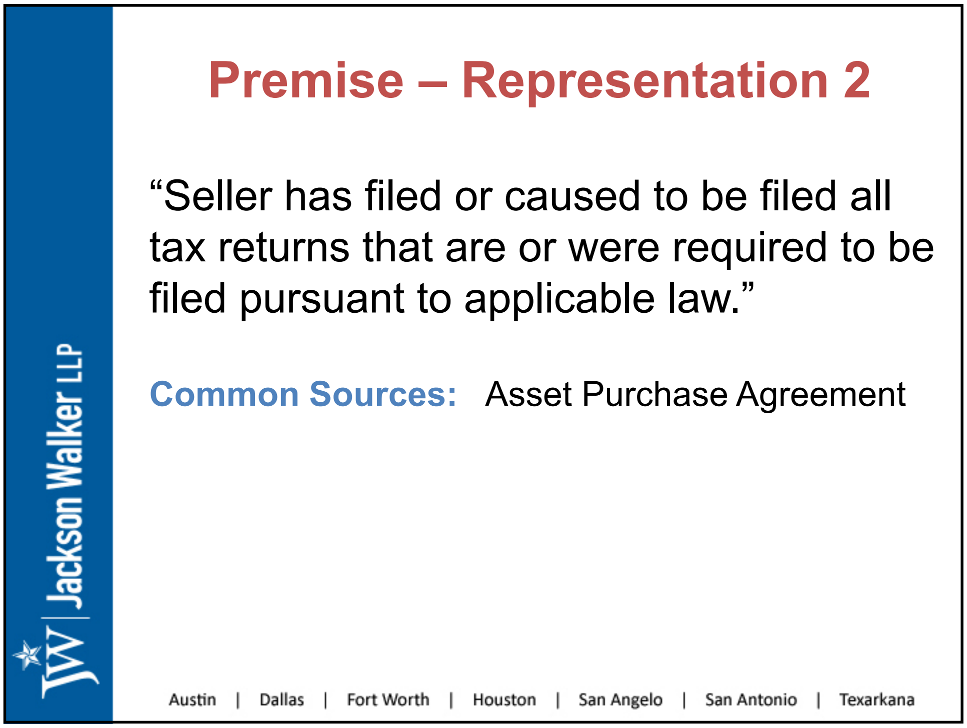
Premise – Representation 2
“Seller has filed or caused to be filed all tax returns that are or were required to be filed pursuant to applicable law.”
Common Sources: Asset Purchase Agreement
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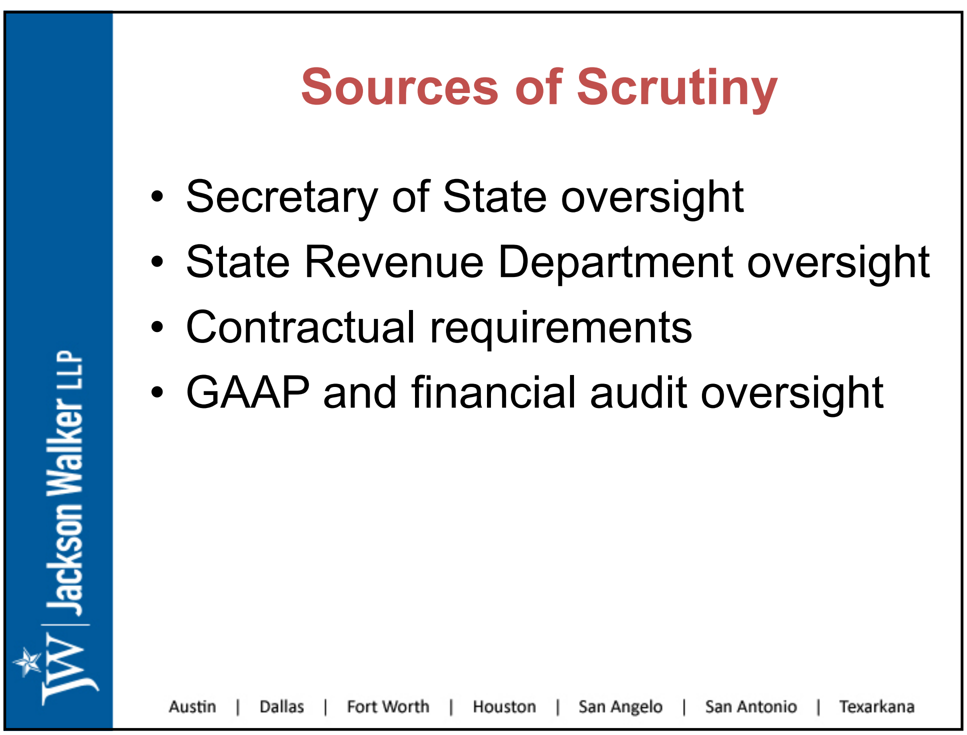
Sources of Scrutiny
• Secretary of State oversight
• State Revenue Department oversight
• Contractual requirements
• GAAP and financial audit oversight
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Successor Liability

- Texas Tax Code §111.020
- Tax collection on sale or termination of a "business"
- Tax clearance certificate
- Buyer liable up to the amount of the purchase price of the business (i.e., could double the amount paid for a business)

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"Business" Defined for Successor Liability Purposes

Comptroller Rule 3.7(d)

- Depending on the type of business involved, a "business" may be sold if an owner sells:
- (1) a building, land, furniture, fixtures, inventory, and the right to use the seller's trade name; ***or***
- (2) all the capital assets of a business; ***or***
- (3) the name and goodwill of a business; ***or***
- (4) all the inventory of a business; ***or***
- (5) fixed assets and realty necessary to operate a similar business as the seller at the same location.

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Occasional Sales

- The primary occasional exemption potentially applicable in M&A transactions is strictly construed by the Texas Comptroller and requires the transfer of:
- the ***entire operating assets*** of a business or
- an ***identifiable segment of a business*** in ***one transaction to one purchaser***.

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Operating Assets Defined for Texas Occasional Sale Exemption

"Operating assets" include all:

- tangible personal property and motor vehicles
- ***used in providing a product or service*** in each identifiable segment of a business that is being sold.
- There is ***no practical de minimis exception***. Obsolete equipment has to be transferred.

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Motor Vehicles

- Licensed motor vehicles can be "operating assets" that if not transferred destroy the occasional sale exemption.
- But, even if they are transferred in an exempt occasional sale they will almost always be subject to the Texas motor vehicle tax.

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Manufacturing Exemption From Texas Sales Tax

- "manufacturing equipment" under Section 151.318 of the Texas Tax Code , is basically defined to include equipment used ***directly in a manufacturing process and causes a direct chemical or physical change to a product being produced***.
- It does not cover any ***intraplant transportation*** equipment., (e.g., forklifts, and conveyors).

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Franchise Tax Apportionment

- Need to understand "location of payor" rule
- If there is gain on the sale of a business, the seller care where the gain is "apportioned" for purposes of the Texas franchise tax.
- In an asset sale gain on the sale of minerals, real estate, or tangible personal property is apportioned based on the physical location of the property

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Location of Payor

- Gain on the sale of intangible (i.e., LLC membership interests, stock, or goodwill is apportioned based on the Texas Comptroller's "location of payor" rules.
- The location of payor of an LLC or Corp. is the "legal domicile" of the payor = charter state.
- The location of payor of an partnership is the principal place of business of the partnership.

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Sample Due Diligence

The below detailed document request is subject to amendment following a more detailed analysis and preliminary management discussions.

		Responsibility	Date Received
1.	A list of state-conforming S elections for Target and its affiliates		
2.	A list of state-conforming Q-sub elections for Target and its affiliates		
3.	A list of any state-conforming Q-sub conversions to disregarded entity (LLC) for state law purposes for Target and its affiliates		
4.	An organization chart showing all Target entities and identifying ultimate individual owners		
5.	An chart breaking down assets/entities to be included in new venture and any assets/entities to be excluded		
6.	An chart scheduling the states in which Target or its affiliates holds titled motor vehicles and the approximate number/value in each state		
7.	An chart scheduling the states in which Target owns real estate and the approximate value in each such state		
8.	A list of the jurisdictions (state, local, etc.) where Target has submitted tax filings (income, sales & use, gross receipts, franchise, property etc.) during the prior reporting period and a separate list of all jurisdictions where Target has not submitted any type of tax filing but for which a claim has been made that tax filings should have been submitted. This information should include any "nexus" questionnaires or similar requests whereby a state is attempting to determine if the target entities are subject to tax in the state for the current period or for any prior period.		

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Sample Due Diligence

		Responsibility	Date Received
9.	If different from #8 above, a list of jurisdictions (federal, state, local, foreign etc.) in which Target: 1) is registered or licensed to operate, 2) has employees that have entered the state for any reason during the previous four tax years, 3) has any independent contractors providing services on behalf of Target in the past four years; or 4) has or has had any real or personal property including inventory (owned or leased) during the previous four tax years		
10.	Please provide contact information for the primary law firms, accounting firms or other outside relationships that have material provided tax advice (oral or written) to Target (including addresses, telephone numbers and contact persons), in each case identifying the matter(s) with respect to which advice was given.		
11.	All tax legal opinions and technical memoranda, whether privileged or not, issued by any third-parties to Target (including related partnerships, if any) related to any state or local tax in the last five years.		
12.	A copy of all of the last-filed state and local tax returns for Target for: i. Income/Franchise ii. Sales & Use		
13.	Any information regarding state tax planning that is currently being utilized. This information would include any intercompany agreements (i.e. management service agreements, intercompany debt agreements, transfer pricing agreements) related to this planning.		

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Sample Due Diligence

		Responsibility	Date Received
14.	Sales/revenues, by state, for each of the last year.		
15.	Brief description of Target procedures to 1) collect and remit sales tax and 2) self-assess use tax		
16.	Documents related to any type of current or historical state or local tax audits, appeals or court proceedings (whether resolved or unresolved) including: statute of limitation waivers i. All Exam documents and correspondence between target or its affiliates including partnerships ii. notices of proposed adjustments iii. state appeals documents and correspondence iv. state protest letters v. state closing agreements or similar documents vi. court briefs, depositions, pleadings, interrogatories dealing with any state or local tax liability		
17.	List of any state tax amnesty and voluntary disclosure listing detailing the jurisdiction, the issues, the tax year(s), the status and the amount of tax, interest and penalty at issue		

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Real Estate Transfer Tax / Conduit Entities

Some states impose real estate transfer tax on the transfer of an LLC interest.

For example (not an exhaustive list):

South Carolina has a conduit ruling for transfers of interests in single member LLCs that are disregarded for federal income tax purposes. See SC revenue ruling 15-3. The current South Carolina real estate transfer tax rate is $1.85 for every $500 of the transferred property's value (e.g., a $10 million property would incur a tax of $37,000).

Florida imposes a .7% tax on the consideration paid for the transfer of an interest in real estate (i.e. a deed). Florida also imposes a .35% tax on the amount of indebtedness secured by a mortgage. Therefore, the total tax rate is potentially 1.05%.

Florida extends its real estate transfer tax to sales of "conduit entities" defined as follows:

"Conduit entity" means a legal entity to which real property is conveyed without full consideration by a grantor who owns a direct or indirect interest in the entity, or a successor entity. Fla. Stat. § 201.02.

The conduit entity tax applies when real property is conveyed to a conduit entity and all or a portion of the grantor's direct or indirect ownership interest in the conduit entity is subsequently transferred for consideration within 3 years of such conveyance.

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CASE STUDIES

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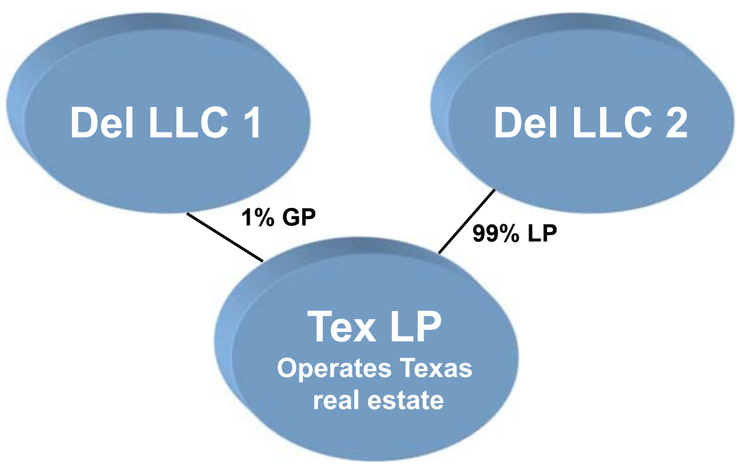
Nexus Case Study 1



See Tex. AG Op. JM7
Cf Comptroller Rule 3.286(c)(12)

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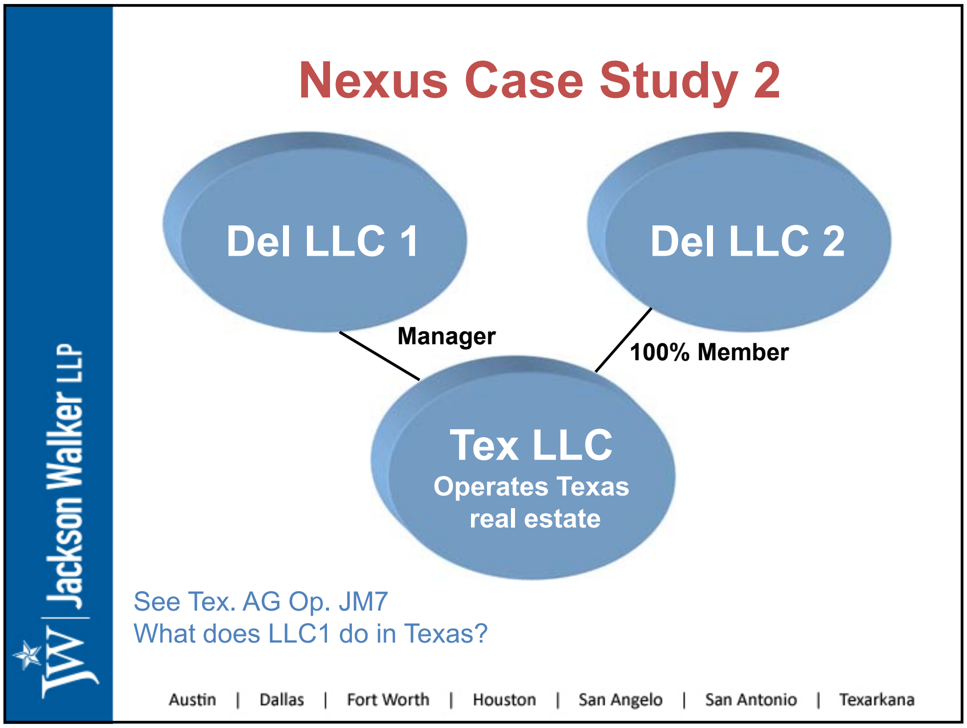
Nexus Case Study 2
Del LLC 1
Del LLC 2
Manager
100% Member
Tex LLC
Operates Texas real estate
See Tex. AG Op. JM7
What does LLC1 do in Texas?
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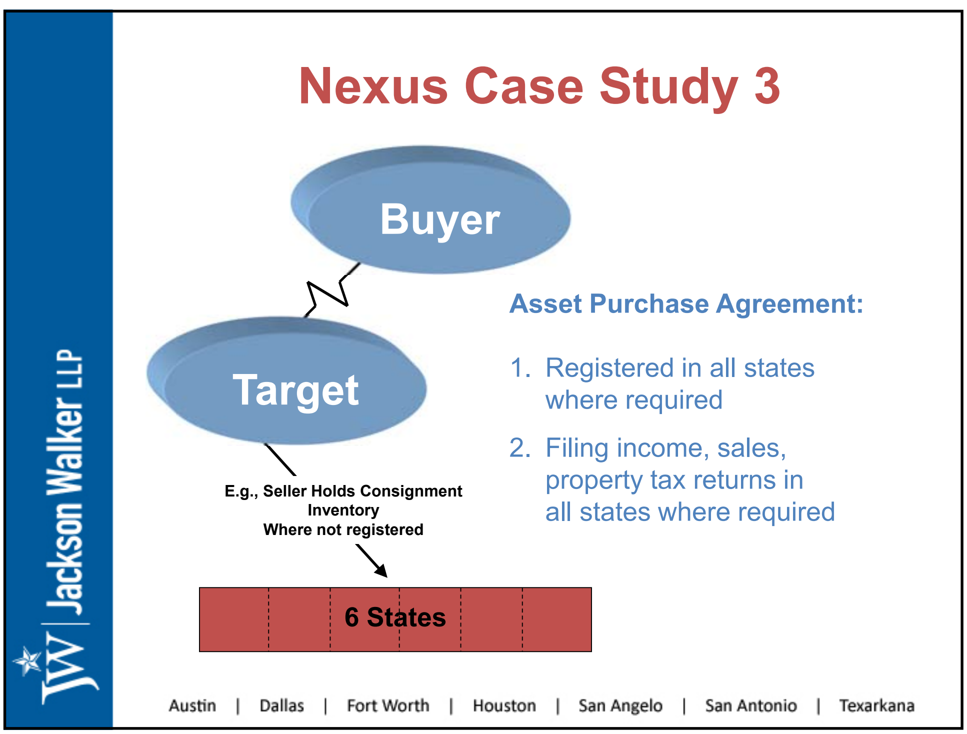
Nexus Case Study 3
Buyer
Target
Asset Purchase Agreement:
1. Registered in all states where required
2. Filing income, sales, property tax returns in all states where required
E.g., Seller Holds Consignment Inventory
Where not registered
6 States
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Nexus Case Study 4

"Bright Line" Economic Nexus: The Next Wave

- States are asserting income tax nexus in spite of 86-272 when businesses have economic presence from:
  1) intellectual property
  2) material sales (e.g., California if >$547K in annual sales or 25% of sales or service benefit received in California)

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