Changing the Way Your Dirt Is Taxed

Texas Margin Tax Pitfalls for Real Estate Practitioners

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In 2006, the Texas Legislature passed the first version of its successor to the Texas franchise tax, commonly (and herein) referred to as the margin tax. Becoming effective on January 1, 2008, the margin tax will come as a surprise to many entities which previously avoided taxation under the franchise tax regime. Although touted as simpler version of its predecessor, the margin tax contains several traps for real estate clients that may not be apparent from a casual reading of the statute.

So What's This Margin Tax All About?

The tax is, in general terms, very simple: it is a gross receipts tax. With only limited exceptions, it means that any money an entity takes in is subject to the tax. The entity then deducts its choice of one of three amounts from the tax (cost of goods sold, wages, or 30% of gross receipts) and pays a tax of 1% on the remainder. A minimum of $300,000.00 in income is required for a tax to be assessed. The tax is one of general applicability to all entities with revenue, unless otherwise exempt. Selected exempt and non-exempt entities are displayed in Table A.

Income subject to tax is determined by income reported on the entity's federal income tax return. For example, corporations pay tax on (i) gross receipts less returns and allowances, (ii) dividends, (iii) interest, (iv) gross rents, (v) gross royalties, (vi) capital gain net income, and (vii) other income.

TABLE A - Selected Exempt and Non-Exempt Entities	
Exempt Entities	**Non-Exempt Entities**
Natural Persons	Corporations
Passive Entities	Limited Liability Companies
Grantor Trusts	Limited Partnerships
Certain General Partnerships	Limited Liability Partnerships
Estate of Natural Persons	Business Trusts
Real Estate Investment Trusts	
Real Estate Mortgage Investment Conduits	
Title Insurance Companies	

How does the margin tax affect a triple net lease?

Triple net leases – leases that require tenants to pay their pro-rata share of common area maintenance costs, taxes and insurance on the underlying property in addition to a base amount of rent – are common among commercial landlords and tenants, especially on retail properties. In these leases, it is common to find "taxes" defined simply as ad valorem property taxes owed on the leased property. The retail lease in the State Bar of Texas' Real Estate Forms Manual takes such an approach. Many property managers will be surprised to find that the triple net expenses that they collect and generally view as pass-through costs are themselves taxable under the margin tax. Perhaps more concerning will be that these leases may be without any provision that requires tenants to pay that tax. If tax liability may change year-to-year based on the change in common area maintenance or insurance costs, a net lease without a margin tax provision look less like a dependable stream of income and more like a gross lease.

Some landlords have become wise to this fact and are pushing provisions requiring tenants to pay any tax resulting from the collection of triple net expenses. Many tenants, however, contend that triple net leases traditionally do not require tenants to pay the income taxes of landlords; assert that this margin tax is inherently an income tax under a different name (whether the margin tax is an income tax is a subject that could be the topic of an article unto itself); and fight the payment of margin taxes of the landlord. Simply requiring the tenant to pay the triple net expenses directly rather than to the landlord (as a middleman) may be a solution for pad sites or similar properties, but does not seem practical for shopping centers and malls with numerous tenants, vendors, and service providers. Many attorneys with experience in lease defaults cringe at the prospect of placing responsibility on each of twenty or more tenants to ensure that ad valorem taxes are paid.

If triple net leases are affected, are management companies affected as well?

After seeing how triple net leases are affected by the margin tax, property managers may become concerned that common area maintenance expenses expended by the property manager and reimbursed ultimately by tenants will be subject to the margin tax. To the extent these reimbursements would be included on a property manager's federal income tax, they are taxed unless a statutory exclusion exists. Fortunately for property managers, that exclusion exists. The margin tax excludes reimbursements received by "management companies" in the management of another entity. "Management companies" are those that receive a management fee and reimbursement of expenses for conducting the active trade or business of another entity. Specifically included in reimbursements are wages and compensation.

Some flow-through funds, funds that are collected and then distributed on behalf of another, are excluded from income under the margin tax. Funds that are collected and then distributed under a fiduciary duty to other entities are excluded from income – these include "taxes collected from a third party by the taxable entity and remitted by the taxable entity to a taxing authority." Presumably, this provision specifically excludes from taxable income a management company's collection of property taxes from tenants on behalf of the property owner (assuming that there is a fiduciary relationship, a common characteristic of property management relationships). It even appears to exclude from taxable income collection of rent on behalf of the property owner. Sales commissions to non-employees (such as split-fee real estate commissions) and subcontractor payments for design and construction on real property are also excludable when they are collected and subsequently paid out as flow-through funds.

Where do limited partnerships stand now?

Under the old franchise tax, most practitioners simply placed assets in limited partnerships ("LPs") rather than limited liability companies ("LLCs") to take advantage of the LP's franchise tax exclusion. As previously noted, the LP is no longer able to avoid taxation with such ease. A number of attorneys have speculated that there is now no reason to choose an LP over an LLC. Is the LP now a dead form to the real estate practitioner? The answer mirrors the lawyer's traditional standby answer to all other questions of law: it depends. There are two main reasons to continue using LPs: the passive entity exception and management considerations.

1. Passive Entities Pay No Margin Tax

Certain entities completely avoid paying margin tax, regardless of how much income they generate. Among the most important of these entities for the property owner is the "passive entity". Passive entities are classified as partnerships that generate at least 90% of their income from passive sources. Passive sources are dividends; interest; distribution of partnership income; capital gains from the sale of real property; royalties, bonuses, or delay rental income from mineral properties; and income from other nonoperating mineral interests. Unfortunately, rental income is <u>not</u> a passive source of income. Note that the passive entity exception is only available for partnerships and non-business trusts.

For many property owners, the knee-jerk reaction is to say that the LLC is still favorable because rental income is such a high percentage of the company's overall income. Consider, however, the situation in which the property owner owns only one or a few properties: the property owner sells its property early in the year, before much rental income has accrued, and the property sale generates a large sum of gross income. There, the seller may qualify as a passive entity in the year of sale and save a sizeable tax bill.

With some entities qualifying for the passive entity exception in the year of sale of a piece of property, real estate practitioners should counsel clients to ensure that the sale closes before too much rental income accrues and the client must pay margin tax on that rental income and the proceeds from the sale of the property. Of course, this consideration is dependent on the size of the margin tax payable compared to the lost rental income.

2. Management Considerations Still Are Relevant

Taxation is not the only reason that the limited partnership is popular. The LP is often used to keep busy-body investors out of the management of the business. In such a structure, the parties designated to manage the partnership are general partners (often using an LLC for liability protection), while the investors are limited partners.

Few real estate attorneys have led long careers without meeting an investor who tries to exert more control than he is allowed. Perhaps we've represented him, loaned to him or worked against him, but he is always the first one to tell management what they are doing wrong, and perhaps he even tries to make decisions for the partnership. In Texas, limited partners who "participate in the control" of the partnership face the liabilities of a general partner, including personal responsibility for the liabilities of the LP. Although the Texas Business Organizations Code is silent as to what constitutes participation in the control of the LP, participation does not include advising the general partner on business matters, voting on certain partnership matters, or acting as an officer or manager of the general partner. Conversely, in an LLC, it is more difficult to place personal liability on an investor who engages in management of the LLC without authorization.

Although drafting the rights, responsibilities and remedies into an entity agreement and then seeking their enforcement in the court system keeps the involved limited partner in check, that course of action is neither cheap nor efficient. Many attorneys find that the best way to keep an investor from exercising managerial control is to choose a limited partnership in which the investor's managerial actions may simply make that investor personally liable for the debts of the partnership. For many investors, the risk that they may become personally liable is reason enough to stay out of the management of the entity.

Cost of Goods Sold: A Friend to Developers

Entities choose to deduct from taxable revenue compensation paid, 30% of its revenue, or costs of goods sold. Costs of goods sold are the cost of acquiring and producing "goods", a term that includes real property sold in the ordinary course of business. For many developers, electing the cost of goods sold deduction is the most advantageous choice. Although "ordinary course of business" is not defined in this chapter of the margin tax code, many developers have taken the position that buying land, constructing improvements and then selling the property on an ongoing basis qualifies as their ordinary course of business. Given the extensive reliance that the margin tax code has on the Internal Revenue Code and IRS forms for determining and defining many key terms, the Internal Revenue Code and related case law seem like natural sources for the definition of "ordinary course of business". Although that phrase has been the subject of substantial litigation, it has come to mean that selling the property (and not holding it as investment property) was the primary purpose of the property's acquisition.[2] Developers often receive ordinary income treatment on the sales of their property for federal income tax purposes because the IRS believes that it is in the ordinary course of their businesses; therefore, they take the position that the same definition should apply in the margin tax context.

The cost of goods sold includes a laundry list of items. Those of particular relevance for real estate developers include: (i) labor costs; (ii) cost of materials that are an integral part of the produced; (iii) cost of materials that are consumed in production; (iv) depreciation associated with production; (iv) costs of leasing equipment; (v) costs of repairing or maintaining equipment; (vi) costs of engineering related to production; (vi) geological and geophysical costs incurred to identify and locate property that has the potential to produce minerals; (vii) taxes paid in acquiring property or in production; (viii) deterioration of goods; (ix) the cost of insurance on machinery, equipment, or materials; (x) the cost of insurance on the goods; (xi) the cost of utilities, including electricity, gas, and water; and (xii) the costs of quality control, including replacement of defective components, and inspection, repairs and maintenance of goods.

Several costs are not considered costs of goods sold: renting or leasing equipment not used in production, selling costs, advertising costs, interest, and officer compensation. Many entities have a stakeholder who is to receive a developer fee or compensation for providing services in lieu of capital contribution. Those entities probably will not be able to qualify such compensation or fees as "labor costs" but should consider them in the structure of that position within the entity and related fee or compensation, in order to qualify as labor costs and not officer compensation or sales costs.

What if my client owns several entities?

Under the Margin tax, entities part of an "affiliated group" or "unitary business" will be combined into one return for margin tax reporting. Affiliated groups are those with a common "controlling interest", which means ownership of at least 80% of the shares of a corporation or ownership of at least 80% of a beneficial interest in a partnership, trust or other entity. For example, if an office building is owned by Office Building, LLC, which is owned 100% by Client, and a tenant of the office building is Tenant, LLC, also owned 100% by Client, the two entities will be consolidated for the purposes of Margin tax.

Unitary businesses are those that are "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." This definition is so vague and broad that the tax code provides a several factor test for unitary businesses. This test includes examining whether the entities are horizontally or vertically integrated, or centrally managed. Some commentators have expressed skepticism as to whether truly separate entities will not be forced into combination for tax purposes.

1. Consolidation Advantages

This consolidation provides some benefit. Income that one entity experiences from another entity in the affiliated group is not included in taxable income (similarly, however, expenses within the affiliated group do not count toward costs of goods sold). To use the Office Building, LLC example, above, all of the rent paid by Tenant, LLC to Office Building, LLC would be disregarded in calculating the taxable income of the consolidation of Tenant, LLC and Office Building, LLC. Essentially, this prevents the double-taxation of those funds: they will be taxed when earned by Tenant, LLC and would otherwise be taxed when Office Building, LLC receives them as rent.

2. Consolidation Disadvantages

Not all affiliated groups will be advantageous for the included entities. Some entities that would otherwise operate below the $300,000.00 minimum threshold for taxation (especially many entities that own a single asset, like a shopping center) will now have their income subject to tax. This would be true if Office Building, LLC and Tenant, LLC each earned $250,000.00 in taxable income: their combined $500,000.00 would subject them to margin tax, but their individual situation would not. Moreover, some commentators have suggested that an unintended consequence of this consolidation would be the additional implication that several separate enterprises are the same for the purpose of obtaining additional assets to satisfy a judgment.

The author's best guess at the reason for this provision is that the State wants to prevent individuals from circumventing the tax with its $300,000.00 minimum. For example, an individual purchases property with several entities as tenants in common, rather than as one entity so that there will be several entities over which to disburse the rental income, each of which will have an income of less than the minimum needed to be taxed. Under this affiliated group mechanism, each of the entities would be considered together for Margin tax purposes and would not escape taxation as a result.

3. Tiered Entity Structures

Tiered entity structures – structures in which one or more entities ("owner entities") own another entity ("subordinate entity") – receive special treatment under the margin tax code. The owner entity may pay its proportionate share, based on its profits interest, of the subordinate entity's margin tax on its own return if the subordinate entity submits a filing to the Comptroller indicating the amount of income attributable to each owner entity. The subordinate entity must be a partnership or LLC that receives pass through taxation on the federal income tax level for this rule to apply. The owner entity cannot take on its share of the subordinate *partnership*'s margin tax if the owner entity is not subject to margin tax, although this does not appear to prevent the subordinate entity from allowing other, qualified owner entities from utilizing this rule. Note that the code mentions only a restriction for partnerships and is silent toward LLCs. Also note that the code is silent as to what qualifies as an entity that "is not subject to the tax" under that chapter of the tax code, but this qualification would seem to include passive entities, which are excluded from the definition of a taxable entity.

Many real estate transactions, at least those done under the previous franchise tax regime, involved the use of an LP which owned the entity and an LLC which owned a small percentage of the LP and operated as the general partner. Typically, both the LP and the LLC are owned by another entity, which is the true developer. Dave's Developments, LLC decides to develop Office Central, an office building, with Money Partner LLC. To do so, it sets up Office Central LP, a Texas limited partnership which will own Office Central and will be owned 1% by Office Central Management LLC, as general partner, 49% by Dave's Developments LLC, and 50% by Money Partner LLC, each as limited partner. In this example, Dave's Developments and Money Partner could choose to include 49% and 50%, respectively, of the income of Office Central LP on their margin tax reports if they are subject to the margin tax. Also, Office Central Management could choose to include its 1% share of Office Central's income on its margin tax report.

Where do REITs and REMICs stand?

Real Estate Investment Trusts (REITs) and Real Estate Mortgage Investment Conduits are exempt from the margin tax in most circumstances. Real Estate Investment Trusts face margin tax when any amount of its assets are in direct holdings of real estate, as opposed to holding interests in limited partnerships or other entities that directly hold the real estate. A REIT does not appear to qualify as a passive entity. Many REITs use limited partnerships to shield the trust from liability arising from the property in the limited partnerships. Limited partnerships owned by REITs are not exempt from margin tax.

Oil and Gas Interests

Oil and gas income is generally included in margin tax computation. Oil wells that produce an average of less than 10 barrels per day over a 90 day period or gas wells that produce an average of less than 250 mcf per day over a 90 day period, however, are excluded from margin tax. Additionally, royalties, bonuses and nonoperating working interests in mineral rights will help an entity qualify for passive status.

Conclusion

The Texas Margin Tax has numerous pitfalls for the unwary practitioner. The careful practitioner should inquire extensively about the nature of his or her client's business to determine if that client may have a margin tax exclusion available to it (such as a REIT or a passive entity designation). The careful practitioner should also pay close attention to the definition of "taxes" when negotiating a triple net lease (or purchasing a property with a triple net tenant) to ensure that the client is not unexpectedly responsible for taxes that were not anticipated. Above all, a thorough understanding of the issues identified in this article is crucial for any real estate practitioner.

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2. See *Malat v. Riddell*, 383 U.S. 569 (1966); *Municipal Bond Corp v. Commissioner*, 341 F.2d 683 (8th Cir. 1965).