A Study by the TTARA Research Foundation

Forms of Business and the Texas Franchise Tax

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EXECUTIVE SUMMARY: FORMS OF BUSINESS AND THE TEXAS FRANCHISE TAX

Since the Select Committee on Tax Equity first raised the issue that increasing amounts of business activity in Texas was being conducted in non-corporate entities, the relationship between business "form" and the state's tax system has been a subject of considerable debate, but not much study. This report attempts to remedy that situation.

Modern businesses have many choices in how they structure their operations and how they organize different parts of their operations. A business today is likely to appear to the outside world like a single entity, but behind the front door, it is common to find a collection of separately organized entities that perform different parts of the company's business. While this separation into distinct legal segments used to be almost exclusively in the domain of the largest businesses, changes in legal and accounting practices have made it possible, if not likely, that most businesses that have grown beyond the single, sole proprietor level to use separate legal entities to provide flexibility of operations and protection from liability.

The legal "forms" that businesses use to conduct their operations are mainly created under state laws. The oldest forms, sole proprietorships and general partnerships, are really common law entities that are indistinguishable from the individuals that make them up. Newer forms, like corporations, limited partnerships, professional associations and limited liability companies, were created by state legislatures to provide structures to govern the conduct of business affairs that are treated as separate entities, apart from their owners.

The advantage of having business forms that were distinct from their owners was that it allowed for accumulation of capital and the separation of the business's liabilities from those of the owners. It also allowed for easier transfer of ownership interests, through stock sales for instance, and for the creation of businesses with "perpetual" lives.

As the number and variety of these newer forms grew, people that joined together to conduct "business" (an activity engaged in with the expectation of making a profit) had an increasing number of choices of forms available to them. The different organizational forms of business are subject to different administrative, legal and tax requirements. Obviously, since the point of doing business was to make a profit (have something left over for the owners), the effect of taxes on the forms and methods of operating the business is also significant.

Tax considerations enter into decisions on how to structure and organize the individual units of a business, but they are typically intertwined with a number of other issues, such as whether to place different parts of an operation in separate legal entities (such as using subsidiaries) to limit their exposure to particular risks, whether to locate certain operations close to their customers or suppliers, whether there are historical or regulatory reasons to keep certain operations distinct from others, and even in which state to formally organize the business. In all of these cases, tax planning is simply one aspect of overall business planning.

Sole proprietorships are simple in structure and, requiring no formal registration with the state, are preferred for many small and sideline businesses. The number of sole proprietorships vastly exceeds all other business forms. On the downside, sole proprietors have no legal liability protections. For all practical purposes, a sole proprietorship is indistinguishable from the individual that is the sole proprietor. The individual proprietor is fully liable for all debts and obligations of the proprietorship regardless of his initial investment.

Partnerships can take a number of different forms with varying degrees of separation between the partnership entity and the partners. The different types of partnerships provide varying degrees of legal liability protection and require varying degrees of formality. The simplest form, the common law "general" partnership, requires no formal partnership agreement and, like the sole proprietorship, is essentially indistinguishable from the individual partners. At the other extreme, a limited liability limited partnership requires a formal partnership agreement that is filed with the state and provides protections just slightly less extensive than a corporation. Members of a partnership can be individuals, other partnerships, limited liability companies, or even corporations.

Corporations were long a preferred business form because they were the first form that was legally distinct from its owners. In a corporation, capital can be raised very efficiently through the sale of shares of stock, and the "corporate shield" protects investors' personal assets against claims on the corporation. While corporations have been the fewest in number of the various business forms, they traditionally have accounted for the greatest amount of business activity.

In addition to these three basic forms, there are a number of other forms that are used in modern business. Various licensed professionals are allowed to form "professional associations" or "professional corporations." These entities are both governed by the Texas Business Corporations Act. Limited liability companies have more organizational flexibility than corporations, but share much of the same liability protections. New forms of business have been created by state legislatures when business practice and legal practice have identified a need for them.

State laws establish the administrative and legal requirements for the various business forms, but states generally follow federal law in determining how individual businesses are taxed—typically either directly under the corporate income tax or indirectly by taxing the owners on their income from the business (through the individual income tax or, if the owner is a corporation, the corporate income tax).

Income from a sole proprietorship is typically taxed as a part of the owner's individual income tax return. Many incorporated businesses are subject to a direct entity level tax—the corporate income tax (while individual owners are subject to tax on the income they receive from their investment on individual tax returns). Many businesses, particularly partnerships, limited liability companies, and corporations meeting certain criteria, may elect their tax treatment. They may elect to be taxed under the corporate income tax, or they may elect to be treated as a "pass-through" entity, in which the business is not subject to direct income taxation, but instead the owners are taxed on their share of income from the business.

Only four states do not tax any form of business income. Those are the states that have neither a business tax nor a personal income tax that applies to business income. All of the other states either levy a tax directly on the business entity, regardless of its form, or follow the federal practice of allowing some entities to elect whether they will be taxed directly, or have their income "passed through" to their owners for taxation.

Texas takes a different approach than most states in taxing business. With no direct tax on personal income, Texas does not tax the income earned by many "pass-through" forms of business at all. While sole proprietorship and partnership activity is taxed at the owner's level in most states, Texas does not levy a personal income tax, therefore the income generated by these business forms do not come under the state's tax umbrella, unless the partnership is owned by another taxable entity. Texas' corporate franchise tax, is however, broader than corporate taxes in most other states, applying to limited liability companies and S corporations—entities not typically subject to corporate taxes in other states. Further, the franchise tax is based on the higher of two calculations—one largely based on net income and one based on net assets—so it falls more evenly on both capital-intensive and turnover-based businesses. The broader application of Texas' tax and the dual calculations have helped hold Texas franchise tax collections steady while a slowing economy has led corporate taxes in many other states to plummet.

The tax policy decisions states (and the federal government) make can impact the decisions businesses make. Businesses weigh the various legal, administrative and tax issues in deciding which form is most appropriate for their particular needs. Not surprisingly, as greater liability protections have been extended to partnership forms of business, whose pass-through tax treatment is viewed more favorably, the number of businesses organizing as partnerships and the amount of business they do in partnerships has increased substantially.

In today's world, businesses can be very complex structures, with a parent company organized in one form and subsidiaries separately organized in a number of alternative forms. Businesses may divide their operations into subsidiaries for a number of reasons, including compartmentalizing liability, management flexibility, attracting outside capital (and partners), historical circumstance, and legal requirements. With multi-state businesses structured with a number of subsidiaries, the location of the parent company and subsidiaries can have tax consequences because of differing tax treatment of intercompany transactions and revenues.

Every state has features of its tax system that are more attractive, or less attractive, than others. Several provisions of Texas' current franchise tax have made the state an attractive location for corporate headquarters. The fact that Texas does not subject forms other than the corporation and limited liability company to the franchise tax has appeal for businesses that choose to operate in other ways.

The 78th Legislature will consider a number of changes in state business tax policy, perhaps ranging from "closing loopholes" to broadening the tax base to include additional forms of businesses. Each policy choice, even the seemingly innocuous, carries weight and sends messages to the business community. They can create effects far beyond those intended by their authors. Because changes in tax policy can impact the economic attractiveness of the state, they should be undertaken only with a clear understanding of the consequences.

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Commonly Used Terms and their Meanings

Business. *An enterprise operated in order to produce a profit. A business may be a single independent entity, or it may include a number of separate entities under common ownership.*

Business Structure. *The manner in which a business opts to divide its operations and/or lines of business into separately formed legal entities. A business may structure itself as a single entity, or it may opt to structure itself as several entities, such as a parent company owning a number of subsidiary companies.*

Disregarded entity. *An entity that is disregarded for income tax purposes. The owners, not the disregarded entity, are liable for whatever income taxes may be applicable.*

Entity. *A business unit formally organized in a specific legal form such as a corporation, limited partnership, and/or limited liability company.*

Form of business. *The legal way in which a business entity is organized. If the business is not formally registered with a state and there is only one owner, it is a sole proprietorship. If the business is not formally registered with a state and there are multiple owners, it is a general partnership. Otherwise, the business is registered with a state, in accordance with statutory law, in a specific business form, such as a corporation, a limited partnership, or a liability company.*

Line of business. *A specific activity of a business or business unit, such as the manufacture of a specific product or the provision of a service.*

Pass-through. *A disregarded entity. The income of the entity is taxed as a part of the tax return of its owner(s). For federal purposes, partnerships, limited liability companies, and S corporations are typically pass-through entities.*

CHAPTER 1:
LEGAL FORMS OF BUSINESS

Key Facts:

- *There are a number of different legal forms in which a business may organize under state law. Each form is subject to different legal requirements, liability protections, administrative procedures, governance guidelines and tax treatment.*
- *While businesses organize under state law, states typically look to how a business is taxed under federal law in determining how they will tax the entity.*
- *There are three broad categories of business forms, but each typically falls under differing tax requirements:*
  - ***Sole proprietorship:** a disregarded entity in which the business's owner pays taxes on the business's income on his individual income tax return. From a legal standpoint, the business is indistinguishable from its owner.*
  - ***Partnership:** an entity separate from its owners for legal purposes, but generally able to elect to be treated as a "pass-through entity" for tax purposes. As such, it is not directly subject to income tax; instead the owners are taxed on their proportionate share of the net income from the business on their own tax returns—either individual or corporate income tax returns.*
  - ***Corporation:** a separate legal entity in which the business is typically taxed directly on its net income. The corporate owners, i.e. stockholders, must also pay taxes on any income received from their investment—be it dividends or capital gains. Some corporations are eligible under federal law to elect to be treated as pass-through entities similar to partnerships.*
- *In Texas, the corporate franchise tax applies to **all** corporations (even those electing to be treated as a pass-through entity for federal tax purposes) and limited liability companies.*

The sign on the door may say "Tom's Shoe Store," and that may be how the business is seen through the eyes of his customers, but how that business is viewed through the eyes of the law is an entirely different matter. There are broad categories of forms of business ownership recognized throughout the country:

- the sole proprietorship,
- the partnership,[1] and
- the corporation.

[1] This category includes a relatively new business form, the limited liability company, which has characteristics similar to the corporate form but is generally allowed to elect to be treated as a pass-through entity (as are partnerships) for tax purposes.

Each of these forms of business is subject to certain filing and legal requirements. These requirements affect how the business operates, how it raises capital, to what extent owners are liable for the obligations of the enterprise, how the business is managed (and the degree its owners participate in its management) and how the business and its owners are taxed.

Within these broad categories of business forms are sub-categories subject to differing degrees of legal requirements and protections. For example, a partnership may be a general partnership with few legal requirements (but few liability protections for the owners), or it may formally register with the state as a limited partnership, paying fees and subjecting it to more stringent administrative and filing requirements, but affording it certain liability protections offered under the law (Figure 1).

Many businesses, particularly companies conducting activities in a variety of states, are actually a combination of a number of entities, each organized in a distinct legal form. For example, distinct lines of business or regional operations may be separately organized subsidiaries. The decision as to the organizational form of business in which to operate is not necessarily a discrete decision made once in the life of a business unit, but may be an ongoing part of a business's growth, as it expands (or contracts), organizes new subsidiaries, adds new product lines, or enters new geographical markets.

In general, the federal government leaves the actual regulation of business forms up to the individual states. There is no federal partnership or corporation act. Instead, each state establishes the standards and requirements in law for the various forms of business that may organize there. That said, there is a fair amount of definitional uniformity across the states. All states have adopted standardized statutes developed by the National Conference of Commissioners on Uniform State Laws (a membership organization of states and legal experts). Even so, there are key differences in legal requirements and governing case law across the states that make it more attractive to organize a particular form of business in one state over another.

A business is formed or "organized" under the laws of only one state, but that status is generally recognized by reciprocal agreement of the states. For example, a company incorporated in Texas may do business as a corporation in California without reincorporating there. Still, the Texas company may be required to register with California authorities, abide by California's laws on business activity it does there, and pay the appropriate California business fees and taxes.

While regulation of business forms is left to the states, the federal government establishes its own standards as to how that business will be taxed under federal law. A business's legal form under state law and its tax form under federal law are not necessarily the same. For example, a business may register as a partnership with the state, but may elect to be

Figure 1
General Characteristics of Various Business Forms

Type of Business	Administrative Complexity	Liability Protections	Tax Treatment: Federal and Most States	Tax Treatment: Texas
Sole Proprietorship	Simple. No registration requirements.	None. The Individual owner is personally liable for all obligations	Income taxed on proprietor's personal income tax return	Income not taxed
Partnerships				
General	Simple. No specific registration requirements.	None.	Pass-through election (see note); taxed on partner's personal income tax return	Income not taxed
Limited (LP)	Must register with state. Partners may or may not have formal legal agreement.	Passive investors (limited partners are not personally liable for business obligations); general partners are personally liable.	Pass-through; taxed on partner's personal income tax return	Income not taxed
Master Limited (MLP)	Must register with state and have formal legal agreement with defined organizational structure.		Pass-through; taxed on partner's personal income tax return	Income not taxed
Limited Liability (LLP)	Must be registered with state. Partnership must have formal legal agreement.	Limited partners not personally liable; general partners are liable only for their own errors, negligence, incompetence or malfeasance.	Pass-through; taxed on partner's personal income tax return	Income not taxed
Limited Liability Company (LLC)	Must register with the state and have formal articles of organization. Simple structure; few restrictions on owners (members).	LLC is responsible for its own debts, not the LLC owners (i.e. members); members are not personally liable for the company's obligations	Pass-through; taxed on member's personal income tax return	Subject to franchise tax
Professional Association (PA)	Must register with state and have articles of association. Relatively simple structure, but form and ownership limited to named professionals.	Each professional is liable with the association for his own acts; members are not personally liable for actions of other members.	Pass-through; taxed on professional's personal income tax return	Income not taxed.
Corporation				
Ordinary (typically a C Corporation)	Must register with state. Must have bylaws, board of directors and named officers. No restriction on owners (i.e. stockholders).	Corporation is responsible for its own debts, not the corporate owners (i.e. stockholders); stockholders are not personally liable for the corporation's obligations	Corporation's net income subject to corporate tax; owner's income from dividends and capital gains are taxed on owner's tax return	Subject to franchise tax
Close (typically an S Corporation)	Must register with state. Simpler structure than C; board not required. Owners (stock holders must be individuals.		Pass-through (if qualifying as an S corp); taxed on owner's personal income tax return	Subject to franchise tax; however, officer/director compensation is not included in tax base.*
Professional (PC; may be either a C or S)	Must register with state. Relatively simple structure, but form and ownership limited to named professionals (excluding medical practitioners).		Generally, most professional corporations elect to be treated as an S Corporation (i.e. as a pass-through entity)	

Note: If a professional corporation does not qualify and elect to be treated as an S corporation, it must add back officer and director compensation in its Texas franchise tax calculation. Under federal law, non-corporate business entities are treated as pass-through entities unless they specifically elect to be taxed as a corporation.

Source: Adapted from a more detailed table developed for the TTARA Research Foundation by Vinson and Elkins, LLP, which is available at www.ttara.org.

taxed as a corporation for federal purposes. Similarly, certain types of corporations may be subject to state corporate taxes, but may be treated as a partnership (i.e. as a "pass-through" entity) for federal tax purposes.

Generally, state tax departments follow the lead of the federal government and follow federal standards for determining a business's state tax treatment.

In this chapter, an overview of the various legal forms of business is presented, identifying the various considerations that enter into the decision to operate in that particular form. The tax issues associated with each is touched on, although specific examples of the different types of tax treatment are presented later in this report.

Sole Proprietorship. For the sake of sheer simplicity, the sole proprietorship is the preferred form of operating a business. The term "sole proprietorship" is a common law term describing a single person who earns business income, either from a full-time or sideline pursuit. To operate as a sole proprietorship, one does not have to register with the state or file specific legal papers, though one is not excused from the typical requirements of a business operation. The sole proprietor is still subject to the licensing requirements specific to their particular line of business or occupation. Should the sole proprietor choose to operate his business under a trade name, the trade name may have to be registered. Further, if the sole proprietor employs other people, he must get an employer identification number from the Internal Revenue Service and pay the required employer taxes to the state and federal government.

For its simplicity, operating as a sole proprietorship comes with substantial liability risk. For legal purposes, the sole proprietorship and the sole proprietor are one and the same—an obligation of the business is an obligation of the owner. If the business incurs a financial obligation—be it through the operations of the business or perhaps a legal claim for damages—the owner is personally liable for the entire amount of the obligation. Liability is not limited to the assets of the business—it can attach to the entire personal assets of the owner. Even if the owner invests a few dollars in a sideline business, his entire personal wealth may be at risk. This risk can be mitigated with insurance, but the sole proprietorship itself as a form of business offers no legal protections.

Capitalizing the business is the responsibility of the sole proprietor. He may use his personal wealth, or personally guarantee a loan for the business, but if he brings in outside investors, by definition, the business becomes a partnership.

The sole proprietorship exists only as long as the owner chooses. Should the owner die or decide to discontinue the business, the sole proprietorship is automatically dissolved.

Figure 2
Sole Proprietorships by Industry, 1999 US data

Industry	US Number of Proprietorships		Total Receipts		Average
	Number (th)	Pct of Total	Amount ($ml)	Pct of Total	Receipts ($th)
Agriculture	306.9	1.7%	$16.7	1.7%	$54.3
Mining	117.1	0.7%	$4.4	0.5%	$37.9
Utilities	9.1	0.1%	$0.1	0.0%	$11.9
Construction	2,283.9	13.0%	$154.2	15.9%	$67.5
Manufacturing	359.6	2.0%	$27.3	2.8%	$76.0
Wholesale	360.0	2.0%	$43.0	4.4%	$119.5
Retail	2,309.3	13.1%	$185.2	19.1%	$80.2
Transportation & Warehousing	790.4	4.5%	$46.0	4.7%	$58.2
Information	236.5	1.3%	$7.0	0.7%	$29.5
Finance & Insurance	579.4	3.3%	$86.4	8.9%	$149.1
Real Estate	851.4	4.8%	$42.9	4.4%	$50.4
Professional & Business Svcs	3,899.6	22.2%	$144.2	14.9%	$37.0
Health Care Services	1,520.4	8.7%	$82.8	8.5%	$54.4
Arts, Entertainment & Recreation	1,040.2	5.9%	$19.5	2.0%	$18.7
Accommodation & Food	315.2	1.8%	$36.3	3.7%	$115.2
Other Services	2,333.9	13.3%	$70.1	7.2%	$30.0
Other	262.8	1.5%	$3.3	0.3%	$12.7
Total	17,575.6	100.0%	$969.3	100.0%	$55.2

Note: Based on the new NAICs codes.
Source: Internal Revenue Service.

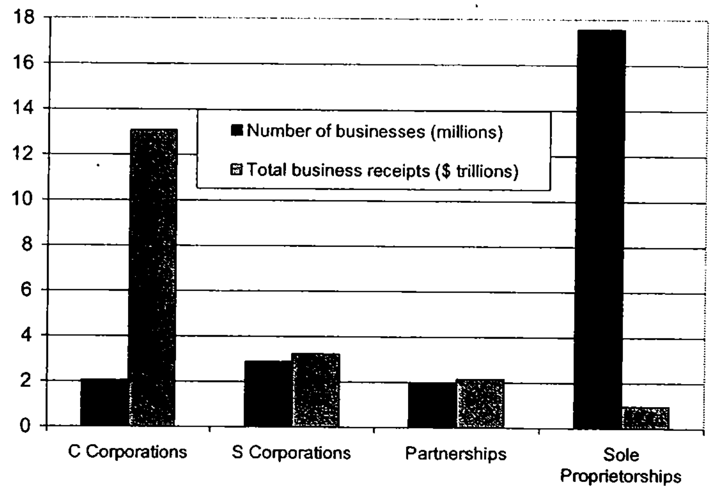
While an heir may decide to continue to operate the business under the same name, from a legal standpoint this is viewed as an entirely new proprietorship.[2]

Sole Proprietorships in the Economy. Nationwide, the Internal Revenue Service reports that there are about 17.6 million sole proprietorships, most of which are individuals engaged in a profession, or doing consulting, construction work, or retail (Figure 2). While there are no firm state numbers available, Texas is likely home to nearly 1.25 million sole proprietors.[3] These are essentially the full-time self-employed and those earning income to supplement wage earnings, retirement income, or to help make ends meet while engaged in a search for a full-time job. Average receipts range from a high of near $150,000 annually in the finance and insurance industry to about $12,000 in miscellaneous services and in utilities.

[2] For example, the new proprietor would also have to get a new Employer Identification Number from the Internal Revenue Service.
[3] Estimated by multiplying Texas' share of US non-farm employment to the total US number of sole proprietorships as reported by the Internal Revenue Service.

While seven of every ten businesses in this nation are sole proprietorships, they account for only $1 in every $20 of business receipts (Figure 3), making them on average the smallest of businesses.

Figure 3
Number of Businesses and Total Business Receipts
U.S. 1999



Source: Internal Revenue Service.

Taxation of Sole Proprietorships. For federal tax purposes the sole proprietorship is disregarded as an entity separate and apart from its owner—the business and its owner are indistinguishable. When the sole proprietor completes his Form 1040 individual income tax return, he must include Schedule C—Profit or Loss from Business, reporting the business's expenses and income. The net amount is included in calculating his personal income tax liability (and his self-employment tax). If the business makes a profit, this is included on the proprietor's personal income tax return, and individual income taxes are due. If the business loses money, this results in an offset against his other income, reducing his tax liability.

In the event the business fails, is sold, or is dissolved, and the proprietor in some way disposes of his assets for either a gain or a loss, the amounts must be appropriately reported on his individual tax return. If the business fails and has outstanding debts, they remain the personal responsibility of the proprietor, and creditors may pursue him directly.

Partnership. "Partnership" is a generic term describing a business arrangement involving more than one party. Texas state law defines a partnership as "an association of two or more persons to carry on a business for profit as owners," and that the partnership is recognized as "an entity distinct from its partners."

Each partner contributes something to the partnership—money, property, labor and/or skills—and shares in the profits and losses of the business. Partnerships are commonly thought of as an agreement among individuals, but partners may also be businesses—

corporations, trusts, or even other partnerships.[4] All partnerships must have at least one general partner, who actively manages the business, and it may have one or more limited partners, who are passive investors and not actively involved in the management of the business. There are various forms of partnerships, ranging in complexity and legal requirements and protections, but, as outlined below, all are generally treated the same for tax purposes.

Partnerships in the Economy. Nationwide there are about two million partnerships, about half of which are engaged in real estate ownership and leasing (Figure 4). Professional and business services, construction, retail, and agriculture account for much of the remaining partnerships. Most partnership business activity (receipts) is in finance, manufacturing, professional and business services, retail and real estate. Partnerships on average are not large businesses—averaging about $1.1 million in total receipts per partnership.

Partnerships account for about eight percent of all businesses and about nine percent of all business receipts (see Figure 3 on page 6), or about 20 times the average size of a sole proprietorship.

Taxation of Partnerships. Generally, partnerships are "pass-through" entities for federal and state tax purposes—the partnership itself is not directly subject to income tax, but its partners, or owners, must pay income taxes on their share of the partnership's income (be they corporations or individuals). Some partnership forms choose to be taxed as corporations, a process that was simplified under federal "check-the-box" regulations adopted by the Internal Revenue Service in 1997. Businesses that are not specifically classified as a corporation are generally allowed to elect how they are treated for federal tax purposes—either taxed as an entity (separate from their owners) and subject to the corporation income tax, or treated as a "pass-through" entity.

Historically, there were certain advantages offered to corporate taxpayers with regards to the treatment of fringe benefits that compelled some entities, professional associations, for example, to opt to be taxed as corporations. Recent federal legislation has changed this. However, for many businesses, converting from their long term *corporate* tax treatment to *pass-through* status could generate huge taxable gains for the business's owners. Consequently, many have opted to continue to be taxed as a corporation.

[4] The Internal Revenue Code (26 USC 761) defines partnership as including "a syndicate, group, pool, joint venture, or other unincorporated organization through or by means of which any business, financial operation, or venture is carried on, and which is not, within the meaning of this title, a corporation or a trust or estate."

Figure 4
Partnerships by Industry, 1999 US Data

Industry	US Number of Partnerships		Total Receipts		Average
	Number (th)	Pct of Total	Amount ($ml)	Pct of Total	Receipts ($th)
Agriculture	115.0	5.9%	$22.3	1.0%	$194.3
Mining	28.1	1.5%	$34.5	1.6%	$1,229.6
Utilities	2.6	0.1%	$65.2	3.0%	$24,970.9
Construction	127.6	6.6%	$131.0	6.1%	$1,027.0
Manufacturing	37.1	1.9%	$322.4	15.0%	$8,696.3
Wholesale	32.9	1.7%	$175.4	8.2%	$5,326.3
Retail	108.9	5.6%	$204.4	9.5%	$1,876.7
Transportation & Warehousing	22.3	1.2%	$41.6	1.9%	$1,863.4
Information	20.3	1.1%	$131.3	6.1%	$6,452.2
Finance & Insurance	219.2	11.3%	$369.2	17.2%	$1,684.2
Real Estate	858.1	44.3%	$201.7	9.4%	$235.1
Professional & Business Svcs	167.9	8.7%	$240.9	11.2%	$1,434.2
Health Care Services	39.9	2.1%	$72.8	3.4%	$1,825.1
Leisure, Accommo-dation & Food	96.9	1.7%	$120.5	5.6%	$1,243.7
Other Services	57.8	3.3%	$12.8	0.0%	$221.3
Other	2.2	3.0%	$0.7	0.6%	$319.7
Total	1,936.9	100.0%	$2,146.8	100.0%	$1,108.4

Note: Based on the new NAICs codes. Includes all non-corporate entities treated as partnerships for tax purposes under federal law, including limited liability companies, but not S Corporations. Categories are as reported by the IRS and may differ from those of other tables.
Source: Internal Revenue Service.

Overwhelmingly, partnerships elect pass-through treatment, so much so that the term "pass-through" may seem synonymous with "partnership." To be treated as a corporation would subject the entity to a direct tax on its income (i.e., the corporate income tax), while the owners would still be subject to taxes on the income they receive from their partnership interest.

Active partnerships must file a federal income tax return (Form 1065) with the Internal Revenue Service, though the return is only for informational purposes—no taxes are due. Instead the partners are taxed on their share of the partnership's income (or loss) on their tax returns. In the event a partnership makes a profit in a particular year, each partner's proportional share of the profit is included as income on their income tax return, resulting in a higher tax liability. The partner's share of the income or loss must be reported regardless of whether any funds are actually distributed to the partner.

The foregoing applies equally to individual- and corporate-owned partnerships. An individual's share of partnership income is subject to personal income taxes while a corporation's share of such income is subject to corporate income taxes. In the event one of the partner's is actually another partnership, the income is reported to the second partnership, which in turn includes it as a part of the income it reports to its partners. Ultimately, that income is passed-through to its final owners—either individual or corporate owners.

General Partnership. The general partnership is the simplest form of partnership. It can involve two parties (i.e., persons, partnerships, or corporations) jointly running a business venture by simple consensus, or it can involve many partners actively engaged in a venture with a formal business agreement. All partners are considered "general partners," actively engaged in the management of the business, and are personally liable for its legal and financial obligations (including court judgments). A general partnership is capitalized by the partners—they may contribute their own capital or offer their personal guarantees for a bank loan. The partners are "jointly and severally" liable for all debts and obligations of the partnership, which may conceivably extend well beyond their initial investment. That means each general partner is potentially liable for the entire obligations of the business. For example, if a partnership with two equal general partners fails, leaving debts of $100,000, and one partner declares bankruptcy, the other is liable for the entire $100,000. In this manner, a general partnership may be more risky than a sole proprietorship. A sole proprietor is liable for his own mistakes, but a general partner is liable for the mistakes of his other partners.

There are approximately 80,000 general partnerships in Texas.[5] The typical general partnership, like a sole proprietorship, is a small business. According to Internal Revenue Service data, the average general partnership has four partners and after expenses nets about $82,000.[6]

Typically, general partnerships do not have to register with the state because state laws afford them no specific legal benefit. Unless there is a formal partnership agreement stating otherwise, the general partnership dissolves with the withdrawal of one of the general partners.

Limited Partnership. The limited partnership is a partnership with two types of partners—general and limited—with the limited partners afforded liability protections under state law. To be a limited, rather than general, partnership, the partners must specifically register with the state and pay registration fees (in Texas, $750). States typically require that a written agreement between partners establish the terms of the business arrangement. This agreement may or may not contain provisions for

[5] Estimated by multiplying applying Texas' share of US non-farm employment to the total US number of general partnerships as reported by the Internal Revenue Service.
[6] Allen Zempee and Tim Wheeler, "Partnership Returns, 1999," Internal Revenue Service, *Statistics of Income*, Fall 2001 Issue.

continuation of the partnership beyond the death or withdrawal of one of the general partners.

The limited partnership must have one or more "general partners," who remain personally liable for the business's legal and financial obligations. Any partner actively engaged in the management of the business is considered a general partner. However, the limited partnership also has one or more "limited partners," who invest capital in the business and share proportionately in profits and losses, but do not participate in the day-to-day management of the company. A limited partner's personal liability is limited to the amount invested in the partnership—he is not personally liable for the debts of the partnership. If a limited partnership fails, and has obligations in excess of the partnership's financial resources, creditors may seek to attach the personal assets of the general partner, but not any of the limited partners.[7]

The limited partnership structure is more conducive to raising capital than either a sole proprietorship or a general partnership. A passive investor, i.e. a limited partner, can share in the profits of the business without undertaking the obligations of day-to-day management or incurring the risk of personal financial ruin.

There are 102,975 limited partnerships registered in Texas according to the Secretary of State.[8] The Internal Revenue Service reports that the average limited partnership has 27 partners—a figure that is surprisingly consistent across industrial sectors.[9] Typically, limited partnerships are larger businesses than either general partnerships or sole proprietorships, netting an average of near $250,000 after expenses.[10]

Publicly-Traded Limited Partnership. The limited partnership structure does not preclude public trading of limited partnership interests, or units. A subset of the limited partnership is the publicly-traded limited partnership (PTLP), also known as a "master limited partnership," (MLP). This structure has certain advantages in raising capital because investors simply purchase units, or shares, in the business rather than going through the legal formality and expense of registering as limited partners with the state. Units trade on major securities exchanges in the same manner as corporate stock.

Originally designed as a pass-through entity for real estate and oil and gas investments, concerns that proliferation of MLPs in other industries could erode the corporate income tax base led Congress to tighten income requirements of MLPs after 1987. MLPs are now subject to corporate income taxes unless 90 percent of their income is passive in

[7] There are limited exceptions to this. Creditors generally have the right to seek return of moneys distributed to a limited partner if the liability arose before the distribution.
[8] Secretary of State Gwyn Shea, Agency Strategic Plan for the 2003-07 period, Office of the Secretary of State, Austin, Texas, 2002.
[9] Partnership return data from the Internal Revenue Service.
[10] Ibid.

nature. Passive income includes interest, dividends, income from real estate, and income relating natural resources. Consequently, MLP status is effectively restricted to certain real estate and natural resource (oil and gas) businesses—industries in which many of the MLPs' competitors commonly operate in other partnership forms. There are over 50 MLPs trading on the major stock exchanges, including a few among the Fortune 500 companies.

Provided they meet the passive income requirements for a given year, MLPs qualify for pass-through tax treatment. The MLP itself is not subject to federal income tax, but its owners report their share of the partnership's income on their tax returns. In the event an MLP fails to meet the requirements, it is subject to the corporate income tax.

Registered Limited Liability Partnership. The registered limited liability partnership (LLP) is a relatively new subset of the partnership business form. The LLP offers liability protections to general partners, shielding them from personal liability for claims arising from the errors, omissions, negligence, incompetence or malfeasance of a co-partner or other representative of the business. They are also protected from liability with respect to contract claims against the partnership. The general partner(s) are still personally liable for their own actions. Texas law requires LLPs to carry $100,000 of errors and omissions insurance.

This structure is attractive for a business with many partners that participate in the management of the company, such as a law firm, but do not want to be exposed to liability for the actions of their fellow partners.

First enacted in Texas in 1991, other states have followed suit in enacting LLP statutes. In Texas, the LLP must register as such with the Secretary of State and pay a $200 fee for each partner (in addition to the $750 registration fee). Texas has 3,920 limited liability partnerships.[11]

Texas law allows either general partnerships or limited partnerships to register as a limited liability partnership. States typically allow *general* partnerships to register as LLPs, but only 15 states allow *limited* partnerships to register as LLPs.[12] Limited partnerships registering as a limited liability partnership may also be referred to as a limited liability limited partnership (LLLP).

For tax purposes, LLPs are treated the same as general and other limited partnerships. Unless they affirmatively elect to be treated as corporations for federal tax purposes, the

[11] Secretary of State Gwyn Shea, op. cit..
[12] Bruce P. Ely and Christopher R. Grissom, *Choice of Entity: An Overview of Tax and Non-Tax Considerations,* Multistate Portfolios, Tax Management, Inc., revised 1/2002.

partnership is not directly subject to federal income taxes; instead, the partners are taxed on their shares of the partnership's income.

Limited Liability Companies. The limited liability company is a hybrid of the partnership and the corporate business form. It is like a corporation in that it enjoys liability protections similar to the "corporate shield," but it is generally allowed to elect to be treated as a pass-through entity for tax purposes—just as a partnership.[13] First enacted in Wyoming, it was not until a 1988 IRS ruling concluding that LLCs would be treated as partnerships for federal tax purposes that other states quickly adopted LLC statutes. Texas's limited liability company law was authorized in 1991, with the provision that they would be subject to the state's corporate franchise tax.[14]

The LLC issues membership interests, or "units" rather than shares of stock. Unit owners are called "members" rather than shareholders. These units may be transferable, similar to stock, but are not traded on major stock exchanges. There are no restrictions on the number of members—it may even be as few as one. Members may include not only individuals, but corporations, partnerships, trusts, foreign investors, and pension plans.

The management structure of a limited liability company is more flexible than that of a corporation. There need not be a board of directors. Instead a member or members may take on the day-to-day management responsibilities, or they may name a professional manager who has no membership interest.

There are 87,699 LLCs registered to do business in Texas—a surprisingly high number given only the recent authorization of the business form. Of these, 90 percent are organized in Texas, while 10 percent are organized in other states but registered to do business in Texas. While LLCs have become a popular structure for corporate subsidiaries, they are still primarily used by small businesses. Nationwide, the typical LLC nets about $60,000 a year after expenses.[15]

While most states follow the federal treatment of LLCs as pass-through entities (absent an election by the LLC to be treated as a corporation), recent concerns about corporations switching to LLCs as a method of reducing their state tax burden have led to a handful of states amending their corporate tax statutes to include LLCs, as does Texas.[16]

With their administrative flexibility (in terms of management and ownership), liability protections, and pass-through tax treatment, limited liability companies have become increasingly popular as a form for both stand-alone entities and for subsidiary entities.

[13] Again, the federal treatment as a pass-through entity is elective. Absent an election, for federal tax purposes a limited liability company is treated as a pass-through entity.
[14] Vernon's Ann.Civ.St. art. 1528n.
[15] Partnership return data from the Internal Revenue Service.
[16] Ely and Grissom, op. cit.

Professional Association. The professional association is a form of business most commonly used by physician groups, though it may also be used by other licensed professionals. The association provides a liability shield for the personal assets of its members, but the association itself is jointly and severally liable for the acts of its members. The professional association offers liability protections for its owners, but is able to elect to be treated as a pass-through entity for federal tax purposes. Professional associations, unlike professional corporations, are not subject to the Texas franchise tax. There are 14,377 professional associations registered in Texas with the Secretary of State's office.

Corporation. The corporation is a specific business form authorized by state law, registered with the state and subject to specific operating requirements, but also afforded certain legal benefits (some of which, as mentioned previously, are also available to registered non-corporate business forms). States may authorize several types of corporations, with differing organizational and legal requirements.

A corporation exists separate and apart from its owners (i.e., stockholders) and may engage in activities separate and apart from its owners, including:

- earning income and owning assets,
- entering into legal agreements and accessing the courts,
- incurring liabilities and obligations, and
- having perpetual existence.

For all intents and purposes, the law views a corporation as an individual separate and apart from its owners with all the rights afforded natural persons in the Bill of Rights (except for the Fifth Amendment right against self-incrimination). Further, a corporation can be charged with a crime where the punishment is monetary restitution.[17] The corporation is liable for its own obligations. Shareholders are not personally liable for the debts or obligations of the corporation. The most shareholders, including the officers and directors of the corporation, can lose is their investment—in the worst case, seeing the value of their stock become worthless.

While this so-called "corporate veil" protects a corporation's owners from the liabilities of the business, the veil can be "pierced" if the corporation fails to meet certain statutory requirements. The officers and directors of the corporation may be held personally liable if the corporation fails to meet, either knowingly or through negligence, its legal responsibilities. This might include failure to hold the requisite board meetings, failure to keep minutes, file the appropriate reports, or maintain proper books and records. Further,

[17] Barbara C.S. Shea with Jennifer Haupt, *Entrepreneur Magazine Small Business Legal Guide*, John Wiley & Sons, Inc., 1995.

the corporate veil may be pierced if the assets of the corporation are used for the personal benefit of the principals.

Though only states authorize corporations, both states and the federal government tax them. While the federal government and almost all states levy a corporate income tax, not all corporations must pay it. Under Subchapter C of the Internal Revenue Code, corporations are subject to a specific tax on their net income (the corporate income tax); however, corporations meeting certain standards under the Code's Subchapter S (as outlined below), may be treated as pass-through entities similar to most partnerships.

Over 543,000 corporations are registered with the Texas Secretary of State to do business here.

Ordinary Corporations, as they are typically called in state law, may be more commonly known as C Corporations, referring to the subchapter of the Internal Revenue Code which governs their federal tax status. Most multi-state and multi-national American companies trading on the major securities exchanges are C corporations—though each of these corporations may typically compartmentalize their businesses into separately organized subsidiaries, which may be corporations or non-corporate entities (see Chapter 5: Forms of Business and Complex Business Structures) owned by the publicly-traded company.

The owners of a C corporation are its stockholders. In issuing stock, C corporations enjoy substantial flexibility in both the number of shares and the classes of the stock shares offered, making the C corporation a preferred form for raising capital. The value of "common" stock is tied to the overall market wealth of the business and usually comes with full voting rights (one share equals one vote on issues submitted to shareholders). It may come with dividends, but more often not. "Preferred" stock generally offers a more predictable return by offering dividends (which take precedence over any dividends offered on common stock), but with less growth (or decline) potential and may not offer voting rights. The corporation's board decides on the number of shares it chooses to issue, and there are no restrictions on who may own them—individuals, other corporations, trusts, mutual funds. This allows C corporations to own other corporations (just as partnerships may own other partnerships and types of entities) and to be subsidiaries of each other.

The administrative and legal requirements of an ordinary corporation are among the most complex of any legal form of business. Organization and operation involves a substantial amount of paperwork. The corporation must register with a state (generally with the Secretary of State), filing articles of incorporation and paying filing fees. The articles of incorporation must also designate the number of shares of ownership. Ordinary corporations typically must have a board of directors, who are required to meet periodically. The daily operations of the company are managed by designated officers.

The corporation is commonly required to hold an annual meeting for shareholders. Corporations that issue stock to the public are also subject to regulation by the Securities and Exchange Commission and by state securities laws.

C Corporations in the Economy. Ordinary, or C corporations, are on average large businesses, though many small businesses do utilize the corporate form. Taxable corporations account for about nine percent of all businesses but near 72 percent of all business receipts (see Figure 3 on page 6). Businesses engaged in professional and business services, retail trade, construction and real estate account for about half of all numbers of taxable corporations, but manufacturing, retail, finance and insurance (including banks), and wholesale trade account for about three-fourths of all receipts of taxable corporations (Figure 5). The largest corporations tend to be those in industries with high capital needs—such as utilities and manufacturing.

Taxation of C Corporations. As a separate legal entity from its owners, the C corporation provides a liability shield for its owners or shareholders, but not without a price. Not only are C corporations subject to separate state and federal taxes[18] on their profits, the owners of the corporation are subject to tax on the income they receive on their investment—in effect, the same income is taxed twice.

If a C corporation makes a profit, it pays corporate income taxes.[19] In the event the corporations incurs losses, rather than get a refund, it accumulates deductions which may be used to offset future income and reduce future years' tax liability.[20] In addition, the individual stockowners of the corporation are subject to any applicable taxes on income earned on their investment in the corporation. If the shareholder receives a dividend from the corporation, this is subject to individual income taxes. If the shareholder sells his stake in the corporation, the gains (or losses) are included on his individual tax return, as well.

S Corporations. S corporations are so-called after the subchapter of the Internal Revenue Code which governs their federal tax status. States do not specifically authorize S corporations; instead certain of the corporations which they do authorize may qualify for an election under Subchapter S of the Internal Revenue Code as outlined below.

[18] A company registered as something other than a corporation may be subject to the corporate income tax if it fails to meet certain federal standards.
[19] The actual calculation of net profits and losses for tax purposes (the domain of the Internal Revenue Service) differs from the calculation of profits and losses required in financial statements (generally the domain of the Securities and Exchange Commission). For example, depreciation schedules of fixed assets differ. Federal law allows property to be depreciated over a shorter period of time to encourage new investment—an effort to achieve a public policy goal. Financial reporting tries to more accurately reflect the actual value of the equipment based on its useful life—an effort to provide for a more meaningful reflection of the financial status of the business.
[20] In some instances they may be allowed "carry-back" of the loss, offsetting prior years' taxes.

Figure 5
Taxable Corporations by Industry, 1999 US Data

Industry	US Number of C Corporations		Total Receipts		Average
	Number (th)	Pct of Total	Amount ($ml)	Pct of Total	Receipts ($th)
Agriculture	70.3	3.2%	$57.3	0.4%	$815.4
Mining	14.8	0.7%	$96.1	0.7%	$6,503.1
Utilities	5.6	0.3%	$475.7	3.6%	$85,182.4
Construction	246.8	11.2%	$517.0	4.0%	$2,094.9
Manufacturing	151.8	6.9%	$4,303.6	32.9%	$28,346.3
Wholesale	114.0	5.2%	$1,612.8	12.3%	$14,146.4
Retail	341.2	15.4%	$1,819.3	13.9%	$5,331.5
Transportation & Warehousing	72.7	3.3%	$397.2	3.0%	$5,465.3
Information	49.2	2.2%	$709.9	5.4%	$14,441.2
Finance & Insurance	114.0	5.2%	$1,682.1	12.9%	$14,751.7
Real Estate	214.3	9.7%	$126.9	1.0%	$592.5
Professional & Business Svcs	354.3	16.0%	$645.5	4.9%	$1,822.0
Health Care Services	165.9	7.5%	$286.2	2.2%	$1,725.4
Arts, Entertainment & Recreation	35.6	1.6%	$38.8	0.3%	$1,091.5
Accommodation & Food	94.6	4.3%	$208.6	1.6%	$2,205.7
Other Services	155.3	7.0%	$93.7	0.7%	$603.8
Other	9.9	0.4%	$0.3	0.0%	$26.6
Total	2,210.1	100.0%	$13,071.2	100.0%	$5,914.2

Note: Based on the new NAICs codes. Includes corporations subject to the corporate income tax, but excludes S Corporations and REITs.
Source: Internal Revenue Service.

To qualify as an S corporation, the business must meet certain criteria. An S corporation may have no more than 75 shareholders and can issue only one class of stock. The investors may often have direct business relationships with one another, or even be family members. Shareholders must be either U.S. citizens, estates, or certain types of trusts or tax-exempt organizations. Because of these restrictions, stock of S corporations do not trade on major stock exchanges.

S corporations were traditionally stand-alone entities—neither a subsidiary nor a parent of another corporation; however, in recent years Congress has liberalized small-business ownership laws to allow S corporations to own subsidiaries under certain conditions.

S Corporations in the Economy. S Corporations account for about 11 percent of all businesses and 15 percent of all business receipts. There are now more S corporations than C corporations, so ironically most corporations do not pay the federal corporate income tax. S corporations tend to be smaller businesses than C corporations, roughly on par with partnerships in terms of average size of business receipts. S corporate status is most popular among professional and business services, retail, construction and real estate, but retail, wholesale, manufacturing and construction account for over 70 percent of all S corporation receipts (Figure 6).

Taxation of S Corporations. For federal tax purposes, an S corporation is treated as a "pass-through entity," similar to a partnership that elects that treatment. S Corporations do not have to pay the federal corporate income tax; instead, stockholders pay taxes on their share of the business (whether distributed to them or not) on their federal and, if applicable, state income tax returns. For this reason, a corporation's election to be an S corporation must be unanimous of all its stockholders; otherwise the corporation is automatically considered to be a C corporation.[21]

Texas, which does not have a personal income tax, subjects S corporations to the state's corporate franchise tax, although in calculating the tax base, they are not required to include some items regular corporations are (see Chapter 3). A handful of other states also tax S corporations under their corporate income tax; though most follow the federal pass-through treatment, taxing S corporation income as a part of the owner's individual income tax (provided a state income tax is levied).

Close Corporation. Most states authorize a special type of corporation typically more suitable for smaller businesses—the "close" corporation. A close corporation is subject to much less formality (and expense)—for example, unlike an ordinary corporation, it doesn't necessarily have to have a board of directors, corporate bylaws, or annual meetings. Instead, it may be managed under terms set out in its shareholders' agreement; and many are directly managed by their shareholders. While the close corporation is a separate legal entity from its owners, it typically has less than 35 shareholders and its stock does not trade on a public exchange.

A close corporation is specifically organized under state law, but for tax purposes may be either an S corporation or a C corporation. Typically they meet the federal criteria to be an S corporation and elect to be treated as such.

[21] S Corporation treatment is elective for those corporations that qualify as set forth above. A corporation not electing S corporation treatment at its inception will be treated as a C corporation until the S corporation elective is effective. S corporations that were formally C corporations may be subject to corporate income taxes on certain "built-in gains" as of the effective date of their S corporation election, as well as corporate income taxes on certain passive gains.

Figure 6
S Corporations by Industry, 1999 US Data

Industry	US Number of S Corporations		Total Receipts		Average
	Number (th)	Pct of Total	Amount ($ml)	Pct of Total	Receipts ($th)
Agriculture	71.4	2.6%	$47.3	1.5%	$663.0
Mining	16.1	0.6%	$13.6	0.4%	$847.3
Utilities	1.5	0.1%	$3.2	0.1%	$2,176.7
Construction	333.5	12.2%	$456.6	14.1%	$1,368.9
Manufacturing	145.9	5.4%	$498.2	15.4%	$3,414.8
Wholesale	160.6	5.9%	$573.4	17.7%	$3,571.4
Retail	332.6	12.2%	$783.9	24.2%	$2,357.1
Transportation & Warehousing	87.5	3.2%	$88.0	2.7%	$1,005.8
Information	58.5	2.1%	$50.9	1.6%	$870.5
Finance & Insurance	103.8	3.8%	$58.1	1.8%	$559.9
Real Estate	307.2	11.3%	$58.5	1.8%	$190.5
Professional & Business Svcs	551.1	20.2%	$306.0	9.4%	$555.3
Health Care Services	137.6	5.0%	$85.2	2.6%	$619.3
Arts, Entertainment & Recreation	58.3	2.1%	$31.9	1.0%	$547.2
Accommodation & Food	157.5	5.8%	$109.9	3.4%	$697.7
Other Services	185.6	6.8%	$73.3	2.3%	$394.7
Other	17.2	0.6%	$4.8	0.1%	$278.2
Total	2,725.8	100.0%	$3,242.8	100.0%	$1,189.7

Note: Based on the new NAICs codes.
Source: Internal Revenue Service.

Professional Corporation. Traditionally, professional corporations have been a business form offered to certain licensed professionals operating together. Unlike other corporate forms, there are no passive investors—stockholders must be licensed members of the profession. As a corporation, the professionals are afforded the liability protections of the corporate form. While these would also be available in a limited liability limited partnership or a limited liability company, the corporate form traditionally offered federal tax advantages for qualified retirement plans. Recent changes in federal law have substantially reduced these advantages, and many professional groups are opting to organize as limited liability companies.

For federal tax purposes, a professional corporation may elect to be treated as an S corporation (provided it meets the qualifying criteria); if not, it is treated as a C corporation. In either case, it is subject to Texas franchise tax. In Texas, the professional corporation form may be used by most professions except for physicians. Physicians may operate instead as a professional association.

Real Estate Investment Trust. Some forms of business are restricted to specific types of activity, and are not available for general business purposes. A real estate investment trust is a corporation[22] that purchases, owns and manages real estate properties and/or loans, but is treated as a pass-through entity for federal tax purposes. REITs were authorized in federal law in 1960. In order to qualify as a REIT, at least 95 percent of the business's income must come from real estate-related activity (rent, interest, investment gains, etc.) and at least 90 percent of its net income must be distributed as dividends to its shareholders. If it meets these requirements, a REIT is not subject to taxes on its income; instead, shareholders pay tax on the amounts they receive from the REIT. Unlike partnership income, REIT shareholders are subject to tax only on the actual amount of distributions they receive;[23] however, investors may not use a REIT's investment losses as a reduction in income as they can a partnership's losses. Some REITs trade on major stock exchanges—but they may be more comparable to a mutual fund as opposed to a corporation.

[22] Technically, a REIT can also be a trust or an another business entity that is treated as a corporation for federal tax purposes.
[23] A further tax advantage to the REIT shareholder is the fact that they will pay the lower long-term capital gains tax rate on that portion of their REIT distribution attributable to long term investments.

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CHAPTER 2: THE EVOLUTION OF FORMS OF BUSINESS AND THEIR TAXES

Key Facts:

- *Historically, corporations were the only form of business to enjoy liability protections for all the owners of the business. For many businesses, these benefits outweighed the complexity, expense, and taxes of the corporate form.*
- *Within the last decade or so, new and simpler business forms have been created with liability protections similar to that of the corporate form, and these forms are generally permitted to elect pass-through treatment for federal and most state income taxes.*
- *Not surprisingly, given the simplicity and the tax advantages of these new forms, they are increasing in numbers and business activity far greater than traditional corporations, limited partnerships, and sole proprietorships.*

The commerce of today's modern world is far more complex than the hunting and gathering business of the Stone Age. As humanity became more efficient in creating food and shelter, this freed time within the community for individuals to provide for other needs and wants, leading to the development of skilled artisans and craftsmen, and merchants and traders of these goods and services. These operated as common law sole proprietorships, or in some cases, partnerships, requiring no special privilege or regulation by the state.

Early Corporations. As societies advanced and as trade expanded throughout much of the world, government leaders recognized the benefits of commercial activity, and sought to encourage it. Certain commercial activities that were closely linked to the public welfare required the grant of special powers from the state—such as the authority to acquire rights-of-way and charge a public toll, or the authority of a bank to issue paper currency.[1] These early corporations were given a specific "franchise," or special privilege to operate, often free of both competition and taxes, to compensate for their high risk nature and to ensure that the commercial activity would indeed take place. Liability was typically limited to the corporation itself, rather than the owners or investors (i.e., the "corporate veil"). While this ran counter to the commonly accepted standard of personal

[1] Seavoy, Ronald E., The Origins of the American Business Corporation 1784-1855, Greenwood Press, Westport, Connecticut, 1982.

integrity and responsibility for debts, it was a price willingly granted to ensure that certain public needs would indeed be met. The corporate form also allowed for ownership to be easily shared among several investors. This made it easier to raise capital—the amounts of which were often well beyond the financial ability of a single individual. Further, the use of investment shares to demonstrate ownership was far easier than separately accounting for the various properties of the business.

While the benefits of the corporate form were substantial, the fact that a charter had to be granted by act of the legislature made it an intensely political undertaking, and it was made available to few endeavors. In the United States, these early corporations tended to be mostly turnpikes, banks, or insurance companies.[2] At the start of the 19th Century estimates put the number of private corporations operating in the United States at only 225.[3]

Most businesses were, as they are today, sole proprietorships and common law partnerships, at the time with no liability protections; however, they tended to offer few complaints about the granting of special privileges to corporations. Their businesses did not compete with corporations, which tended to be engaged in activities of specific public benefit as opposed to general commerce.

The first general incorporation statute in this country allowing corporations to be formed by administrative process rather than specific legislative authorization was in New York in 1784, but it applied solely to religious congregations. The act established a standardized governance structure, but more importantly allowed the church to own property in its own name.[4] It was not until 1811, in an effort to promote domestic production of textiles, that New York enacted a general incorporation statute available to for-profit enterprises, though it was limited solely to manufacturing concerns.

Something of a popular backlash soon emerged. Corporations, which were accepted as a means to meet a compelling public need, were less acceptable to the public as profit-oriented enterprises. One of the privileges enjoyed by these earliest corporations was an exemption from taxation, but in 1823, New York enacted the first tax on corporations. At the time, an individual's stock interest was subject to property tax, but it was rarely reported and rarely paid. The New York law was designed more as a way to collect the tax of the corporation's owners. The tax applied to the value of the corporation's stock and was to be taken out of the amount of dividends the corporation was to pay to its shareholders. This began a long tradition of taxing the capital base of a corporation,

[2] Seavoy, Ronald E., The Origins of the American Business Corporation 1784-1855, Greenwood Press, Westport, Connecticut, 1982.
[3] Buehler, Alfred G., Public Finance, McGraw-Hill book Company, Inc. New York, 1940.
[4] Seavoy, Ronald E., The Origins of the American Business Corporation 1784-1855, Greenwood Press, Westport, Connecticut, 1982.

which is still a part of Texas' corporate franchise tax today and still in effect in several other states, as well.

The Birth of Limited Partnerships. Political leaders were also sensitive to calls for liability protections for businesses not using the corporate form. In response, New York put into law a new statute authorizing the creation of limited partnerships in 1822. The new law delineated two classes of partners:

- *general partners,* who managed the business and were personally liable for its debts, and
- *limited partners*, who would be more like passive investors and whose potential liability would be limited only to the extent of their initial investment.[5]

For the limited partner, the liability protections were significant. The general partner, however, remained personally liable for all of the debts of the partnership. If the debts exceeded the assets of the partnership, the general partner's personal assets could be at risk. Partnerships were not considered entities separate and apart from their owners, and were not subject to specific taxes as were corporations.

Based on a concept in old French law, the New York limited partnership statute would be adopted in most other states over the next 20 years. Texas would adopt a limited partnership law in 1846.[6]

General Incorporation Statutes. Still, the benefits of the corporate form extended beyond liability protections, and was to be preferred for many pursuits, offering an easier avenue to raising capital through the issuance of stock shares. Rather than further regulate or limit the use of those companies doing business in the corporate form, policy makers instead moved to broaden its availability to others. In 1837 Connecticut became the first state to enact a general incorporation statute open to any legitimate business enterprise, not just manufacturing.[7] Eventually other states would follow suit.

It was this "laissez-faire" policy of providing a legal and organizational framework for commercial enterprise to thrive that many historians credit with the burgeoning growth of American capitalism:

> In the early nineteenth century, the United States appeared to be one of the least likely nations to industrialize. It was land rich, technologically backward, and capital deficient, and its population

[5] Seavoy, Ronald E., The Origins of the American Business Corporation 1784-1855, Greenwood Press, Westport, Connecticut, 1982, p. 97.
[6] Vernon's Ann.Civ.St. art. 6110-6132 (repealed), Historical Note.
[7] Seavoy, Ronald E., The Origins of the American Business Corporation 1784-1855, Greenwood Press, Westport, Connecticut, 1982, p. 255.

> was highly dispersed compared to the compact, centralized, and technologically advanced nations of Europe. There were neither great landed or commercial magnates to supply capital, nor an efficient centralized government that could accumulate capital through taxation, nor a vigorous national policy to encourage industrialization, nor any external threat to national survival that dictated a policy of rapid industrialization. In spite of these deficiencies, the United States did industrialize. The seed capital had to be contributed voluntarily from numerous small savers, and a means had to be found to mobilize and magnify it. The means of voluntary mobilization was the business corporation and the means of magnification was banks. Industrialization developed in a social and political climate that had three major assets that more than compensated for the other deficiencies: a stable government, and energetic people experienced in voluntary corporate self-help, and responsive state legislatures that framed laws that encouraged individuals to save and invest.[8]

Individual and Corporate Income Taxes. With the states' enactments of general incorporation statutes typically came the assessment of state registration fees and capital-based taxes on the assets of the corporations. As states authorized entities, the federal government initially looked elsewhere for tax revenue. And when Washington eventually did look to tax businesses, their focus was on income as opposed to assets.

The federal government did have brief experiences of taxing income (an income tax was used to help finance the Civil War in the North). A federal personal income tax was even enacted in 1894, but it proved temporary for it was declared unconstitutional the following year. In the landmark case of *Pollock v. Farmers' Loan & Trust, Co.*, the Supreme Court held that personal income taxes were direct taxes and would have to be equivalent across the states on a per capita basis—meaning, for example, that people in the largely poor agricultural states would have to pay as much in taxes as the wealthier populations in states that were large financial centers.[9]

Similar legal concerns did not extend to income taxes on corporations, however. Rather than "direct" taxes, the court viewed these as permissible "excise" taxes levied upon the incidence of ownership as measured by income. In 1909, two years after Texas enacted the corporate franchise tax, the federal government authorized a federal income tax specific to corporations, which remains in effect today.

In 1913, the Sixteenth Amendment to the U.S. Constitution took effect, which states:

> The Congress shall have power to lay and collect taxes on incomes, from whatever source derived, without apportionment among the several States, and without regard to any census or enumeration.

In October of that year, President Woodrow Wilson signed enabling legislation into law, and the federal personal income tax became the law of the land.

[8] Seavoy, Ronald E., *The Origins of the American Business Corporation 1784-1855*, Greenwood Press, Westport, Connecticut, 1982, p. 258-9.
[9] Pollock v. Farmers Loan and Trust Company, 157 U.S. 429 (1895).

Initially the individual income tax targeted the very wealthiest Americans. Deductions were allowed for home mortgage interest and income from government bonds were excluded.[10] Income up to $20,000 after deductions was taxed at one percent, while income over $500,000 was taxed at seven percent (in two years the highest marginal rate would increase to 67 percent). Income subject to tax included that from wages, investments and business interests (ultimately including investment income from corporate stock). Partnerships were not taxed directly, as were corporations, but their owners were taxed on their shares of profits from their partnership interests.

Corporate tax rates and individual tax rates varied over the years, with the highest marginal individual tax rates ranging from 24 percent in 1929 to as high as 94 percent by 1944. Corporate tax rates tended to be much lower, and for the wealthiest Americans, private corporations proved to be an effective means of sheltering income. With high marginal individual tax rates, partnerships were sometimes valuable for the paper tax losses they generated as well as the income they might make.

Generally, the corporate form was a cumbersome one for enterprises requiring only a few investors. This led to states authorizing a modified corporate form—the close corporation. These enjoyed the same liability protections as an ordinary corporation, but were subject to fewer regulations, such as eliminating the requirement for regular meetings of the board of directors (or even the requirement that there be a board). Generally, close corporations could issue only one class of stock and have no more than 35 shareholders—all of whom had to be individuals who are citizens of the U.S.[11]

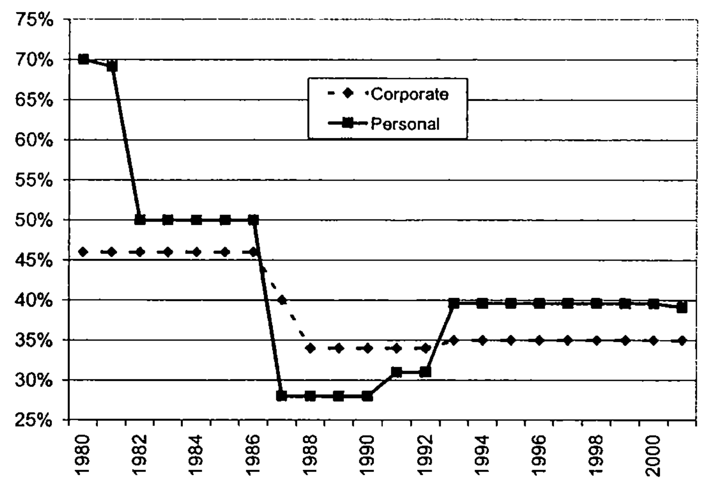
In 1958, Congress offered special tax treatment geared for these small, privately-held corporations under Subchapter S of the Internal Revenue Code, allowing them to be treated as pass-through entities similar to partnerships—relieving them of the requirement to pay the federal corporate income tax. With high marginal individual tax rates, though, S corporations were not always the best alternative. While most states followed the federal treatment of S corporations as pass-throughs, Texas did not. Without a personal income tax which would apply to S corporation owners, pass-through treatment would be tantamount to a complete tax exemption.

Prior to the early 1980s, the highest marginal tax rate for individuals was 70 percent—substantially greater than the maximum 46 percent rate on corporate income (Figure 7). With the Reagan-era tax reforms, marginal individual income tax rates were substantially reduced, narrowing the gap between corporate and individual taxes. This essentially

[10] History of the Federal Income Tax, The Century Foundation, at http://www.tcf.org/Publications/Basics/Tax/History.html
[11] Amy M. Gill, S Corporation Returns, 1992, Statistics of Income, Internal Revenue Services, Spring 1995.

eliminated the tax rate advantages of the corporation (or conversely, reduced the tax penalty of the individual income tax). Ordinary corporations were less attractive as tax shelters, especially since corporate income would be taxed, and then taxed again when the income was distributed as dividends to the shareholders. S corporations, treated as pass-throughs, became very popular, however, as well as newly authorized forms of business, the limited liability company and the limited liability partnership.

Figure 7
Highest Marginal Federal Income Tax Rates, 1980 to 2002



Source: Internal Revenue Service.

The Limited Liability Company. In 1977, Wyoming enacted a statute authorizing a hybrid form of business—enjoying the liability protections of the corporate form while having sufficient partnership attributes to potentially qualify for pass-through tax treatment under existing federal tax regulations. The Limited Liability Company (LLC) was actually based on similar business forms authorized in other countries, but was simpler than the S Corporation. The LLC allowed greater organizational, management, and ownership flexibility. Foreign investors could be owners of an LLC, as could corporations and other forms of businesses. The LLC proved valuable not just as a form for small business, but also for subsidiaries of other businesses.

Wyoming adopted its LLC statute in an effort to attract oil and gas exploration investment into the state,[12] but the form attracted interest in other states. Florida followed suit in 1982, but few other states were interested until the Internal Revenue Service began ruling in 1988 that LLCs would be treated as pass-through entities for tax purposes, receiving the identical treatment as partnerships. By 1994, every state had enacted statutes authorizing limited liability companies.

[12] Robert M. Kozub and James T. Collins: 2001 Multistate Tax Guide to Pass-Through Entities, Panel Publishers, New York, 2001.

Figure 8
Changes in Uses of Various Business Forms, 1985-1999 U.S. Totals

	Number of Returns (thousands)			Total Receipts ($billions)		
Form of Business	1985	1999	Change	1985	1999	Change
Sole Proprietorships	11,929	17,576	47.3%	$540.0	$969.3	79.5%
Pass Through Entities						
General Partnerships	1,434	898	-37.4%			
Limited Partnerships	280	354	26.4%			
Limited Liability Companies	n.a.	589	n.a.	$367.1	$1,907.2	419.5%
Limited Liability Partnerships	n.a.	42	n.a.			
Check-the-box companies	n.a.	52	n.a.			
S Corporations	725	2,726	276.0%	$430.6	$3,300.9	666.6%
Total	2,439	4,661	191.1%	$797.7	$5,208.1	552.9%
Directly Taxed Entities						
Taxable Corporations	2,548	2,210	-13.3%	$7,967.7	$15,591.5	95.7%

Note: Figures are based on number of federal tax returns filed. "Check-the-box companies" are those that might qualify for pass-through treatment under federal law, but elect to be taxed as a corporation.

Source: Compiled from published data by the Internal Revenue Service.

The Limited Liability Partnership. In 1991, the same year the limited liability company statute was passed in Texas, the Texas legislature blazed new territory by authorizing a new subset of the partnership business form, the limited liability partnership. The LLP shields a general partner from personal liability for claims arising from the errors, omissions, negligence, incompetence or malfeasance of a co-partner or other representative of the business (unless the partner was directly involved in the activities relating to the claim). The general partner is still liable, however, for their liabilities arising from their own actions. The LLP must register as such with the Secretary of State and pay a $200 fee for each partner (in addition to the $750 registration fee). Texas law allows both general partnerships and limited partnerships to register as limited liability partnership.

The Changing Nature of American Business. With the availability of new forms of business much simpler in nature than traditional corporations yet offering expanded liability protections, coupled with a tax climate more favorable to pass-through entities, not surprisingly, the face of American business is changing (Figure 8).

Sole proprietorships still account for the greatest number of America's businesses, and traditional C Corporations still account for the lion's share of America's business activity, but both are diminishing relative to other business forms. General partnerships, which enjoy no liability protections, are also diminishing in numbers, as more businesses migrate to alternative business forms which do offer liability protections.

Since 1985, the number of sole proprietorships has increased 47 percent, with their business receipts increasing by near 80 percent. In contrast, the total economic output of the United States has increased by 124 percent (as measured by gross national product). C corporations have dwindled in popularity, down nearly 14 percent in numbers, but with receipts increasing 95.7 percent (still less than overall economic output).

The number of pass-through entities with liability protections has increased substantially in both numbers and in economic activity. The number of S corporations has almost quadrupled since 1985, and, in only a few short years, over half a million limited liability companies nationwide have been established. Total receipts from S corporations are up by 666.6 percent while other pass-through entities are up 419.5 percent, well in excess of the nation's economic growth.

Liability concerns have always been an important issue for businesses in choosing the form in which to organize and operate; however, the imposition of special income taxes on the corporate form have made the newer liability-protected, tax pass-through business forms much more attractive. Liability-protected tax pass-through entities, such as S corporations, limited liability companies, limited partnerships, and limited liability partnerships are becoming increasingly popular forms for conducting business activities.

CHAPTER 3:
THE TEXAS FRANCHISE TAX AND STATE TAXES ON FORMS OF BUSINESS

Key Facts:

- *The franchise tax is Texas' "general business" tax, applying to all corporations (Subchapter C and S, alike) and to limited liability companies. It is "general" in the sense that it is not a tax on businesses in a specific industry or productive activity.*
- *It is a "separate entity" tax that applies independently to each different legally-organized segment of a business.*
- *Taxpayers calculate their tax liability in two ways: one on earned surplus (which is largely net income), and the other on their net assets (i.e., total assets less debts). Taxpayers effectively pay the higher of the two calculations.*
- *With the economic slowdown, most other states have grappled with severe declines in corporate tax revenues, while Texas' franchise tax collections have been relatively stable, in spite of newly enacted tax credits and recent concerns about tax planning.*
- *Texas' franchise tax has been more stable than corporate taxes of other states partly because the capital tax calculation effectively operates as an alternative minimum tax and because Texas' tax base includes S corporations and limited liability companies—forms of business typically exempt from corporate taxes in other states*

In concept, the franchise tax is a license, or "privilege" tax, in other words, paid for the right to do business in the state as a corporation (or limited liability company). In return, the state grants the corporation certain privileges, such as the right to exist as an entity separate and apart from its owners (i.e., shareholders). Consequently, a corporation may accumulate earnings and take on liabilities separate and apart from its owners. In Texas, each corporation pays the tax on a "separate entity basis"—i.e., based on its individual circumstances—regardless of whether it is affiliated through common ownership with other corporations.

This chapter provides an overview of the Texas franchise tax, including:

- how the taxpayer calculates franchise tax liability,

- how the franchise tax falls across industrial sectors,
- the role of the franchise tax in the state's revenue system, and
- how the Texas franchise tax compares with "general business taxes" in other states.

Calculation of the Franchise Tax. The franchise tax applies to all corporations (both C and S) and limited liability companies doing business in the state. There are several steps in calculating a taxpayer's liability:

1. The corporation (or LLC) determines if it is doing business in the state (i.e., whether it has "nexus").
2. The company calculates its earned surplus and taxable capital (net assets).
3. The tax base is apportioned to properly reflect the share of the tax base attributable to activity in Texas.
4. The appropriate tax rate is applied to determine gross tax liability.
5. The appropriate credits are claimed against the calculated liability to determine the net tax due.

Nexus. Nexus describes the threshold of business activity that must be present before a taxing jurisdiction has the right to impose tax on a corporation. To be subject to the franchise tax, a corporation (or limited liability company) must have some type of connection, or *nexus* to the state. While seemingly a simple concept, determining what constitutes "doing business in the state" can be extremely complex. If a corporation has a physical presence in Texas, either by owning or leasing property or by having employees here, it clearly has nexus and is subject to the Texas franchise tax. But a corporation may have nexus in Texas even without property or payroll here. Among the other types of activity which may establish nexus are:

- serving as the general partner of a partnership doing business in Texas;
- hiring independent contractors in Texas to promote sales here;
- providing services here; and/or
- franchising independently owned businesses.

Texas' franchise tax consists of two separate calculations based on two separate tax bases and nexus standards differ slightly between them.[1] A corporation can have nexus for the capital portion of the corporate franchise tax but not have nexus for the earned surplus tax. Under federal nexus law,[2] a foreign corporation (i.e., a corporation legally incorporated in a state other than Texas) whose only Texas business activity is soliciting orders for the sale of tangible personal property, and whose orders are processed and shipped from another

[1] Nexus is determined separately for different state taxes as well, such as sales tax and franchise tax.
[2] Federal PL86-272 establishes thresholds states are subject to in establishing their nexus standards for income tax purposes.

state into Texas, does not have nexus for state income tax (earned surplus) purposes. However, it can be subject to the capital tax.

A corporation may also have nexus in Texas but be a part of an affiliated business group that contains corporations that do not have nexus in the state (and therefore are not subject to the tax). For example, a corporation may be domiciled (i.e., "headquartered") in Texas, but may own a subsidiary corporation located in another state that has no nexus in Texas. Similarly, a corporation with nexus in Texas may be a subsidiary of a parent located in another state that has no nexus in Texas, or that has other subsidiaries that have no nexus in Texas. Nexus is determined individually for each separate corporation.

Tax Base. The franchise tax is, in essence, two distinctly different taxes—one based on capital, or net assets, and another based on earned surplus, or net income (Figure 9). The earned surplus, or income, calculation is based on a corporation's income and expenses. It draws from federal income tax definitions, with a few modifications:

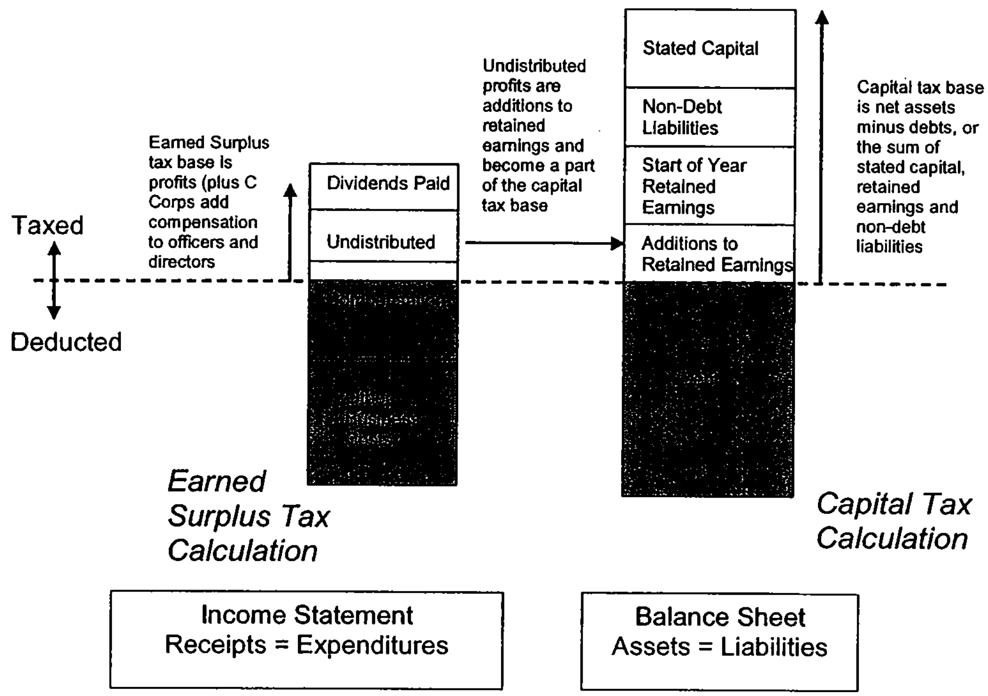
Start with:	Federal taxable income (as defined by the 1996 Internal Revenue Code)[3]
Plus:	Amounts claimed on the federal return for the net operating loss deduction (Texas allows a different modified loss carryforward)
Minus:	Certain income from foreign sources included on the federal return
Plus:	Officer/director compensation (generally, corporations with less than 35 shareholders and S corporations do not add this item)
Equals:	Total Earned Surplus

Some of a corporation's income may include dividends and income from ownership of subsidiary corporations. Texas, as in most states, essentially excludes most dividend income from affiliated entities to prevent double taxation of income within a business group. Income from investments in non-affiliated entities is fully taxable, however.

The *capital* calculation draws from a corporation's balance sheet. In very simple terms, the tax base is roughly the net worth, or shareholders' equity, of the corporation—the total assets of the corporation less debts (not "liabilities"—"debts" are "sum certain" and "time certain" obligations the company is legally obligated to pay, and include current liabilities and long term debt; non-debt liabilities are taxable). From another vantage point, the capital tax base may be viewed as the sum of a corporation's *surplus* (accumulated retained earnings) and capital stock (essentially the value of the corporation's stock at the time of its issuance). Some of a corporation's capital may include ownership of stock in a subsidiary corporation—a corporation that may also pay franchise tax. Even so, the parent may not

[3] Texas draws on the federal definition of taxable income as it existed in 1996. Changes made to the federal tax code in recent years, such as the bonus depreciation rules enacted in 2002 to stimulate capital investment, are not reflected in the franchise tax. Consequently, a taxpayer must keep two sets of tax books—one based on current federal law for federal tax purposes, and one based on 1996 federal law for Texas franchise tax.

Figure 9
A Simplified View of the Franchise Tax Calculation



Note: Items above the line are subject to tax. Essentially corporations calculate their tax liability as the higher of 4.5 percent of earned surplus apportioned to Texas or 0.25 percent of apportioned taxable capital.

exclude the amount invested in the subsidiary (initial purchase and other contributed capital). In this manner, the franchise tax double taxes capital.

Apportionment of the Tax Base. Under federal law, a state's tax on the net income of a multi-state corporation must fairly reflect the activity of the corporation in that state. States use mathematical formulas to apportion the tax base to their state.

In Texas, both earned surplus and taxable capital are apportioned to the state based on the ratio of a business' gross receipts from business done in Texas to its gross receipts everywhere. *Gross receipts* is the total amount of revenue a business receives from all sources. It includes revenues not only from the sale of goods or services, but also intangible sources of income such as interest, dividends, capital gains, royalties, etc. Apportionment involves determining the source of each business receipt in order to determine the overall proportion of activity that may be attributed to the taxing state.

Figure 10
Sourcing of Corporate Receipts for Franchise Tax Apportionment

Type of Gross Receipt	How Receipts are "Sourced"
Sale of tangible personal property	Where product sold is delivered
Sale of services	Where service is performed
Sale of software	Where the payor is incorporated (state of legal domicile)
Corporate share of profits from partnerships	Receipts are sourced differently: *capital:* net receipts sourced to the location of the partnership's principal place of business, or *earned surplus:* the corporation "looks through" to the partnership, sourcing its share of the partnership's gross receipts as if it received them directly
Bank depository interest	Interest received from a Texas bank or a national bank domiciled in Texas is sourced to Texas
Patents	Where the patent is used in production, fabrication or processing
Trademarks	Where the trademark is used
Receipts from sale of real property	Where the property is located
Lease or rental income	Where the property is located
Dividends	Where the payor is incorporated (state of legal domicile)
Interest	Where the payor is incorporated (state of legal domicile)
Sales of intangibles (i.e., stocks, bonds)	Where the payor is incorporated (state of legal domicile)

Note: Some businesses may have income of a "non-unitary" nature (i.e., income that does not result from a business's normal operations). This income is not included in a corporation's apportionment calculation, but is separately allocated for earned surplus purposes to the commercial domicile of the recipient. For tax purposes, however, the Comptroller presumes all income to be unitary and subject to apportionment.

Apportionment of multi-state income is one of the most complex areas of state tax administration. Businesses today generate a complex array of revenues from a myriad of activities that may cross state boundaries. A business might generate income from sales of goods, services, or both. It may have income from patents, trademarks, and royalties. It likely earns some type of interest, either through loans or simply from its bank accounts. (Figure 10 above illustrates Texas' sourcing methods for different types of receipts.)

While federal law effectively requires states to apportion business income, it grants wide latitude in doing so. Apportionment rules vary widely across the states. Many states use some combination of three factors—receipts (or sales), property, and payroll. Even more confusing for multi-state businesses is the fact that each state may define each factor somewhat differently. For example, *gross receipts* as defined by the state of Texas includes sales of goods and services, interest, dividends, and other types of intangible income; Louisiana defines gross receipts for income tax apportionment essentially as those from sales of goods and services only. And even among states with similar *statutory* definitions, state court decisions may result in somewhat different interpretations of those definitions.

The state to which a receipt should be attributed is not always self-evident. Even a fairly simple transaction, such as the sale of a good, can be difficult to source (i.e., determine whether the resulting item is a Texas or non-Texas receipt for apportionment purposes).

For example, a Texas manufacturer might sell some pipe to a Louisiana refinery. Typically, this might be seen as a "non-Texas" sale for purposes of apportionment, and generally it is. But, if the Louisiana company chooses to defray shipping costs by picking up the pipe at the Texas factory, Texas considers this to be a Texas sale.[4] In this particular instance, Louisiana also considers this to be a Louisiana sale,[5] so if the Texas seller also has nexus in Louisiana, the sale is "taxed" for apportionment purposes in both states. Further, in the event the Texas pipe manufacturer does not have nexus in Louisiana and is not subject to Louisiana business taxes, Texas considers *any* sale shipped to Louisiana, by whatever means, to be a Texas sale.[6]

As complex as sourcing revenue from the sale of tangible personal property is, the task of sourcing *intangible income*, such as dividends, interest, and capital gains, offers even greater potential for difficulty. For example, a subsidiary doing business in several states may pay some type of consideration (such as interest or dividends) to its Texas parent company. The subsidiary's income may have originated from any number of those states, none of which might be Texas. Tracing through the source of the original business activity would be cumbersome and complex. Under a long-standing Texas administrative rule adopted by the Comptroller, income from dividends, interest, and the sale of intangibles is sourced to the location of the payor, i.e., the state where the paying corporation has filed its legal papers of incorporation.[7]

Dividends and Apportionment. While both franchise tax calculations use receipts-based apportionment, what is considered to be a receipt differs between the two taxes. This is to better reflect the tax base being apportioned.

The *entire* amount of dividends received is included in the capital tax base, so the entire amount of dividends received is counted as a gross receipt for apportioning the capital tax. However, only a certain portion of dividends received are included in the calculation of net

[4] Texas Administrative Code, Section 3.549.
[5] Louisiana Administrative Code, Section 306, March 1988.
[6] This is the "throwback rule" in which business activity is "thrown back" to Texas for apportionment purposes if the company is not subject to tax in the state in which they are making the sale.
[7] An exception to this is provided for in V.A.T.S., Tax Code § 171.1061 for the earned surplus tax. Certain intangible income (except dividends and interest) of a non-unitary nature is directly allocated to the commercial domicile of the recipient. No clear definition of unitary/non-unitary exists, though non-unitary income is generally that unrelated to the direct business activity of the company. The Comptroller notes in the franchise tax instructions: "All income is presumed unitary.... Such income will be apportioned in the normal fashion and will not be subject to allocation."

taxable income for earned surplus purposes, so this reduced percentage is counted as a gross receipt for apportionment.[8]

Figure 11
Federal Dividends Received Deduction

Dividend Received From:	Amount of Deduction:
An affiliated corporation (one sharing at least 80 percent common ownership)	100 %
A non-affiliated corporation that is at least 20 percent owned by the corporation receiving the dividend	80 %
Non-affiliated corporations less than 20 percent owned by the corporation receiving the dividend.	70 %

Source: Internal Revenue Code, Section 243

Texas, as most states, has adopted the federal "dividends received deduction" for income tax purposes (Figure 11). The rationale for the deduction is to eliminate multiple taxation of business income. In theory, dividends are paid out of the profits remaining after taxes have been paid. Taxing the dividends received by a business would subject that income to taxation again. This is of particular concern to "affiliated" corporations, i.e., those corporations that are a part of a commonly owned corporate group. Also in line with most states, Texas does not tax dividends received from subsidiary corporations doing business outside the United States.

Tax Rate. Once the tax base is apportioned to correctly identify the amount of Texas earned surplus and Texas taxable capital, it is multiplied by the tax rate to determine the amount of a corporation's gross tax liability. Technically, all taxpayers remit their payment based on taxable capital. In the event the earned surplus calculation yields an amount higher than what is due on capital, the taxpayer pays the additional amount on earned surplus.[9] In effect, though, the taxpayer pays the higher of the two calculations, the capital calculation is essentially an alternative minimum tax.

The gross tax liability is the greater of $2.50 per $1,000 of a corporation's Texas-apportioned capital base (i.e., 0.25 percent), or 4.5 percent of its Texas earned surplus. If the calculation yields a tax liability of less than $100, or if the corporation or limited liability company has less than $150,000 in total receipts, then no tax is due.

Tax Credits. In 1997, the Texas Legislature enacted a series of franchise tax credits. These credits are netted against a taxpayer's calculated gross liability to determine

[8] Dividends are "booked" for tax purposes on the earlier of the date they are declared or the date they are paid/received.
[9] The rationale for this distinction was that some other states allow corporations to reduce their tax base in those states for taxes "not based on income."

Figure 13
Sample Simplified Franchise Tax Return

Texas Corporate Franchise Tax Report Sample

Corporation Name:
The Texas Company

Capital Tax Calculation	
1. a. Stated Capital	$10,000
1. b. Plus: Surplus	$4,990,000
2. Equals: Taxable Capital	$5,000,000
3. Gross Receipts Everywhere	$5,007,000
a. Sales	$5,000,000
b. Interest	$5,000
c. Dividends	$2,000
d. Other	$0
4. Texas Gross Receipts	$4,005,000
a. Sales	$4,000,000
b. Interest	$5,000
c. Dividends	$0
d. Other	$0
5. Texas Apportionment (4/3)	79.99%
6. Total Texas Tax Base (2*5)	$3,999,500
7. Less: Allowable Deductions	$0
8. Equals: Gross Taxable Capital	$3,999,500
9. Tax Rate ($2.50 per $1,000)	0.25%
10. Total Texas Taxes (8*9)	$9,999

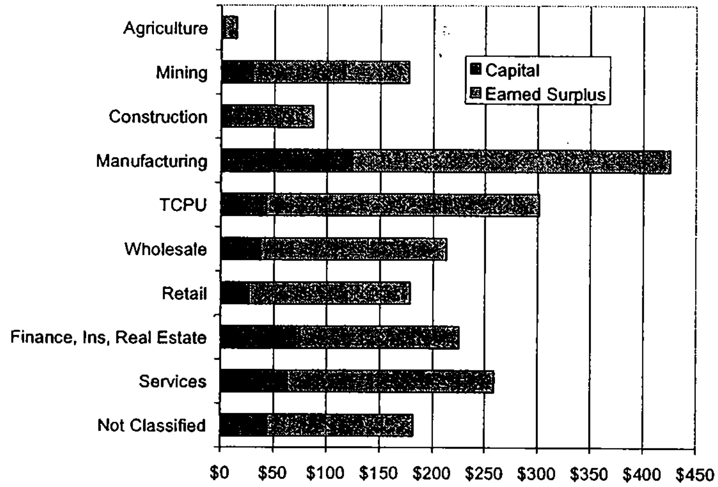
	Earned Surplus Tax Calculation
$5,007,000	1. a. Gross Receipts
$1,400	1. b. Less: Dividends Received
$5,005,600	1. c. Equals: Gross Operating Receipts
$4,906,100	1. d. Less: Deductible Expenses
$99,500	1. e. Equals: Federal Taxable Income
$500,000	1. f. Plus: Officer/Director Compensation
$599,500	2. Equals: Taxable Earned Surplus
$5,005,600	3. Gross Receipts Everywhere
$5,000,000	a. Sales
$5,000	b. Interest
$600	c. Taxable Dividends
$0	d. Other
$4,005,000	4. Texas Gross Receipts
$4,000,000	a. Sales
$5,000	b. Interest
$0	c. Dividends
$0	d. Other
80.01%	5. Texas Apportionment (4/3)
$479,660	6. Total Texas Tax Base (2*5)
($100,000)	7. Less: Allowable Deductions
$379,660	8. Equals Gross Taxable Earned Surplus
4.5%	9. Tax Rate
$17,085	10. Total Texas Taxes (8*9)

11. Gross Tax Liability Before Credits (higher of line 10)	$17,085
12. Less: Tax Credits	($2,000)
13. Tax Due	$15,085

Earned surplus apportionment is calculated the same as under the capital tax, except that the amount of dividends is adjusted for the dividends-received deduction (line 3c: $600, which is $2,000 in gross dividends received less the $1,400 allowable federal deduction). Total gross receipts for the purpose of apportioning the earned surplus tax is therefore $1,400 less than that for the capital tax calculation. Texas receipts are the sum of sales in Texas, plus the $5,000 in depository interest it received from a Texas bank (line 4: $4,005,000). Its earned surplus apportionment factor is 80.01% (line 5: $4,005,000 divided by $5,005,600), just slightly higher than the capital tax apportionment factor. The amount of Taxable Earned Surplus is multiplied by this apportionment factor to yield Texas taxable earned surplus. In this example, the taxpayer offsets against this amount $100,000 in net operating losses incurred in the prior year, reducing its taxable earned surplus to $379,660. This is taxed at 4.5 percent to arrive at a total earned surplus liability of $17,085 (line 10).

The ultimate tax liability is essentially the higher of the capital or the earned surplus calculation—in this case the $17,085 under earned surplus. Against this the taxpayer claims $2,000 of tax credits for its expenditures for new investment, jobs creation, and/or research and development (line 12), resulting in a net tax due of $15,085.

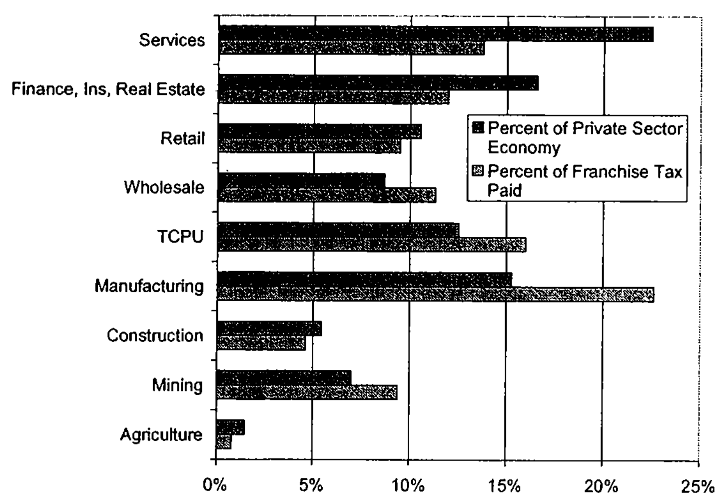
Figure 14
The Texas Franchise Tax across Industries, 2001



Note: Earned surplus is the total tax liability of those taxpayers paying on earned surplus. It includes the portion of their tax payment based on capital.
Source: Derived from data provided by the Comptroller of Public Accounts.

Who Pays the Franchise Tax. Most of the Texas franchise tax is paid under the earned surplus calculation. Across industries, manufacturing by far accounts for the largest share of franchise taxes paid, about $425 million in 2001 (Figure 14). Transportation, communication, and utilities account for near $300 million, followed by services at over $250 million.

Figure 15
Franchise Taxes and Economic Output, 2001

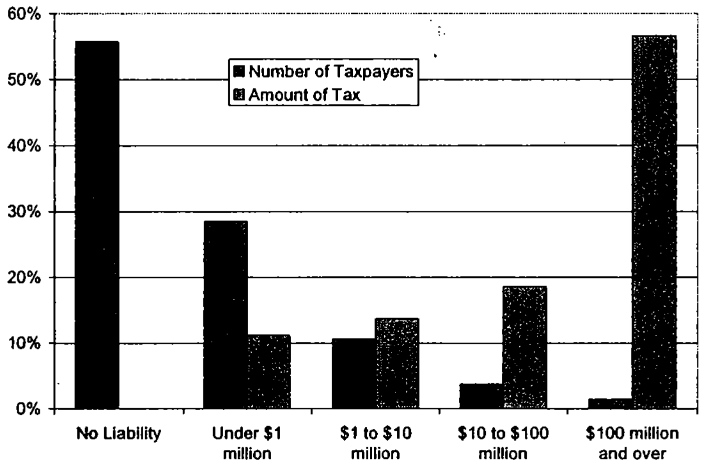


Source: Texas Comptroller of Public Accounts and U.S. Bureau of Economic Analysis.

Comparing the franchise tax to industries' shares of economic output illustrates that the franchise tax roughly mirrors the overall Texas economy, though not without some deviations (Figure 15). Service corporations account for the largest share of the state's economic output (as measured by gross state product), about 23 percent, but pay about 14 percent of the franchise tax. Manufacturing corporations pay about 23 percent of the franchise tax but account for just over 15 percent of the state's economic output.

The franchise tax is a "big business" tax. As might be expected, the state's largest corporations account for the lion's share of it (Figure 16). The state's 7,000 corporations with receipts in excess of $100 million annually account for nearly $1.2 billion in franchise tax payments, meaning 57 percent of the tax is paid by 1.4 percent of the taxpayers. Of the 511,000 corporations filing returns, more than half—285,000—owed no tax because they had under $150,000 in total receipts or their tax liability was less than $100.

Figure 16
Franchise Taxpayers by Size, 2001



Source: Texas Comptroller of Public Accounts.

Traditional C corporations account for most of the franchise tax paid. Half of the franchise tax is paid by C corporations organized under the laws of other states (i.e., "foreign corporations"—Figure 17). Corporations organized here in Texas account for roughly one fourth of the franchise tax. S corporations account for about ten percent of the tax, while limited liability companies account for about 7 percent.

Figure 17
Texas Franchise Tax Paid by Form of Business, 2002

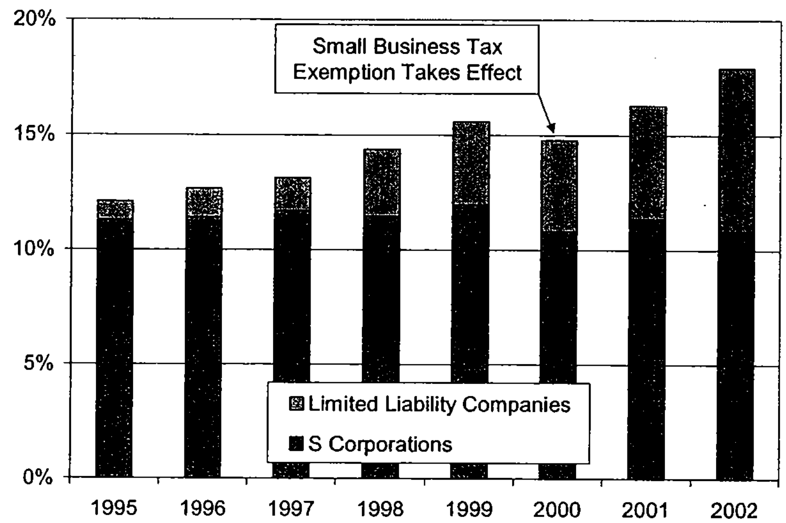
Form of Business	Gross Amount	Percent of Total
Texas C Corporations	$565.7	26.6%
Foreign C Corporations	$1,060.4	49.9%
S Corporations	$230.3	10.8%
Professional Corporations	$6.7	0.3%
Limited Liability Companies	$150.5	7.1%
Banks	$32.6	1.5%
Other/Not Classified	$80.6	3.8%
Total	$2,126.7	100.0%

Notes: Amounts shown are preliminary tax payments for the 2001 report year. Net franchise tax collections may differ because of differences in timing of payments, refunds and audit payments for prior years.

Source: Comptroller of Public Accounts, unpublished data.

Though Texas is unusual in including S corporations and limited liability companies under the franchise tax, it has not seemed to discourage their popularity (Figure 18). Since 1995, S corporations have accounted for a fairly steady portion—about 11 to 12 percent—of the state's franchise tax collections. Taxes from limited liability companies have increased from less than one percent in 1995 to over seven percent by 2002. The number of LLCs paying franchise tax has increased from just under 7,000 companies to over 62,000 companies.

Figure 18
Trends in S Corporations and Limited Liability Companies: Franchise Tax Liability



Source: Texas Comptroller of Public Accounts, unpublished data.

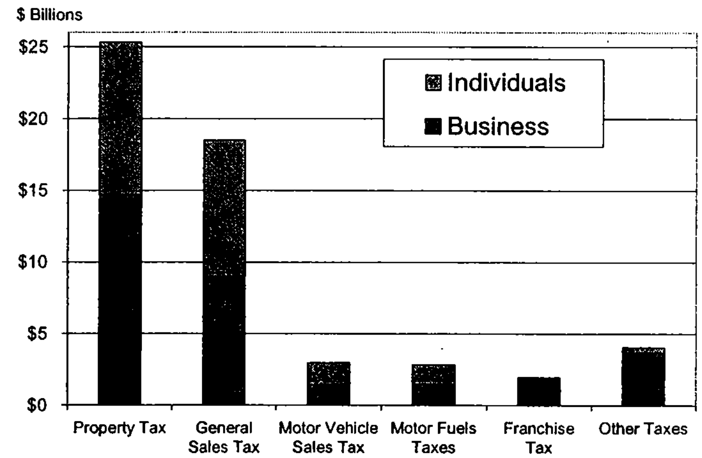
The Franchise Tax in the Texas Revenue System. While commonly thought of as the state's general business tax, the franchise tax does not apply to all businesses; it is limited in its application to corporations and limited liability companies, with sole proprietorships, professional associations, and all forms of partnerships not subject to tax. Further, the franchise tax is not the largest state and local tax businesses pay. Property and sales taxes are well known to individuals, but roughly half of all sales taxes are paid by businesses on their purchases of property and services used in their operations, and almost three-fifths of all local property taxes are paid by business (Figure 19). The franchise tax is the single largest tax, however, that is exclusively paid by businesses.

In the *state* revenue system,[11] the franchise tax is the state's fourth largest source of tax revenue—accounting for just over $1.9 billion in revenue, or 7.4 percent of all tax collections, in 2002. The tax has been on the books since 1907, primarily as a tax on the net assets of a corporation. Prior to the mid 1980s, the franchise tax had been a fairly stable revenue performer, accounting for from five to seven percent of state tax revenue (Figure 20). Various tax increases and surtaxes imposed during the economic turmoil of the 1980s caused it to briefly increase to nearly nine percent of state tax revenues; however, in the late 1980s a series of court cases sparked substantial refunds.

Since the inception of the franchise tax, accounting standards have evolved to require corporations to record more and more information about the nature of their assets and

[11] This excludes property taxes, which may only be levied by local governments.

Figure 19
Who Pays Texas Taxes, 2002



Note: Figures include state and local taxes combined.
Source: Compiled by the TTARA Research Foundation from Comptroller data.

liabilities—whether certain items are "firm" or "speculative" (i.e., based on hard figures or estimates). This provides investors and financial institutions better and consistent information concerning the corporation as either an investment or as a borrower of funds. Increasingly, contingent liabilities and assets began to be included in a company's books and records for regulatory purposes—items not originally contemplated in the franchise tax statutes. To preserve the traditional revenue stream, the state resisted recognizing many of these items of contingent liability as debt, and correspondingly, as a deduction from the franchise tax base. The courts ruled against these ad hoc policies, leading to a substantial amount of refunds in the late 1980s.

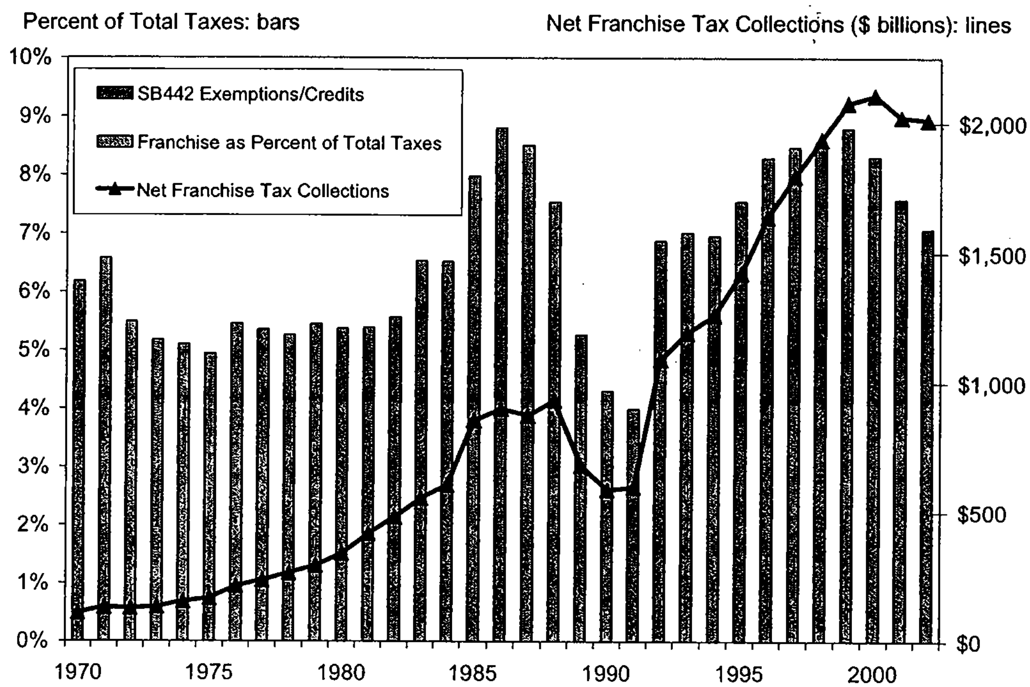
Faced with increasing litigation losses and making a policy decision to make the franchise tax less reliant on capital and more reflective of a modern Texas economy, the Legislature restructured the tax in 1991. These revisions lowered the tax rate on capital and added an alternative tax calculation based on "earned surplus"—essentially the sum of a corporation's net income and the amount of compensation paid to its officers and directors. These changes shifted the tax from one based entirely on capital to one predominately levied on corporate income (the chief component of earned surplus).

With the booming economy of the 1990s producing record corporate profits, franchise tax revenues increased steadily. Most recently, however, tax collections have dipped. In her biennial revenue estimate for 2004-05, Comptroller Carole Strayhorn noted three factors that were dampening growth of franchise tax revenues:

- new tax credits to encourage economic investment,
- tax planning strategies, and
- falling corporate profits.

New Tax Credits. In 1999, the Texas legislature passed Senate Bill 442 into law adding a new tax exemption for small business along with new economic incentives. These included tax credits for amounts spent in Texas on research and development, new

Figure 20
The Texas Franchise Tax in the Texas Tax System



investment, and new jobs. Initially estimated to cost the state $143.8 million in 2001, the most recent year for which data is available, the actual cost of these exemptions has proven to be much less—only $15.6 million.[12]

Tax Planning. The Comptroller's Office has estimated that a second factor could be taking its toll on franchise tax revenues. Partnerships are not subject to the state's franchise tax and there is anecdotal evidence that some corporations have created partnership subsidiaries to conduct their business activities in Texas. The Comptroller's concern has been that as more corporations adopt this approach the franchise tax base will erode.

Many corporations structure their activities in a variety of combinations of subsidiaries in different business forms. Because partnerships are not directly subject to the franchise tax, this creates a tax incentive to organize a subsidiary partnership as opposed to a C corporation or a limited liability company.

[12] The small business exemption removed approximately $45 million annually from the tax base, but is not included in the above figures..

Figure 22
Taxation of Business Forms across the States

	Range of Individual Income Tax Rates	Range of Corporate Income Tax Rates	Sole Proprietorships	Partnerships	LLCs	S Corps	C Corps
Alabama	2%-5%	6.50%	Owner's PIT	Election	Election	Election	CIT
Alaska	X	1%-9.4%	X	X	Election	Election	CIT
Arizona	2.87-5.04%	6.968%	Owner's PIT	Election	Election	Election	CIT
Arkansas	1%-7%	1%-6.5%	Owner's PIT	Election	FT; Election	Election	CIT
California	1%-9.3%	8.80%	Owner's PIT	Graduated fee	Graduated fee	1.5% IT	CIT
Colorado	4.63%	4.63%	Owner's PIT	Election	Election	Election	CIT
Connecticut	3%-4.5%	7.50%	Owner's PIT	Election	Election	CIT	CIT
Delaware	2.2%-5.95%	8.70%	Owner's PIT	Election	Election	Election	CIT
Florida	X	5.50%	X	X	Election	CIT	CIT
Georgia	1%-6%	6%	Owner's PIT	Election	Election	Election	CIT
Hawaii	1.5%-8.5%	4.4%-6.4%	Owner's PIT	Election	Election	Election	CIT
Idaho	1.6%-7.8%	7.60%	Owner's PIT	Election	Election	Election	CIT
Illinois	3%	7.30%	Owner's PIT	PPRT	PPRT	PPRT	CIT
Indiana	3.40%	gross/net combo	Owner's PIT	Election	Election	Election	CIT
Iowa	0.36%-8.98%	6%-12%	Owner's PIT	Election	Election	Election	CIT
Kansas	3.5%-6.45%	4%-7.85%	Owner's PIT	Election	Election	Election	CIT
Kentucky	2%-6%	4%-8.25%	Owner's PIT	Election	Election	Election	CIT
Louisiana	2%	4%-8%	Owner's PIT	Election	Election	Election	CIT
Maine	2%-8.5%	3.50%	Owner's PIT	Election	Election	Election	CIT
Maryland	2%-4.8%	7%	Owner's PIT	Election	Election	Election	CIT
Massachusetts	5.6%-	9.50%	Owner's PIT	Election	Election	Election	CIT
Michigan	4.10%	2.0% of value-added	SBT	SBT	SBT	SBT	SBT
Minnesota	5.35%-7.85%	9.80%	Owner's PIT	Election	Election	Election	CIT
Mississippi	3%-5%	3%-5%	Owner's PIT	Election	Election	Election	CIT
Missouri	1.5%-6%	6.25%	Owner's PIT	Election	Election	Election	CIT
Montana	2%-11%	6.75%	Owner's PIT	Election	Election	Election	CIT
Nebraska	2.51%-6.68%	5.58%-7.81%	Owner's PIT	Election	Election	Election	CIT
Nevada	X	X	X	X	X	X	X
New Hampshire	5% D&I	8.5%	BPT	BPT	BPT	BPT	BPT
New Jersey	1.4%-6.37%	7.5%-9%	Owner's PIT	Election	Election	Election	CIT
New Mexico	1.7%-8.2%	4.8%-7.6%	Owner's PIT	Election	Election	Election	CIT
New York	4%-6.85%	7.50%	Owner's PIT	Election	Election	Election	CIT
North Carolina	6%-8.25%	6.90%	Owner's PIT	Election	Election	Election	CIT
North Dakota	2.67%-12%	3%-10.5%	Owner's PIT	Election	Election	Election	CIT
Ohio	0.743%-7.5%	5.1%-8.5%	Owner's PIT	Election	Election	Election	CIT
Oklahoma	0.5%-6.75%	6%	Owner's PIT	Election	Election	Election	CIT
Oregon	5%-9%	6.60%	Owner's PIT	Election	Election	Election	CIT
Pennsylvania	2.80%	9.99%	Owner's PIT	Election	FT	FT	CIT
Rhode Island	25.5% federal liability	9%	Owner's PIT	Election	Election	Election	CIT
South Carolina	2.5%-7.0%	5%	Owner's PIT	Election	Election	Election	CIT
South Dakota	X	X	X	X	X	X	X
Tennessee	6% D&I	6%	X	X	Graduated fee	CIT	CIT
Texas	**X**	**4.5% earned surplus**	**X**	**X**	**CIT**	**CIT**	**CIT**
Utah	2.3%-7.0%	5%	Owner's PIT	Election	Election	Election	CIT
Vermont	24% federal liability	7%-9.75%	Owner's PIT	Election	Election	Election	CIT
Virginia	2.0%-5.75%	6%	Owner's PIT	Election	Election	Election	CIT
Washington	X	X	X	X	X	X	X
West Virginia	3%-6.5%	9%	Owner's PIT	BFT	BFT	BFT	CIT
Wisconsin	4.6%-6.75%	7.90%	Owner's PIT	Election	Election	Election	CIT
Wyoming	X	X	X	X	X	X	X

Notes: D&I = dividends and interest; PIT = personal income tax; "Election" signifies that the entity may choose to be treated as a pass-through entity for tax purposes (in which the owner pays tax on the income from the entity) or be taxed directly under the corporate income tax; SBT = single business tax; BPT = Business Profits and Business Enterprise Tax; PPRT = Personal Property Replacement Tax; FT = franchise tax (typically asset-based; for *corporations* subject to franchise taxes see Figure 23); CIT = corporate income tax.

Sole Proprietorships. Most states, 40 of 50, tax the income from sole proprietorships exclusively on the proprietor's individual income tax return. Income tax rates vary widely across these states, as do tax brackets, deductions, and exemptions. Two states tax sole proprietorships directly through their state's general business tax—New Hampshire and Michigan.

New Hampshire's Business Profits and Business Enterprise Tax applies to all forms of business, including sole proprietorships. Sole proprietors report their income from their federal tax return schedules C (profit or loss from business), E (supplemental income and loss—generally rental and royalties), and F (profit or loss from farming), attributable to activity in New Hampshire. A deduction is allowed for reasonable compensation for the services of the proprietor. Businesses with less than $150,000 of receipts for a given year do not have to pay the tax, which effectively eliminates most sole proprietorships from tax.[13]

Michigan's single business tax also applies to all business forms, but exempts businesses with less than $250,000 in gross receipts (again, effectively eliminating most sole proprietorships from the tax). Michigan's tax includes labor costs as a part of the tax base, so there is no deduction for proprietor's compensation as with New Hampshire's tax. New Hampshire has no individual income tax on owner's income (its personal income tax applies only to interest and dividend income), but Michigan subjects sole proprietor's income to its state income tax.

Texas is one of eight states (Alaska, Florida, Nevada, South Dakota, Tennessee, Washington, and Wyoming are the others) that do not tax the personal income of individuals, including owner's income earned from a sole proprietorship (Tennessee does, however, tax the dividends and interest individuals receive from their business investments).

Partnerships. Most states tax the business activity of a partnership through the owner's tax return—either a state individual income tax or a corporate income tax, depending on the form of the partner.

New Hampshire and Michigan subject partnerships to their Business Profits and Business Enterprise Tax and Single Business Tax, respectively (with New Hampshire allowing a reasonable deduction for the value of a partner's services to the partnership).

Illinois levies its Personal Property Replacement Income Tax of 1.5 percent on net income of partnerships attributable to their business activity in Illinois. Like New Hampshire's tax, it allows a deduction for the value of personal services provided by partners to the partnership. West Virginia levies an "assets-based" franchise tax, rather than an income

[13] Under an alternative "enterprise value" calculation, some businesses failing to meet the receipts threshold may be required to file a return.

tax on partnerships. It is based on the value of the partnership's capital accounts. California imposes a graduated fee on partnerships.

New Jersey, while having no direct tax on partnerships, recently enacted legislation making a limited partnership (along with limited liability companies) responsible for the income taxes of their corporate partners, in the event their corporate partners do not themselves pay New Jersey corporate taxes on it. This legislation was enacted in response to the increasing use of subsidiary partnerships (and limited liability companies) as a method of minimizing corporate taxes.

States with personal income taxes generally treat an individual's share of partnership income as a part of taxable income on the individual's tax return. Texas is one of only eight states that neither taxes partnerships directly, nor subjects an *individual* owner to income tax on their proportionate share of the partnership's income. Four of those states, including Texas, do have corporate income taxes that require corporate partners to include their proportionate shares of income from partnership interests as a part of their reported taxable income on the corporation tax return.

Limited Liability Companies. As with partnerships and sole proprietorships, most states tax the business activity of a limited liability company through a member's (owner's) tax return—either a state individual income tax or a corporate income tax, depending on the form of the member. Some states do levy entity level taxes on LLCs. Illinois' Personal Property Replacement Income Tax, New Hampshire's Business Profits and Business Enterprise Tax, and Michigan's Single Business Tax apply to LLCs. In addition, Texas subjects LLCs to the corporate franchise tax; Tennessee subjects LLCs to its corporate profits tax; West Virginia and Pennsylvania subject LLCs to their asset-based franchise taxes; and, California levies a graduated fee based on net income (but capped at $11,790 in 2002). These taxes do not necessarily preclude owners from also being taxed on their income from the LLC.[14]

Just four states tax limited liability companies neither directly through a business tax nor indirectly through an income tax on individual owner's share of income.

S Corporations. Most states treat S Corporations as pass-through entities—taxing income at the owner's level. Texas is one of several states, including Connecticut, Tennessee, Michigan and New Hampshire that make no distinction between S Corporations and C Corporations—treating S Corporations as taxable entities.[15] California levies a special assessment on S Corporations, while Illinois subjects them to the Personal Property Replacement Tax. Massachusetts levies a franchise tax on S corporations. Pennsylvania S

[14] John C. Healy and Michael S. Schadewald, *2002 Multistate Corporate Tax Guide* (New York, New York: Panel Publishers, 2002).
[15] James Edward Maule, *State Taxation of S Corporations*, Multistate Tax Portfolios, (Washintgon, D.C., BNATax Management, 2002).

corporations must pay the state's capital stock tax. These special assessments do not necessarily relieve owners from paying taxes on the income earned on their investment in the S corporation.

Most other states with personal income taxes simply tax S Corporation income at the owner's level.

C Corporations and Corporate Taxes. Few states levy a capital-based tax, instead relying solely on an income- or activity-based corporate tax. Forty-six states, including Texas levy income-based taxes on corporations.[16] Twenty-three states, including Texas levy some type of capital-based tax. Some states, such as Tennessee, require businesses to pay *both* a tax on corporate income *and* a separate tax on capital (although at a much lower burden than Texas). The breadth of the business tax bases, tax deductions and tax credits varies widely across states, as do the rates of the taxes. And even among those states levying similar types of business taxes (such as income-based taxes), state tax law, administrative rules, and case law vary widely.

As a percent of gross state product (a common measure of state economic activity), Texas' corporate taxes rank 38th among all states—low relative to other states' business taxes, but higher than Texas' 46th place ranking in terms of overall state taxes (Figure 23).

While Texas' franchise tax appears to compare favorably to that of other states by the fact that the overall tax burden is relatively low, it is important to note that a business does not pay taxes *overall;* it pays them *individually.* Some aspects of Texas' franchise tax are clearly more favorable to certain taxpayers than those of other states, while other parts of Texas' franchise tax are clearly unfavorable. These are summarized in Figure 24.

Tax Base and Rate. Texas' corporate tax base is broader than that of most other states. Most states solely tax corporate net profits (following the federal definition of taxable income with some exceptions). Texas taxes net profits as well, but requires taxpayers to add to this the amount of compensation paid to the corporation's officers and directors, yielding a result termed "earned surplus." From a sheer dollar standpoint, the officer and director add-back amounts to roughly an additional five percent of the base of the tax, but it comes with a high administrative cost. While corporate directors are named positions, there is no clear statutory or administrative definition of what constitutes a corporate officer—an issue that often leads to misunderstandings and disputes between the taxpayer and the Comptroller's Office.

Offsetting the broader tax base is the fact that at 4.5 percent Texas' earned surplus tax rate tends to be lower than the profits tax rate in other states. However, Texas' capital tax is

[16] This includes Michigan, which levies a single business tax on the sum of net income, labor and capital. Michigan's tax applies to all businesses, incorporated and unincorporated.

Figure 23
Business Taxes Across the States

	Corporation Net Income	Corporate License Tax	Business Taxes as Pct of GSP	Rank Among States	Range of 2002 Income Tax Rates	Type of Capital Stock Tax	Capital Tax Rate (As Pct)
Alabama	174,069	81,912	0.22%	43	6.5%	Capital Stock+Surplus+Debt	.025-0.175%
Alaska	400,442	1,278	1.52%	2	1.0-9.4%	None (fee)	
Arizona	541,174	10,623	0.38%	22	6.968%	None (fee)	
Arkansas	186,277	7,970	0.30%	27	1.0-6.5%	Capital Stock+Surplus+Debt	0.27%
California	6,899,302	45,192	0.57%	7	8.84%	None (fee)	
Colorado	340,039	5,812	0.22%	42	4.63%	None (fee)	
Connecticut	413,109	12,710	0.28%	32	7.5%	Net Income (see left)	
Delaware	207,320	600,593	2.33%	1	8.7%	Tax based on # shares issued	$30-150,000
Florida	1,591,473	123,905	0.39%	21	5.5%	Banks; Fee for others	
Georgia	691,473	32,708	0.26%	38	6.0%	Capital Stock+Surplus	$10-5,000
Hawaii	60,499	2,667	0.15%	47	4.4-6.4%	None (fee)	
Idaho	141,986	1,273	0.42%	20	7.6%	None (fee)	
Illinois	2,216,842	151,605	0.53%	9	4.8%+2.5%	Capital Stock+Surplus	0.1%
Indiana	825,017	5,715	0.46%	13	0.3-7.9%	None (fee)	
Iowa	166,745	28,719	0.23%	41	6.0-12.0%	None (fee)	
Kansas	236,723	27,782	0.33%	26	4.0-7.35%	Capital Stock+Surplus	0.1% (c)
Kentucky	361,390	204,474	0.50%	11	4.0-8.25%	Capital Stock+Surplus+Debt	0.21%
Louisiana	293,056	252,710	0.42%	19	4.0-8.0%	Capital Stock+Surplus+Debt	0.15-0.3%
Maine	96,283	3,313	0.29%	31	3.5%-8.93%	None (fee)	
Maryland	501,365	14,204	0.30%	30	7.0%	Financial Inst. net income	7.0%
Massachussetts	1,211,584	23,129	0.47%	12	9.95%	None (fee)	
Michigan	2,102,093	12,459	0.69%	4	1.9% (b)	None (fee)	
Minnesota	732,004	4,375	0.43%	18	9.8%	None (fee)	
Mississippi	210,786	66,100	0.43%	17	3.0-5.0%	Capital Stock+Surplus	0.25%
Missouri	236,261	77,158	0.18%	45	6.25%	Capital Stock+Surplus	0.05%
Montana	103,670	1,277	0.51%	10	6.75%	None (fee)	
Nebraska	138,040	6,190	0.27%	34	5.58-7.81%	None (fee)	
Nevada	(X)	23,058	0.03%	49	N.A.	None (fee)	
New Hampshire	350,363	4,347	0.80%	3	7.0%	None (fee)	
New Jersey	1,300,785	145,753	0.44%	14	7.5-9.0%	Limited to certain industries	
New Mexico	190,673	2,402	0.38%	23	4.8-7.6%	None (fee)	
New York	3,199,483	65,505	0.43%	16	7.5%	Capital	0.178%
North Carolina	723,635	398,278	0.43%	15	6.9%	Capital Stock+Surplus	0.15%
North Dakota	63,390	(X)	0.37%	24	3.0-10.5%	None (fee)	
Ohio	663,376	296,642	0.27%	36	5.1-8.5%	Capital-based	0.4%
Oklahoma	167,222	42,700	0.24%	39	6.0%	Capital Stock+Surplus+Debt	0.125%
Oregon	322,651	5,007	0.30%	28	6.6%	None (fee)	
Pennsylvania	1,401,299	895,161	0.60%	6	9.99%	Capitalized Net Inc.+Net Worth	0.649% (d)
Rhode Island	77,998	11,470	0.27%	33	9.0%	Capital Stock	0.025%
South Carolina	192,070	64,432	0.24%	40	5.0%	Capital Stock+Surplus	$15+0.01%
South Dakota	43,387	2,130	0.21%	44	N.A.	None (fee)	
Tennessee	673,465	480,242	0.68%	5	6.0%	Capital Stock+Surplus	0.25%
Texas	**(a)**	**2,030,756**	**0.30%**	**29**	**4.5%**	**Capital Stock+Surplus**	**0.25%**
Utah	162,754	2,573	0.26%	37	5.0%	None (fee)	
Vermont	44,606	1,267	0.27%	35	7.0-9.75%	None (fee)	
Virginia	363,757	29,437	0.16%	46	6.0%	Banks Only	
Washington	(X)	14,685	0.01%	50	N.A.	None (fee)	
West Virginia	214,297	5,649	0.54%	8	9.0%	Capital-based	0.7%
Wisconsin	495,449	87,857	0.35%	25	7.9%	Limited to certain industries	
Wyoming	(X)	7,290	0.04%	48	N.A.	Capital+Property+Assets	0.02%
United States	31,729,682	6,422,494	0.41%		46 states		

Source: Census Bureau, Texas Comptroller's Office, and various state statutes.

Figure 24
Key Aspects of State Corporation Taxes

Policy	Texas	Other States	Comparison
Tax Base	Two calculations: • Earned Surplus (sum of net income and officer director compensation) • Net Taxable Capital	Typically based on net income alone; 14 states have somewhat significant capital-based taxes—typically levied under separate statute	With capital tax essentially serving as a very high alternative minimum tax, capital tax is more burdensome to companies operating with little or no profits
Tax Rates	Earned Surplus: 4.5 percent Taxable Capital: 0.25 percent	Corporate income tax rates average about 6.0 percent; few states have a significant capital tax	Texas' effective tax on net income is comparatively low; tax on capital is very high
Entities Subject to Tax	C Corporations S Corporations Limited Liability Companies	Typically only C Corporations (see note)[17]	Most states tax S Corporations and LLC's through owner's personal income tax
Filing require-ments	Separate entity	28 states allow or require consolidated reporting; 24 states allow or require combined reporting; 18 prohibit combined reports[18]	Separate entity filing is less discriminatory and limits taxation of business activity in other states
Methods of apportion-ment	Single factor based on receipts	Typically three factors based on sales, property, and payroll	Single factor receipts is more advantageous to Texas-based companies
Sourcing of intangible income	Location of payor	Commercial domicile of recipient	Location of payor limits taxation of out-of-state business activity
Dividends from subsidsidi-aries	Excluded from earned surplus; Taxable under capital calculation	Most states follow federal exclusion; others have different ownership thresholds	Earned surplus treatment is consistent with income tax states, but burdensome for taxable capital
Net operating loss carry-forward	5 years	5 years: 8 states 7 years: 2 states 15 years: 10 states 20 years: 20 states	Texas NOL is among the shortest; NOLs must be claimed even if paying on capital
Nexus of Partners	General partners have nexus; limited partners do not	General partners have nexus in 44 taxing states; limited partners have nexus in 35 states	Texas treatment favorable to attract out-of-state investors

[17] Michigan and New Hampshire have "single business" taxes that apply to corporate and partnership forms of business. Illinois has a separate partnership tax of 1.5 percent of income. New Jersey taxes partnerships if corporate partners do not pay tax. Ohio taxes out-of-state partners. Tennessee subjects business entities with limited liability to its corporate income tax. Washington subjects all businesses to its gross receipts-based business and occupation tax.
[18] Healy and Schadewald, Ibid.

very high relative to that of other states, in effect leaving Texas with a very high alternative minimum tax not seen in other states.

Entities Subject to Tax. As noted earlier, Texas' franchise tax applies to more business forms than the corporate taxes of most other states. Texas includes limited liability companies and S corporations, entities most other states opt to tax at the owner level. The broader application of the tax is beneficial to traditional C corporations, who are placed on equal state tax footing with a number of the businesses with which they compete. Of course, it is relatively disadvantageous to limited liability companies and S corporations, which are subject to taxes they would not have to pay if they were doing business in another state, although their owners would likely be liable for that state's personal income tax on their income from their S corporation investment.

Filing Requirements. Tax return filing requirements can also impact how flows of intangible income are ultimately taxed. Many businesses, particularly corporations doing business in a variety of states, are often made up of several separate legal entities: corporations, joint ventures, partnerships, and other forms of business. Many states have provisions for the filing of a consolidated or combined return, in which the financial data for the affiliated corporations subject to that state's jurisdictions are summed, then apportioned to the particular state for tax purposes. Transactions between affiliated entities, such as interest, dividends, and intercompany sales, may "net out" of the tax calculation, eliminating the need for separately sourcing each one. Consolidated and combined reporting options or requirements vary widely.[19] Some states allow it at the taxpayer's option, other states impose it as a mandatory filing method, and some states require it under selected conditions. Some states require a combined report, but tax the

[19] Consolidated and combined reporting are similar in concept, though technically different. State consolidated reporting often draws on the federal tax return (which is filed on a consolidated basis). Generally, for firms to be included in a state *consolidated* return, they must be a part of a federal consolidated return and must have nexus within the state (though not always). Consolidated reporting is traditionally considered a "privilege"—generally it is at the taxpayer's option to file either a consolidated return or individual returns for each entity with nexus in the state. *Combined* reporting is decidedly more complicated. Under combined reporting, affiliated corporations who are engaged in an integrated, or unitary, business are required to combine their income for tax purposes. There is, however, no standard definition of what constitutes a "unitary" business. Various court decisions have established three tests of determining whether firms are engaged in a unitary business, though they may be applied differently in different states:

- the three unities test (ownership, operation, and use)—the firms may have common ownership, common operations (such as advertising, accounting, pension plans, facilities, insurance, etc.), and centralized management and services.
- the contribution or dependency test—the firms have intercoporate exchanges of either funds, technology or materials that contribute to the business as a whole, and
- the factors of profitability test—functional integration of operations.

Typically, a combined report may include unitary corporations that do not have nexus in the state. Combined reporting is typically at the discretion of the taxing entity, not the taxpayer. All this said, it should be noted that the delineation between consolidated and combined reporting is not always clear. In practice, many states employ elements of both in their filing requirements, leaving any distinctions between the two more a matter for academic discussion.

corporations individually. States may have different requirements as to which affiliated corporations within the group must be included within the combined or consolidated return. Texas is a "separate entity" state, in which each individual corporation must file a tax return in its own right.

It is a taxpayer's individual circumstances that would determine whether separate entity filing or combined/consolidated filing is financially more beneficial. Under consolidated/combined reporting, businesses may reduce their tax liability in the event they have credits and deductions in certain subsidiaries or affiliated companies that cannot be fully claimed by the business unit accruing them. For example, a business unit losing money may not be able to claim an investment tax credit in a given year because the credit exceeds the actual liability. Combined reporting allows the taxpayer to reduce taxes at profitable units by offsetting them with losses and credits accrued at affiliated entities that were not profitable. Other taxpayers may benefit from separate entity reporting. The differences between separate entity and combined/consolidated reporting requirements allow multi-state businesses to consider differences in state tax policies when deciding where to locate individual units of its business, particularly those involving income from intangibles. A company may generate tax savings when placing certain of their operations in states with more favorable reporting requirements—differences that might be muted by consolidated or combined reporting.

Methods of Apportionment, Allocation, and Income Sourcing. States use a variety of formulas to properly apportion taxable activity to their states. Most states use the average of three equally-weighted factors—property, payroll, and receipts (or sales)—while many other states "double weight" the sales or receipts factor.[20] Texas is one of a growing number of states that uses a single factor—gross receipts—which includes amounts of taxable income from intangibles. Increased emphasis on the receipts factor is generally viewed as a positive for investing in a particular state. A multi-state company may build a new factory and hire additional payroll in Texas, but its franchise taxes would not increase unless its sales increased here.

Intangible income, such as that from dividends, interest, royalties, and capital gains and losses, is generally assigned to a state either by apportionment or allocation (or in some special instances by separate accounting). Most states assign intangible income to the commercial domicile, i.e., the state in which a company's headquarters is located, regardless of the state in which the income was generated. This may place a tax premium on companies locating in such a state. For *income tax* calculations, this is typically less of an issue for intra-company dividends because states follow the federal treatment of excluding them from taxation. This is to prevent multiple taxation of income since the company generating the dividends is already subject to tax. It is a potentially huge issue, however, on the capital side of Texas' franchise tax calculation.

[20] This would be the average of sales + sales + property + payroll.

Texas sources income from most intangibles to the location of the payor, i.e., the state of incorporation of the entity paying the dividends, interest, royalty, etc. Texas-headquartered companies benefit from this treatment over commercial domicile sourcing, and location of payor is a key factor in encouraging companies to locate their headquarters here even if the bulk of their operations is elsewhere. Location of payor prevents particular problems with the capital tax calculation, however, because dividends received are included as a part of the tax base and the corresponding apportionment factors.

Net Operating Losses. States and the federal government allow companies to accrue tax deductions for the amount of losses they incur. These may be used to reduce tax liability in future years (the federal government also allows a carryback of losses to certain preceding years, generating a refund of federal taxes previously paid). The federal government allows taxpayers to carry loss deductions forward up to 20 years—a practice followed by 20 other states.[21] Texas' five year carryforward ranks it as the shortest carryforward period allowed. Even worse, companies must use the maximum amount of their accrued loss carryforwards to reduce their earned surplus liability, even if the ultimate tax liability is paid on taxable capital. It is possible for a company doing business in Texas to incur substantial losses yet still be subject to a sizeable tax bill and never be able to realize any benefit from the accrued loss carryforwards. This policy compares unfavorably with other states.

Limited Partnership Interests and Nexus. Businesses today are typically a combination of many separate entities—parents, subsidiaries and affiliated companies. It is not unusual for corporations to participate in partnerships, sometimes with other independent businesses, sometimes among affiliated businesses. A corporation with a general partnership interest in a limited partnership operating in any state is deemed to give it economic presence, or nexus, in that state. That requires the corporate general partner to pay income taxes to the state(s) in which the partnership is doing business. Most states also require corporations whose only activity in a state is ownership of a limited partnership interest to pay corporate taxes as well. Texas is one of nine states in which a corporation may own a limited partnership interest in a limited partnership operating in the state but not be deemed to have nexus. This tax policy is generally viewed as favorable to both partnerships and corporations. For partnerships, it removes a potential tax barrier to attracting passive investment capital. For corporations investing in Texas partnerships, it eliminates the potential barrier of higher taxes on those parts of their equations.

[21] The federal government also allows a taxpayer to carry net operating losses back two years, and such carryback taxes are given priority over a carryforward unless a special election is made. As a special rule, net operating losses arising in 2002 may be carried back five years.

CHAPTER 4
A CASE STUDY OF TAXES AND FORMS OF BUSINESS

Key Facts:

- *The form in which a business organizes and the structure in which it operates are not discrete decisions made for the life of the business. A business may alter its form and structure as its circumstances change.*
- *Tax considerations may affect some business decisions, but typically they are only one of several factors that enter into how a business organizes and structures itself.*

This chapter looks in more detail at how tax policy affects the finances of the various types of business organizational forms and their owners. In doing this, the company history of a fictitious business, the Muffin Mann Company, is presented. As the company grows, it becomes more complex. It changes in form from a sole proprietorship, to a partnership, to a corporation, and as an affiliated entity within a larger business unit.[1] It should be noted that smaller businesses do not always have simple structures as presented in this chapter, nor do larger businesses necessarily have complex structures.

A Sole Proprietorship: The Muffin Mann Company. A sole proprietorship is an individual (or husband and wife) who owns a business that is not formally registered as a partnership, corporation, or other business form. The law does not consider a sole proprietor's business to be a separate entity from its owner; the two are one and the same. The revenues and expenditures of the business are reported as a part of the individual income tax return of the owner. Income from the business is generally taxed as the owner's income. In a state without an individual income tax, the income is not taxed at all, except by the federal government.

Julie Mann was laid off from her job at the local factory. Julie is divorced and her children are grown, but at 50, she is neither interested in retiring nor financially able to do so. After several months of trying, she has been unable to find another job. Julie's

[1] The Muffin Mann Company and the individuals and other businesses presented in this chapter are solely fictitious creations for the purposes of illustrating how taxes affect different forms of business differently. Any similarity to existing companies or individuals is completely unintentional.

friends have always raved about her baking. Her sister Nancy, who manages a small local restaurant, the *City Café*, has offered to buy any muffins Julie makes so that the restaurant can expand its breakfast menu. Julie is interested, but doesn't think the sales would generate sufficient income to live on. Julie approaches one of her acquaintances, who owns several convenience stores. He agrees to sell Julie's baked goods, but he wants to buy more than she could make at home. Julie approaches her sister again, and they work out an arrangement. Julie can use the restaurant ovens to bake her wares, provided she finishes by 7:00 a.m. each morning. Julie will pay her sister $200 a month to cover rent and utilities for the privilege of using her ovens. In turn, her sister will buy a certain number of Julie's baked goods to sell at the *City Cafe*. Julie will also sell her baked goods at the local convenience stores. She decides she will name her business the *Muffin Mann* (Figure 25).

Figure 25
The Muffin Mann Sole Proprietorship and Taxes

Muffin Mann Financials	Year of Sole Proprietorship 1	2	3
Gross Revenues			
Sales	$30,000	$60,000	$100,000
Interest Income	$432	$864	$1,440
Total Gross Revenues	$30,432	$60,864	$101,440
Operating Expenses			
Cost of Goods Sold	($10,500)	($21,000)	($35,000)
Rent	($2,400)	($2,400)	($2,400)
Interest	$0	$0	$0
Depreciation	$0	$0	$0
Use of Car	($1,860)	($3,720)	($4,650)
Other Expenses	($500)	($600)	($800)
Total Expenses	($15,260)	($27,720)	($42,850)
Net Income	$15,172	$33,144	$58,590
Muffin Mann Company Taxes			
Federal Income Tax	No entity-level tax. Income is taxed on owner's return.		
Texas Franchise Tax	Sole Proprietorships are not subject to the franchise tax		
Julie Mann's Individual Income Taxes			
Total Income	$15,172	$33,144	$58,590
Standard Deduction	($4,550)	($4,550)	($4,550)
Personal Exemption	($2,900)	($2,900)	($2,900)
Net Taxable Income	$7,722	$25,694	$51,140
Federal Income Tax	$1,158	$3,854	$10,682
State Personal Income Tax	N.A.	N.A.	N.A.

Note: This is a simplified example of a sole proprietorship

Julie doesn't really view herself as creating a business. She is just trying to make some money until the economy improves and she can go back to work. Consequently, she doesn't feel any need to consult with an accountant or formally organize her business.

Julie figures it will cost her about 21 cents in ingredients to make one muffin, which she will sell for 60 cents. The restaurant and the stores will sell her muffins for $1.00 each. The only additional cost Julie will have will be the cost of using her minivan to deliver the muffins—something she has to do herself to each of the convenience stores. For tax purposes, she will be able to claim a deduction for her business's use of her personal vehicle.

Unlike most start-up businesses, Julie's does well. She grosses $30,000 in sales her first year, making almost 200 muffins a day, five days a week. After expenses, she nets a little over $15,000. Both the restaurant and the convenience stores increase their orders after the first year, and again through the third year in which her sales reach $100,000. After expenses, Julie nets over $33,000 and $58,000, respectively, in years two and three of the business.

Taxes and the Muffin Mann Proprietorship. The Muffin Mann is simply a business name for Julie's venture. As the sole owner, operator, and employee, Julie Mann is, in effect, the business. And that is how the Internal Revenue Code views her, as well. As a sole proprietorship, the business is not directly subject to income tax, but Julie's individual income tax return reflects the income she earns through the business.

As a sole proprietorship, Julie files Schedule C with her federal 1040 Individual Income Tax Return, itemizing the revenues and expenses of the business. While Julie created a bank account in the name of the business, the interest it earned is reported as a part of her individual income on her 1040 form, and not on Schedule C for the business. She reports her gross business sales on Schedule C, as well as her business expenses. She deducts the cost of flour and other ingredients, reporting them as "cost of goods sold," as well as the rent she pays to her sister, the mileage on her minivan, and other expenses for office supplies and other business items she purchased. After these deductions, Julie's adjusted gross income for her first year is $15,172, which she reports on her 1040 form.

Julie takes the standard deduction and the personal exemption, resulting in taxable income of $7,722, on which she pays $1,158 in federal income taxes.[2] Against this liability she credits the quarterly estimated tax payments she has sent to the IRS during the year, and makes an additional payment or receives a refund as appropriate.

[2] As a self-employed individual, Julie is also liable for federal self employment taxes which support Social Security and Medicare. Half of these taxes are deductible for federal income tax purposes. For the sake of simplicity these taxes are not included in this illustration.

Sole proprietorships are not subject to the Texas franchise tax, although Julie still must pay appropriate sales taxes on the taxable items she uses in her business. The business owns no property, so no property taxes are due. Nationally, state income taxes average about four percent of income, so if Julie had started her business in another state, she might have expected to pay about $300 in state individual income taxes.

After three years, Julie's business is thriving. Her income is far greater than her old job at the factory, but the responsibility of running her own business is taking its toll. She has not had a vacation in three years, and while she is not doing any marketing, she is being approached by other retailers about carrying her goods. Her sister is concerned about Julie's heavy use of *City Café's* restaurant ovens and suggests Julie rent a full-time baking facility to help her expand. That would involve buying the ovens and machinery to equip the shop, but Julie doesn't have enough of her own savings to do so, nor will a bank lend her business the money. If the Muffin Mann wants a loan, Julie will have to take out a loan herself and be personally liable for it. Nancy agrees to give Julie needed financial support to expand, and by co-mingling their savings, they feel they can expand appropriately. Julie and her sister decide to enter into a partnership.

Liquidating the Sole Proprietorship. In this instance, there are no special tax considerations of converting the sole proprietorship to a partnership. The business had no hard assets of any value, and as a non-registered form of business, there are no special requirements for ending the sole proprietorship.

Evaluation of the Sole Proprietorship. Julie formed her business without considering any issues regarding business form. By default, she was a sole proprietorship. From a standpoint of simplicity, there were no permits, no formal registration, nor any special legal requirements to meet. For tax purposes, the sole proprietorship was fairly simple; she just had to keep records of her revenues and expenses. The accounting was made even simpler by the fact that she owned no depreciable property.

On the downside, the sole proprietorship offers no special liability protections, nor could the business get financial support on its own. The owner is personally liable for any debt.

A Partnership: The Muffin Mann, LP. While there are many types of partnerships—general, limited, limited liability, etc.—the Internal Revenue Code generally views them all equally. Partners may elect for the partnership to be taxed as a pass-through entity, in which case partners pay tax on their share of the partnership's income, whether they received it or not. For federal tax purposes, S corporations and limited liability companies are generally treated as pass-through entities similar to partnerships. S corporations and limited liability companies are, however, subject to Texas franchise taxes, though partnerships are not.

Figure 26
The Muffin Mann Partnership

Muffin Mann Financials	Year of Partnership 1	2	3
Descriptive and Financial Data			
Number of Employees	4	7	16
Number of Partners	2	2	2
Purchases of Capital Equipment	$25,000	$100,000	$100,000
Depreciated Value of Equipment	$18,878	$90,015	$131,108
Borrowing During Year	$0	$100,000	$100,000
Debt at Year End	$0	$83,055	$147,760
Partner Contributions	$50,000	$0	($100,000)
Gross Revenues			
Sales	$400,000	$750,000	$1,500,000
Interest Income	$1,920	$3,600	$7,200
Total Gross Revenues	$401,920	$753,600	$1,507,200
Operating Expenses			
Guaranteed Partner Payments	($45,000)	($45,000)	($45,000)
Cost of Goods Sold	($144,000)	($277,500)	($555,000)
Employee Salaries	($72,000)	($126,000)	($288,000)
Payroll Taxes	($8,440)	($14,770)	($30,828)
Rent	($36,000)	($66,000)	($72,000)
Interest	$0	($7,388)	($13,369)
Property Taxes	($472)	($2,250)	($3,278)
Depreciation	($6,123)	($28,863)	($45,103)
Other Expenses	($50,000)	($200,000)	($100,000)
Total Expenses	($362,034)	($767,771)	($1,152,577)
Net Income	$39,886	($14,171)	$354,623

Julie and her sister agree that Julie will actively manage the Muffin Mann business (her sister does not want to quit her job at the *City Café*). They draft a partnership agreement and register the partnership as the Muffin Mann Limited Partnership with the Secretary of State, and pay the required $750 registration fee. They each contribute $25,000 as "seed capital." Julie is the general partner and Nancy is the limited partner, each owning 50 percent of the business (Figure 26).

Julie locates a building that she can use as a bakery, but she will have to pay for remodeling costs to bring it up to the required building code. In addition, she will have to buy her own equipment. The $50,000 is enough to get them started, but by the second year, they need more capital and approach the local bank about a $100,000 loan (increased by an additional $100,000 the following year). As would be the case with a loan for Julie's sole proprietorship, the sisters must personally guarantee the loan (even though it is made to the partnership), which given the current health of their business, they are willing to do.

Because Julie is running the company full-time, the partnership agreement between her and her sister specifies that she will receive a guaranteed payment of $40,000. Her sister will receive an annual guaranteed payment of $5,000. The sisters will split any profits or losses 50-50. The partnership also hires employees to work the bakery and make deliveries.

Julie and her sister eventually decide to branch out in their business. In addition to their current customers, in the second year they put two kiosks in local office buildings to sell their baked goods. They have to buy the kiosks and pay rent to the office building owners. They also hire additional employees to staff the kiosks and pay employer taxes and overhead costs for the employees.

Business continues to expand, and the company adds more kiosks and more customers, but a bump in the road comes in the partnership's second year. Another person had previously registered the rights to the Muffin Mann trademark. The partners must pay $150,000 to purchase the rights of the trademark and eliminate the potential for a lawsuit (which is included as a part of "other expenses" in year two in Figure 26). Because of this expense, the partnership loses money. The business recovers in year three, however, as expansion continues.

Taxes and the Muffin Mann Partnership. Because she owns her own equipment, has debt, and employs staff, Julie finds her business has become more complex (Figure 27), regardless whether the business is operated as a sole proprietorship or a partnership.

As an employer, Julie is responsible for paying social security, Medicare, and unemployment taxes on her payroll. Social security taxes are 6.2 percent of her payroll (on the first $84,900 of salary), and Medicare is 1.45 percent (she has to withhold an equal amount from her employees' salaries, along with their income tax withholding, and remit it to the Internal Revenue Service. In addition she must pay state and federal unemployment taxes. The state tax rate for her is set at 2.7 percent of the first $9,000 in wages paid to each employee; the federal rate is 6.2 percent of the first $7,000 of wages paid to each employee.[3]

[3] Brackets and rates presented in this paragraph are based on 2002 tax law. State unemployment tax is creditable against the federal unemployment tax.

Figure 27
Taxes and the Muffin Mann Partnership

	Year of Partnership		
Partnership Tax Consequences	1	2	3
Julie Mann's Individual Taxes			
Total Income			
Guaranteed Payment	$40,000	$40,000	$40,000
Share of Partnership Income	$19,943	($7,085)	$177,139
Less: Tax Basis Claimed	$0	$0	$0
Exhibit: End of Year Basis	$44,943	$37,858	$164,996
Total Taxable Income	$59,943	$32,915	$217,139
Standard Deduction	($4,550)	($4,550)	($4,550)
Personal Exemption	($2,900)	($2,900)	($2,900)
Net Taxable Income	$52,493	$25,465	$209,689
Individual Federal Income Taxes			
Julie Mann's Taxes	$11,054	$3,820	$62,254
Nancy Mann's Taxes on Partnership	$6,859	($573)	$45,520
Total Individual Federal Income Tax	$17,914	$3,246	$107,775
Federal Corporate Income Tax	$0	$0	$0
Texas State Income Tax	$0	$0	$0
Texas Franchise Tax	$0	$0	$0
Total Taxes	$17,914	$3,246	$107,775

While leasing property and space, the business still owns kiosks and ovens and other tangible personal property, and the business must render the value of this equipment to the local chief appraiser and pay property taxes on it.

The partnership's gross income for its first year is $401,920, mostly from sales. Against that the partnership deducts the cost of goods sold (i.e., the cost of raw materials), guaranteed partner payments, employees' salaries and benefits, rent, and other expenses. The partnership has no debt the first year, but it does in subsequent years, deducting the 8.0 percent interest it pays on the outstanding debt. The portion of the payments to retire principal is not deducted; instead, the equipment is depreciated over seven years (according to the federal schedule for the appropriate type of equipment), of which the first year amount is $6,123. After deductions, the partnership nets $39,886 in its first year.

Like the sole proprietorship, the partnership is not directly subject to income taxes; instead, the owners pay taxes on their portions of the income from their investment in the business.

Julie's individual income tax return includes the $40,000 from the guaranteed payments she received—essentially this is her salary. In addition, she includes her 50 percent interest in the net income the partnership earned, which amounts to $19,943, even though the funds remain in the bank account of the partnership. Julie's adjusted gross income is the $40,000 from her guaranteed payments plus $19,943 from her share of the net income, for a total of $59,943. After taking her personal standard deduction and exemption, her taxable income is $52,493, resulting in a federal tax liability of $11,054.[4]

Nancy Mann's tax return includes her guaranteed payment ($5,000) and her 50 percent interest in the partnership's income. Nancy pays income taxes on her earnings from her full-time job and is in the 27.5 percent tax bracket. The additional income taxes she has to pay with respect to her partnership interest amounts to $6,859.

Because of the large payment for the Muffin Mann trademark, the partnership loses money in its second year, but that offers a tax benefit to the Mann sisters.[5] Each sister gets to subtract their share of the partnership's losses in calculating their adjusted gross income, even though they experienced no reduction in the amount of cash they took out of the partnership. Julie took out the same $40,000 and Nancy the same $5,000 they did in the first year. Even so, because of the change in the partnership's financial condition (going from profit to loss), Julie sees her taxes drop by over $7,000, and Nancy sees hers drop by nearly $6,000.[6]

In year three, even with the partnership in expansion mode, the sisters record a profit of $354,623. They intended to invest all of this money back into the business to expand, but their accountant warns them that each faces a substantial increase in her federal tax liability. Even though the profits would remain in the bank account of the partnership, the sisters are taxed on their share of it—an amount in excess of $50,000 each. To pay their tax bill, the sisters grumble and withdraw $50,000 each from the partnership's bank account.

Julie and her sister begin to disagree about the company. While Julie is the general partner, responsible for hiring and firing, Nancy is unhappy with some of the company's employees. On top of this, the business is undergoing growing pains. Julie wants to open more kiosks, but Nancy is concerned these might somehow compete against the restaurant she manages. Nancy decides to "cash out" her partnership interest and use her

[4] Even though the partnership is an employer paying social security taxes on its employees, it remains the responsibility of each partner to pay any legally-required self employment taxes on their income from the partnership (limited partners are generally exempt from self-employment taxes). For simplicity, self-employment taxes are excluded from this analysis.

[5] Technically, the purchase of a trademark is an expense that should be capitalized, rather than deducted. The cost is expensed in this example to help illustrate the treatment of profits and losses in the partnership form of business.

[6] The difference in the two sisters' tax amounts is due to the fact that the have different income levels, putting them in different tax brackets.

share of the proceeds to purchase the restaurant, so she can become the manager-owner. Julie does not have enough cash to buy Nancy's share, and the bank will not extend her credit. Further, while there are a number of community leaders interested in buying into the business, each has a limited amount of funds they can invest.

After consulting with an attorney, the sisters decide to end the partnership by selling it to the new corporation.[7]

Figure 28
Ending the Muffin Mann Partnership

Assets		
Tangible Assets		
Cash	$124,993	
Equipment (depreciated)	$144,913	
Inventory	$30,000	
Intangible Assets		
Trademark	$150,000	
Premium	$200,000	
Total Assets		$649,905
Liabilities		
Outstanding Debt	($147,762)	
Total Liabilities		($147,762)
Net Value of Company		$502,144
Julie's Partnership Interest		50%
Julie's Receipts from Liquidation		$251,072
Julie Mann's Tax Account		
Initial Contribution	$25,000	
Cumulative Net Income	$189,996	
Cash Withdrawals	($50,000)	
Total Tax Basis		$164,996
Net Capital Gain/(Loss)		$86,075

Selling the Partnership. The tax impact of ending a partnership or selling a partnership interest is complex. Essentially, the partners must calculate the value of their investment in the partnership on which taxes have not yet been paid.

The sisters agree to sell the Muffin Mann Partnership at its net asset value plus a fair premium of $200,000. The partnership's cash account will be used to pay off all outstanding debt. The assets of the business include cash, equipment (at its depreciated value), and inventory, plus the intangible value of the trademark the partnership purchased. Against this is netted the outstanding debt, which is paid off with available cash. The remaining value of the business is $502,144, which is the purchase price paid by the corporation. Each sister receives half of this—$251,072—as their share of the return on their investment in the partnership (the effect on Julie Mann's taxes is shown in Figure 28).

In calculating the impact on her taxes, Julie takes into account her "basis" in the partnership—the fact that she has already paid taxes on much of the partnership's activity. Julie reduces her share of the proceeds from the sale by the amount of her initial

[7] There are other approaches available to converting the partnership to a corporation that would offer greater tax advantages to the partners; however, the approach presented here serves to illustrate the tax consequences of liquidating a partnership.

investment, by the amount of her share of the annual income reflected in her personal tax returns, less the amount of cash she has withdrawn from the partnership. Her basis in the partnership at its sale is $164,996.

The result reflects a net gain for tax purposes of $86,075, which she will report on her individual tax return. This does not mean that she made $86,075 on her investment in the business—in fact, she made much more. The $86,075 is the portion of her gain from the partnership on which she has not yet paid taxes.

Evaluation of the Partnership. Over the three years of its operation, the Muffin Mann Partnership has total gross sales of $2.7 million with a net profit of near $379,993. While the partnership paid no business taxes directly, the partners paid a total of $123,250 in individual federal income taxes attributable to their interests in the business. Since the partnership is not subject to Texas franchise tax, it paid no state taxes on that activity.

[Note: Partnership tax returns are extremely complex, especially when it comes time to liquidate the partnership. This example involved a number of assumptions for simplicity of presentation that might not offer the best technical approaches to minimizing the personal income tax liability of the owners.]

As a structure, the partnership encountered problems when the equal partners disagreed on the future direction of the company. Further, the partnership was hampered by an inability to raise the amount of capital needed to expand. There was no simple way to resolve the partner's disagreement short of dissolving the partnership. From a tax vantage point, the partnership benefited the owners' individually when it lost money; the partners were able to claim this loss directly on their personal returns. But when the partnership made money, the owners were liable for taxes on it even if they did not take cash out of the partnership.

A Corporation: The Muffin Mann Corporation. The corporation is a separate entity for both legal and tax purposes. As such, it must file its corporate charter with the state and pay registration fees, and also pay federal and state corporation taxes. The corporation sells shares of stock to generate capital. Stockholders must pay individual income taxes on the income generated from their investment in the stock.

The Muffin Mann Corporation begins with a $25 million stock offering, selling 2.5 million shares at $10 each (Figure 29). Of the proceeds, $7.5 million was spent to build and equip a modern baking facility. This amount is depreciated, as is the amount the corporation paid in buying the partnership.

In its first year of operation as a corporation, the business hires 115 workers, growing to 200 in year two and 350 by year three. Employee overhead costs increase over those of

Figure 29
The Muffin Mann Corporation

	Year of Corporation		
Descriptive and Financial Data	1	2	3
Number of Employees	115	200	350
Purchases of Capital Equipment	$8,000,000	$2,500,000	$2,500,000
Depreciated Value of Equipment	$6,040,800	$6,529,350	$6,980,650
Borrowing During Year	$0	$0	$0
Debt at Year End	$0	$0	$0
Shares of Stock Issued	2,500,000	-	-
Share Price	$10.00	$11.00	$12.00
Market Capitalization	$25,000,000	$27,500,000	$30,000,000
Gross Revenues			
Sales	$8,000,000	$15,000,000	$25,000,000
Interest Income	$750,000	$500,000	$500,000
Other Revenues	$0	$0	$0
Total Gross Revenues	$8,750,000	$15,500,000	$25,500,000
Operating Expenses			
Officer/Director Compensation	($300,000)	($400,000)	($400,000)
Cost of Goods Sold	($2,800,000)	($5,250,000)	($8,750,000)
Employee Salaries	($2,300,000)	($4,000,000)	($7,000,000)
Employee Benefits and Taxes	($805,000)	($1,400,000)	($2,450,000)
Rent	$0	$0	$0
Interest	$0	$0	$0
Depreciation	($1,959,200)	($2,011,450)	($2,048,700)
Property Taxes	($250,000)	($270,000)	($291,600)
Other Expenses	($1,250,000)	($2,000,000)	($2,500,000)
Total Expenses	($9,664,200)	($15,331,450)	($23,440,300)
Net Income Before Taxes	($914,200)	$168,550	$2,059,700

Note: This is a simplified view of the finances of the Muffin Mann Corporation. Statements of actual profits and deficits may differ for tax and financial reporting purposes.

the partnership not because of the change in form, but because of the increase in the number of workers and the fact that the company offers its employees health care benefits.

Julie is named the chief executive officer of the corporation, earning an annual salary of $100,000, and also serves as chairman of the board of directors (largely comprised of local community leaders, who are paid a modest stipend). The board also appoints a corporate secretary and a chief financial officer to assist in managing the daily affairs of the company.

Like most startups, the company loses money its first year of operation. Still it has numerous contracts with grocers operating in the region, and business continues to expand. In the second year, it essentially breaks even, but in the third year the company generates enough profit that the board opts to pay a dividend of $0.50 per share.

Taxes and the Muffin Mann Corporation. Because it suffered a $914,200 operating deficit in its first year, the Muffin Mann Corporation owes no federal income taxes in that year. However, rather than receiving a tax refund from the government for its negative profit, the corporation is allowed to carry this operating loss forward to reduce future year's taxable income (Figure 30). From a tax policy standpoint, this net operating loss carryforward recognizes the problems associated with measuring the financial circumstances of a business in a snapshot of a single year. Allowing a loss carryforward permits a more accurate measurement of the profitability of a business concern.

As a corporation doing business in Texas, the company owes franchise tax.[8] For its earned surplus calculation, the company begins with federal taxable income and adds back the amount of compensation paid to officers and directors. Even with the officer/director add-back, total earned surplus is negative in the first year, and the company has no earned surplus tax liability. As with the federal tax loss, the earned surplus loss carries forward into subsequent tax years (the federal loss carryforward is good for 20 years, but unused franchise tax loss carryforwards expire after five years).

On the capital side, the Muffin Mann Corporation begins with $25 million in taxable capital and no debt, which is reduced by its operating loss at the end of the year.[9] Still, the company has substantial capital, and calculates a $60,215 capital tax liability, which it pays in taxes as the higher of the two calculations.

In its year two federal tax calculation, the corporation uses a portion of its loss carryforward to reduce its net income to zero, and again pays no taxes. For Texas franchise tax purposes, the company similarly uses its business loss carryforward from the previous year to reduce its earned surplus to zero. However, as with year one, the company calculates a capital tax liability (of $60,636) which it must pay in franchise taxes. Even though the company does not pay taxes on earned surplus, it is required to use up a part of its business loss carryforward against its calculated amount of earned surplus.

In its third and most successful year of operation, the company nets $2.1 million in profits. In calculating its federal corporate income tax liability, it uses up the remainder

[8] First year franchise taxpayers are subject to special provisions which are excluded here for the sake of simplicity.
[9] The taxable capital calculation presented here is simplified.

Figure 30
Taxes and the Muffin Mann Corporation

	Year of Corporation		
Taxes and the Corporation	$1	$2	$3
Federal Taxable Income			
Current Year Taxable Income	($914,200)	$168,550	$2,059,700
Net Operating Loss Carryforward	$0	($168,550)	($745,650)
Net Taxable Income	($914,200)	$0	$1,314,050
Federal Income Tax Due	$0	$0	$446,777
Texas Franchise Tax			
Earned Surplus			
Federal Taxable Income	($914,200)	$168,550	$2,059,700
Officer Director Compensation	$300,000	$400,000	$400,000
Current Taxable Earned Surplus	($614,200)	$568,550	$2,459,700
Business Loss Carryforward	$0	($568,550)	($45,650)
Net Taxable Earned Surplus	($614,200)	$0	$2,414,050
Earned Surplus Tax Rate	4.5%	4.5%	4.5%
Earned Surplus Tax Due	$0	$0	$108,632
Taxable Capital			
Stated Capital	$25,000,000	$25,000,000	$25,000,000
Surplus	($914,200)	($745,650)	$1,314,050
Less Dividends Paid	$0	$0	($1,250,000)
Taxable Capital	$24,085,800	$24,254,350	$25,064,050
Taxable Capital Tax Rate	0.25%	0.25%	0.25%
Tax Rate on Taxable Capital	$60,215	$60,636	$62,660
Franchise Tax Due	$60,215	$60,636	$108,632

Note: For the purposes of illustration, the tax calculations shown are greatly simplified. For example, the definition of taxable income differs for state and federal purposes. The state definition is based on the 1996 Internal Revenue Code and does not reflect subsequent changes in federal law.

of its loss carryforward, but still shows $1.0 million in taxable income. *Even though the company paid out $1.25 million of its profits in dividends, these are not deducted from its federal taxable income.* For Texas franchise tax purposes, the company calculates an earned surplus liability of $108,632, even after using up its remaining business loss carryforward. The company remits this amount in taxes because it exceeds the capital tax liability.

Taxes and the Muffin Mann Owners. While the Muffin Mann Corporation pays taxes in its own right, the owners (i.e., stockholders of the corporation) are still liable for paying individual income taxes on their earnings from their corporate stock.

Julie Mann is paid a salary of $100,000 by the Muffin Mann Corporation (the corporation deducts this amount in computing its income subject to tax). Julie reports the income on her individual return and is subject to individual income taxes. After taking her standard deduction and personal exemption, her tax liability is $22,880 in years one and two of the corporation. In year three, Julie receives two other types of income not related to her work for the corporation, but rather to her investment in the corporation.

At the time the corporation was created, Julie purchased 20,000 shares at $10 per share. The $0.50 per share dividend in year three generated additional income for her of $10,000, which is taxable to her as ordinary income, even though the corporation paid taxes on its entire net income, including amounts ultimately paid out as dividends.

In addition, Julie sold 50,000 shares of stock in year three3 at a price of $12 per share, netting her a profit of $100,000. Because she held the stock for more than one year, these gains are taxed at the more favorable 20 percent long term capital gains tax rate.

Ultimately, in year three Julie pays $45,930 in federal income taxes. Texas has no state individual income tax, so no state taxes are due.

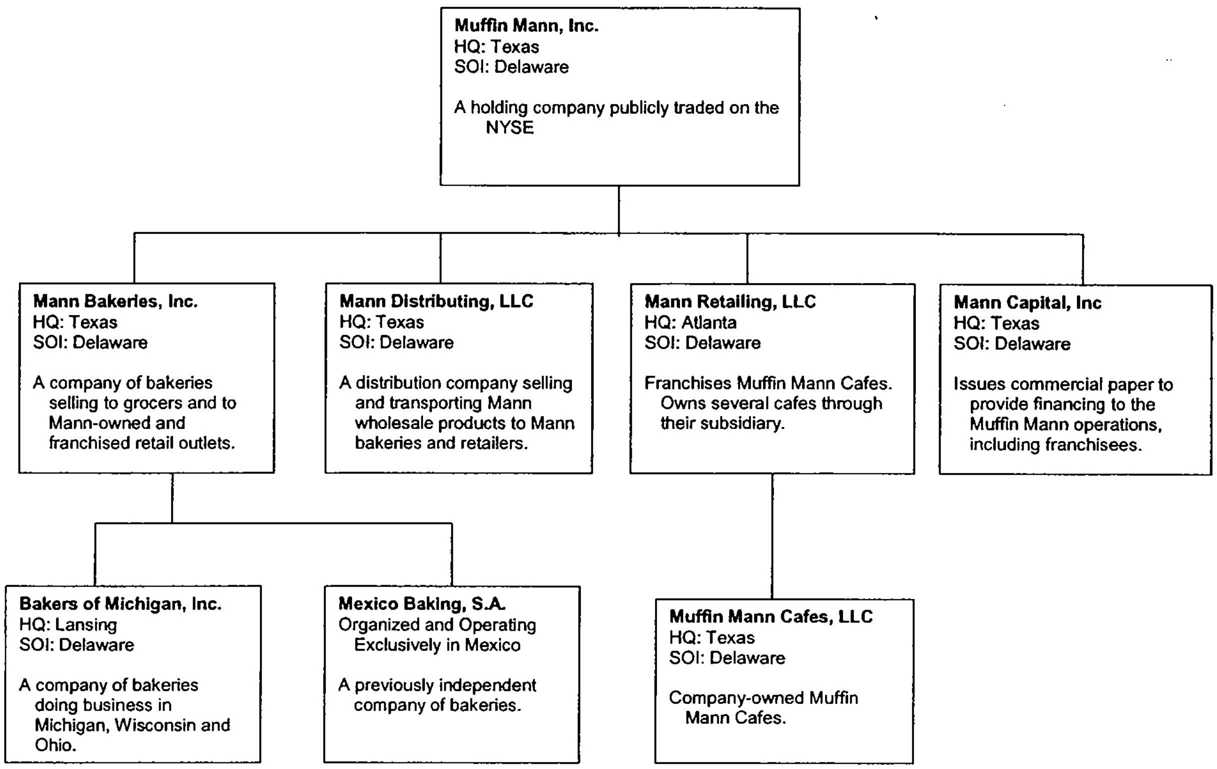
Evaluation of the Corporate Form. The corporate form offered the least tax advantages, but offered the easiest avenue for raising large amounts of capital for investment.

Over the three years presented here, the corporation netted $1.3 million and paid over $0.4 million in federal corporate income taxes. In the years the corporation lost money, individual investors could not claim the losses to offset other income as they may have been able to do with a partnership. Instead, losses accrued to the corporation. Further, the corporation was subject to Texas franchise tax, which it had to pay even when it was losing money. And in fact, the business operating loss deduction offered little advantage to the company because it had to use up the deduction even when paying on taxable capital.

Individual investors were subject to taxes on the dividends they received, plus they had to pay capital gains taxes on any income realized from the disposition of their investment in the company's stock.

A Parent Company and Subsidiaries. The Muffin Mann Company has proven to be a profitable and growing enterprise, but the next several years are wildly successful. Sales increase and the business expands into a number of states. The basic bakery business—supplying groceries and other retailers with baked products—does well. Further, the company's retail operation proves enormously popular, and the company decides to franchise local *Muffin Mann Cafes* over a number of states. As a multibillion dollar

Figure 31
Structure of the Muffin Mann Business



company, Muffin Mann evolves into a compartmentalized business with distinctly different, yet related, operations (Figure 31).

Muffin Mann, Inc. is the parent company—a Texas-based holding company (incorporated in Delaware) that is the 100-percent direct owner of four companies, some of whom own subsidiaries, as well. Muffin Mann, Inc. provides management services to its subsidiaries, for which it is reimbursed. The bulk of its income, though, is from dividends and distributions it receives from its subsidiaries. Muffin Mann, Inc. is publicly-traded on the New York Stock Exchange, and distributes $275 million per year in dividends to its shareholders.

Mann Bakeries, Inc. is the manufacturing operation. Though the corporation is Texas-based, it has plants in a number of states, and only 20 percent of its sales are to locations in Texas. The company sells baked goods to groceries throughout the states, and also provides certain finished goods to Muffin Mann Cafes. Mann Bakeries has two subsidiaries—*Bakeries of Michigan, LLC* and *Mexico Baking, S.A.*, a foreign company based and organized in Mexico. Both were existing baking companies with existing clients and were purchased by Mann Bakeries as a more cost-effective way of expanding into new markets. The bakeries unit receives $25 million in dividends from the Michigan subsidiary and another $30 million from the Mexico foreign subsidiary. The bakery unit remains highly profitable and distributes $250 million in dividends to its parent company, Muffin Mann, Inc.

Mann Distributing, LLC is a Texas-based limited liability company responsible for supplying all Muffin Mann baking operations, including manufacturing plants and retail operations. The use of a single supplier enhances quality control. Standardized ingredients enable the business to ensure that its finished products are consistent in all market areas.

The distributing company maintains the company's fleet of trucks, providing all transportation services within the Muffin Mann business and to local franchisees. The manufacturers must pay the distributing company for all supplies they purchase, as well as transportation costs, as do the local retail operations. Mann Distributing distributes $25 million in dividends to its parent, Muffin Mann, Inc.

Mann Retailing, LLC is an Atlanta-based limited liability company organized in Delaware. The company is based in Atlanta because the individual the Muffin Mann hired to manage the franchise operation wished to be in Atlanta. The franchise agreement requires local franchisees (as well as the company-owned stores) to purchase all supplies from Mann Distributing and also requires each franchisee to pay ten percent of their gross revenues to the retailing company as a royalty. The retailing company also owns a subsidiary, *Muffin Mann Cafes, LLC*, which operates the original storefront outlets in Texas. These are profitable, but the business uses them more to monitor customer trends and to test new products and marketing ideas. Income to Mann Retailing consists of revenue from the Muffin Mann Cafes, LLC and franchise fees paid by the independent franchisees. The retailing arm distributes $50 million in dividends to the corporate parent, Muffin Mann, Inc.

Mann Capital Inc. is essentially the company's finance operation. It issues commercial paper and uses the proceeds to provide financing for the various Muffin Mann entities. The capital entity also provides local franchisees with credit to facilitate opening a Muffin Mann Cafe. While other entities within the corporate group are profitable, the capital side of the business has lost money—$35 million—hurt by falling interest rates and by certain bad debts.

Taxes and the Muffin Mann Group. For federal corporate income tax purposes, the Muffin Mann business is viewed as a single taxpayer, Muffin Mann, Inc. Under a consolidated federal return, the financial items for the domestic members of the group are combined; however, intercompany transactions and dividends are excluded (Figure 32). For this reason the sum of the individual financial items computed on a stand-alone basis for all members of the group is greater than the actual figures reported on the federal return. This same principle holds with respect to a consolidated financial statement filed with the Securities and Exchange Commission.

The exception to the rule that operations of subsidiaries be combined with the parent company for federal tax reporting purposes is the foreign subsidiary, Mexico Baking, S.A. Its finances may not be consolidated on the US federal tax return. Instead, the foreign-source dividends received from Mexico Baking are reported as income on the Muffin Mann's consolidated US tax return. To adjust for the fact that Mexico Baking's income may already have been taxed by Mexico, Muffin Mann may be entitled to claim a tax credit to reflect the foreign taxes its subsidiary paid.

Overall, Muffin Mann, Inc., the holding company, reports $3.6 billion of revenues on its federal tax return, with most of that coming from sales (actually those of its subsidiaries), but a portion coming from the interest received on its loans to franchisees (see the Column labeled "Consolidated Federal Return on Figure 32). Against this, it deducts its operating expenses, reflecting net income near $525 million. The company also claims a $20 million loss-carryforward from previous years. Its federal taxable income is $504.5 million, on which it pays $176.6 million in taxes.

The consolidated return is complex, requiring numerous adjustments for transactions across affiliates, but it allows the company to offset the profits of its more successful units against the losses of its capital subsidiary.

Of the eight members of the Muffin Mann group, six have nexus, or economic presence, in Texas and are subject to the state's franchise tax. Bakers of Michigan and Mexico Bakers, while owned by a Texas company, are not, they have no operations in Texas, nor do they make any sales in the state. Overall, the Muffin Mann group pays $5.35 million in franchise taxes. Unlike the federal consolidated return; however, each separately organized unit of the Muffin Mann Company subject to Texas franchise tax files a return based on its individual financial circumstance. Four of the six units with nexus in Texas pay tax on the earned surplus base, and two use the capital base.

Muffin Mann, Inc., the holding company, has little direct business activity, with most of its income being dividends received from its wholly-owned subsidiaries. For earned surplus purposes, the company begins with net taxable federal income (while the company did not file a federal return in its own right, it calculates the figures as if it had). The company reports $10 million in revenues from charges for services to its subsidiaries, and $10 million in deductible expenses, of which $7.0 million is compensation to the company's officers and directors. In addition, the company received $325 million in dividends from its wholly-owned subsidiaries, but these are deducted in calculating net

Figure 32
Taxes and the Muffin Mann Business
($ millions)

Item	Muffin Mann, Inc.	Mann Bakeries, Inc.	Bakers of Michigan, LLC	Mann Distributing, LLC	Mann Retailing, LLC	Muffin Mann Cafes, LLC	Mann Capital, Inc.	Consolidated Federal Return	Mexico Baking, Inc.
Financial Information (Tax Basis)									
Gross Revenues									
Sales of Goods and Services	$10.0	$2,250.0	$400.0	$1,700.0	$200.0	$250.0	$0.0	$3,350.0	$250.0
Interest Income	$0.0	$3.0	$1.0	$2.0	$2.0	$2.0	$300.0	$224.0	$1.0
Dividend Income	$325.0	$55.0	$0.0	$0.0	$0.0	$0.0	$0.0	$30.0	$0.0
Other Revenues	$0.0	$0.0	$0.0	$0.0	$0.0	$0.0	$0.0	$0.0	$0.0
Total Gross Revenues	$335.0	$2,308.0	$401.0	$1,702.0	$202.0	$252.0	$300.0	$3,604.0	$251.0
Operating Expenses									
Officer/Director Compensation	$7.0	$2.0	$0.5	$0.5	$0.5	$0.5	$0.5	$11.3	$0.2
Cost of Goods Sold	$0.0	$750.0	$125.0	$1,000.0	$0.0	$75.0	$0.0	$1,000.0	$100.4
Employee Salaries	$2.0	$750.0	$132.3	$200.0	$2.0	$100.8	$6.0	$1,142.9	$50.2
Employee Benefits and Taxes	$0.0	$187.5	$33.1	$50.0	$0.5	$25.2	$1.5	$285.2	$12.6
Rent	$0.0	$0.0	$10.0	$0.0	$1.0	$0.0	$2.0	$3.0	$10.0
Interest	$0.0	$50.0	$5.0	$20.0	$0.0	$10.0	$290.0	$290.0	$0.0
Depreciation	$0.0	$75.0	$3.0	$40.0	$0.0	$20.0	$0.0	$126.0	$12.0
Other Expenses	$1.0	$250.0	$50.0	$150.0	$15.0	$20.0	$35.0	$221.0	$25.0
Total Expenses	$10.0	$2,064.5	$358.9	$1,460.5	$19.0	$251.5	$335.0	$3,079.5	$210.4
Federal Income Taxes									
Net Inc. Before Taxes & div deduct.	$325.0	$243.5	$42.1	$241.5	$183.0	$0.5	($35.0)	$524.5	$40.7
Less Dividends Deduction	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	$0.0	n.a.
Net Operating Loss Carryforward	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	($20.0)	n.a.
Net Taxable Income	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	$504.5	n.a.
Federal Income Tax Due	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	$176.6	n.a.
Texas Franchise Tax									
Earned Surplus									
Fed. Taxable Income (less divs)	$0.0	$188.5	n.a.	$241.5	$183.0	$0.5	($35.0)		n.a.
Officer Director Compensation	$7.0	$2.0	n.a.	$0.5	$0.5	$0.5	$0.5		n.a.
Current Taxable Earned Surplus	$7.0	$190.5	n.a.	$242.0	$183.5	$1.0	($34.5)		n.a.
Business Loss Carryforward	$0.0	($5.0)	n.a.	$0.0	$0.0	$0.0	$0.0		n.a.
Net Taxable Earned Surplus	$7.0	$185.5	n.a.	$242.0	$183.5	$1.0	($34.5)		n.a.
Texas Apportionment	75.00%	19.97%	n.a.	20.00%	5.00%	100.00%	28.33%		n.a.
Texas Earned Surplus	$5.3	$37.1	n.a.	$48.4	$9.2	$1.0	($9.8)		n.a.
Earned Surplus Tax Rate	4.5%	4.5%	n.a.	4.5%	4.5%	4.5%	4.5%		n.a.
Earned Surplus Tax Due	$0.24	$1.67	n.a.	$2.18	$0.41	$0.05	n.a.		n.a.
Taxable Capital			n.a.						n.a.
Stated Capital & Surplus	$4,000.0	$2,500.0	n.a.	$1,000.0	$200.0	$200.0	$500.0		n.a.
Dividends Paid	($275.0)	($250.0)	($25.0)	($25.0)	($50.0)	$0.0	$0.0		($30.0)
Taxable Capital	$3,725.0	$2,250.0	n.a.	$975.0	$150.0	$200.0	$500.0		n.a.
Texas Apportionment	2.24%	19.50%	n.a.	20.00%	5.00%	100.00%	28.33%		n.a.
Texas Taxable Capital	$83.4	$438.7	n.a.	$195.0	$7.5	$200.0	$141.7		n.a.
Taxable Capital Tax Rate	0.25%	0.25%	n.a.	0.25%	0.25%	0.25%	0.25%		n.a.
Tax Rate on Taxable Capital	$0.21	$1.10	n.a.	$0.49	$0.02	$0.50	$0.35		n.a.
Franchise Tax Due	$0.24	$1.67	n.a.	$2.18	$0.41	$0.50	$0.35		n.a.

Note: Royalties are included in sales of goods and services. Figures may not add due to rounding.

continued on next page

income in order to prevent double taxation of income flows, yielding a net federal taxable income of zero.

To calculate earned surplus, it adds to this the amount of compensation it paid to its officers and directors, $7.0 million. This is apportioned to Texas based on the share of non-dividend revenue it received from within Texas, 75 percent (which is $7.5 million of the $10 million it charged its subsidiaries). Applying the 4.5 percent earned surplus tax rate yields a tax liability of $240,000. Ironically, in a state boasting the lack of a personal income tax, the firm's tax liability stems entirely from the income it paid to its officers and directors. For capital tax purposes, after receiving $325 million in dividends, the firm's total capital stands at $4 billion—which is then reduced by the $275 million it distributes to its shareholders, so at the end of the tax year its total capital is $3.7 billion. The dividends it received are included in the apportionment calculation for taxable capital, however. Texas state law looks to the legal domicile of the payor as the source of the income—Delaware in this instance—so the dividends are not considered to be Texas income. This treatment has the net effect of preventing the double taxation of the capital the holding company has invested in its Texas-based subsidiaries. The only source of Texas revenue is the Texas-portion of charges to its subsidiaries, yielding an apportionment percentage of 2.24 percent ($7.5 million of $335 million in total receipts). Total taxable capital apportioned to Texas is $83.4 million, which at a tax rate of $2.50 per $1,000, or 0.25 percent, results in a tax liability of $210,000.

As a result, the holding company pays the higher of the two calculations—the $240,000 based on earned surplus.

Mann Bakeries, Inc. is an operating subsidiary with ongoing production activity. Its gross revenues are $2.3 billion, deductible expenses $2.1 billion, and federal net income after deducting dividends of $188.5 million (again, calculated as if the entity had filed its own federal return). To calculate earned surplus, it adds $2.0 million of officer/director compensation. From this total it subtracts a business loss it incurred in a previous year—in this instance, $5.0 million—resulting in total earned surplus of $185.5 million. Of its total sales, 20 percent are within Texas which is its apportionment factor, yielding apportioned earned surplus of $37.1 million and a tax liability of $1.67 million.

On the capital side, its total taxable capital is $2.25 billion. In calculating the apportionment factor for capital purposes, to its sales and interest it adds dividends (which are not sourced to Texas), resulting in an apportionment factor of 19.5 percent. On total net taxable capital of $438.7 million it incurs a tax liability of $1.1 billion. The company pays the higher of the two amounts, which is the liability based on earned surplus of $1.67 million.

Bakers of Michigan, LLC, a subsidiary of Mann Bakeries, Inc., has no business operations or sales in Texas and consequently has no nexus here and is not subject to Texas franchise tax.

Mexico Baking, S.A., a subsidiary of Mann Bakeries, Inc., has no business operations or sales in Texas and consequently has no nexus here and is not subject to Texas franchise tax.

Mann Distributing, LLC is an operating subsidiary with ongoing activity. Its gross revenues are $1.7 billion, deductible expenses $1.5 billion, and federal net income of $241.5 million (again, calculated as if the entity had filed a separate federal return). It adds to this $0.5 million of officer/director compensation to yield a calculation of total earned surplus of $242 million. Of its total sales, 20 percent are within Texas and this is its apportionment factor, yielding apportioned earned surplus of $48.4 million and a tax liability of $2.18 million.

On the capital side, its total taxable capital is $975 million. The company receives no dividends, so its apportionment factor is the same as for earned surplus—the 20 percent of its business from sales within Texas. On total net taxable capital of $195 million it incurs a tax liability of $490,000. The company pays the higher of the two amounts, which is the liability based on earned surplus of $2.18 million.

Mann Retailing, LLC is an operating subsidiary with ongoing franchising activities. Its gross revenues are $202 million, deductible expenses $19 million, and federal net income of $183 million (again, calculated as if the entity had filed a separate federal return). It adds to this $0.5 million of officer/director compensation to yield a calculation of total earned surplus of $183.5 million. Of its total receipts, five percent are within Texas and this is its apportionment factor, yielding apportioned earned surplus of $9.2 million and a tax liability of $41,000.

On the capital side, its total taxable capital after distributing dividends is $150 million. The company receives no dividends, so its apportionment factor is the same as for earned surplus—the five percent of its business from sales within Texas. On total net taxable capital of $7.5 million it incurs a tax liability of $20,000. The company pays the higher of the two amounts, which is the liability based on earned surplus of $41,000.

Muffin Mann Cafes, LLC is an operating subsidiary consisting of the Texas retail outlets. Its gross revenues are $252 million, deductible expenses $251.5 million, and federal net income of $500,000 (again, calculated as if the entity had filed a separate federal return). It adds to this $500,000 of officer/director compensation to yield a calculation of total earned surplus of $1.0 million. Of its total sales, 100 percent are within Texas and this is its apportionment factor, yielding apportioned earned surplus of $1.0 million and a tax liability of $45,000.

On the capital side, its total taxable capital is $200 million. The company receives no dividends, so its apportionment factor is the same as for earned surplus—the 100 percent of its business from sales within Texas. On total net taxable capital of $200 million it incurs a tax liability of $500,000. The company pays the higher of the two amounts, which is the liability based on capital $500,000, ironically equal to the entire amount of its calculated net income for the year.

Muffin Mann Capital, Inc. is the financial arm of the business. Unfortunately, it lost money in a volatile interest rate environment during the year. Its gross revenues are $300 million and it has deductible expenses of $335 million for a federal net income loss of $35 million (again, calculated as if the entity had filed a separate federal return). It adds to this $0.5 million of officer/director compensation to yield a calculation of total earned surplus of a negative $34.5 million. Of its total income, 28.33 percent is from activity within Texas, which is its apportionment factor, yielding apportioned earned surplus of negative $9.8 million. Because the earned surplus is negative, the company owes no tax on earned surplus, and it may carry this loss forward for subsequent year's tax returns (up to five years).

On the capital side, its total taxable capital is $500 million. The company receives no dividends, so its apportionment factor is the same as for earned surplus—the 28.33 percent of its business from activity within Texas. On total apportioned net taxable capital of $141.7 million it incurs a tax liability of $350,000, which is the company's tax liability.

Conclusions on Organizational Choices. This fictitious company has provided a very simplified look at the tax treatment of a business as it operates in a variety of different organization and structural forms.

Clearly, as a business grows or contracts, it must make operational decisions about entering or leaving certain lines of business and certain market areas. It must re-evaluate both its labor needs and its capital needs. As a part of a business's evolution, the form and structure in which the business operates may undergo changes, as well.

For the very small business that needs neither outside labor nor capital and has few liability concerns, there may be no need to make a formal decision about organizing in a particular business form. By default the company may operate as a sole proprietorship, or perhaps as a general partnership. This invites no special tax considerations—the business and the owner are considered one and the same, with the business's revenues reported on the individual tax return of the owner.

As additional investors or labor may be brought into the company, a more formal arrangement may be needed to clarify management responsibilities, manage capital needs or own property, provide for proper distribution of income and transferability of ownership interests, and offer liability protections to passive investors. In some instances a registered limited partnership may prove appropriate. The additional owners invite some new administrative complexity in dividing up the income of the business, which is reported on each partners' income tax return. Still, like the sole proprietorship, the partnership as an entity is generally not subject to direct taxes at either the federal or state level.

In the event the managing partners are concerned about personal liability exposure, a limited liability partnership or a limited liability limited partnership may be appropriate. As a partnership, the entity may still elect pass-through treatment for federal tax purposes, while not be subject to the Texas franchise tax.

For a company with somewhat greater capital needs, a limited liability company may be more suitable. Limited liability companies are also common as a way of compartmentalizing liability as a subsidiary within a business group. Further, they provide liability protections for the managers, just as with the corporate form or the limited liability partnership form. In Texas, unlike most states, limited liability companies are subject to corporate franchise tax. Most states follow the federal treatment of allowing income from a limited liability company to be taxed at the owner's level.

For company with even greater capital needs, a wider range of investors with easy transferability of ownership interests and offering strong liability protections the corporation is clearly more appropriate. For all its protections, the corporate form is among the most complex, however, and is subject to corporate franchise tax in Texas, as well as the federal corporate income tax. In addition, the corporate owners must pay tax on the income they receive from their investment, if they are subject to individual income taxes at the state or federal levels.

CHAPTER 5:
FORMS OF BUSINESS AND COMPLEX BUSINESS STRUCTURES

Key Facts:

- *In conjunction with choosing the form in which to operate, a business must make several related decisions, some of which may involve tax considerations, others may not.*

- *Companies typically organize subsidiaries as a way of conducting business, particularly companies doing business in a number of states or with multiple lines of business. Taxes are but one of many considerations in how a business organizes and structures itself. Where a business organizes and where it places certain of its business units can have significant tax consequences, however.*

- *Business organizational forms are authorized in state law. While there is substantial uniformity across the states, differences in administrative requirements and in case law history make certain states, such as Delaware, more attractive for businesses to organize (thereby establishing legal domicile). Because of reciprocal agreements among the states, a business may organize in one state and operate in others.*

- *Not to be confused with legal domicile is "commercial domicile," i.e., the state in which the company locates its headquarters. The choice of commercial domicile can impact a company's tax liability. Texas franchise tax is generally viewed favorably for corporate headquarters of businesses that operate in many jurisdictions.*

Choosing a form of business in which to operate is not a decision that can be made independently of other business decisions, particularly for companies with a number of business units active in a number of states. These businesses may include a corporate parent company with a number of subsidiary or affiliated businesses, each of which may have subsidiaries of its own. The complexity of these business structures invites a host of issues in determining the form of business in which the parent company and each of its subsidiaries will organize and operate. While there is substantial definitional uniformity across the states, the few areas of difference can be significant. Among the key decisions often made in conjunction with the decision to organize a business are:

- How it structures its business units (as single or multiple entities).
- How it organizes those business units (corporations, partnerships, limited liability companies, etc.).
- Where it organizes (legal domicile).
- Where it locates its operations, particularly its headquarters (i.e., commercial domicile).

These decisions are sometimes discrete, but more often, as a company grows over time, or as it contracts, as it alters its product line, as it enters new or leaves old markets, these decisions are continuously reevaluated and modified. This is particularly true when a company acquires or disposes of existing businesses or business units.

Business Structures and Subsidiaries. The view of "one business = one entity" is an archaic one, more reflective of the years before the Civil War than of today.[1] The broader availability of the corporate form (detailed in Chapter 2) led to the emergence of what the noted business historian Alfred D. Chandler calls the "modern business enterprise" in which a business is often a conglomerate of a number of separately-structured companies engaged in several lines of business.[2]

These post-Civil War "big businesses" were no longer just focused on meeting local infrastructure needs, but instead involved developing national networks, such as rail transportation or communications systems. Creating those systems involved engaging in a variety of very different, yet coordinated, endeavors. A railroad company, for example, was not a single business unit engaged in a single enterprise. Managing freight and passenger traffic was clearly a line of business generating direct profits, but rail companies also bought and sold real property and *built* the railroads themselves. These were each very different propositions, but still vital to the expansion of the railroad business.

The late 1800s saw corporations become increasingly integrated. Mass production of goods enabled manufacturers to take advantage of economies of scale, lowering the average production costs of their goods, but it invited two potential problems. First, to produce goods in mass quantities required ample and stable supplies of raw materials. Second, merchants who previously had no problems selling their product locally by word-of-mouth found they had to be more sophisticated in marketing their goods in new locales.

[1] Richard R. John, *Elaborations, Revisions, Dissents: Alfred D. Chandler, Jr.'s The Visible Hand after Twenty Years*. Business History Review, 71 (Summer 1997): 151-206.
[2] Alfred D. Chandler, Jr., *The Visible Hand: The Managerial Revolution in American Business* (Cambridge, MA: Harvard Belknap, 1977).

As a business expanded, it often found that it needed to become more vertically integrated in order to prosper. To ensure adequate supplies of raw materials, many companies acquired sources of supply. For example, refineries might purchase oil-producing properties, or a lumber mill might purchase a logging operation. To ensure that their products had access to markets, a company might buy its own wagons to distribute them in new cities. Companies who originally were formed around a single basic economic function found themselves engaging in a variety of vertically-integrated economic tasks involving a number of different lines of business.

Compartmentalizing differing lines of business into separately structured entities was, and still is, desirable for a number of reasons, including:

- **Liability Risk:** By subdividing its different operations, a company's risks are spread and contained. If one business unit fails, for whatever reasons, its debts and obligations are its own.
- **Geography:** Companies may also form subsidiaries when they operate in different geographical markets, in order to permit local involvement in management, encourage local investment, or to segregate local operations for accounting, regulatory, or tax reasons as set forth below.
- **Historical Circumstance:** As businesses expand, they may often find it more cost effective to acquire an existing business with an established market presence and customer base. Rather than immediately consolidate the new members of the corporate family, where corporate cultures and finances may clash, the newly acquired firms may become separate subsidiaries, either temporarily or permanently.
- **Legal and/or Regulatory Requirements:** A corporation may be engaged in a certain line of business that is subject to unique legal requirements or is doing business in a regulated industry. For example, a corporation acquiring a public utility may be required by a state public utility commission to maintain the utility's operations apart from the company's other businesses.
- **Flexibility:** Corporations often wish to subdivide operations to keep from mixing lines of business, or they may form a subsidiary in conjunction with other partners. They may also create a new subsidiary to enter a new line of business.
- **Management and Accounting[3]:** Establishing a separate entity(ies) may help businesses more effectively account for certain management functions, such as payroll and central administration, services which can be provided to affiliated entities at market cost.

[3] It should be noted that the use of subsidiaries, particularly partnerships, was a key part of the accounting abuses that led to the bankruptcy of Enron. The company created a number of investment partnerships with third parties (often Enron managers) as a way of shielding liabilities and debt from Securities and Exchange Commission reporting requirements. Coupled with aggressive accounting practices, these were used to reduce the level of debt Enron reported and overstate the actual profitability of the company.

- **Capitalization:** A subsidiary may be created when the parent company desires to raise outside funds to capitalize a new venture. Outside investors may be brought in as partners or as shareholders of the new venture. In this manner, the subsidiary may not necessarily be a wholly-owned venture of the parent corporation.
- **Tax Considerations:** There may be tax advantages to creating different entities for certain lines of business and locating them in certain jurisdictions. For example, Texas' current franchise tax makes the state an attractive location for corporate headquarters operations. Non-US tax considerations (i.e., the tax regimes of foreign countries in which the business is operating) also may favor the formation of companies and holding companies in other countries.

Most large public companies are structured with a parent, typically a corporation whose stock trades on a major stock exchange, with multiple subsidiaries set up in tiers of ownership. Today's Fortune 500 Companies—the largest corporations in America (ranked by revenues)—are typically complex holding companies with many subsidiaries that conduct the actual lines of business (Figure 33).

Each of these subsidiaries is legally organized in its own right, e.g., as some type of partnership, a limited liability company, or a corporation.

Although generally less complex, most significant businesses that operate in more than a few locations are also characterized by multiple entity structures. Modern legal and accounting practices have made it possible for all but the smallest businesses to use separate entities to raise capital, limit liability, and increase flexibility.

Subsidiaries and Form of Business. For a subsidiary to be recognized as a separate entity, it has to be formally organized—either as a partnership, a limited liability company, or a corporation.[4]

Partnerships are commonly used by businesses in joint ventures with other companies or outside investors. Partnerships may also be used for subsidiary units within a consolidated corporate group (with separate subsidiaries serving as the partners), though the partnership form offers few direct federal tax advantages; the partners are still liable for their proportionate share of federal income taxes on the partnership's operations. There can be *state* tax advantages for some corporations to use the partnership form among its subsidiaries when doing business as a partnership in a state in which a corporate partner does not have nexus, or is not otherwise subject to that state's corporate tax—a key aspect of the planning strategy commonly referred to in Texas as the "Delaware sub."

[4] A foreign company may report its U.S. operations as a separate legal entity.

Figure 33
The Top 20 Fortune 500 Corporations and their Subsidiaries

Rank	Company	Commercial Domicile	State of Incorporation	Number of Subsidiaries
1	Wal-Mart Stores	Arkansas	Delaware	12
2	Exxon Mobil	Texas	New Jersey	153
3	General Motors	Michigan	Delaware	316
4	Ford Motor	Michigan	Delaware	73
5	Enron	Texas	Oregon	3,215
6	General Electric	Connecticut	New York	24
7	Citigroup	New York	Delaware	N.A.
8	ChevronTexaco	California	Delaware	30
9	International Business Machines	New York	New York	88
10	Philip Morris Company	New York	Virginia	292
11	Verizon Communications	New York	Delaware	21
12	American International Group	New York	Delaware	198
13	American Electric Power	Ohio	New York	11
14	Duke Energy	North Carolina	North Carolina	5
15	AT&T	New Jersey	New York	35
16	Boeing	Chicago	Delaware	247
17	El Paso	Houston	Delaware	1,242
18	Home Depot	Atlanta	Delaware	5
19	Bank of America	North Carolina	Delaware	783
20	Fannie Mae	Washington, D.C.	Charter of Congress	N.A.

Source: Securities and Exchange Commission, 2001 and 2002 10-K reports for the various companies.

Limited liability companies have become more popular for subsidiaries because they offer many of the same liability protections enjoyed by the corporate form without the red tape and administrative expense. Further, limited liability companies may be used for a joint venture between independent companies in much the same way as a partnership.

Generally, most states do not tax limited liability companies directly but treat them as pass-through entities, as they do partnerships.

Corporations are still a popular, though perhaps waning, form for subsidiaries. They involve a great deal more administrative complexity than limited liability companies. Perhaps the greatest advantage the corporate form offers is inertia. Their longstanding acceptance as the entity of choice has led to an understanding of the corporate form that is unmatched by other organizational forms.

Legal Domicile. The state in which a business entity chooses to formally organize or register is called its *legal domicile*. Choice of legal domicile is not a key decision for sole proprietorships and general partnerships, which tend to be small businesses operating in a single geographic area. Because they do not operate with any specific legal benefits granted by the state, they are generally not required to file formal articles of organization and register with the state in which they conduct their business.

It is a more critical issue for larger companies, particularly corporations with subsidiaries doing business in a number of states. In fact, businesses have a fair amount of flexibility in choosing the state(s) in which to formally organize their parent company and its subsidiaries. Under reciprocal agreements of the states, a business may organize in one state while operating in many others.

Typically, the decision to organize in a particular state is less driven by tax considerations than are the decisions as to the states in which to operate, locate facilities and structure subsidiary companies.

Still, the choice of legal domicile is a significant one. While there is a fair amount of uniformity in the types of business forms states authorize, there may be key differences in, for example, the administrative requirements and legal governance.

Corporations are chartered in all 50 states, but over 50 percent of all corporations trading on the New York Stock Exchange are organized in Delaware.[5] Delaware state law offers broad flexibility in its corporate charters with regards to the line(s) of business a corporation may engage in, while offering an attractive legal and legislative climate. Delaware has low incorporation fees, low annual franchise taxes (which can be paid over the internet by credit card), and its corporate income tax does not apply to corporations that do not operate inside of Delaware.[6]

Delaware also maintains a separate court system for businesses that expedites cases quickly while being viewed as "business friendly":

> *The judges for Delaware's Court of Chancery are chosen on the basis of their familiarity with the intricacies of corporate law and finance, which prevents cases from dragging on for years. Increasingly, the appeal and benefit of incorporation in Delaware—to officers and investors alike—has been its well-developed body of judicial decision on the meaning of virtually every point that might be the subject of litigation. And when there have been ambiguous or seemingly contradictory judicial precedents, the Delaware legislature has eliminated them by periodically*

[5] http://www.nationalbusinessinc.com/whydelaware.html

[6] Unlike Texas, Delaware levies a separate corporate income tax *and* a franchise tax. Delaware's franchise tax is based on stock shares outstanding, with a minimum of $30 and a maximum of $150,000. Texas levies only a franchise tax, but its largest component is corporate income.

> *revising and codifying its corporate statutes. These features have made it easier to predict court decisions, and thus to avoid litigation which drains the energies and financial resources of all parties.*[7]

Delaware incorporation is also attractive for small businesses. Businesses can incorporate anonymously and one person may serve as incorporator and assume the role of all necessary officers of the corporation.

Nevada has become increasingly attractive as a state of incorporation, rivaling Delaware, particularly for smaller businesses. Unlike Delaware, Nevada has no franchise tax, no corporate income tax, no tax reports or shareholder disclosures, and no taxpayer information sharing agreement with the Internal Revenue Service.[8]

A corporation organized in, for example, Delaware, but operating in another state is considered to be a "foreign corporation" by that state, even if the company has its entire business operations there. For example, a business may manufacture all its products in Texas, its headquarters may be located in Texas, and all its sales may be in Texas, but if the business is incorporated under the laws of Delaware, for legal purposes it is a "Delaware corporation," and is considered to be a "foreign corporation" with respect to Texas.

Commercial Domicile. While many corporations have their legal domicile in Delaware, they typically have their *commercial domicile* in some other state. A business's commercial domicile by definition is the state where its headquarters are located:

> *[A] headquarters is the center of authority for both the operations and administration of an enterprise. Its work is distinctive and specific. It requires its own organization to achieve its tasks, which have been identified as follows:*
>
> - *Defines the mission of the business, develops strategies and plans, sets objectives and makes decisions that relate to these matters;*
> - *Sets the standards, the values and the procedures;*
> - *Develops the firm's human resources and identifies the next generation of leaders;*
> - *Creates and implements the best corporate-wide organization that will meet its business strategies and needs;*
> - *Establishes and maintains those external relationships that are of central importance to the company's performance;*

[7] Robert Hessen, *In Defense of the Corporation* (Stanford, California: Hoover Institution Press, Stanford University, 1989).
[8] http://www.corpshield.com/why_nevada_.htm

- *Partakes in and leads key ceremonial activities;*
- *In concert with the board of directors, acts as the most effective organ for dealing with any major crisis faced by the company.*[9]

Typically, the headquarters is where the upper management of the company locates, and often, but not always, it is close to a center of the company's chief business operations or in a state with an attractive business climate. Its location is independent of the legal domicile. For example, the largest Texas-based corporation is ExxonMobil, headquartered in Irving. While ExxonMobil's commercial domicile is Texas, its legal domicile is New Jersey, the state where the company was formed over a hundred years ago. El Paso Corporation is Texas born and bred, headquartered in Houston, but from a legal standpoint, it is a Delaware Corporation.

Texas is currently home to 46 corporate headquarters among *Fortune 500* companies and many smaller ones (Figure 34). Texas has continuously increased its share of major American corporations locating here. Just five years ago, Texas was home to only 36 Fortune 500 headquarters.

The headquarters parent may or may not have operating responsibilities of its own. It may simply be a holding company at the top of a pyramid of subsidiary operating companies, or it may have actual operating divisions. A holding company parent often has two primary functions:

- **Management**: to provide overall management and guidance to the business's units and,
- **Money**: to facilitate the finances of the business. Typically it is the parent company that raises and distributes capital for the business.

An operating parent performs the central management functions for the corporation but also is involved in managing actual lines of business. For example, the corporate parent may have an operating division that develops and markets technology. In some cases, the services a parent "sells" are to its own subsidiaries. It may develop and sell technology used by the subsidiaries or it may perform administrative functions, such as accounting, personnel management, and property management (these functions may also be handled by a subsidiary). There are no hard and fast guidelines for how corporations may choose to organize themselves. They are typically guided by a host of considerations, including historical circumstance, legal issues, geographic location, and taxes.

A corporate headquarters may or may not be a large organization in terms of employment. The headquarters employment of even the largest corporations seldom exceeds 1,000 employees, and some have less than 100. Nonetheless, these are important jobs for a

[9] Peter F. Drucker as quoted in Business International Corporation, *Managing Today's International Company: The Role of Headquarters* (New York: Business International Corporation, 1989).

Figure 34
Texas-Based Corporations in the Fortune 500

Texas Rank	Company	US Rank	Line(s) of Business	Headquarters	Legal Domicile
1	ExxonMobil	2	Petroleum Refining	Irving	New Jersey
2	Enron	5	Energy	Houston	Oregon
3	El Paso	17	Energy	Houston	Delaware
4	Reliant	26	Energy	Houston	Delaware
5	SBC Communications	27	Telecommunications	San Antonio	Delaware
6	Dynegy	30	Pipelines	Houston	Illinois
7	Marathon Oil	43	Petroleum Refining	Houston	Delaware
8	Compaq Computer	46	Computers, Office Equip.	Houston	Delaware
9	Conoco	48	Petroleum Refining	Houston	Delaware
10	J.C. Penney	50	General Merchandising	Plano	Delaware
11	Dell Computer	53	Computers, Office Equip.	Round Rock	Delaware
12	TXU	58	Utilities: Gas & Elec.	Dallas	Texas
13	Sysco	95	Wholesale Food	Houston	Delaware
14	EDS	97	Computer	Plano	Delaware
15	AMR	108	Airlines	Fort Worth	Delaware
16	Fleming	129	Wholesale Food	Lewisville	Oklahoma
17	Valero Energy	138	Petroleum Refining	San Antonio	Delaware
18	Kimberly-Clark	141	Household/Personal products	Irving	Delaware
19	Halliburton	153	Oil & Gas Equip & Services	Dallas	Delaware
20	Waste Management	172	Waste Management	Houston	Delaware
21	Burlington Northern Santa Fe	211	Railroad	Fort Worth	Delaware
22	USAA	215	Insurance	San Antonio	N.A.
23	Continental Airlines	216	Airlines	Houston	Delaware
24	Anadarko Petroleum	232	Mining, Crude Oil	The Woodlands	Delaware
25	Texas Instruments	236	Semiconductors	Dallas	Delaware
26	Clear Channel Communications	243	Entertainment	San Antonio	Texas
27	Advance PCS	265	Health Care	Irving	Delaware
28	Plains All American Pipeline	274	Pipeline	Houston	Delaware*
29	Centex	281	Homebuilders	Dallas	Nevada
30	Dean Foods	290	Food Production	Dallas	Delaware
31	Southwest Airlines	317	Airlines	Dallas	Texas
32	Baker Hughes	323	Oil & Gas Equip & Services	Houston	Delaware
33	Tesoro Petroleum	335	Petroleum Refining	San Antonio	Delaware
34	Radioshack	348	Specialty Retailers	Fort Worth	Delaware
35	Adams Resources	351	Energy	Houston	Delaware
36	D.R. Horton	368	Homebuilders	Arlington	Delaware
37	Administaff	376	Diversified Outsourcing	Kingwood	Delaware
38	Cooper Industries	386	Electronics & Elec Equip.	Houston	Ohio
39	Temple-Inland	389	Packaging, Containers	Austin	Delaware
40	Group 1 Automotive	408	Auto Retailing & Services	Houston	Delaware
41	Encompass Services	412	Diversified Outsourcing	Houston	Texas
42	Smith International	448	Oil & Gas Equip & Services	Houston	Delaware
43	Burlington Resources	470	Mining, Crude Oil	Houston	Delaware
44	Lyondell Chemical	478	Chemicals	Houston	Delaware
45	Enterprise Products	484	Pipelines	Houston	Delaware*
46	Lennox International	493	Home & Industrial Products	Richardson	Delaware

Notes: Line of business is as defined by Forbes Magazine; many businesses engage in a variety of lines in addition to that listed. Business is a fluid enterprise. Mergers and changes in company financial positions have occurred since this list was compiled. Plains All American Pipeline and Enterprise Products are partnerships, not corporations.

Source: Fortune Magazine, April 18, 2002.

state. By and large, they are high paying and technically skilled jobs, and corporate management is the sort of "clean" industry states often seek. Moreover, corporate headquarters are often major contributors to the local community, often actively involved in a range of charitable projects and contributing significantly to a variety of local charities.

Tax Issues of Commercial Domicile. Unlike legal domicile, which is generally chosen for legal and administrative reasons, a business's choice of commercial domicile can have real and substantial tax consequences, particularly for corporations doing business in a number of states.

Apportionment of Tangible Business Income. One of the most complex areas of income tax law for business is determining the amount of a corporation's tax base attributable to business activity in a particular state. Under federal law, a state's tax on the net income of a multi-state business must fairly reflect the activity of the corporation in that state. States have a fair amount of flexibility in how that it calculated. Most states levying corporate income taxes apportion a corporation's active business income based on a mathematical formula using three factors: a company's sales, property and payroll (Figure 35). A corporate headquarters typically has a neutral effect on sales, but it increases the company's payroll factor (headquarter's staff) and property factor (the headquarter's facility). This has the net effect of increasing a company's overall tax liability in the place of commercial domicile.

Texas is one of four states apportioning business income on sales or receipts (i.e., single factor apportionment). Since sales are relatively neutral with regard to the commercial domicile of a business, a company may locate its headquarters in Texas without suffering the penalty of higher corporate taxes (of course, Texas' high property and sales taxes are still an issue because they are relatively higher than those of most states).

Apportionment/Allocation of Intangible Income. Not all of a business's income emanates from sales, especially a corporate parent company that may oversee the finances, patents, and trademarks, while also earning interest income and receiving dividends or other investment income from its subsidiaries. For most states, the sourcing of this income from intangibles is not a major issue because under combined or consolidated reporting these inter-unit transactions net out. That is not the case in Texas, which requires each unit of a corporate group to file a separate tax return, provided each is an entity subject to the state's franchise tax. These inter-affiliate receipts typically inflate the net amount of activity of a business with multiple subsidiaries.

Dividends pose a particular concern. The dividends of a subsidiary are passed up to its parent so that the parent may appropriately direct the company's profit, either reinvesting it in the company or distributing it as dividends to the parent company's stockholders. Taxing the parent on its dividend income from subsidiaries would tax the

Figure 35
Apportionment and Allocation of Income

State	Apportionment Factors (a)	Weighting (b)	Sourcing of Income from Intangibles	Dividends from Affiliates Taxed?	Alternative Minimum Capital Tax?
Alabama	3 factor	equal	com. domicile	No	No
Alaska	3 factor	equal	com. domicile	No	No
Arizona	3 factor	50% sales	com. domicile	No	No
Arkansas	3 factor	50% sales	com. domicile	No	No
California	3 factor	50% sales	com. domicile	No	No
Colorado	2 or 3 factor	equal	com. domicile	No	No
Connecticut	3 factor	50% sales	com. domicile	No	Yes
Delaware	3 factor	equal	com. domicile	No	No
Florida	3 factor	50% sales	com. domicile	No	No
Georgia	3 factor	50% sales	com. domicile	No	No
Hawaii	3 factor	equal	com. domicile	No	No
Idaho	3 factor	50% sales	com. domicile	No	No
Illinois	1 factor	100 % sales	com. domicile	No	No
Indiana	3 factor	50% sales	com. domicile	No	No
Iowa	1 factor	100 % sales	com. domicile	No	No
Kansas	3 factor	equal	com. domicile	No	No
Kentucky	3 factor	50% sales	com. domicile	No	No
Louisiana	3 factor	50% sales	com. domicile	No	No
Maine	3 factor	50% sales	com. domicile	No	No
Maryland	3 factor	50% sales	com. domicile	No	No
Massachusetts	3 factor	50% sales	com. domicile	No	No
Michigan	3 factor	90% sales	com. domicile	No	No
Minnesota	3 factor	70% sales	com. domicile	No	No
Mississippi	3 factor	equal	com. domicile	No	No
Missouri	3 factor	equal	com. domicile	No	No
Montana	3 factor	equal	com. domicile	No	No
Nebraska	1 factor	100 % sales	com. domicile	No	No
Nevada	no tax	no tax	no tax	no tax	no tax
New Hampshire	3 factor	50% sales	com. domicile	No	No
New Jersey	3 factor	50% sales	com. domicile	No	No
New Mexico	3 factor	50% sales (c)	com. domicile	No	No
New York	3 factor	50% sales	com. domicile	No	Partial
North Carolina	3 factor	50% sales	com. domicile	No	No
North Dakota	3 factor	equal	com. domicile	No	No
Ohio	3 factor	sales 60%	com. domicile	No	Partial
Oklahoma	3 factor	50% sales (c)	com. domicile	No	No
Oregon	3 factor	50% sales	com. domicile	No	No
Pennsylvania	3 factor	50% sales	com. domicile	No	No
Rhode Island	3 factor	equal	com. domicile	No	No
South Carolina	3 factor	sales*2	com. domicile	No	No
South Dakota	no tax	no tax	no tax	no tax	no tax
Tennessee	3 factor	50% sales	com. domicile	No	No
Texas	**1 factor**	**100% receipts**	**Legal domicile of payor**	**ES no; capital yes**	**Yes**
Utah	3 factor	equal	com. domicile	No	No
Vermont	3 factor	equal	com. domicile	No	No
Virginia	3 factor	50% sales	com. domicile	No	No
Washington	no tax	no tax	no tax	no tax	no tax
West Virginia	3 factor	50% sales	com. domicile	No	No
Wisconsin	3 factor	50% sales	com. domicile	No	No
Wyoming	no tax	no tax	no tax	no tax	no tax

Notes: (a) 3 factors are: property, payroll, and sales; (b) if sales factor is more heavily weighted, remainder is distributed equally over property and payroll; (c) allowable in some circumstances same income multiple times. To prevent double taxation, all income-taxing states and the federal government exclude from both net taxable income and apportionment formulas the amount of dividends received from a subsidiary. Texas follows the same practice in calculating the net income component of the earned surplus portion of the franchise tax.

Unlike most states, however, Texas' franchise tax includes an alternative calculation based on net taxable capital. Dividend income is considered a contribution to capital, and is included in both the capital tax base and the receipts factor. Were this income sourced to the commercial domicile of the recipient, it would make Texas a prohibitively expensive state to locate a company's headquarters. Instead, Texas' longstanding practice dating back to the origin of the franchise tax, is to source income from intangibles to the legal domicile of the payor, a practice commonly referred to as "location of payor." With most companies organized in Delaware, dividends are not considered Texas receipts, preventing multiple taxation of the same revenue. The company's Texas capital tax liability, already one of the highest in the nation, is not artificially inflated further.

In 1997, the House Select Committee on Public School Finance considered changing the sourcing of income from intangibles from location of payor to commercial domicile, as a way of trying to eliminate a tax planning strategy commonly referred to as the "Delaware sub." The following year, the TTARA Research Foundation conducted an extensive analysis into the consequences of changing from location of payor. This study, *The Franchise Tax and Location of Payor: Untangling the Issues*, found:

- Changing the sourcing of income from intangibles would not eliminate the "Delaware sub." Corporations doing business in Texas, but headquartered in *any other* state would still be able to utilize the Delaware sub strategy.
- Commercial domicile sourcing would greatly increase the capital tax liability of Texas-based companies, increasing their tax liability based on business activity that occurred not in Texas but in other states.
- The increases on Texas-based companies would be significant enough for many to relocate their headquarters out of state.
- Statements that "other states do it" are misleading—like comparing apples to oranges. While other states utilize commercial domicile sourcing, they do not levy a capital based tax similar to that of Texas, which is the tax that would be impacted.

Location of payor helps to mitigate the potential for multiple taxation of capital, eliminating a potential tax barrier to locating headquarters in Texas.

Taxes and Corporate Decision-Making. Regardless of how they finally organize and structure their business units, businesses are indeed mindful of the tax consequences of their decisions. This consciousness is no different than their concerns over minimizing operating costs by locating close to suppliers of raw materials or close to the markets they serve. It is no different from an individual seeking to minimize his own tax liability by investing in a private retirement account or in tax-exempt municipal bonds.

Taxes are typically not the sole determinant in a business decision over form or structure:

> *Seldom will tax reasons alone justify changing the legal structure of your business. More often, entrepreneurs going past sole proprietorships are influenced by non-tax issues, such as the shield from personal liability for business debts that corporations and limited liability companies offer. Also, partnerships, corporations and limited liability companies allow bringing co-owners into the business. And some proprietors believe the letters, "Inc." in a business impress customers, investors and lenders, and so they incorporate without even bringing in co-owners.*[10]

Taxes can and do influence decisions about where to locate a business or a unit within a larger business group. In specific cases, a package of tax incentives may influence a company's location decision. In general situations tax policy can influence a company's decision. For example, Texas tax policy is relatively benign for locating a corporate headquarters, but with property taxes among the nation's highest, it may not be the best tax location for a capital intensive manufacturing unit. Still, taxes are typically only one of several factors that enter into the decision-making process, and Texas' workforce, climate, and central location may tilt in its favor.

[10] Frederick W. Daily, *Tax Savvy for Small Business: Year Round Tax Strategies to Save You Money* (Berkeley, California: Nolo.com, October 1999).

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CONCLUSIONS

Business is defined as an activity engaged in with the expectation of making a profit. People who engage in business organize their affairs in a variety of ways. The laws governing the organization, operations and taxation of businesses are among the most complex and confusing laws on the books. While most businesses operate in very simple forms and are very small, the vast majority of business activity in our modern economy takes place in forms that are neither small nor simple.

There are a variety of ways in which businesses may organize themselves. The legal "forms" that businesses use to conduct their operations are mainly created under state laws. Business forms typically differ in terms of governance requirements, reporting requirements, liability protections for the owners, and tax treatment.

Tax considerations enter into the decisions a business makes on how to structure and organize its operations, but they are typically intertwined with a number of other issues and are rarely the only factor in the decision. More often, historical or regulatory reasons for keeping certain operations separate, or efforts to limit exposure to particular legal or credit risks, determine whether a firm chooses to use distinct legal entities to perform particular activities. Taxes are a cost of doing business, however, and all businesses try to minimize their costs so they may be profitable. Tax planning is simply one aspect of overall business planning.

Tax planning may take many forms. For the individual, it may involve whether to contribute to an Individual Retirement Account in a given year or whether to take part in various estate planning practices. For the business person, the consideration may involve deciding what form of business in which to organize—certain forms, being subject to direct taxes, have a higher tax cost than others—or when and how to recognize certain income or expenses. For the larger company doing business across state lines, the issue is far more complex. While most states levy personal and corporate income taxes, rates and policies differ widely. Seemingly small differences in policy can have substantial tax impacts. Tax issues may come into consideration in deciding how to structure different business units and in which states to locate them.

Texas takes a different approach than most states in taxing business. Only four states do not tax any form of business income. All of the other states either levy a tax directly on the business entity, regardless of its form, or follow the federal practice of allowing some entities to elect whether they will be taxed directly, or have their income "passed through" to their owners for taxation. With no direct tax on it, Texas does not subject the income earned by many "pass-through" forms of business to taxation at all unless the partnership is owned by another taxable entity.

Texas' corporate franchise tax is, however, broader than corporate taxes in most other states, applying to limited liability companies and S corporations, entities not typically subject to corporate taxes in other states. Further, the franchise tax is based on the higher of two calculations—one largely based on net income and one based on net assets—so it falls more evenly on both capital intensive and turnover-based businesses. The broader application of Texas' tax and the dual calculations have helped hold Texas franchise tax collections steady while a slowing economy has led corporate taxes in many other states to plummet.

As increasing amounts of business activity in Texas are being conducted in forms of business that are not subject to the franchise tax, concerns have arisen that Texas' tax base is withering because of rampant and abusive tax planning—taxpayers reorganizing into partnerships, a form of business not subject to the franchise tax. To date, with franchise tax collections still healthy, the evidence for this appears merely anecdotal. Nonetheless, the contention invites consideration of the fact that Texas' chief business tax does not apply to all forms of business. That clearly creates an incentive for operating in one form over another—an incentive all the greater given the absence of a personal income tax on income received by individual owners of business interests.

Other aspects of Texas' franchise tax offer tax advantages that have proven beneficial to taxpayers and to the Texas economy. Texas is an attractive location for corporate headquarters, and is home to 46 of the nation's Fortune 500 corporations.

The 78th Legislature faces severe fiscal challenges, and the franchise tax is under considerable scrutiny. It is tempting in difficult budget times to make policy decisions based on the amount of money a particular proposal raises or in the guise of closing a purported loophole. Tax policy decisions have financial consequences for those who must pay for them. Thus, each proposed change in tax policy should be evaluated and understood in light of how it fits within a broader framework of business taxation.