The Texas Franchise Tax and Location of Payor: Untangling the Issues

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One of the most hotly debated tax issues considered by the Texas Legislature in 1997 was the various methods of franchise tax planning through corporate restructuring and whether such "loopholes" in the law should be closed.[1] Legislators learned that it was possible for corporate taxpayers to conduct their business through limited partnerships (LPs) in Texas, effectively reducing or eliminating their state franchise tax liability. Moreover, other firms were found to have created intermediary corporate holding companies-often referred to as "Delaware subs"-which pay income to the Texas corporate parent as dividends and interest. This approach also reduces a firm's tax liability because the dividends are treated as out-of-state income tied to the state in which the payor is incorporated-often Delaware, hence the term "Delaware sub."

Although various alternatives for dealing with these supposed "loopholes" were discussed, the approach which received the most attention was shifting the sourcing of intangible income-like dividends, interest and capital gains-from the current location of payor approach to one tied to the commercial domicile of the state in which the corporation has its operating headquarters.[2] After considerable debate, primarily in the House Select Committee on Revenue and Public Education Funding, the proposed change was part of House Bill 4, the property tax relief legislation, as reported from the Revenue and Public Education Funding Committee; however, it was removed from the legislation by the full House. It was considered and rejected by the Senate. Following the legislative session, House Speaker Pete Laney assigned the Select Committee the interim charge:

> *Review the state's laws, rules and practices for apportioning receipts from intangible assets under the state franchise tax. The review should include an examination of the current location of payor rule, as well as alternatives and their effects on tax equity, business expansion and job creation, and opportunities for tax avoidance.*

This dangling tax policy issue is undesirable from the standpoint of the state's business climate. One of the critical factors clouding any state's business climate is tax policy uncertainty. Economists debate the actual influence of taxes on business location decisions, but there is common agreement that tax uncertainties can have a chilling effect on efforts to bring jobs and investment to a state. Businesses, faced with making long-term investment decisions, may be driven off if future shifts in tax policy could undermine current projections of the success of a given investment. That is where Texas finds itself. While it remains a preeminent state, offering many natural advantages attractive to business capital investment and job creation, the possibility that a future Legislature might change sourcing rules as a means of "solving" perceived problems with the franchise tax is a powerful question mark hanging over the state.

Sourcing of intangible income under the franchise tax is, at best, an obscure subject, but it is one that is of critical importance to many of the state's most important business organizations. It is clear from the discussions during the legislative session that the relationship between modern business structure and the franchise tax is not well understood. The larger implications of significant shifts in sourcing policy have not been clearly defined and discussed.

At the heart of the location of payor issue is the question of whether a business organizing with tax consequences in mind represents a questionable effort to avoid taxes or whether it is simply the same sort of cost-consciousness that businesses exercise when they work to reduce travel costs or cut material expenses. Examined closely, it is difficult to argue that businesses shouldn't work to minimize their tax burdens across the states where they do business. Individuals do the same thing when they get receipts for charitable contributions or put funds into Individual Retirement Accounts to reduce their federal income tax bill. Several decades ago, Judge Learned Hand noted: "Again and again courts have said there is nothing sinister in arranging one's affairs to keep taxes as low as possible. Everyone does so, rich or poor; and all do right, for nobody owes any public duty to pay more than the law demands: taxes are enforced exaction, not voluntary contributions."

Thus, the tax planning that is of concern in the location of payor issue is not an aberration. It is not a "loophole" unique to Texas. It is merely one element in this state's tax policy to which businesses must respond in the course of their operations. Shifting to a commercial domicile sourcing rule would not eliminate franchise tax planning opportunities by business, nor would such a change make the franchise tax more equitable or less of a burden on state economic development. Indeed, there is evidence that such a shift would create some level of economic "backlash" as corporations reevaluate the attractiveness of Texas as a business location. Specifically, the change would most hurt firms headquartered in the state who already pay a significant share of the franchise tax and have a large investment in the state.

Moreover, shifting to commercial domicile could potentially alter Texas' reputation as a low-tax state, a reputation that, along with other factors, has led at least 36 Fortune 500 companies to establish their headquarters in the state, either from their birth or by relocation from other states. The cost could eventually be felt in Texas jobs, prestige, and the many tangible and intangible benefits that follow major corporate headquarters to a state. While there would be a significant revenue increase from this change, it would be short-lived and come at a high economic cost.

State policy is a series of choices. Each choice carries weight and sends messages, intended and unintended, to the businesses who have invested in the state or who are interested in future investments here. Thus, each proposed change in policy should be understood and weighed in terms of its potential costs and benefits to the state as a whole.

Such is the case with the location of payor issue. State officials became interested in this complex tax issue because of concerns that the rule for sourcing intangible income under the franchise tax might be used widely as a mechanism for tax avoidance. A possible solution has been discussed, shifting to commercial domicile sourcing. Thus, for tax apportionment purposes, the tax equation would shift from where the payor of the dividend, interest or capital gain was located to where the receiving corporations is located-its commercial domicile.

Like most complex public policy issues, there is more to the story than has been generally revealed to date. The location of payor issue is not a simple case of closing a tax loophole. Though obscure to the average observer, it amounts to a dramatic shift in the state's entire attitude toward business investment, and whether intended or unintended, understood or misunderstood, implementation of the change could have a chilling effect on the location of corporate headquarters in the state. It could halt or even reverse a decades-long trend toward more and more corporations making their homes in this state. Such a change should not be undertaken lightly or without the full understanding of the potential consequences.

The location of payor issue is extraordinarily complex and hinges critically on how businesses organize themselves to do business in the world today. To shed some light on this issue, the TTARA Research Foundation commissioned this study of the implications of changing franchise tax sourcing rules. In this study, we provide an overview of the Texas franchise tax and how income from intangibles is sourced. We identify common methods of structuring businesses today to gain a better grasp of how intangible income flows across affiliated entities. We work through some examples of different types of Texas corporations, and how sourcing of intangible income works with location of payor and how that would change under commercial domicile. We canvas how other state business taxes work and how other states source intangible income. And finally, we evaluate the likely consequences of changing Texas' current sourcing policy to commercial domicile.

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1. Although interest in the location of payor issue was intense during the 1997 legislative session, the issue first came to legislative attention in 1996. In response to a request from the House Ways and Means Committee, the Comptroller's office prepared an analysis entitled "The Texas Franchise Tax: Methods of Tax Avoidance." The paper outlined various franchise tax planning techniques and presented estimates of the revenue loss associated with them.

2. Interest and dividends received by banks and savings and loan associations currently are apportioned based where the institution has its commercial domicile in the state. The reason for this divergence in policy is tied to the way in which banks and savings and loans came under the franchise tax. Until the 1980s, these financial institutions paid a separate ad valorem tax on bank stock which was allocated to Texas local governments. In 1985, this special tax was repealed, and banks and savings and loans were placed under the franchise tax. However, tax collections initially continued to be allocated to local governments. Since there was no branch banking at the time, the application of commercial domicile sourcing made sense because it allowed collections to continue to be tied to the location of the bank for purposes of local apportionment. In 1991, the local allocation was eliminated, but the sourcing of interest and dividends was unchanged.

Chapter 2: An Overview of the Texas Franchise Tax

The corporate franchise tax generated $1.8 billion in revenues in 1997, making it the state's third largest source of tax revenue. 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. Various tax increases and surtaxes imposed during the economic turmoil of the 1980s caused it to increase to nearly nine percent of state tax revenues; however, a series of court cases sparked substantial refunds, leading to a restructuring of the tax in 1991. Historically, the tax had been based on a corporation's capital or net assets. The 1991 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.

Since the 1991 revisions, rates have not changed, nor have there been any substantial legislative changes to the tax base, yet the tax has performed increasingly well. Amid anecdotal concerns that tax planning has caused a growing erosion of the tax base, franchise tax revenues have grown more rapidly than all other state taxes combined (Figure 1).

As a tax on corporations, Texas' franchise tax is generally viewed as low. Texas franchise tax revenues equal 0.33 percent of the state's gross product, ranking it 38th among the states in terms of corporate taxes,[1] which may reflect the state's overall low level of spending more than anything. That low rank is offset when all other Texas taxes businesses pay are considered (sales, property, etc.). Overall, businesses pay an estimated 54.0 percent of all Texas state and local taxes, the second highest proportion nationwide.[2] Consequently, while Texas overall is a "low tax" state-ranking 46th among the states in terms of taxes as a percent of gross state product, it is not necessarily so for many businesses. In fact, Texas' business tax load is the 13th highest of all states.[3]

The franchise tax serves as Texas' general business tax, though it applies only to corporations (except for non-profits) and limited liability companies doing business in Texas. Partnerships and other non-incorporated business forms are not subject to the tax (although corporate owners of partnerships are taxed on their partnership income). In concept, the franchise tax is a license, or "privilege" tax, i.e. paid for the privilege or right to do business in the state as a corporation, and in return, the state grants the corporation certain privileges as well.[4] In Texas, each corporation pays the tax on a separate entity basis-i.e., based on its individual circumstance, regardless of whether it is affiliated through common ownership with other corporations.

Nexus. To be subject to the franchise tax, a business must have some type of connection, or nexus to the state. Nexus describes the threshold of business activity that must be present before a taxing jurisdiction has the right to impose a tax on a corporation.

While this is a fairly 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:

- having a certificate of authority from the Texas Secretary of State allowing a company to do business in the state;
- serving as the general partner of a limited partnership doing business in Texas;
- hiring independent contractors in Texas to promote sales here;
- providing services here; and/or
- franchising independently owned businesses.

Nexus standards differ slightly between the earned surplus component of the franchise tax and the capital tax.[5] 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 law, 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 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 have nexus in Texas, but be a part of an affiliated business group that contains corporations who do not have nexus in the state. For example, the Texas Widget Company may be domiciled in Texas, but may own a subsidiary corporation, the Ohio Sub-Widget Corporation, located in another state that has no nexus in Texas. Similarly, the Texas Widget Corporation may be a subsidiary of the Montana Holding Corporation, located in another state and having no nexus in Texas. 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. 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
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[6] do not add this item)
Equals:	Total Earned Surplus

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 (debts are "sum certain" and "time certain" obligations the company must repay, and include current liabilities and long term debt). 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).

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. If the company does all of its business within Texas, the franchise tax applies to its business in entirety; if the company does business in a number of states (or a number of countries), however, the application of a state tax becomes far more complex. Some method must be used to apportion business activity to the state in order for the business tax to be fairly applied.

In Texas, both earned surplus and taxable capital are apportioned to Texas based on the ratio of a business' gross receipts from business done in Texas to its gross receipts everywhere. *Gross receipt*s 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 which may be attributed to the taxing state.

Apportionment of multistate 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. 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 2 illustrates Texas' sourcing methods for different types of receipts.

Apportionment rules vary widely across the states. Texas uses a single factor, gross receipts, to apportion business activity. 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 only 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 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.[7] In this particular instance, Louisiana also considers this to be a Louisiana sale,[8] 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.[9]

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 their 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.[10]

Dividends and Apportionment. The Texas franchise tax involves two separate tax calculations-one for capital and one for earned surplus. While both use receipts-based apportionment, the actual calculation of *receipts* between the two differs with respect to the treatment of dividends. 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 taxable income for earned surplus purposes, so this reduced percentage is counted as a gross receipt for apportionment.[11]

Texas, as most states, has adopted the federal "dividends received deduction" for income tax purposes (Figure 3). 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 federal law (and 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 tax liability. The amount due 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 earned surplus. If the calculation yields a tax liability of less than $100, then no tax is due. This equates to an earned surplus of $2,222 or less, or $40,000 of taxable capital or less.

Sample Calculation of the Franchise Tax (Example 1). A simplified example of a franchise tax return is shown in Figure 4. The Texas Company is a manufacturing company domiciled in Texas. The Texas Company is unaffiliated-it has no subsidiaries nor is it a subsidiary itself, and it has no partnership interests. The bulk of its gross income is from sales ($5 billion), of which $1 billion are in Texas. The Texas Company receives a relatively small amount of depository interest ($5 million) from a Texas bank, and some dividends ($2 million) from various equities it holds in other non-affiliated companies (which for the purposes of this example, are all legally domiciled in Delaware).

Under the capital calculation, the Texas Company has $5 billion of taxable capital (Capital Tax Calculation, line 2). Its gross receipts everywhere are the sum of its sales, interest and dividend revenues (line 3: $5,007,000,000). Its Texas revenues are the sum of its sales in Texas, plus the $5 million in depository interest (line 4: $1,005,000,000). Its capital apportionment factor is 20.07% (1,005,000,000 divided by $5,007,000,000). Applying this to total taxable capital yields a Texas capital tax base of $1,003,500,000 (line 6). At a tax rate of 0.25% ($2.50 per $1,000 of taxable capital), total capital tax due would be $2,508,750.

The earned surplus calculation draws from the federal income tax return. The *Texas Company* had total gross receipts of $5,007,000,000 (Item A. under the Informational Items from Federal Income Tax Return). Subtracting their dividends-received deduction (Item B: the $2,000,000 of dividends received from a non-affiliated entity are entitled to a 70 percent deduction), and other deductible items yields a net federal taxable income of $499,500,000 (Earned Surplus Tax Calculation, line 1a). Earned surplus is the sum of federal taxable income (line 1a) and the amount of compensation paid to officers and directors (line 1b: $500,000). Texas Company's total earned surplus is $500,000,000 (line 2).

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: $600,000, which is $2,000,000 in gross dividends received less the $1,400,000 allowable federal deduction). Total gross receipts for the purpose of apportioning the earned surplus tax is therefore $1,400,000 less than that for the capital tax calculation. Texas receipts are the sum of sales in Texas, plus the $5,000,000 in depository interest it received from a Texas bank (line 4: $1,005,000,000). Its earned surplus apportionment factor is 20.08% (line 5: 1,005,000,000 divided by $5,005,600,000), just slightly higher than the capital tax apportionment factor. Earned surplus apportioned to Texas (line 6: $100,400,000) is taxed at 4.5 percent to arrive at a total earned surplus liability of $4,518,000 (line 8).

The ultimate tax liability is essentially the higher of the capital or the earned surplus calculation-in this case the $4,518,000 under earned surplus.

This technical set of calculations illustrated above greatly understates the true level of complexity in calculating a corporation's franchise tax liability. While some liberties have been taken here in simplifying the tax calculation, even greater liberties have been taken in designing the sample firm. The stand-alone corporation as the sum total of a business entity is not representative of the structure of business organizations paying the bulk of franchise taxes today. Today, as the following chapter reports, most large businesses are actually conglomerations of numerous corporations and subsidiaries, joint ventures, partnerships, and other business forms.

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1. Figures are calculated using tax collection data from the U.S. Bureau of the Census and Gross State Product from the U.S. Commerce Department's Bureau of Economic Analysis. State by state detail is presented in Figure 19.

2. The Institute on Taxation and Economic Policy, The Business Share of State and Local Taxes, How Oregon Compares to Other States, Washington, D.C., April 1997.

3. This ranking was developed by the TTARA Research Foundation for the Texas Strategic Economic Development Planning Commission drawing from the Institute on Taxation and Economic Policy study, gross state product data from the U.S. Department of Commerce and state tax collection data from the U.S. Department of Commerce.

4. Among the privileges granted the corporation are: to exist as an entity separate and apart from the individuals who own it, to accumulate earnings distinct from its owners, to sue (and be sued), and the ability to take on liabilities separate and apart from its owners.

5. Nexus is determined separately for different state taxes, as well, such as sales tax and franchise tax.

6. Subchapter S of the Internal Revenue Code authorizes a special type of corporation which is treated like a partnership for federal tax purposes.

7. Texas Administrative Code, Section 3.549.

8. Louisiana Administrative Code, Section 306, March 1988.

9. 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.

10. 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."

11. Dividends are "booked" for tax purposes on the earlier of the date they are declared or the date they are paid/received.

Chapter 3: Business Forms of Organization in the Real World

The dominant form of business organization today in terms of size and value is the corporation, and of course, corporations in large measure pay the Texas franchise tax. The corporate form offers businesses the opportunity to raise capital from investors or shareholders and in turn protects the shareholders from liability for business debt beyond their investment.[1] Moreover, a corporation's existence may be perpetual, and there are federal tax advantages offered only to corporations. Interest in the corporation can also be transferred freely, meaning shareholders can easily transfer their interest in the business to a nonmember without prior consent of the other members.[2]

Through time, corporations have become extremely complex in their organization and management. This is particularly true of the large multinational corporations which pay the bulk of the Texas franchise tax.[3] Most large corporations are structured as a parent with multiple subsidiaries set up in tiers of ownership. A very simple hypothetical model of this type of organization is illustrated in Figure 5. The figure reflects only the basic structure of modern corporate ownership. In fact, large, multistate or multinational corporations may have many tiers of ownership and literally hundreds of operating subsidiaries. In general, a corporation has great flexibility in how it organizes its activities. It may divide business responsibilities into separate, discrete pieces, much as the Legislature has done in creating within its own structure a separate Legislative Budget Office, Legislative Council, and State Auditor's office. It may also manage all of these functions through a single consolidated organization, just as the state has attempted in recent years to consolidate environmental responsibilities in the Texas Natural Resource Conservation Commission and workforce responsibilities within the Texas Workforce Commission.

If they are organized as corporations, the parent and each subsidiary will be separately incorporated. The state where a corporation's legal charter is issued is called its *legal domicile*. Corporations are chartered in different states, but most major corporations today have chosen to incorporate in Delaware. Delaware offers broad flexibility in its corporate charters with regards to the line of business a corporation may engage in, and offers an attractive legal and legislative climate:

> *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 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.*[4]

Whether organized in Delaware or some other state, most of the familiar American corporations are "C corporations," so called after the subchapter of the Internal Revenue Code that authorizes them and sets out the basic federal tax provisions affecting them and their federal tax liability.

While many corporations have their legal domicile in Delaware, they often have their *commercial domicile*-or headquarters-in some other state. The headquarters of a firm is where its "mind and management" 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;*
- *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.*[5]

Typically, the headquarters is where the upper management of the company locates, and often it is close to a center of the company's chief business operations or in a state with an attractive business climate. For example, Exxon Corporation has its legal domicile in New Jersey but its headquarters in Irving, outside Dallas. Compaq Computer is a Delaware corporation but has its headquarters in Houston. Texas is currently home to 36 corporate headquarters among *Fortune 500* companies and many smaller ones (Figure 6). This is double the number of large firms located in Texas two decades ago and reflects the attractiveness of the state to business.

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 operating divisions. A holding company parent often has two primary functions: to provide overall guidance to the corporate family and to act as a "bank" for financing corporate operations and new investments (in some cases, the treasury function itself is in a subsidiary).

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 chose 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 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. A recent survey of 196 U.S. corporations found charitable contributions totaling $1.8 billion nationally in 1996, much of it found where the companys' headquarters are located.[6] As the *Corporate Giving Directory* points out: "Most companies prefer to award charitable contributions near headquarters and operating facilities."[7] Indeed, one study found the headquarters of corporations spend about 80 percent of the total in charitable contributions made by the firm, with the other 20 percent being spent by field locations.[8]

Subsidiaries. Businesses form subsidiaries for many reasons. Based on the discussion during the last legislative session, there may be a lingering impression that they are often formed primarily for tax reasons. In reality, this isn't the case at all. The most common reasons for creating subsidiaries include:

- **Risk:** By subdividing its different operations, a company's risks are spread and contained.
- **Geography:** Companies may also form subsidiaries when they operate in different geographical markets, a common division in the case of international operations.
- **Historical circumstance:** As businesses expand, they may often find it easier to "buy out" 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 requirements:** A corporation may be engaged in a certain line of business that is subject to restrictive legal requirements. Thus, 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.

Do tax considerations enter into the decision on how a business organizes its operations? The answer clearly is "yes." Although in large multistate businesses, taxes are usually not the primary strategic consideration, they are an important consideration. Corporate financial planners must balance a number of factors, weighing the strategies of corporate management with various other concerns such as location, material costs, legal issues, and taxes. Moreover, tax considerations only rarely involve a single state. Tax consequences must be balanced in all of the states where the business operates. In addition, the tax matters that often preoccupy corporate financial staff are not state tax matters but rather federal tax concerns.

Alternatives to the Corporate Form. Historically, corporations have been the preferred form of business organization because the corporate form protects shareholders from liability for business debt beyond their actual investment. There are other forms of business organization, of course, including the sole proprietorship and partnerships. The last decade in particular has seen the development of a number of other alternative forms which try to provide some of the benefits of the corporate form with the flexibility offered by partnership arrangements. Some of these are addressed by Texas franchise tax law; others are not.

The S corporation. Among the oldest of these alternatives is the S corporation. It is very much an outgrowth of federal tax law, created as part of the Internal Revenue Code in 1958.[9] An S corporation is a domestic corporation that is treated for federal income tax purposes as a flow-through entity.[10] That is, income from the corporation is reflected in the shareholders' personal tax returns and is taxed as ordinary income. The S corporation itself is exempt from tax, and the business' profits and losses are passed directly through to the shareholders. The S corporation allows small businesses or businesses with few shareholders to realize the benefits of the corporate form. Prior to 1997, S corporations could not have more than 35 shareholders. Beginning with the 1997 tax year, this changed to 75 shareholders and S corporations were allowed to have subsidiaries.[11] Despite these changes, S corporations remain vehicles for small firms or firms with a small number of shareholders, and most of the larger corporate franchise tax payers are C corporations.

Although their net profits pass through to the shareholders, S corporations are subject to Texas franchise tax just as C corporations are. Generally, C corporations include officer/director compensation in their calculation of earned surplus; S corporations do not.[12]

Partnerships. A partnership is simply two or more partners carrying on a business together and sharing profits and losses. Each partner is liable for acts of other partners within the scope of the business. Unlike a corporation, a partnership is not a separate legal or taxpaying entity apart from its owners.

At the federal level, partnership income is passed through to the partner's individual or corporate income tax returns. Texas does not directly tax partnerships under the franchise tax, although the idea has been intensely debated in the Legislature. In 1997, Governor Bush proposed a business activities tax that would have included partnerships as well as corporations. Both legislative houses passed tax legislation that would have taxed them during the 1997 session. However, no final action was taken on the issue when the overall property tax relief legislation was scaled back to its final form.

It is important to note that corporations invest in partnerships from time to time and for a variety of reasons. "For example, a corporation may enter into a new or risky business venture for which it prefers to share the risk of loss with another corporation, or a corporation may invest excess cash in an investment or business partnership."[13] And while the partnership itself is not directly taxed, to the extent the partnership adds to the capital or proceeds of a corporation, the corporation must pay Texas franchise tax on its share of the partnership.

Gaining in popularity as a business form in recent years is the **limited partnership** (LP). A limited partnership has characteristics similar to both corporations and partnerships. There are general partners who have the control and liability for the enterprise, and there are limited partners who only put in money and whose liability is limited to what they paid for their share of the partnership-not unlike a corporate shareholder. While they contribute capital, the limited partners have no control over the business or liability for its debts. A number of states, including Texas, distinguish between general and limited partnership interests for corporate tax purposes. In Texas, an out-of-state corporation's general partnership interest is deemed to establish nexus in Texas, subjecting that corporation to the Texas franchise tax; a limited partnership interest does not if the partner has no other contact with or activity in the state.[14]

Limited liability companies. Another alternative to the corporation is the limited liability company (LLC). It is a relatively new form of business organization that is like a limited partnership without general partners. It has characteristics of both a corporation and a partnership. None of the members have liability, and all can have some control. The first LLCs were actually created in Wyoming in 1977, but they were not authorized under Texas law until 1991, after doubts about their federal income tax status were resolved by the Internal Revenue Service.[15] LLCs are not subject to some of the restrictions that a corporation must satisfy to qualify as an S corporation. Individuals, corporations, partnerships (general and limited), trusts and foreign persons may all be members of an LLC.

Despite the advantages they enjoy, LLCs have only recently begun to be widely used by businesses in Texas-and particularly by multistate businesses. Although most states have authorized LLCs, the statutes vary from state to state. A good example of this is state tax treatment. Some states treat them as partnerships for state tax purposes, while others, including Texas, treat them as corporations.

Tax Planning and Corporate Decisionmaking. Regardless of how they finally organize, businesses must be mindful of the tax consequences of their decisions; however, this consciousness is no different than their concerns over locating close to suppliers or raw materials or finding a good deal on land for a new expansion. Businesses today face a wide array of costs: raw materials, labor, energy, and so on. Taxes are one of those costs, and tax costs have been rising steadily in many states since the early 1980s. Tax planning is the process in which lawful decisions are made about how to limit those tax costs. It is a way of using legal means to operate as cost effectively as possible. In today's competitive environment, it is an essential strategy for the company that wants to maintain its economic position, and the work done for this report shows that it is part-though typically not the central part-of every major business decision a corporation makes. This is not really a new development in taxation.

While no doubt tax planning has cost the Texas state treasury funds it might otherwise have had, Texas has also been the beneficiary of tax planning. Over the past 25 years, many corporate headquarters have relocated to Texas from other states, at least partly because of the tax benefits the state offers. These companies were engaged in tax planning that benefited the State of Texas, and in coming to the state, they pay property taxes on their offices, and sales tax on their equipment. They hire Texas employees and contract with Texas businesses to provide various goods and services. Most corporate tax planning does not involve a single state, and the way that businesses respond to state tax policy gives valuable indications of where the state is on the right track economically and where it is having difficulties.

Recognizing the benefits of expanded business activity, states actively encourage certain types of tax planning. For example, virtually all states offer some form of enhanced credit for investments or job creation in their states. These credits are offered as an incentive for businesses to build facilities and hire workers in their states, as opposed to other states where tax costs might be higher. Texas has not enacted many of these general tax credits, but it does have various tax incentives, for example, to encourage oil and gas production or to further the development of the semiconductor industry. Texas' use of a single receipts factor to apportion the franchise tax is a clear example of a policy designed to benefit the corporations which locate property and payroll in the state but make sales to customers outside it.

The tax policies a state adopts matter to its corporate citizens. In general, no single policy change is enough to cause a change in how the company structures itself. However, there are cases where a policy change can be so costly to a company that simple common sense requires action. This is the case with the proposal for Texas to shift from location of payor to commercial domicile sourcing. Rather than eliminate tax planning, such a shift would set off a flurry of tax planning, and the state would be the loser. The next two chapters look at sample corporations' tax liability under location of payor and commercial domicile. They illustrate what the taxpayers' concerns are with this possible change in policy.

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1. Rita Cain and Larry R. Garrison, "The Limited Liability Company: When Is It the Right Choice?" Journal of State Taxation, Volume 11, Number 4 (Spring 1993), p. 52.

2. Armando Gomez, "Limited Liability Companies: Passthrough Entity of the Future," Journal of State Taxation, Volume 12, Number 3 (Winter 1994), p. 9.

3. The largest one percent of franchise taxpayers (about 3,600 taxpayers) accounts for 65 percent of total tax collections. The largest 10 percent accounts for 90 percent of collections.

4. Robert Hessen, In Defense of the Corporation (Stanford, California: Hoover Institution Press, Stanford University, 1989), pp. 73-74.

5. Peter F. Drucker as quoted in Business International Corporation, Managing Today's International Company: The New Role of Headquarters (New York: Business International Corporation, 1989), p. 5.

6.Kelly Prelipp Lojk, "Corporate Gifts Rise 31 Percent, Report Says," Philanthropy Journal (February 9, 1998), Internet document (www.philanthropy-journal.org/corp/corpgifts0298.htm).

7.Corporate Giving Directory (14th Edition), (Rockville, Maryland: The Taft Group, 1993), p. x.

8. The Conference Board, The Corporate Contribution Function (Report No. 820), p. 27. Much of this is spent in the headquarters community, although a portion of the funds are often allocated to field locations.

9. Like C corporations, S corporation refers to another subchapter of the Internal Revenue Code.

10. Karen J. Boucher and John C. Healy, 1998 Multistate Corporate Tax Guide (New York: Panel Publishers, 1998), p. I-97.

11. The federal Small Business Job Protection Act of 1996 expanded the shareholder size of the S corporation and allowed S corporations to have wholly owned C corporations and certain S subsidiaries. The subsidiaries must be wholly owned by the parent S corporation and meet other qualifications. These subsidiaries are called qualified Subchapter S subsidiaries (QSSS).

12. Not all C corporations add back officer and director compensation because not all C corporations have more than 35 shareholders.

13. Boucher and Healy, p. I-159.

14. Boucher and Healy, p. I-162.

15. Rev Rul 88-76, 1988-2 CB 360 classified a Wyoming LLC as a partnership for federal tax purposes, clearing the way for the expanded use of the business form. Prior to the ruling, the IRS had refused to issue private letter rulings addressing the classification of LLCs. More recently, the IRS has issued similarly favorable rulings on LLCs in a variety of other states.

Chapter 4:The Franchise Tax in Practice: Location of Payor

In Chapter 2, the fictitious Texas Company in Example 1 provided a basis for understanding how the franchise tax works in concept. In Chapter 3, however, it was illustrated that the single unaffiliated corporation is not typical of today's business operations. In this chapter several additional examples of more complex business operations are used to illustrate how the sourcing of intangibles affects different corporations differently.

While these illustrations are more typical of the types of corporate structures used by today's businesses, it should be noted that even so, they are still very simplistic representations. They do provide a basis for understanding which items "trigger" tax changes. Any Texas-based firm with income from intangibles, even if it had a substantial amount of active business income, would be similarly impacted (though the magnitude might vary). While the sample corporations are all large firms, similar effects would be experienced by any similarly structured Texas-based businesses, regardless of size. The ultimate magnitude of the tax impact would vary based on the size of a firm and the amount of intangible income it receives. The direction of the impact would be the same.

Three additional examples of Texas-based companies are presented here to augment the Texas Company in Example 1. One pays the capital tax while owning several corporate subsidiaries. Another is a corporate parent who pays the earned surplus tax. Finally, one is a corporation conducting its business operations through a limited partnership and a Delaware subsidiary.

Texas-based Capital Payor (Example 2).[1] In this example, Texas Capital Company is a Texas-domiciled holding company that pays franchise tax based on the capital tax calculation (Figure 7). Texas Capital Company has $5 billion of net assets, or taxable capital, most of which is in the form of stock in three subsidiaries, one each headquartered in Texas, Louisiana and California. Each of the subsidiaries is incorporated in its own right in Delaware, and each pays corporate taxes in the states in which they do business, as well as federal taxes (which may be filed separately, or paid as a part of a consolidated tax return for the conglomerate as a whole)-in fact, one of the subsidiaries is a Texas corporation that is profitable and already pays $15 million in Texas franchise taxes.

The three subsidiaries are profitable and pay a combined total of $500 million in dividends to Texas Capital Company, their parent corporation (which in turn, pays dividends to its stockholders). Texas Capital Company also receives $2 million in depository interest from a Texas bank.

Under current franchise tax provisions, Texas Capital Company would calculate its franchise taxes as illustrated in Figure 8.

On the capital tax side, Texas Capital Company has $5 billion of taxable capital to apportion. Its total receipts everywhere are $502,000,000 (Capital Tax Calculation: line 3)-the sum of its dividends and interest. Of these receipts, only the $2,000,000 of depository interest from a Texas bank is sourced to Texas (line 4). The $500,000,000 of dividends from its subsidiaries are considered non-Texas receipts because they are sourced to the legal domicile of the payor-in this case Delaware, the state where each subsidiary has filed its legal articles of incorporation. Texas Capital's Texas apportionment factor is 0.40 percent (line 5, or the $2,000,000 of Texas receipts divided by the $502,000,000 in receipts everywhere). Applying this apportionment percentage to Texas Company's $5 billion of net capital yields $20,000,000 in Texas net capital, which results in a capital tax liability of $50,000.

On the earned surplus side, the Texas Capital Company draws from its federal tax return. Its federal tax calculation began with reported total gross receipts of $502,000,000 (Informational Items from Federal Income Tax Return, item A). It deducted $500,000,000 under the dividends received deduction, (item B-since these dividends were paid out of subsidiary profits which had already been taxed). Another $1,500,000 of operating expenses were deducted to yield a net taxable income for federal tax purposes of $500,000 (Earned Surplus Tax Calculation: line 1a). To this, officer and director compensation is added to arrive at a total earned surplus of $1,000,000 (line 2).

Earned surplus apportionment is based on the $2,000,000 in interest received from a Texas bank (the subsidiary dividends are not considered since they are not included in the calculation of earned surplus)-for an apportionment factor of 100 percent. The tax on the $2,000,000 of earned surplus apportioned to Texas is $45,000 (line 8). This is less than the capital tax liability, so it is the $50,000 in capital taxes that are paid to the state.

It is important to note that on paper, it appears that Texas Capital Company is netting somewhere in the vicinity of half a billion dollars a year, yet does not pay the income-based Texas earned surplus tax. That is because Texas mirrors the federal dividends received deduction to limit double taxation of income.[2] All of the dividends received by Texas Capital Company have been paid out of the profits of its subsidiaries-profits that have already been taxed. In fact, one of the subsidiaries is a Texas-based firm itself, and has already paid Texas franchise taxes in its own right-$15 million. The other subsidiaries could pay Texas taxes, as well, should they make sales into the state and establish nexus here. All totaled, the combined entity-Texas Capital and its three subsidiaries-generated $867 million in net taxable profits and paid $304 million in federal income taxes and over $63 million in state income and franchise taxes. Further, it should be noted that less than eight percent of all state and local taxes paid by business are franchise taxes, the bulk are sales, property and miscellaneous other taxes not considered in this analysis.[3]

Intuitively, it might seem appropriate to source the dividend income to the commercial domicile of the payor. In this case the $200 million in dividends paid by the Texas Subsidiary Company would be considered Texas receipts, but it is important to stress again that the Texas Subsidiary Company has already paid Texas franchise taxes on that income. Sourcing to the location of payor in this case, mitigates the potential for double taxation.

For illustration purposes, this example used dividend income. However, the net calculation would have been the same had either interest or gains from the sale of intangibles been the source of income to the parent corporation. Further, while this example used a holding company, the treatment of intangible income would have been the same for a firm with active business income, or sales.

Texas-based Earned Surplus Payer (Example 3). This example looks at Texas Surplus Company-a Texas-based parent corporation paying franchise tax based on earned surplus (Figure 9). It has used its assets to capitalize three subsidiaries in Texas, Louisiana and Florida, though each is incorporated in Delaware. Texas Surplus issues corporate debt to loan money to finance the operations of its subsidiaries, each of which pays interest on the debt to Texas Surplus (the subsidiaries do not currently pay dividends, in fact, each one is just breaking even). The Texas Surplus Company has income from the use of its trademark, which it sells to other companies (who may use it to print on t-shirts and other consumer products that do not compete with Texas Surplus' products).

Under current franchise tax provisions, Texas Surplus Company would calculate its franchise taxes as illustrated in Figure 10.

On the capital side, Texas Surplus has net assets of $2.5 billion. It has gross receipts of $330 million, of which $180 million is interest payments from its subsidiaries and $150 million is revenues from the sale of its trademark. For apportionment purposes, Texas receipts do not include any of the interest income (which is sourced to Delaware, the state of incorporation of its subsidiaries), but does include the portion of trademark revenues used in Texas ($50 million). This produces a Texas apportionment factor of 15.15 percent, which applied to the $2.5 billion in net assets yields a capital tax liability of $946,875.

On the earned surplus side, Texas Surplus has $330 million in gross receipts. To calculate its net income, it subtracts the $180 million in interest it must pay on its corporate debt (after all, it borrowed the money to loan to its subsidiaries), and $5 million in operating expenses. It adds back $1 million in officer/director compensation for a total earned surplus of $146 million. Its Texas apportionment percentage calculation is the same as under the capital tax calculation-15.15 percent, yielding a Texas earned surplus of $22,119,000, or a tax liability of $995,355. This is the higher of the two amounts and is the franchise tax Texas Surplus pays.

Again, as before it should be noted that the Texas Surplus company is a fairly large and profitable corporation, and even though its subsidiaries are not generating a profit, the corporate group still pays a substantial amount of state business taxes (in addition to sales, property and miscellaneous taxes). Two of Texas Surplus Companies subsidiaries-Texas Subsidiary and Louisiana Subsidiary operate in states that levy capital-based taxes, taxes due regardless of profitability. In fact, the Texas Subsidiary Company pays $2.5 million in Texas franchise taxes on the capital given it by its parent corporation, even though that capital is also taxable to the parent company (though in this case, Texas Surplus pays on earned surplus). All totaled, as a group Texas Surplus and its subsidiaries generated overall net taxable income of $150 million, paid $50 million in federal income taxes, and paid almost $6.5 million in various state income and capital-based taxes.

The Delaware Subsidiary/Limited Partnership Intermediary (Example 4). This example illustrates a business structure that was much discussed during the recent Legislative session, a variant of the so-called "Delaware Sub."

The Texas Holding Company is a Texas-headquartered corporation with $5 billion of assets, all of which is invested in its subsidiary operations (Figure 11). It is the sole owner of the Delaware Subsidiary Corporation, a company incorporated and located in Delaware. Texas Holding Company and the Delaware Subsidiary Corporation jointly own the Texas Limited Partnership, a Texas-based manufacturing operation operating profitably with $500 million of net income on $5 billion of sales. Texas Holding Company is the general partner, with a one percent share, and Delaware Subsidiary Corporation is a limited partner owning a 99 percent interest.

Texas Holding Company has two sources of income. It receives $5 million from its one percent share of the Texas Limited Partnership, and it receives $495 million in dividends from the Delaware Subsidiary Company (which are derived from its partnership interest in Texas Limited Partnership). The only "active" business of the conglomerate is the manufacturing operation of the Texas Limited Partnership.

Of the three entities, only the Texas Holding Company is subject to Texas franchise tax. It is a corporation, and any one of several circumstances cause it to have nexus in Texas-it has physical presence here (payroll and property), and it is a corporate general partner.[4]

The Delaware Subsidiary Corporation, as the limited partner with a 99 percent share of the partnership's revenues, is an out-of-state firm and is not subject to Texas franchise tax. It does not directly own property nor have employees in the state. And while any corporation with a general partnership interest in Texas is deemed to have nexus here, that does not hold true for corporations with limited partnership interests, which are viewed as passive in nature.

The Texas Limited Partnership clearly has presence in Texas. It is, after all, a fairly large manufacturing operation, owning Texas property, employing Texas people and making Texas sales. However, it is not incorporated and therefore is not subject to the Texas franchise tax.

The Texas Company calculates its Texas franchise tax as illustrated in Figure 12. On the capital side, the Texas Company has $5 billion in net assets, or taxable capital (Capital Tax Calculation, line 2). For apportionment purposes, Texas Company has total receipts of $500 million-the sum of its $5 million in general partner revenues plus the $495 million of dividends it has received from the Delaware Subsidiary Corporation. Only the $5 million from the Texas Limited Partnership are considered Texas receipts; the $495 million in dividends are sourced to the legal domicile of the payor-Delaware, the state of incorporation of the Delaware Subsidiary Corporation.[5] Texas Company's apportionment percentage is 1.0 percent ($5 million divided by $500 million), which results in Texas apportioned capital of $50,000,000, for a tax bill of $125,000.

On the earned surplus side, Texas Company has $500 million in gross receipts, though $495 million are dividends from the Delaware Subsidiary, and are deducted from receipts (note the informational items from the federal income tax return in Figure 12). In calculating net taxable income, only the $5 million from its general partner share of the Texas Limited Partnership remains.

Earned surplus apportionment differs at this point from the methods most commonly used by capital tax filers. For earned surplus purposes, corporations must count their share of the partnerships gross receipts as if it had received them directly. In the case of Texas Holding Company, it's reported receipts are based on its share of Texas Limited Partnership's receipts-one percent. Texas Limited Partnership had total sales everywhere of $5 billion; Texas Holding Company reports one percent of this amount, or $50 million as its gross receipts everywhere (Earned Surplus Tax Calculation, line 3a). Texas Limited Partnership had $1 billion of Texas sales; Texas Holding Company reports one percent of this amount, or $10 million, as its Texas receipts (line 4a).

The only receipts considered for apportionment for the Texas Holding Company are those directly related to the partnership. The dividends Texas Holding Company received from the Delaware Subsidiary Company are not considered, because these are not a part of Texas Holding Company's earned surplus tax base.

Texas Holding Company therefore has an apportionment factor of 20 percent (reported on line 5: $10 million divided by $50 million). Applying this factor to the total earned surplus of $5 million yields a tax base of $1 million, translating into an earned surplus tax liability of $45,000.

The tax due is the higher of the two calculations; in this case, it is the $125,000 due as capital tax.

The Texas Holding Company and its subsidiaries in this example have clearly engaged in tax planning. Overall, their business operations are about the same size as the Texas Company in Example 1 and generate about the same amount of net income. While the Texas Company in Example 1 pays $4.5 million in Texas franchise taxes, the Texas Holding Company pays $125,000.

It is not, however, Texas' policy of sourcing dividend income to the location of payor that enable the Texas Holding Company to operate at a relatively low tax burden. A combination of provisions in Texas tax law make this structure attractive from a tax planning perspective:

- Partnerships may operate without paying state business taxes.
- An out-of-state corporation (the Delaware Subsidiary Corporation) may participate as a limited partner in Texas without being subject to Texas business taxes. This allowed the Delaware Subsidiary Corporation to receive 99 percent of the net revenues from the Texas Limited Partnership without being subject to Texas taxes.
- Tax returns are filed on a separate entity basis. Unlike the federal tax return, in which corporations report on a consolidated basis, Texas taxes each corporation separately, without regard to the activity of its subsidiary operations.

As a result of this combination of tax policy provisions, any corporation, whether Texas-based or not, may use this particular tax planning approach. The location of payor provision only affects Texas-based companies by enabling them to "repatriate" net revenue to Texas. The location of payor provision has no bearing on an out of state corporation operating with the tax advantages of this particular tax planning structure.

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1. Example 1 is the Texas Company presented in Chapter 2.

2. It should be noted that while Texas law attempts to limit double taxation of income, it does not offer similar treatment with regard to capital. A parent corporation may have capital that consists of stock in a subsidiary. Under the capital calculation in Texas franchise tax law, the parent is subject to the capital tax on the stock they own in the subsidiary, and the subsidiary is subject to the capital tax on the paid-in capital received from the parent.

3. Based on distribution data provided by the Comptroller's office, applied to 1997.

4. Texas Administrative Code, Title 34, Chapter 3, Subchapter V, Sections 3.546 and 3.554.

5. Ibid., section 3.549. It should be noted that under the capital tax, certain corporations may "look through" to the partnership and record its share of the partnerships receipts as if it received them directly. This provision may only be used if allowed under generally accepted accounting principles (GAAP), which effectively limits it to certain oil and gas concerns. Sourcing net revenues from a partnership directly to the location of the partnership, as illustrated above, is the more common approach under the capital tax calculation.

Chapter 5: The Tax Impact of Commercial Domicile

Changing the sourcing of intangible income from location of payor to commercial domicile has a wide ranging, and in many cases, substantial, impact on Texas-based firms. In this chapter, the examples used previously are revisited, but with intangible income sourced to the commercial domicile of the recipient. In each case the change in sourcing policy results in higher taxes for the Texas-based firms; and in some instances causes tax "pyramiding" in which certain revenue flows are double taxed.

The Texas Company (Example 1). In the first example, the Texas Company, was an unaffiliated corporation with almost all its revenues from sales and a relatively small amount from interest and dividends. Because the change in sourcing policy affects only a small part of the Texas Company's revenues, the corresponding franchise tax impact is small, though positive (Figure 13).

Texas Company's only interest income was from its deposits with a Texas bank, so these were already sourced to Texas. A change to sourcing based on commercial domicile only affects the amount of taxable dividends the Texas Company receives. Figure 13 illustrates the impact of this change as it works its way through the tax calculation. The net dividend income, after deductions, are now sourced to Texas, causing an increase in Texas' apportionment factor of 0.01 percentage points, for a corresponding increase in franchise tax of $2,250.

It should be noted, that had the Texas Company's dividends been received from a subsidiary, Texas Company's earned surplus taxes would not have changed. Under the federal dividends-received deduction, they would not have been a part of the tax base, and under Texas law, only receipts included in the earned surplus tax base are considered in the apportionment calculation.

As pointed out earlier, however, Texas Company is not typical of how many companies are structured in today's modern economy. Many medium and most large businesses are conglomerates of several affiliated corporations. Changing how intangible income is sourced can have dramatic franchise tax consequences given the revenue flows across these affiliated entities.

The Texas Capital Company (Example 2). In Example 2, the Texas Capital Company, a Texas-based corporation, received a sizable amount of dividends from three subsidiaries, one of which was also a Texas-based firm. These dividends were sourced to the location of the legal domicile of the paying subsidiary, Delaware, and were not counted as Texas receipts. Under the commercial domicile sourcing of intangible income, they become Texas receipts, the state where Texas Company's headquarters are located. The net effect on the firm's tax return is illustrated in Figure 14.

The net capital and the amount of receipts everywhere do not change; but the amount of Texas receipts, and the corresponding apportionment percentage change dramatically. Rather than being taxed on 0.40 percent of its net capital, it is taxed on 100 percent. The resulting tax liability increases by $12.45 million, or roughly 25,000 percent.

The $500 million in dividend flows that are now counted as Texas receipts originated from the three subsidiaries. Of this, $200 million of the dividends received were paid by the Texas Subsidiary Company, a company that had already paid $15 million in Texas franchise taxes on the business activity which was the original source of the income from which the dividends were paid. In fact, each of the three subsidiaries has already paid taxes on the profits from which the dividends are paid. Commercial domicile sourcing causes "tax pyramiding"-effectively double taxing revenues that have already been subject to taxation.

That double taxation changes the nature of Texas' business tax as being low relative to other states. Texas Company's subsidiary paid $15 million of franchise taxes on its $333 million of net taxable income on its Texas business activity before it distributed the $200 million left after taxes as dividends to the Texas Company. Under commercial domicile sourcing, the parent Texas Company must pay an additional $5 million attributable to that same business activity.[1] The two companies now pay a combined total of $20 million in taxes on $333 million of net income attributable to business done in Texas, compared to a combined total of $15 million in taxes under location of payor sourcing. The net effect is that Texas's profits' tax rate of 4.5 percent, one of the nation's lowest, increases substantially-to an effective rate of 6.0 percent.

Similarly, under commercial domicile sourcing, Texas Company is double taxed on its Louisiana and California business activity as well-it pays taxes not only in the states where the business activity originates, but also in Texas, where the parent receives the dividends. Texas would be one of the few states with such business tax pyramiding. Most states rely predominately on income taxes as their general business tax, not capital-based taxes. In these states, the "dividends-received" deduction eliminates the potential for double taxation of income flows from subsidiaries (in fact, because of the dividends-received deduction, there would be no change in the Texas Capital Company's earned surplus liability). There is no similar safeguard under the Texas capital tax. Among those 22 states with capital-based taxes, many offer deductions or credits for capital invested in subsidiaries; Texas does not. Further, Texas' capital tax is by far the most significant. It has one of the nation's highest rates, and among the broadest tax bases. Without some safeguard against double taxation of capital, **the Texas capital tax, under commercial domicile sourcing would place a unique and substantial premium cost on businesses with income from intangibles who choose to locate their headquarters in the state**.[2]

While this example illustrates the impact on a capital payor of changing the sourcing rule using dividends, the revenue effect would be the same if the revenues had been either interest payments or gains from the sale of intangibles were used.[3]

The Texas Surplus Company (Example 3). In Example 3, the Texas Surplus Company is a Texas-based corporation that receives a sizable amount of interest revenue on loans it has made to finance the operations of its subsidiaries. Under current law, these interest revenues are sourced to the legal domicile of the payors-in this case, Delaware. Changing the sourcing of the interest to commercial domicile converts this interest to Texas business activity (Figure 15). The Texas apportionment percentage increases from 15.15 percent to 69.7 percent; and the resulting tax liability increases by $3.6 million, or over 260 percent (changing from $995,355 to $4,579,290). Similar effects would be realized under the capital tax calculation. Though not illustrated here, Texas Surplus Company's capital apportionment factor increases from 15.15 percent to 69.7 percent as well. Capital tax liability increases from $946,875 to $3,409,375. In both cases, the amount is less than that calculated under earned surplus, so the tax due would be paid on earned surplus.

Under the change from location of payor to commercial domicile, Texas Surplus Company would have experienced similar tax consequences had the receipts been from the sale of intangibles. In this particular example, however, changing the sourcing of any dividends received from the subsidiaries would not cause an earned surplus tax impact because of the dividends received deduction. More likely, an earned surplus payor with a substantial amount of dividend income would end up converting to a capital tax payer.

The Texas Holding Company (Example 4). The final example used for illustration purposes is that of a Texas Holding Company conducting its active business operations through a Texas limited partnership entered into with its Delaware subsidiary. Figure 16 compares the tax calculations for the Texas Holding Company under both location of payor and commercial domicile sourcing. On the capital tax calculation, the $495 million in dividends from its Delaware subsidiary are now considered to be Texas receipts. As a result, the Texas apportionment factor increases from 1 percent to 100 percent, and the capital tax liability increases from $125,000 to $12.5 million.

This type of impact would only be felt by parent companies headquartered in Texas. Out-of-state based firms conducting their Texas business through a limited partnership would not see any change in their tax liability as a result of the change in sourcing policy.

On the earned surplus side, there is no change in franchise tax liability. The dividends from the Delaware subsidiary are deducted in calculating federal taxable income and do not enter into the apportionment calculation. The fact that the earned surplus tax is not impacted by the change in sourcing (as would be true of most other state income-based taxes) may be of scant consolation given that the tax due is the higher of earned surplus or capital, which in this case would be the $12.5 million capital tax liability.

Confronted with such a sizable liability, the Texas Holding Company would likely consider changing its operations after examining its tax planning opportunities. Two of the options that might be considered are discussed below.

Option 1: Restructure. One option Texas Holding Company could pursue would be to combine its subsidiaries into a single firm. Were Texas Holding Company to reorganize in such a manner, it could reduce its prospective franchise tax liability by 60 percent. This is illustrated in Figure 17. As a holding company with a corporate subsidiary and a partnership agreement, all of Texas Holding Company's income is essentially "pass-through" in nature-$5 million from its partnership and $495 million in dividends from its Delaware subsidiary-and reflected the net income of its entire business conglomerate. Much of this business is conducted outside of Texas, but with the change in sourcing to commercial domicile, all of the profit would be taxed regardless of origination.

By combining into a single entity, the Texas Holding Company would become a company with $5 billion in sales, $1 billion of which are in Texas. Under either the capital tax or the earned surplus calculation, its apportionment percentage is 20 percent. Applying this percentage to its $5 billion of capital yields a tax base of $1 billion, and a resulting tax liability of $2.5 million. On the earned surplus side, 20 percent of $500 million is $100 million, for a tax liability of $4.5 million. This is the amount the restructured company would pay, since it is the higher of the two calculations. This reflects a savings of $7.5 million over the amount it would pay under commercial domicile without restructuring.

It should be noted that after restructuring, this company is very similar to the Texas Company in Example 1. They have almost the same amount of receipts, the same amount of Texas sales, and almost identical tax liabilities.

Option 2: Relocate headquarters. A second option the Texas Holding Company might consider to reduce its Texas franchise tax would be to relocate its headquarters operation out of state. Most states levy corporate income taxes which, as with Texas' earned surplus tax, provide a dividends-received deduction. This would exclude the income relating to the dividends from the Delaware subsidiary from their definition of net income (provided the state allowed separate entity filing). And while a handful of states impose a substantial capital tax, many of these, unlike Texas, offer deductions for investments in subsidiaries, minimizing the impact of commercial domicile sourcing of intangible income.

Further, the cost of relocation may not be substantial for the Texas Holding Company. Most of the conglomerated company's property including the manufacturing plant, are owned by the partnership, which is not subject to franchise tax. Most of the conglomerates employees are employed not by the Texas Holding Company, but by the partnership, as well. They would not have to be relocated. Only the Texas Holding Company and its few employees would have to be relocated. Even after moving out of state, the Texas Holding Company, as the corporate general partner in a Texas partnership would be deemed to have nexus here and would be subject to Texas franchise tax. However, it would only be taxed on its general partner one percent share, and would not be taxed on its dividends received from its Delaware subsidiary. Its total Texas franchise taxes would be the same as calculated in the previous chapter--$125,000. As an out-of-state corporation, it could continue to operate in Texas with relatively lower tax levels than the comparably-sized Texas Company in Example 2, but Texas would no longer derive any benefit from the headquarters.

Changing the sourcing of intangible income to commercial domicile does not eliminate the tax planning opportunities of the Delaware sub-it would still be available to non Texas-based corporations. As with the previous examples, the only corporations affected are those headquartered in Texas.

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1. Texas Company's Texas apportionment factor increases by 99.6 percent. The portion of that 99.6 percent increase attributable to Texas Subsidiary's dividends is 39.8 percent; 39.8 percent of Texas Company's total capital times the tax rate is $4,980,080.

2. A further consequence that may affect some firms, though not illustrated above, relates to accounting for deferred taxes. Under Generally Accepted Accounting Principles, a company is generally required to book a liability for estimated future taxes. For Texas firms using deferred tax accounts, the change in sourcing could substantially increase the amount of the liability booked, resulting in a reduced financial statement of the company's income and assets, but no corresponding tax gain to the state in that year.

3. The effective tax rates on interest payments may differ, however, because interest is deductible in many states (though consolidated/combined reporting could net out the deduction).