Texas Enacts Franchise Tax Bills with Changes to the Tax Rate, Determination of Taxable Margin, and the addition of New Credits and Sales/Use Tax Exemption

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Overview
On June 14, 2013, Texas Governor Rick Perry signed House Bill 500 ("HB500") and House Bill 800 ("HB800") into law. This Tax Alert summarizes the franchise tax changes enacted through HB500 and provides a brief overview of the new tax credit and sales/use tax exemption created by the enactment of HB800. These bills contain several new provisions that impact a variety of industries and taxpayers as well as changes with potential application to a wider range of taxpayers, such as:

- Temporary tax rate reductions for Report Year 2014 and potentially 2015;
- New tax credit for certified rehabilitation of certified historic structures;
- New tax credit and sales/use tax exemption for research and development activities;
- Changes to determination of total revenue and cost of goods sold; and
- Deduction of relocation costs for entities moving to Texas after September 1, 2013.

Temporary Franchise Tax Rate Reduction

- For reports originally due on or after January 1, 2014, and before January 1, 2015, a taxable entity may elect to determine its franchise tax at a tax rate of 0.975% of taxable margin.\(^1\) A taxable entity primarily engaged in retail or wholesale trade may elect to determine its franchise tax at a tax rate of 0.4875% of taxable margin.\(^2\)
- For reports originally due on or after January 1, 2015, and before January 1, 2016, a taxable entity may elect to determine its franchise tax at a tax rate of 0.95% of taxable margin.\(^3\) A taxable entity primarily engaged in retail or wholesale trade may elect to determine its franchise tax imposed at a rate of 0.475% of taxable margin.\(^4\) However, the reduced tax rates for 2015 will only be available if the Comptroller certifies, on or after September 1, 2014, that probable revenue for the state fiscal biennium ending August 31, 2015, is estimated to exceed probable revenue as stated in the Comptroller's Biennial Revenue Estimate for the 2014-2015 fiscal biennium. If the Comptroller does not make this certification, a taxable entity shall pay the tax at the rates provided by Tex. Tax Code §171.002 (i.e., 1.0%, or 0.5% for taxable entities engaged in retail/wholesale trade).\(^5\)
- For reports originally due on or after January 1, 2016, the franchise tax rate will revert to 1.0%, and for a taxable entity engaged in retail or wholesale trade the rate will revert to 0.5%.\(^6\)

Tax Credit for Rehabilitation of Certified Historic Structures

Effective January 1, 2015, a new tax credit will be allowed against the franchise tax for certified rehabilitation of certified historic structures equal to 25% of the total eligible costs and expenses incurred in the certified

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\(^1\) Acts of 83\(^{rd}\) Legislature, Regular Session, H.B. 500, § 2, Tex. Tax Code § 171.0022(a).
\(^3\) Acts of 83\(^{rd}\) Legislature, Regular Session, H.B. 500, § 2, Tex. Tax Code § 171.0023(a).
rehabilitation of a single certified historic structure.⁷ Key provisions of the new credit provisions include:

- Application to the Texas Historical Commission for issuance of a certificate of eligibility regarding the rehabilitation to be forwarded to the Comptroller along with an audited cost report issued by a CPA.⁸
- The rehabilitated certified historic structure must be placed in service on or after September 1, 2013, and owned by the taxpayer in the year placed in service.⁹
- The credit is limited to the franchise tax for such year after any other applicable credits, with a carryforward of unused credit for 5 consecutive reports.¹⁰
- The credit may be assigned or sold.¹¹

Research and Development (“R&D”) Activities

Effective January 1, 2014, taxpayers may elect to either take a sales/use tax exemption for the purchase of tangible personal property used for R&D activities, or take an R&D credit against the franchise tax for qualifying research expenditures.¹² The R&D credit is available on returns originally due on or after January 1, 2014.¹³

Sales/Use Tax Exemption

The sales/use tax exemption will apply to the sale, storage or use of depreciable tangible personal property directly used in qualified research if the property is sold, leased, rented to or stored or used by a person who is engaged in qualified research.¹⁴ However, the sales/use tax exemption is not available if the taxpayer (or another member of the taxpayer’s combined franchise group) claims an R&D credit on its franchise tax return for the period.¹⁵ Qualified research will have the same meaning as that used in Internal Revenue Code § 41.¹⁶ Any taxpayer who receives a sales/use tax exemption will be required to complete a form annually that allows the Comptroller to report to the legislature the amount of R&D activity being undertaken in Texas.¹⁷ The sales/use tax exemption will be effective January 1, 2014,¹⁸ and will expire on December 31, 2026.¹⁹

Franchise Tax Credit

The amount of credit will be 5% of the difference between:

- the qualified research expenses incurred in Texas during the period on which the report is based; and
- 50% of the average amount of qualified research expenses incurred in Texas during the three tax periods immediately preceding the period on which the report is based.²⁰

The franchise tax credit will not be available for any qualified research expense incurred in Texas during the period on which a report is based if the taxpayer (or another member of the taxpayer’s combined franchise group) claims a sales/use tax exemption under Tex. Tax Code §151.3182 during that period.²¹

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⁷ Acts of 83rd Legislature, Regular Session, H.B. 500, § 14(a), Chapter §171, Tax Code, is amended by adding Subchapter S. Tex. Tax Code § 171.905(a); § 14(b).
¹² Acts of 83rd Legislature, Regular Session, H.B. 800, §§ 2, 3, 6, 7.
If the taxable entity contracts with one or more public or private institutions of higher education for the performance of qualified research the credit will be 6.25% of the difference referenced above.\textsuperscript{22}

If the taxable entity has no qualified research expenses in Texas in one or more of the three tax periods preceding the period on which the report is based, the credit for the period on which the report is based equals 2.5% of the qualified research expenses incurred in Texas during that period.\textsuperscript{23} Likewise, if the taxable entity contracts with one or more public or private institutions of higher education for the performance of qualified research, but has no qualified research expenses in Texas in one or more of the three tax periods preceding the period on which the report is based, the credit for the period on which the report is based equals 3.125% of all qualified research expenses incurred during that period.\textsuperscript{24}

The credit is limited to 50% of the amount of franchise tax due before any other applicable tax credits.\textsuperscript{25} The credit can be carried forward for 20 consecutive reports.\textsuperscript{26} Credits are considered to be used in the following order:

- R&D credit carryforward generated prior to January 1, 2008;
- R&D credit carryforward pursuant to this bill, and
- Current year R&D credit.\textsuperscript{27}

The R&D credit cannot be conveyed, assigned or transferred unless all the assets of the taxable entity are conveyed, assigned or transferred in the same transaction.\textsuperscript{28} A taxpayer must apply for the credit on the tax report for the period which the credit is claimed.\textsuperscript{29} The franchise tax R&D credit statute will expire on December 31, 2026; however the expiration will not affect the unused credit carryforwards allowed under Tex. Tax Code §171.659.\textsuperscript{30}

\textbf{Deduction of Relocation Costs}

A taxable entity may deduct from its apportioned margin relocation costs incurred in relocating the taxable entity's main office or other principal place of business to Texas from another state if the taxable entity:

- did not do business in Texas before relocating the taxable entity's main office or other principal place of business to Texas; and
- is not a member of an affiliated group engaged in a unitary business, another member of which is doing business in Texas on the date the taxable entity relocates the taxable entity's main office or other principal place of business to Texas.\textsuperscript{31}

"Relocation costs" means the costs incurred by a taxable entity to relocate the taxable entity's main office or other principal place of business from one location to another. The term includes:

- costs of relocating computers and peripherals, other business supplies, furniture, and inventory; and
- any other costs related to the relocation that are allowable deductions for federal income tax purposes.

A taxable entity must take this deduction on the report based on the taxable entity's initial period described by Tex. Tax Code § 171.151(1).\textsuperscript{32} The change in law applies only to a taxable entity that relocates the taxable entity's main office or other principal place of business to Texas on or after September 1, 2013.\textsuperscript{33}

\begin{itemize}
  \item \textsuperscript{22} Acts of 83\textsuperscript{rd} Legislature, Regular Session, H.B. 800, § 3, Tex. Tax Code §171.654(b).
  \item \textsuperscript{23} Acts of 83\textsuperscript{rd} Legislature, Regular Session, H.B. 800, § 3, Tex. Tax Code §171.654(c).
  \item \textsuperscript{24} Acts of 83\textsuperscript{rd} Legislature, Regular Session, H.B. 800, § 3, Tex. Tax Code §171.654(d).
  \item \textsuperscript{25} Acts of 83\textsuperscript{rd} Legislature, Regular Session, H.B. 800, § 3, Tex. Tax Code §171.658.
  \item \textsuperscript{26} Acts of 83\textsuperscript{rd} Legislature, Regular Session, H.B. 800, § 3, Tex. Tax Code §171.659.
  \item \textsuperscript{27} Acts of 83\textsuperscript{rd} Legislature, Regular Session, H.B. 800, § 3, Tex. Tax Code §171.659(1)-(3).
  \item \textsuperscript{28} Acts of 83\textsuperscript{rd} Legislature, Regular Session, H.B. 800, § 3, Tex. Tax Code §171.660.
  \item \textsuperscript{29} Acts of 83\textsuperscript{rd} Legislature, Regular Session, H.B. 800, § 3, Tex. Tax Code §171.661.
  \item \textsuperscript{30} Acts of 83\textsuperscript{rd} Legislature, Regular Session, H.B. 800, § 3, Tex. Tax Code §171.665.
  \item \textsuperscript{31} Acts of 83\textsuperscript{rd} Legislature, Regular Session, H.B. 500, § 13(a), Subchapter C, Chapter §171, Tax Code, is amended by adding § 171.109; Tex. Tax Code §171.109(b).
  \item \textsuperscript{32} Acts of 83\textsuperscript{rd} Legislature, Regular Session, H.B. 500, § 13(a), Tex Tax Code §171.109(c).
  \item \textsuperscript{33} Acts of 83\textsuperscript{rd} Legislature, Regular Session, H.B. 500, § 13(b),(c).
\end{itemize}
**Expansion of Retail and Wholesale Trade Definition**

Effective January 1, 2014, for reports originally due on or after January 1, 2014, taxpayers engaged in the following additional activities will be considered to be engaged in “retail or wholesale” trade:

- Automotive repair shops.
- Taxpayers engaged in rent to own transactions.
- Taxpayers engaged in renting tools, party and event supplies and furniture.
- Taxpayers engaged in leasing heavy construction equipment.

**Additional Exclusions from Total Revenue**

In determining total revenue, the following changes have been made to Tex. Tax Code §171.1011 effective January 1, 2014, for reports originally due on or after January 1, 2014:

- A taxable entity that provides a pharmacy network shall exclude from its total revenue, reimbursements, pursuant to contractual agreements, for payments to pharmacies in the pharmacy network.
- A taxable entity that is primarily engaged in the business of transporting aggregates shall exclude from revenue the subcontracting payments made by the taxable entity to independent contractors for the performance of delivery services on behalf of the taxable entity.
- A taxable entity that is primarily engaged in the business of transporting barite shall exclude from revenue the subcontracting payments made by the taxable entity to nonemployee agents for the performance of transportation services on behalf of the taxable entity.
- A taxable entity that is primarily engaged in the business of performing landman services shall exclude from its total revenue, subcontracting payments made by the taxable entity to nonemployees for the performance of landman services on behalf of the taxable entity.
- A taxable entity shall exclude from its total revenue the actual cost paid by the taxable entity for a vaccine.
- A taxable entity primarily engaged in the business of transporting goods by waterways that does not subtract cost of goods sold in computing its taxable margin shall exclude from its total revenue the direct costs of providing transportation services by intrastate or interstate waterways to the same extent that a taxable entity that sells in the ordinary course of business real or tangible personal property would be authorized by Tex. Tax Code §171.1012 to subtract those costs as costs of goods

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40 Acts of 83rd Legislature, Regular Session, H.B. 500, § 7; Tex. Tax Code § 171.1011(g-8); “aggregates” means any commonly recognized construction material removed or extracted from the earth, including dimension stone, crushed and broken limestone, crushed and broken granite, other crushed and broken stone, construction sand and gravel, industrial sand, dirt, soil, cementitious material, and caliche. Id.
41 Acts of 83rd Legislature, Regular Session, H.B. 500, § 7; Tex. Tax Code § 171.1011(g-10); “barite” means barium sulfate (BaSO4), a mineral used as a weighing agent in oil and gas exploration. Id.
42 Acts of 83rd Legislature, Regular Session, H.B. 500, § 7; Tex. Tax Code § 171.1011(g-11); “Landman services” means: performing title searches for the purpose of determining ownership of or curing title defects related to oil, gas, or other related mineral or petroleum interests; negotiating the acquisition or divestiture of mineral rights for the purpose of the exploration, development, or production of oil, gas, or other related mineral or petroleum interests; or negotiating or managing the negotiation of contracts or other agreements related to the ownership of mineral interests for the exploration, exploitation, disposition, development, or production of oil, gas, or other related mineral or petroleum interests.
43 Acts of 83rd Legislature, Regular Session, H.B. 500, § 7; Tex. Tax Code § 171.1011(u). “Vaccine” is defined as a preparation or suspension of dead, live attenuated, or live fully virulent viruses or bacteria, or of antigenic proteins derived from them, used to prevent, ameliorate, or treat an infectious disease. Acts of 83rd Legislature, Regular Session, H.B. 500, § 8; Tex. Tax Code § 171.1011(p)(8).
sold in computing its taxable margin, notwithstanding Tex. Tax Code §171.1012(e)(3) (which limits outbound distribution costs).44

- A taxable entity that is registered as a motor carrier under Chapter 643, Transportation Code, shall exclude from its total revenue, to the extent included in total revenue, flow-through revenue derived from taxes and fees.45

Cost of Goods Sold Amendments

In determining cost of goods sold, the following changes were made to Tex. Tax Code §171.1012:

- The determination of cost of goods sold has been amended by adding subsection 171.1012(k-2) that applies to pipeline entities. Specifically, subsection (k-2) applies only to a pipeline entity that: (a) owns or leases and operates the pipeline by which the product is transported for others, and only to that portion of the product to which the entity does not own title; and (b) is primarily engaged in gathering, storing, transporting, or processing crude oil, including finished petroleum products, natural gas, condensate, and natural gas liquids, except for a refinery installation that manufactures finished petroleum products from crude oil. A pipeline entity providing services for others related to the product that the pipeline does not own, and to which this subsection applies, may subtract as a cost of goods sold its depreciation, operations, and maintenance costs related to the services provided.46 This amendment takes effect on January 1, 2014, for reports originally due on or after January 1, 2014.

- For this purpose “processing” means the physical or mechanical removal, separation, or treatment of crude oil, including finished petroleum products, natural gas, condensate, and natural gas liquids after those materials are produced from the earth. The term does not include the chemical or biological transformation of those materials.47

- Effective September 1, 2013, if a taxable entity that is a movie theater elects to subtract cost of goods sold, the cost of goods sold shall be the costs in relation to the acquisition, production, exhibition, or use of a film or motion picture, including expenses for the right to use the film or motion picture.48

$1 Million Small Business Deduction

Tex. Tax Code §171.101(a)(1)(A) has been amended to allow a taxable entity the ability to compute its taxable margin based on the lesser of:

(i) 70% of total revenue or total revenue minus $1 million, or
(ii) total revenue less the greater of:
   a. a deduction of $1 million,
   b. or at the election of the taxpayer, either:
      i. cost of goods sold as determined under Tex. Tax Code §171.1012, or
      ii. compensation determined under Tex. Tax Code §171.1013.49

- This change will likely impact only small businesses with total revenue of approximately $3.3 million or less. This amendment takes effect on January 1, 2014 for reports originally due on or after January 1, 2014.

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48 Acts of 83rd Legislature, Regular Session, H.B. 500, § 10; Tex. Tax Code § 171.1012(t). Section 171.1012(t), as added by this section, is a clarification of existing law and does not imply that existing law may be construed as inconsistent with the law as amended by this section. Id at (b).
49 Acts of 83rd Legislature, Regular Session, H.B. 500, § 6 Tex. Tax Code §171.101(a) and (b).
Combined Group Modifications

Tex. Tax Code § 171.1014(d) has been amended to allow a combined group to elect to subtract either cost of goods sold or compensation that applies to all of its members, or $1 million. Regardless of the election, the taxable margin of the combined group may not exceed 70% of the combined group’s total revenue.⁵⁰

Further, a taxable entity that provides retail or wholesale electric utilities may not be included as a member of a combined group that includes one or more taxable entities that do not provide retail or wholesale electric utilities if that combined group would not otherwise:

- meet the requirements of Tex. Tax Code §171.002(c) (lists what is required to be considered engaged primarily in retail or wholesale trade) solely because one or more members of the combined group provide retail or wholesale electric utilities; and
- have less than 5% of the combined group’s total revenue derived from providing retail or wholesale electric utilities.⁵¹

Change in Internet Hosting Company Revenue Sourcing

Receipts from internet hosting as defined by Tex. Tax Code §151.108(a) are receipts from business done in Texas only if the customer, to whom the service is provided, is located in Texas.⁵² This amendment takes effect on January 1, 2014, for reports originally due on or after January 1, 2014.

Throwback and Finnigan Informational Reporting Repealed

Tex. Tax Code § 171.103(c) and (d) are repealed by HB500.⁵³ Previously under these sections, for informational purposes, a combined group was required to report the Texas gross receipts and gross receipts subject to taxation in another state under a throwback law of each member of the combined group that did not have nexus in Texas. This amendment takes effect on January 1, 2014, for reports originally due on or after January 1, 2014.

Exemptions for Non-admitted Insurance Organizations

Effective January 1, 2014, for reports originally due on or after January 1, 2014, a non-admitted insurance organization that is subject to an occupation tax or any other tax that is imposed for the privilege of doing business in another state or a foreign jurisdiction, including a tax on gross premium receipts, is exempt from the franchise tax.⁵⁴ Under the prior law the nonadmitted insurance organization was only exempt from the franchise tax if it paid a Texas gross premium receipts tax in the same year.⁵⁵

ASC 740 Considerations

Pursuant to ASC 740, Income Taxes (“ASC 740”), companies are required to account for the effect of a change in income tax law or rate on a deferred tax asset or deferred tax liability in the period that includes the enactment date of the applicable law change. The effect of a change in tax law or rate on taxes currently payable or refundable is accounted for beginning in the period that the tax law is both enacted and effective. We recommend that companies consult with applicable advisors for further guidance regarding the ASC 740 impact of these Texas law changes.

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⁵⁵Tex. Tax Code §171.052(a).
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