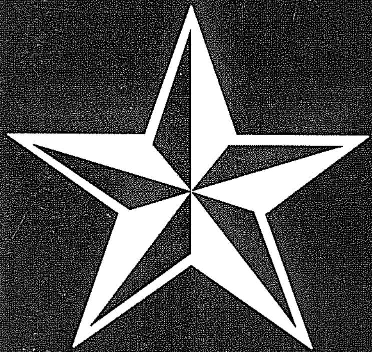

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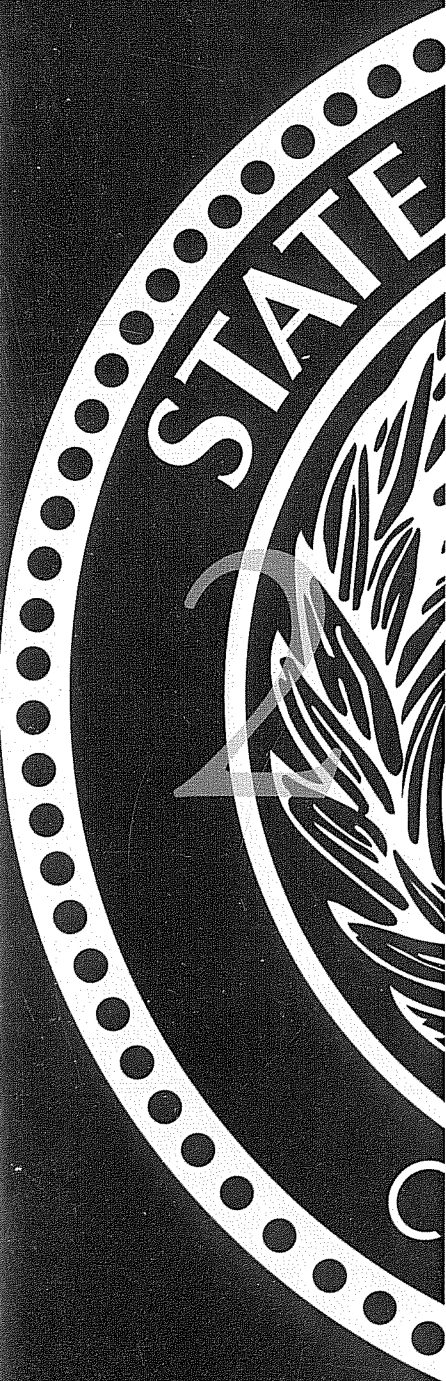

the organization's website without causing any of the licensing income from such insurance companies to lose its character as royalty income not subject to the unrelated business income tax.

The organization also distributed periodicals to its members and sold advertising for such periodicals, treating all net income from such advertising sales as subject to the unrelated business income tax. Under Treas. Reg. Sec. 1.512(a)-1(f), advertising income related to an exempt periodical may be offset in part by costs of producing the exempt periodical. The organization planned to begin providing banner advertising on its website for no additional charge to all customers advertising in its periodicals. The Service held that a portion of the advertising fee would have to be allocated to the banner advertisements and that such portion of the advertising income would be treated as advertising income from a periodical only if it appeared as part of an on-line periodical. Banner advertisements appearing generally on the organization's website would not be treated as producing advertising income from a periodical.

4. PLR 200307094 (Service Approves Operation of Large-Scale Web-based Health Care Provider Placement Services by Exempt Organization). The Service held in this private letter ruling that a Section 501(c)(3) organization would not lose its Section 501(c)(3) status or incur unrelated business income tax when it expanded its health care provider placement services that are offered only to nonprofit members of the organization. The services would help locate and employ a significant range of health care workers in several states, including physicians, physician assistants, nurses, nurse practitioners, certified nurse midwives, registered nurse anesthetists, and potentially other "mid-level" licensed health care providers. The Service relied primarily on Rev. Rul. 55-656, which held that a community nursing bureau operated as a community project could qualify for exemption under Section(c)(3).

ENDNOTES

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2 References to the "Service" refer to the Internal Revenue Service.

3 *St. David's Health Care System Inc. v. United States*, 5th Cir., No. 02-50959.

TEXAS CORPORATE FRANCHISE TAX – THE APPLICABILITY OF OFFICER AND DIRECTOR COMPENSATION ADDBACK IN DETERMINING NET TAXABLE EARNED SURPLUS

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I. INTRODUCTION

Nearly every state imposes some form of income-based tax on corporations that establish a taxable presence in the state. State corporate income taxes generally may be classified as either (1) an excise tax on doing business, or owning property, or engaging in other activities within the state, or on the holding of a license or privilege to do business in the state; or (2) a tax on net income derived from or attributable to the state. An excise tax is also commonly referred to as a "franchise tax," while a tax on net income is commonly known as a "direct net income tax."[1]

Texas is no exception. In 1905, the Texas Legislature enacted the Franchise Tax Act. Acts of 1905, 29th Leg., ch. 19, p. 21, § 1. The Texas franchise tax is levied annually on corporations that are incorporated in Texas or that conduct business in Texas, for the privilege of doing business in Texas in the corporate form. *Tex. Tax Code Ann. § 171.001* (Vernon's 2002); *Bullock v. National Bancshares Corp., 584 S.W.2d 268, 270* (Tex. 1979); *General Dynamics Corp. v. Sharp, 919 S.W.2d 861, 863* (Tex. App.—Austin 1996, writ denied); (Tex. App.--Austin 1996, writ denied); *United North & South Dey. Co. v. Heath, 78 S.W.2d 650, 652* (Tex. Civ. App.—Austin 1935, writ ref'd). The amount of the franchise tax levied approximates the value of this privilege. *Sterling Oil & Ref. Co. v. Isbell, 202 S.W.2d 300, 302* (Tex. Civ. App.—Austin 1947, no writ); *General Dynamics Co. v Bullock, 547 S.W.2d 255, 258* (Tex. 1977), *cert. denied, 434 U.S. 1009, 54 L. Ed. 2d 751, 98 S. Ct. 717 (1978).* Consequently, the franchise tax has two components: the tax on capital and the tax on earned surplus. Corporations pay the greater of the tax on net taxable capital or net taxable earned surplus. *Tex. Tax Code Ann. § 171.002* (Vernon's 2002).

A. The Texas Franchise Tax

Prior to 1992, the Texas franchise tax was based solely on a corporation's taxable capital. This was changed after 1991 when an amendment to the franchise tax code changed the tax base to the greater of the corporation's taxable capital or its earned surplus. *Id.*

A corporation's net taxable capital consists of adding the corporation's stated capital, as defined by Article 1.02 of the Texas Business Corporation Act, and the corporation's surplus. *Tex. Tax Code Ann. § 171.102* (Vernon's 2002). "Surplus" consists of the corporation's net assets minus its stated capital. *Tex. Tax Code Ann. § 171.109(a)(1)* (Vernon's 2002). "Net assets" means the total assets of a corporation minus its total debts. *Tex. Tax Code Ann. § 171.109(a)(2)* (Vernon's 2002). A corporation's "net taxable earned surplus" on the other hand is computed by taking the corporation's "reportable federal taxable income," subtracting from that amount any amount included in reportable federal taxable income under Section 78 or Sections 951-964 of the Internal Revenue Code, and dividends received from a subsidiary, associate, or affiliated corporation that does not transact a substantial portion of its business or regularly maintain a substantial portion of its assets in the United States (foreign source income), and adding to that amount any compensation of officers or directors, to the extent, or if a bank, any compensation of directors and executive directors, to the extent excluded in determining federal taxable income to determine the corporation's taxable earned surplus. *Tex. Tax Code Ann. § 171.110(a)(1)* (Vernon's 2002).

The portion of a multi-state corporation's taxable capital and earned surplus subject to the Texas franchise tax is then apportioned by using a single-factor, gross-receipts apportionment formula ("the Texas formula"). *Tex. Tax Code Ann.* § § *171.103, 171.1031, 171.105, 171.1051* (Vernon's 2002). Gross receipts are generated from business and investment activities, such as selling goods and services, realizing capital gains from sales of assets, and receiving dividends and interest from investments. *Id.* A corporation's gross receipts generated in Texas are divided by the corporation's total worldwide gross receipts to arrive at a fraction representing the corporation's percentage of business done in Texas. This fraction is then multiplied by the total tax base to calculate the amount of the apportioned Texas tax base. The apportioned Texas tax base is then multiplied by the tax rate [0.25 percent per year of privilege period of net taxable capital, *Tex. Tax Code Ann. § 171.002(a)(1)*; or 4.5 percent of net taxable earned surplus, *Tex. Tax Code Ann.* § *171.002(a)(2)*] to determine a corporation's Texas franchise tax liability. *Tex. Tax Code Ann.* § § *171.002, 171.006, 171.110* (Vernon's 2002). The following discussion is a basic summary of the applicability of the officer and director add-back provision of Texas Tax Code Section 171.110 as it relates to the determination of a business' net taxable earned surplus for purposes of determining the Texas franchise tax liability.

B. Net Taxable Earned Surplus

In determining the "net taxable earned surplus" of a corporation for purposes of the Texas Franchise Tax Code Section 171.110(a)(1), the code requires corporations to add back to the corporation's "reportable federal taxable income", any amounts of compensation of corporate officers and directors ("O&D"), or if a bank, any compensation of directors and executive officers, to the extent excluded in determining "federal taxable income." Compensation of an officer or director includes the amount includable in the federal taxable income such as salary, bonuses, and payments to pension plan, profit sharing, or stock bonus plan on behalf of an employee or the employee's beneficiaries.

As an exemption to the "add-back" provision of Subsection (a)(1), Section[2] 171.110(b) provides that a corporation subject to Texas franchise tax is not required to add the compensation of officers or directors as required by subsection (a)(1) if the corporation is: (1) a corporation that has not more that 35 shareholders; or (2) an S corporation, as defined by Section 1361 of the Internal Revenue Code. However, under Code Section 171.110(c), the exemption in subsection (b) does not apply to a subsidiary corporation unless it applies to the subsidiary's parent corporation.

1. The Parent Corporation

Example: Consider this likely scenario. A taxpayer corporation doing business in Texas and subject to the Texas franchise tax is wholly owned by a shell corporation. Therefore the taxpayer has only one shareholder. This immediate parent shell corporation is 100% owned by a holding company also 100% owned by a foreign corporation whose stock is publicly traded either in the United States or in another foreign country, and has thousands of shareholders. The question asked then is who is the parent corporation, and is the corporation exempt from the "add-back" provision?

In the example given above, clearly the taxpayer corporation and its immediate parent have both less than 35 shareholders. If the line of ownership ends with the shell corporation, then in applying Tax Code Section 171.110, the taxpayer corporation is exempt from adding back its officers and directors compensation to its earned surplus, and therefore reducing its taxable earned surplus base. Should we therefore look to the ultimate parent corporation whose stock is publicly traded and has thousands of shareholders? The State of Texas says yes.

Pursuant to its authority to adopt tax rules under Texas Tax Code Section 111.002, the Texas Comptroller has interpreted Section 171.110 (c), and has adopted Comptroller Rule Section 3.558[3] specifically to address this tax code section. Under Rule 3.558(h), a subsidiary corporation may not qualify for the exemption under Tax Code Section 171.110(b), if it has a parent corporation that does not qualify for the exemption. For purposes of Tax Code Section 171.110(c), a corporation qualifies as a parent corporation if it ultimately controls the subsidiary even though the control may arise through any series or group of other subsidiaries or other entities. *See e.g.*, Comptroller Decision Nos[4]. 36,057 (1997), 33,864 (1996), 36,518-520 (1998), 35,186 (1997); Comptroller Letter Nos. 9207l1215f09 (1992), 9702409l (1997).

In Comptroller Decision No. 36,057, the taxpayer was a Delaware corporation and was 100% owned by its parent corporation ("DI"). DI was then 100% owned by "DIAI". DIAI in turn, was 100% owned by "DIL" which was ultimately owned by "DPLC," which was a foreign (non-U.S.) corporation, whose ownership exceeded 35 shareholders. In denying the corporate taxpayer's contention for exemption from the add-back provision, the Administrative Law Judge looked to Comptroller's Rule 3.558(h), and held that "A subsidiary corporation may not qualify for the exclusion under the Tax Code § 171.110(b), if it has a parent corporation which does not qualify for the exclusion." "...a corporation qualifies as a parent if it ultimately controls the subsidiary, even though the control may arise through any series or group of other subsidiaries or other entities." In Comptroller Decision No. 33,864, the Texas Comptroller also looked to the subsidiary's line of ownership to its "ultimate parent" (a publicly held Japanese company with more than 35 shareholders) in denying the corporate taxpayer's contention for exclusion.

Because the Comptroller has the duty of enforcing the Texas Tax Code, courts will defer to the Comptroller's interpretation and application of the statute. *Texas Citrus Exchange v. Sharp*, 955 S.W.2d 164 (Tex.App.—Austin 1997, no writ). Once a state agency has adopted a rule, it is presumed to be valid and is entitled to the weight of the law unless overturned by judicial decision. *Houston Gas Corp. v. Southwestern Apparel, Inc.*, 558 S.W.2d 950 (Tex.Civ.App.—Austin 1977, writ dism'd); *Lewis v. Jacksonville Building & Loan Ass'n*, 540 S.W.2d 307 (Tex. 1976). Texas courts generally give deference to the Comptroller's interpretation of Texas Tax Code provisions, and in cases involving agency decision-making, Texas courts apply a deferential standard of review. *Nabisco, Inc. v. Rylander*, 992 S.W.2d 678 (Tex.App.—Austin 1999, pet. denied).

Recently however, taxpayers have began to question the constitutionality of Rule 3.558 as it applies to Texas Tax Code Section 171.110. For example, corporate taxpayers have recently argued that Rule 3.558 is an unconstitutional burden and interference with foreign commerce, and that the rule violates the Fourteenth Amendment Due Process and Equal

Protection Clauses of the United States Constitution as well as the Equal and Uniform Clause of article VIII, section 1 of the Texas Constitution.

As of this writing, no Texas state court has ruled on the constitutionality of Rule 3.558, and therefore the presumption should remain that it is. *Infra., Texas Citrus Exchange; Rylander v. 3Beall Bros.3, Inc., 2 S.W.3d 562* (Tex. App.—Austin 1999, writ denied).

2. Officers & Directors

Assuming that the add-back provision applies, who then are the applicable officers and directors? Nowadays corporations have personnel titles such Vice President, Senior Vice President, General Manager, Area Vice President, Market Research Vice President, Managing Director, and the like. Texas draws the line under Rule 3.558(B), and for a limited liability company or a corporation other than a banking corporation, any person designated as an officer is presumed to be an officer of the corporation for purposes of Tax Code Section 171.110, and subject to compensation add-back if that person:

(i) holds an office created by the board of directors or pursuant to the corporate charter or bylaws (or the articles of organization, operating agreement, or similar agreement in the case of a limited liability company; and

(ii) has legal authority to bind the corporation with third parties by executing contracts or other legal documents.

A limited liability company or a corporation other than a banking corporation may rebut the presumption that a person is an officer if it conclusively shows, through the person's job description or other documentation, that the person does not participate or have authority to participate in significant policy making aspects of the corporate operations.

In Comptroller Decision No. 36,051 (2001), the Administrative Law Judge held that although the taxpayer's divisional officers had no corporate wide authority or responsibility, they had nevertheless qualified as officers due to the nature of their responsibilities in participating in significant policy-making aspects of corporate operations. For Example, the taxpayer's divisional officer in charge of its Houston, Texas stores had input on decisions made with respect to lines of merchandise to be offered, personnel policies to be applied within the division, and all other aspects of the business within the division. In essence, its divisional officers had legal authority to bind the corporation regarding decisions relating to the applicable decision and therefore the corporate taxpayer failed to rebut the presumption pursuant to Comptroller's Rule 3.558(b)(10)(B) and (C).

3. Compensation

Under Rule 3.558(b)(3), compensation is the amount reportable to an officer or director for the tax-reporting period as includable in the officer or director's federal taxable income without regard to any monetary limitations imposed for federal income tax purposes. Compensation does not include any amount reported to an officer or director, which is disallowed as a reduction to federal taxable income for any taxable period for federal income tax purposes. For example, compensation does not include employee remuneration for which a deduction is disallowed under Internal Revenue Code, sec. 162(m). Compensation is included wherever reportable on federal tax reporting forms including a Form W-2 Wage and Tax Statement, a Form 1099-MISC, or Schedule K-1 of Form 1065. For example (if all compensation is deductible):

(A) if a corporation (subject to the add-back of officer and director compensation) issues a Form W-2 to an officer, the compensation included in earned surplus is the amount reflected on Form W-2 that must be included in the officer's federal taxable income (Block 10 of the 1991 Form W-2);

(B) if a corporation (subject to the add-back of officer and director compensation) issues an officer and director of a corporation a Form W-2 and a Form 1099-MISC, compensation included in the corporation's earned surplus for that officer or director is the sum of the amount reflected on Form W-2 that the officer must include in federal taxable income, the amount reflected on Form 1099-MISC as nonemployee compensation that the director must include in federal taxable income, plus any compensation which would be reportable on Form 1099-MISC except for monetary limitations.

Compensation is also included in computing earned surplus even if any portion of the compensation is capitalized for federal income tax purposes. *Infra. Rule 3.558(e).*

C. Conclusion

Since many of the issues that relate to the officer and director compensation add-back provision of Texas Tax Code Section 171.110 have not yet been addressed by the Texas courts, disputes will continue to arise at the administrative level between the State and corporate taxpayers. Texas state tax practitioners continue to be innovative in the application of the statutes and the rules, and therefore should seek guidance from the Comptroller via policy and opinion letters. Ultimately however, the Texas Legislature may provide some additional guidance on the taxability of the more complex issues discussed herein.

ENDNOTE

i Elias is an Assistant General Counsel with the Texas Comptroller of Public Accounts, Administrative Tax Hearings Office in Austin, Texas.

1 *See* Hellerstein and Hellerstein, State Taxation: Corporate Franchise, Net Income, Capital Stock Taxes, Vol. 1, Part IV (3d ed. 2001).

2 References are to Tex. Tax Code Ann. (Vernon's 2002).

3 **Source Note:** Title 34 Tex. Admin. Code § 3.558. The provisions of Rule § 3.558 adopted September 29, 1992, 17 Tex. Reg. 6373; amended to be effective February 10, 1994, 19 Tex. Reg. 633; amended to be effective February 16, 1996, 21 Tex. Reg. 882; amended to be effective August 17, 1998, 23 Tex. Reg. 8463.

4 References are to Texas Comptroller Decisions based on administrative tax hearings before the Texas Comptroller Administrative Law Judges' Office. Decisions may be found on LEXIS under Texas Tax Cases and Comptroller of Public Accounts Decisions. It may also be found on the Texas Comptroller's State Tax Automated Research System (STAR System) on the world-wide-web at http://taxstar.cpa.state.tx.us/star/index.html, which is a comprehensive database of 22,000 plus documents of past Texas Comptroller of Public Accounts Decisions and Letter Opinions.

SIGNIFICANT DEVELOPMENTS IN PARTNERSHIP AND REAL ESTATE TAXATION IN 2002

Shilpa N. Jariwala and Vicki L. Martin[1]

The following is a summary of selected 2002 developments in the federal income taxation of partnerships and real estate, prepared by Shilpa N. Jariwala and Vicki L. Martin, as a project of the Partnership & Real Estate Tax Committee. Unless otherwise indicated, all section references contained herein are references to the Internal Revenue Code of 1986, as amended (the "***Code***").

A. Partnership Taxation.

1. Section 701 – Partners, Not Partnership, Subject to Tax.

(i) FSA 200205021 – The IRS ruled that it is not appropriate to apply the anti-abuse regulation, Treasury Regulations Section 1.701-2(e), in the context in which two U.S. corporations each held, through their respective foreign affiliates, a fifty percent (50%) interest in a foreign partnership because the foreign partnership had substance and the partnership form was not interposed in order to effectuate a distortion of income.

(ii) FSA 200242004 – The IRS ruled that the anti-abuse regulation, Treasury Regulations Section 1.701-2(e), prevents shifting an inherent loss to a third party in a situation in which a partner contributed loss property to a partnership, sold its interest in the partnership to a third party, and had the partnership sell the loss property.

2. Section 704 – Partner's Distributive Share.

(i) PLRs 200203043, 200203044, 200203046 through 200203052, 200204013, 200204015 through 200204018 and 200204023 – In each of these fifteen identical letter rulings, the IRS ruled that Section 1063 of the Taxpayer Relief Act of 1997, requiring that pre-contribution gain must be recognized if property contributed to a partnership is distributed in kind within seven years of its contribution, does not apply to various family trusts that contributed assets to a partnership pursuant to a binding contract in effect on June 8, 1997, and the contribution will not cause the partners to recognize pre-contribution gain under Sections 704(c)(1)(B) or 737(b)(1).

(ii) PLR 200210047 – The IRS ruled that, provided that a contribution or revaluation of property and the corresponding allocation of tax items with respect to such property are not made with a view to shift the tax consequences of built-in gain or loss among the partners in a manner that substantially reduces the present value of the partners' aggregate tax liability, a partnership's aggregate method for making reverse Section 704(c) allocations as described in Treasury Regulations Section 1.704-3(e)(3)(iv) is a reasonable method. The IRS further granted the partnership permission to aggregate built-in gains and losses from contributed qualified financial assets with built-in gains and losses from revaluations of qualified financial assets that were already held by the partnership for purposes of making allocations under Treasury Regulations Section 1.704-3(a)(6).

3. Section 707 – Transactions Between Partner and Partnership.

(i) CCA 200246014 – With regard to a situation in which, as a result of a series of several planned transactions, a partner contributed property to a partnership and then guaranteed a loan to the partnership, the IRS ruled that, if the guaranty by the partner may be disregarded pursuant to Treasury Regulations Section 1.752-2(j), the related contribution and distribution will be treated as a disguised sale under Section 707(a)(2)(B).

(ii) CCA 200250013 – The IRS ruled that the assumption by a partner of a partnership's debt that occurred contemporaneously with a transfer of assets from the partnership to such partner is presumed to be a sale of the partnership's property to the partner.

4. Section 708 – Continuation of Partnership.

(i) FSA 200219008 – The IRS ruled that where the liquidations of two upper-tier partnerships through distributions included their respective interests in a subsidiary partnership, the distributions of the interests in the subsidiary partnership should be treated as an exchange under Section 761(e) for purposes of Section 708 and, because more than fifty percent (50%) of the total interests in the subsidiary partnership's capital and profits were exchanged in the distributions, the subsidiary partnership terminated pursuant to Section 708(b)(2)(B).

5. Section 721 – Nonrecognition of Gain or Loss on Contribution.

(i) PLR 200210047 – The IRS disregarded a limited liability company's contribution of cash to a partnership in determining whether diversification of assets had occurred on the funding of such partnership where all the other property transferred to the partnership was common stock of a publicly-traded corporation. The transfer was not considered a transfer to an investment company within the meaning of Section 351(e) and Treasury Regulations Section 1.351-1(c)(1) if the partnership were a corporation, and Section 721(b) does not apply to the contributions of assets to the partnership.

(ii) PLR 200211017 – The IRS concluded that a