

New Texas Franchise Tax

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Originally Published: June 28, 2006 revised: May 20, 2007



Several of my clients are concerned about how the new Texas Franchise Tax will affect their business. **This new tax is a major revision and adds a lot of complexity.** Entities will no longer be taxed based on their modified net income or taxable capital, but instead on their profit margin. There are still a few rules to iron out, but Texas has issued temporary guidelines. In general, although more entities will be reporting their income to Texas, **many small businesses stand to reduce or avoid this tax completely.**

Currently, Texas assesses a franchise tax on all businesses EXCEPT:

- sole proprietors (who are not single member LLCs)
- general partnerships
- limited partnerships
- professional associations (physicians, dentists, and other medical professionals) and
- non-profit entities.

For tax years beginning January 1, 2007, all for-profit entities who are seeking state liability protection will be subject to the tax. The two groups that will be subject to this tax for the first time are physicians and other medical professionals who organized as a professional association and limited partnerships. **All taxable entities must file a report, even if no tax is due.**

Currently, the Texas Franchise tax provides for a dual calculation, but most of my clients and most entities who are subject to this franchise tax, the tax is based off their modified net income. Currently, the Texas franchise tax kicks in if your entity has "receipts" (or revenues) of \$150,000 or more. Once you trigger the Texas franchise tax, all net income is subject to a tax rate of 4.5%. You can reduce the tax with expenses, including guaranteed payments or salaries to owners.

Beginning with 2007 tax years (reported in 2008), the hurdle (receipts) rate is raised to \$300,000 from \$150,000, so fewer companies will trigger this tax. The franchise tax rate also is reduced to 1% for most taxpayers and 0.5% for wholesales and retailers. This rate will be applied to the companies taxable margin, not net income.

Let's take a look at how this might affect two of my clients. The first client we will look at is a physician, who has never been subject to the Texas Franchise Tax as he incorporated under the Texas Professional Association Act. He is anticipating gross revenues of \$600,000. Medical professionals are allowed to reduce this amount by revenues received from:

- Medicaid
- Medicare
- CHIPs
- Workers Compensation Claims
- TRICARE and
- the actual cost of uncompensated care.

My client had to revise their general ledger to easily separate all these payments in order to make things more efficient come tax time. The hardest part is obviously determining the actual cost of uncompensated care.

After my client deducts all these exempt revenues his Texas Revenues totaled approximately \$480,000. Service providers get to elect each year, if they would like to reduce this amount by either the W-2 wages they paid to themselves and all their employees (not to exceed \$300,000 per person) or 30% of their Texas Revenues. My client estimates paying W-2 wages of approximately \$390,000 and employee benefits of \$15,000. This would reduce my client's taxable margin to \$75,000 and Texas Franchise tax is computed at \$750, but no tax is due if you owe less than \$1,000. My client will still have to file this form, but he will still not be subject to the Texas Franchise Tax.

The second client we will look at is a retailer. He is anticipating gross sales of approximately \$2 millions with a cost of goods of nearly \$1 million, making his margin approximately \$1 million. Since he is a statutory retailer he will be paying tax at 0.5% of this amount or \$5,000. Although this sounds like a lot of tax, under the current Texas Franchise Tax System he will be paying on his net income, which is almost twice as much tax owed.

Both of these clients anticipate saving tax dollars under the new Texas Franchise Tax system. Just remember this won't take affect until your report your 2007 income.

Gina will compute an estimate of what your potential new Texas Franchise Tax will be utilizing your 2006 tax return information for a nominal fee. Please visit her website at <http://GLGcpa.com/TexasFranchiseTax.htm> for more details.

Gina L. Gwozdz is a CPA who has chosen to specialize in taxes. Visit her website at <http://GLGcpa.com> to view more Tax Tip Articles.