A Reprint from *Tierra Grande*, the Real Estate Center Journal

Corporations and limited liability companies (LLCs) doing business in Texas are subject to the state franchise tax regardless of whether the business is officially chartered (organized) in Texas or some other state. Partnerships and sole proprietorships are not subject to the tax. One type of partnership, the limited liability partnership, provides business owners with the benefits of limited liability and allows them to avoid the franchise tax.

Corporations and LLCs pay the greater of a tax on net taxable capital (computed at a .25 percent tax rate on net capital) or net taxable earned surplus (computed at a 4.5 percent tax rate on adjusted federal taxable income). Companies earning a rate of return on business capital in excess of 5.556 percent (rounded) pay their franchise tax based on income rather than on capital. This would be the case for most service-oriented companies, including real estate sales companies.

For example, assume a company has land and a building with a total cost of $1 million and no debt. The franchise tax based on assets is $2,500 ($1 million × .0025) and would be the tax liability as long as taxable income were less than 5.556 percent of $1 million, or $55,560, as 4.5 percent of $55,560 is $2,500. If taxable income for this company exceeds $55,560, the franchise tax would be 4.5 percent of taxable income. These computations and relationships apply regardless of whether the income is from rents or from commissions on real estate sales.

For real estate businesses, net taxable earned surplus is equal to federal taxable income plus compensation paid to officers and directors of the corporation. S corporations and corporations with fewer than 36 shareholders are generally exempt from the compensation add-back. A 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 corporate operations.

Amounts computed for federal income tax purposes cannot be recomputed using a different method for franchise tax purposes. For example, if a corporation reduces the deduction for wages and salaries to claim a federal jobs credit in determining its federal taxable income, the corporation must use the same wages and salaries deduction in determining taxable income for franchise tax purposes.

Some other specific rules are as follows:

Net taxable capital is contributed capital plus surplus (also called "retained earnings"). Generally, net taxable capital is equal to the book value of assets less debt. In the absence of debt, the book value of assets is net taxable capital, as in the example above.

Operating losses from prior years can be "carried over" and used in the current tax year to reduce net taxable earned surplus. Such losses can be carried forward for up to five years. At the end of five years, they expire.

Consolidated tax returns are not permitted for franchise tax purposes. Two or more corporations that file a federal consolidated return must recompute their taxable income and related amounts (such as compensation) for franchise tax purposes as though they were separate corporations. If the Texas Comptroller's office determines that transactions among or between affiliated corporations were not at "arm's-length," the corporation's income can be reallocated to prevent franchise tax avoidance.

S-corporation taxable income for franchise tax purposes is computed the same as taxable income for regular corporations. Thus, segregated income and deduction items (such as capital gains, capital losses and charitable contributions) that normally flow through and are taxed to shareholders for federal tax purposes are included in the S corporation's taxable income for the franchise tax calculation.

The Texas franchise tax rules and computations can be complex. Consultation with an accountant, attorney or real estate professional is recommended.

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Tierra Grande (ISSN 1070-0234), formerly *Real Estate Center Journal*, is published quarterly by the Real Estate Center at Texas A&M University, College Station, Texas 77843-2115. Subscriptions are free to Texas real estate licensees. Other subscribers, $20 per year.

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