"Investing in Texas Real Property—Choice of Entity"

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The State of Texas has an entity taxation scheme that is substantially different from other states. Consider the following examples.

A California real estate investment trust ("Cal REIT") is taxable as a real estate investment trust ("REIT") for federal income tax purposes. Cal REIT has decided to make its first real estate acquisition in Texas. Desiring to minimize its liability in a state known for some extraordinarily high judgments, Cal REIT decides to incorporate a Texas corporation ("Texcorp") that will constitute a "qualified real estate subsidiary" for federal[1] and California tax purposes.[2]

Institutional investor ("Institutional") has never invested in Texas. Since the adoption of the "check the box" regulations[3] for federal income purposes, Institutional has been using a new limited liability company ("TexLLC" in this case) to acquire each of its real property investments and decides to do so for a new shopping center acquisition in Texas. Institutional has found the limited liability company ("LLC") structure to be nearer to a corporate format that it prefers and less complicated than the limited partnership ("LP") structure.

Structure of the Texas Franchise Tax.

Each of Cal REIT and Institutional have subjected their Texas real estate operations to the Texas franchise tax. The Texas franchise tax is imposed annually on each corporation and limited liability company that is "doing business" in Texas or is chartered or authorized to do business in Texas.[4] In general, the franchise tax imposed on a corporation is calculated as the sum of the following:(1) the amount calculated by applying a tax rate of 0.25% to the "taxable capital"[5] of the corporation apportioned to Texas and (2) the difference between (A) the amount calculated by applying a tax rate of 4.5% to the "taxable earned surplus"[6] of the corporation apportioned to Texas and (B) the amount determined pursuant to (1) above.[7] It is important to note that the Texas franchise tax is imposed only on that portion of a corporation's taxable capital and taxable earned surplus that is apportioned to Texas. In general, both taxable capital and taxable earned surplus will be apportioned to Texas based upon the ratio of Texas gross receipts to gross receipts from all sources.[8] Gross receipts for purposes of allocating taxable capital are generally determined under generally accepted accounting principles.[9] Gross receipts for purposes of allocating taxable earned surplus means all revenues reportable by a corporation on its federal tax return.[10] Receipts are generally considered to be Texas receipts if they are derived from business done in Texas.

In the above examples Texcorp and TexLLC would each probably have 100% Texas gross receipts. Hence, each would owe a 0.25% tax on its taxable capital and a 4.5% tax on earned surplus in excess of the taxable capital tax.

Limited Partnerships under the Texas Franchise Tax rules.

The LP still reigns king in Texas. Under current law a LP (domestic or foreign) is not subject to the Texas franchise tax. In addition, while a general partner of a LP doing business in Texas is also considered to be doing business in Texas, as further discussed below, a foreign corporation that is a limited partner in the LP is not considered to be doing business in Texas.[11] Accordingly, under current law, a foreign corporation that does not hold a Texas certificate of authority and does not have any contacts with Texas other than holding a limited partner interest in a LP doing business in Texas, will not be subject to Texas franchise tax.

In the examples discussed above, Cal REIT should have used Texcorp to serve as a 1% (or less) general partner and Cal REIT should have been the limited partner in a LP which could have acquired the Texas real property. Institutional should have used TexLLC as the general partner of a LP which could have acquired the shopping center.12 As a general partner, Texcorp and TexLLC would each still be subject to Texas franchise tax but only as to 1% of the taxable capital and the taxable earned surplus of its respective LP. The related limited partner, which would hold the remaining 99% interest in each such LP, would not be subject to the Texas franchise tax. Thus, properly structured, substantially all of Cal REIT's and Institutional's real estate activities in Texas could be removed from exposure to the Texas franchise tax.13

Activities of the Foreign Limited Partner.

As stated above, a foreign corporation that does not hold a Texas certificate of authority and does not have any contacts with Texas other than holding a limited partner interest in a partnership doing business in Texas, will not be subject to the Texas franchise tax. However, notwithstanding this rule, the Comptroller of the State of Texas has taken the position on Texas franchise tax audits that if a foreign corporation that is a limited partner has officers or directors that reside or otherwise act in Texas or has other contacts with Texas, such as a Texas address, Texas telephone numbers, etc., that is sufficient nexus to Texas for that corporation to be subject to the Texas franchise tax. The following summarizes the actions that should be avoided by the corporate foreign limited partner to minimize the risk that it be determined to have a nexus with Texas for franchise tax purposes. The foreign limited partner should not (through its officers, directors, or agents) do any of the following:

(1) maintain any employees providing services in Texas (or share with an affiliated entity, any employees performing services in Texas);

(2) conduct corporate meetings in Texas;

(3) conduct board of director or stockholder meetings in Texas;

(4) manage investments from a Texas location;

(5) make any decisions or adopt resolutions while in Texas;

(6) maintain office space in Texas;

(7) vote on any matters of the limited partnership upon which such limited partner is entitled to vote while in Texas;

(8) maintain a Texas bank account; or

(9) have a Texas phone listing.

In addition the foreign limited partner and Texas general partner should go to great lengths to demonstrate that they are indeed separate and independent legal entities. Thus, the limited partner and general partner should:

(a) maintain separate bank accounts and records;

(b) observe the formalities of separate corporate procedures for each corporation, including holding separate meetings for each corporation's board of directors and corporate officers;

(c) hold themselves out to the public as being separate enterprises; and

(d) avoid to the extent possible the sharing of employees.

In summary, proper planning for the structure of real estate investments in Texas by

non-Texas entities may save substantial Texas franchise taxes.

1 I.R.C. § 856(i) treats certain wholly owned subsidiaries of a REIT not as separate corporations, but as part of the REIT.

2 Cal. Rev. & Tax. Code §§ 24870-73 (Deering 1988). California generally incorporates I.R.C. §§ 856-60.

3 Treas. Reg. §§ 301.7701-1 through 4.

4 Tex. Tax Code Ann. § 171.001 (West 1992). The franchise tax is imposed on a corporation regardless of its status for federal income tax purposes as a taxable "C" corporation, as a flow-through "S" corporation, or otherwise. In addition, the franchise tax is also imposed on LLCs. Although this discussion refers to "corporations", the same principles apply to LLCs. Significantly, a partnership, whether general or limited, is not currently subject to franchise tax.

5 The term "taxable capital" is defined to be the sum of the corporation's stated capital, as defined in Article 1.10 of the Texas Business Corporation Act (generally, the par value of all shares of outstanding stock), and the corporation's surplus (generally, the net assets of the corporation in excess of stated capital). Tex. Tax Code Ann. § 171.101 (West 1992). In general, a corporation must compute its surplus for taxable capital purposes in accordance with generally accepted accounting principles. 34 Tex. Admin. Code § 3.547(c)(3) (West 1997).

6 The term "taxable earned surplus" is defined to be the corporation's reportable federal taxable income after any Schedule C special deductions and before any net operating loss deductions. Tex. Tax Code Ann. § 171.110 (West 1992). If a corporation has more than 35 shareholders, it must include deductible compensation to officers and directors in its taxable earned surplus. A subsidiary corporation would not be able to exclude compensation under this rule unless its parent would also be able to exclude compensation paid to its officers and directors.

7 Tex. Tax Code Ann. § 171.002 (West 1992). Never having had an income tax in Texas and being ever mindful of their political future, apparently the members of the Texas legislature did not want to pass an "income tax." Instead, Texas has a "franchise tax" based almost entirely on "earned surplus." Presumably, the Texas legislature did not believe that Texans had ever heard the story about the duck (walk like a duck, quack like a duck, etc.)

8 Id. at § 171.106.

9 Id. at § 171.112.

10 Id. at § 171.1121(a).

11 A foreign corporation is subject to Texas franchise tax if it is authorized to do business in Texas or "doing business in Texas." Note that 34 Tex. Admin. Code § 3.546(c)(12) (West 1997), dealing with taxable capital-nexus, sets forth the following specific activities which constitute doing business in Texas:

1. acting as a general partner in a general partnership which is doing business in Texas; and
2. acting as a general partner in the limited partnership which is doing business in Texas. (A foreign corporation which is a limited partner in a limited partnership is not doing business in Texas).

12 Interesting, under I.R.C. § 856(i) Texcorp would be ignored for federal income tax purposes and, as a consequence, the Cal REIT LP would have only one owner, Cal REIT. Therefore, under Treas. Reg. § 1.7701-2, the LP will be ignored for federal income tax purposes. For similar reasons, Institutional could structure its LP to be ignored for federal income tax purposes.

13 It should also be emphasized that the franchise tax savings depend on the continued application of 34 Tex. Admin. Code § 3.546(c)(12). The Comptroller of the State of Texas could modify the provisions of Tex. Admin. Code § 3.546(c)(12) at any time so that limited partners would be subject to the Texas franchise tax. Also, in 1997 the Texas legislature considered, but did not pass, a bill to make LPS subject to the Texas franchise tax.