March 18, 2010

Warning: Trusts in Texas May Be Subject To Texas Franchise Tax!

The Texas franchise tax (also known as the "margin tax") is so expansive that it can apply to private trusts administered in Texas. Every taxable entity is subject to the franchise tax, and the term "taxable entity" generally includes trusts, partnerships, limited liability companies, and corporations. If the franchise tax applies to a trust, the amount of franchise tax will typically be 0.7% of the trust's federal gross income that is apportioned to Texas (i.e., generally attributable to transactions occurring and business done in Texas).

Two common exemptions from the franchise tax apply to certain trusts: trusts that qualify as "passive entities," and trusts that are qualified grantor trusts (each of which is discussed below). In addition, the following trusts are excluded from the definition of taxable entity: certain real estate investment trusts (REITs), nonprofit self-insurance trusts created under Chapter 2212 of the Texas Insurance Code, trusts qualified under Section 401(a) of the Internal Revenue Code (the "Code"), and trusts exempt under Code Section 501(c)(9). A trust also may be exempt from the franchise tax if it satisfies the requirements of an applicable franchise tax exemption (for example, a trust exempt from federal income tax under Code Section 501(c)(3), which has submitted an exemption application to the Texas Comptroller).

When is a Trust a Passive Entity? To qualify as a passive entity, the trust must (i) not be a business trust, (ii) have 90% or more of its federal gross income attributable to certain passive sources (for example, dividends, interest, distributive shares of partnership income, gains from the sales of securities, capital gains from the sale of real property, and royalties, bonuses, or delay rental income from mineral properties), and (iii) have no more than 10% of its federal gross income attributable to conducting an active trade or business, which includes real estate rental income.

> *For example, assume Trust X owns stocks, bonds, and real estate rental properties, and it receives 89% of its federal gross income from dividends and interest and 11% of its income from real estate rental income. Because less than 90% of Trust X's federal gross income is from eligible passive sources, Trust X will not qualify as a passive entity.*
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> *However, if Trust X's rental income is in the form of distributions from a partnership (i.e., a partnership in which the trust holds an interest owns the real estate), 100% of Trust X's federal gross income will be attributable to passive sources, and Trust X will qualify as a passive entity.[1] Thus, none of Trust X's income will be subject to Texas franchise tax.*

A trust's income is tested each year to determine whether the trust qualifies as a passive entity for that year, so depending on the trust's annual income, it is possible a trust could be a passive entity one year but be subject to the franchise tax the following year.

Which Grantor Trusts Are Excluded from the Texas Franchise Tax? Even if a trust is not a passive entity, it may nevertheless be excluded from the Texas franchise tax if (i) it is a grantor trust for federal income tax purposes, (ii) all of the grantors and beneficiaries are natural persons (i.e., individuals) or charitable organizations described in Code Section 501(c)(3), and (iii) the trust is not a business trust.

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[1] In October 2009, the Texas Comptroller proposed a rule amendment to look through such a partnership so the distributions from a partnership with rental income would be treated as income from an active trade or business; however, the Comptroller withdrew the rule before the final amendments were published in December 2009.

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