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Subject: Texas Overhauls Franchise Tax
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To: Our Clients and Friends

Texas has repealed its current franchise tax (calculated on the higher of 0.25% of taxable capital or 4.5% of taxable earned surplus) effective for returns due on or after January 1, 2008. The current franchise tax is being replaced by a new franchise tax based on taxable margin. Highlights of the new franchise tax are set forth below.

- . The new tax applies to a broader spectrum of businesses than the current tax, including limited partnerships, trusts, and certain other entities.
 - .. Thus, the loophole that has allowed businesses to avoid paying franchise tax in Texas by conducting activities through a limited partnership structure has been closed.
- . The new tax is based on taxable margin, which is defined as the lesser of (1) 70% of total revenue, or (2) total revenue reduced by either (a) cost of goods sold, or (b) compensation.
- . Taxable margin will be apportioned by a single gross receipts factor. This is similar to the current franchise tax apportionment method.
 - .. However, with respect to apportionment of taxable margin, the throwback rule is repealed.
- . The tax rate on taxable margin is generally 1%. For entities primarily engaged in retail or wholesale trade, the tax rate is generally 0.5%.
- . The new tax requires water's edge combined reporting if 80% ownership and unitary business tests are met. The current tax requires separate reporting.
- . Transition rules are provided with respect to use against the new tax of unused net operating losses and credits generated under the current tax.
- . According to the legislation, the new tax is not an income tax, so the protections of Public Law 86-272 may not be applicable.

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The new legislation contains many detailed rules and definitions that taxpayers will need to be familiar with. If you have any questions regarding the new Texas franchise tax or its impact on your company, please do not hesitate to contact me.

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