

Texas Margin Tax: The impact on investment real estate

In Texas property taxes are the primary source of revenue used to fund school district budgets. Unfortunately, Texas residential and commercial property owners pay one of the highest tax rates in the nation. For example, in 2005 property owners located within Dallas ISD paid 56.6% of their total property tax bill to the school district and these taxes comprised 85.7% of the district's \$1.027 billion budget. In addition to the large burden placed on property owners, the process of redistributing property tax revenue under the Robin Hood plan from so called property rich districts to property poor districts was criticized as an unconstitutional state income tax. These issues affected all school districts within Texas and resulted in legislative changes to reform school financing. In 2006 the Supreme Court of Texas adopted a mandate to reform school financing, which became effective in May 2008. The new school financing plan decreased school tax rates and increased state funding to school districts. The state plans to pay for this with higher business taxes, cigarette taxes, and budget surpluses. The legislative effect on the school tax rates resulted in a two year phase in period in 2006 and 2007. School district tax rates are comprised of two parts: maintenance and operation (M&O) and debt service or interest and sinking fund (I&S). The M&O rate was capped at 1.50% in 2005 and prior years. In 2006 the cap on this rate was lowered to 1.33% and in 2007 it was reduced again to 1.00% where it will remain. The rate is allowed to step up by 0.04%, effectively raising the M&O cap to 1.04%. As a result of these changes the combined tax rate for Dallas ISD decreased from 1.68836% in 2005 to 1.199643% in 2007, a difference of \$0.488717 per \$100. The ultimate result of this legislation was franchise taxes evolved into margin taxes because of the need for higher business taxes.

Margin taxes are a state tax on revenue from business enterprises. It also applies if the revenue source is rental income from investment real estate. To estimate the margin tax, deduct 30% from total revenue received to determine taxable margin and multiply that figure by a 1% tax rate. A short cut is to multiply effective gross income by 0.7%. Be aware that there are two other methods for calculating margin tax that are applicable for businesses and involve substituting the 30% deduction for either cost of goods sold or compensation. Margin tax applies to corporations, LLCs, limited liability partnerships, joint ventures, and other legal entities. The tax is exempt for sole proprietor forms of ownership and for those with total revenue less than \$300,000. Also, there is a phase out schedule if total revenue is between \$300,000 and \$900,000. Some real estate investors that were previously exempt from paying franchise taxes because of the form of ownership that was used to hold property are now required to pay margin taxes. Something else to be aware of is that margin taxes are calculated from gross rather than net income, so even if a property is operating at a loss it is still subject to margin taxes. This is a tax on the ownership entity and is essentially a state income tax on businesses.

To illustrate the magnitude of the new margin tax expense compared to the decreased property tax expense, an example of a 300-unit apartment complex located in Dallas ISD will be used. Property assumptions include: an average monthly rent of \$1,000 per unit; an economic occupancy of 90%; a 50% operating expense ratio; and an assessment of \$70,000 per unit. The margin tax on this property is calculated at \$22,680. Conversely, the change in the Dallas ISD property tax rate results in a \$102,631 decrease in property taxes from 2005 to 2007. Although the decreased property taxes could be partially offset by any increases in the assessment, the difference of \$79,951 is a windfall to the annual cash flow of the property and is a direct result of the legislative change. In the previous example, the effect of the tax rate decrease results in a 6.3% increase in both net operating income (NOI) and value assuming no other variables changed. Decreased school tax rates have already been accounted for by investors, developers, appraisers, and lending institutions; however, the impact of margin taxes has not yet been accounted for. Margin tax is effectively a state income tax to the ownership entity and therefore is not an operating expense and is not deducted from net operating income (NOI). It is a deduction that applies to after-tax-cash-flow and results in a slightly reduced equity yield. If buyers will not

accept an erosion of their equity yield, then the effect of the margin tax must increase in the overall capitalization rate to compensate for the tax. Based on the earlier example of the 300-unit apartment, the effect of the margin tax is an increase in the overall capitalization rate of 8.6 basis points. This is a nominal amount and difficult to detect from sales data.

It is evident that the benefit from the property tax reduction far outweighs the cost of margin taxes. The effect of margin taxes on capitalization rates will be a nominal increase. The concern remains that tax rates have historically increased to fund the growing budgets of school districts. The cap on the school district M&O rate will provide protection for property owners against rate increases, but any shortfall in revenue to school districts will result in budgetary deficits. Currently Dallas ISD has an \$85 million budget deficit and plans to terminate 1,200 employees. The debate on how to adequately fund school districts is likely to continue.

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