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July 11, 2006



LETTER OF COMMENT NO. 2

Director of Major Projects and Technical Activities
Financial Accounting Standards Board
401 Merritt 7
Norwalk, CT 06856-5116

Re: Texas Franchise Tax

Dear Director,

We are writing to urge the Board to consider releasing immediate guidance relating to the recently passed modifications to the Texas franchise tax pursuant to H.B. 3, 79th Leg., 3d C.S. (2006) ("H.B. 3"), as applied to Statement of Financial Accounting Standard 109 ("SFAS 109").

On May 18, 2006, the Texas governor signed H.B. 3, which enacted a new Texas Franchise Tax system. The new tax is based on a gross margin and equals the lesser of (1) 70% of gross revenue; (2) 100% of gross revenue less cost of goods sold ("COGS"); or (3) 100% of gross revenue less compensation. The choice between the foregoing calculations is made annually at the election of the taxpayer on a unitary combined group basis. The election can be changed annually. The tax base is subject to a 0.5 or one percent tax rate. The new tax applies to previously non-taxable entities, such as partnerships. It is our understanding that the Big Four Accounting Firms have collectively interpreted the tax to be an income tax for purposes of applying SFAS 109, thereby requiring the recognition of deferred taxes in the quarter ending June 30, 2006.

As discussed below, we believe there is guidance to support that the Texas Franchise Tax is not an income tax. Alternatively, we believe that this determination should be based on a company's facts and circumstances. If the tax is not treated as an income tax, its effects would not be reflected in the financial statements until 2008, which would provide ample time for pending revisions and technical guidance to be issued by the State of Texas. We question whether accounting for the new tax law at this time will be helpful to users of financial statements, given the lack of reliable interpretive guidance from state officials. Finally, we request FASB guidance on the proper period to recognize taxes for a particular privilege period and recommend that such taxes be accrued during the privilege period to which the tax relates.

GAAP Guidance Regarding Franchise Taxes

Appendix E of SFAS 109 defines taxable income as "[t]he excess of taxable revenues over tax deductible expenses and exemptions for the year as defined by the governmental taxing authority." This definition suggests that any fees paid to a governmental entity based on a reasonable calculation of revenue less expense should be treated as an income tax.

Rule 5-03(b)(11) SEC Regulation S-X requires public companies to include only taxes based on income in the income tax expense section of the income statement. The Rule does not define an income tax.

Available interpretive guidance regarding the Michigan Single Business Tax provides that the accounting for such tax, which is based on taxable income with adjustments for payroll (add-back) and construction expenditures (subtraction), should be based on a facts and circumstances interpretation. The guidance on how to account for this tax varies, but suggestions include (a) treating the tax based on income as an income tax and the payroll and construction expenditure adjustments as operating expenses, (b) providing for the entire tax as an operating expense, or (c) providing for the entire tax as an income tax. This guidance provides support for treating the Texas Franchise Tax as an income or non-income tax based on a company's facts and circumstances.

In addition, EITF 91-8 provides that the current Texas Franchise Tax (in effect through December 31, 2007), which is based on the greater of a capital calculation or a taxable income calculation, is a capital tax, and that an income tax results only to the extent that the taxable income (or earned surplus) portion exceeds the capital tax portion. Similarly, a company might conclude that the newly enacted Texas Franchise Tax is a gross receipts tax (all revenues x 70% x 1%) and that any reduction in this ceiling limitation (through a COGS or compensation deduction, if applicable) is a benefit provided by the gross receipts tax or an income tax benefit depending on the company's unique facts and circumstances. This highlights why a facts and circumstances approach may be appropriate in correctly classifying the new Texas Franchise Tax.

The available guidance regarding whether or not a tax is an income tax is limited, and therefore additional guidance is necessary. The following discussion supports the treatment of the Texas Franchise Tax as a non-income tax and presents other complicating matters that should be considered by the Board.

New Tax Law Is Not an Income Tax

Mechanics of Franchise Tax Not Indicative of an Income Tax

Gross Receipts is Starting Point - The margin tax requires that almost all types of revenue be included in the tax base, but only three types of expenses are deductible: (1) COGS, (2) compensation, or (3) a deemed 30 percent revenue deduction.¹ Certain types of income, such as interest and capital gains, are includible, but the related expenses (e.g., interest expense, transaction costs) are not.² In addition, the COGS expense deduction is limited to companies that "produce goods" and the compensation deduction is capped at \$300,000 per employee.³ Therefore, these deductions are limited and do not allow companies to deduct all business expenses (such as advertising, selling, and distribution costs), which is not representative of an income tax. Most strikingly, the 70 percent gross margin ceiling (or deemed 30 percent deduction) is not related to business activities or based on a company's facts and circumstances. Therefore, it should be considered a 0.7 percent (1% x 70%) gross receipts tax.

Economic Benefits Disallowed Are Substantial - The annual election to calculate the Texas Franchise Tax using one of the three alternatives allowed is made on a combined unitary basis. Therefore, integrated companies may pay more tax as a result of their structure. For example, assume a sales company and a manufacturing entity are wholly-owned subsidiaries of a publicly-

¹ Tex. Tax Code §§ 171.101, 171.1011 (All section references are to the Texas Tax Code, as amended by H.B. 3)

² Tex. Tax Code § 171.1011.

³ Tex. Tax Code §§ 171.1012, 171.1013.

traded holding company. All three companies operate in Texas. The parent company determines that the COGS of the manufacturing entity is greater than the compensation expenses of the sales company, and both are greater than the 30% deemed deduction. As a result, the combined group calculates all revenues less only COGS to determine its Texas margin tax base. Depending on the group's tax sharing agreement, the sales company pays tax to the holding company based on its gross revenue as a result of the combined group filing. However, on a stand-alone basis, the sales company would pay tax based on revenues less compensation expenses, which would generate less tax due. This example highlights that all economic expenses in producing revenue are not considered in determining the margin tax base, especially for certain taxpayers required to report and pay tax as a combined group. Therefore, this result is not indicative of an income tax.

Carryover of Losses Disallowed - The new Texas Franchise Tax explicitly disallows the carryover of losses. In computing a company's taxable margin, the statute specifically states that "[i]n making a computation under this section, an amount that is zero or less is computed as a zero."⁴ Therefore, there is an implicit limitation of deductible business expenses against total revenues. Also, under the combined group concept, this means that losses of one member of the combined group cannot offset the income of another member of the combined group. These results are not indicative of an income tax.

Texas Legislature Explicitly Found that the Franchise Tax Is Not an Income Tax

Although not determinative of the financial statement position, the Texas legislation specifically states that the franchise tax is not an income tax.⁵ If considered an income tax for Texas law purposes, the law may be, in whole or in part, unconstitutional. Texas law requires an income tax on natural persons, including certain partnerships, to be approved by a statewide vote. It is expected that the Texas legislation will be challenged on constitutional grounds directly at the Texas Supreme Court level. If declared unconstitutional, the Texas Supreme Court could declare the entire tax invalid, in which case there would be no tax liability to accrue under the currently enacted law.

Other Complicating Matters

Interpretation of New Tax Law is Uncertain

H.B. 3 was enacted under a court-imposed deadline. Due to this circumstance, Texas legislators did not have ample time to appropriately draft certain provisions of the new franchise tax. These provisions now require future technical or substantive correction. For example, through the limited guidance issued to date, it has come to our attention that an extremely broad credit provision in the Texas Franchise Tax statute is being interpreted by the Texas Comptroller of Public Accounts ("Comptroller") as having no application whatsoever. Specifically, the face of the franchise tax statute provides for a temporary credit, which is described in Sec. 171.111 as a credit computed by:

... determining the amount, as of the end of the taxable entity's accounting year ending 2006, of the difference between (i) the taxable entity's deductible

⁴ Tex. Tax Code § 171.101(c).

⁵ H.B. 3, § 21 (stating that "[t]he franchise tax imposed by Chapter 171, Tax Code, as amended by this Act, is not an income tax . . .")

temporary differences and net operating loss carryforwards, net of related valuation allowance amounts shown on the taxable entity's books and records on the last day of its taxable year ending in 2006, and (ii) the taxable entity's taxable temporary differences shown on those books and records on that date.

The credit is then apportioned to the State, multiplied by 10 percent and the applicable tax rate, and may be claimed for not more than 20 consecutive periods beginning with 2007 reports.

The literal interpretation of this language is that an entity is allowed a credit equal to 10 percent of its net deferred tax position (asset OR liability) for each of the next 20 years (subject to a valuation allowance pursuant to SFAS 109). However, the guidance issued by the Comptroller related to this credit indicates that the credit is really very narrow in scope and has no relation at all to temporary differences or federal net operating loss carryforwards. The limited guidance issued indicates that the credit relates only to certain loss carryforwards existing under the current Texas Franchise Tax calculation (i.e., the earned surplus component) and applies for the next 10 years (not 20 as indicated in the law). We have read guidance from three of the Big Four Accounting Firms advising the reader to calculate this credit under the Comptroller's guidance. Further, in recent industry meetings, a representative of the Comptroller's office stated that the Comptroller's guidance is based on drafted legislation intended to amend the current law and is not based on the current law itself. We question whether it is appropriate to consider the Comptroller's guidance given that it is based on drafted legislation.

There are a number of other similar technical issues for which the Comptroller has not issued guidance, but legislators have drafted the legislation amending the current law in preparation for the next legislative session beginning in January 2007. We do not believe it is appropriate to consider the draft legislation at this time.

Double Inclusion of Tax Expense in 2007 Financial Statements if an Income Tax

The franchise tax is based on a current year privilege period. For example, the tax is effective for 2008 calendar year taxpayers and applies to the 2008 privilege period. However, the base for the 2008 tax is the 2007 gross margin. Generally, privilege period taxes should be charged to expense over the period to which the privilege relates (e.g., 2008). By contrast, an entity generally accrues an income tax when the income (or gross margin) is earned (e.g., 2007). For a taxpayer that pays the capital tax under the current Texas Franchise Tax, and therefore expenses the tax in the privilege period, treatment of the newly enacted tax as an income tax potentially results in recognition of tax expense under both the current and new franchise tax laws during 2007. The capital tax (under the current law) would be reported in operating expenses in 2007 and the new gross margin tax (if an income tax) would also be accrued as an income tax expense in 2007. We question whether the double inclusion of tax expense presents an accurate picture to financial statement users.

Considering the above, we request FASB guidance on the proper time to recognize taxes for a particular privilege period tax, such as the new Texas Franchise Tax. It is our understanding that some companies expense privilege taxes in the period for which the tax gives the company the privilege of doing business in the state. In contrast, other companies use a methodology (which we believe is the generally accepted methodology) that accrues the taxes during the period the income included in the tax computation is earned (e.g., the year prior to the actual privilege period to which the tax relates in the case of both the old and new Texas Franchise Tax). We

believe recognizing a privilege period tax in a year other than the privilege period year is inconsistent with the nature of a privilege period tax.

Financial Statement Disclosure Impaired

We believe that adjusting our deferred tax assets and liabilities for a tax law with so many uncertainties does not benefit users of financial statements. Related disclosures would be difficult to provide in clear language. We believe the financial statements are more reliable and beneficial to users of financial statements without including an inaccurate estimate of the Texas Franchise Tax liability. Given the situation, we question whether the Texas Franchise Tax can be considered enacted for purposes of applying SFAS 109 (if, indeed, it is an income tax)

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We therefore recommend a determination that the Texas Franchise Tax is not an income tax. At the very least, considering the mechanics of the new tax, such determination should be based on a company's facts and circumstances. Additionally, any deferred tax accounting for the Texas Franchise Tax (if determined to be an income tax) should not occur until the issuance of reliable interpretive guidance from state officials. It is questionable whether accounting for the new law at this time will be helpful to users of financial statements. In the event the tax is considered an income tax, we further request FASB guidance on the proper time to recognize taxes paid to cover a particular privilege period and recommend that such taxes be accrued during the privilege period to which the tax relates.

Sincerely,



Stan Szlauderbach
Senior Vice President and Controller
TXU Corp.