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LEGAL ALERT

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Be Ready to Pounce on a Texas Margins Tax Challenge

On July 29, 2011, Allcat Claims Services, L.P. (Allcat) and one of its individual partners filed a petition with the Texas Supreme Court seeking a declaratory judgment that the Texas margins tax (TMT) is unconstitutional under the Bullock Amendment of the Texas Constitution. *In re Allcat Claims Service, L.P. and John Weakly*, No. 11-0589. Tax practitioners have anticipated this challenge since the TMT was first enacted in 2006. The legislature also anticipated this type of challenge and created a special procedure whereby any challenge to the constitutionality of the TMT is filed directly with the Texas Supreme Court for expedited review.[1] Regardless of whether the Texas Supreme Court will strike down the TMT in its entirety, the court's decision could have significant implications for many corporate taxpayers. In this Legal Alert, we summarize the legal issues and ramifications of the *Allcat* challenge.

Is the TMT Constitutional?

Article VIII, § 24(a) (known as the Bullock Amendment) of the Texas Constitution provides that:

> A general law enacted by the legislature that imposes a tax on the *net incomes of natural persons, including a person's share of partnership and unincorporated association income*, must provide that the portion of the law imposing the tax not take effect until approved by a majority of the registered voters in a statewide referendum held on the question of imposing the tax [emphasis added].

Texas voters never approved the TMT, and its constitutionality therefore turns on two issues: (1) whether the TMT is an income tax, and (2) whether it is imposed on a natural person's share of partnership income.

Tax Classification: Is the TMT a Tax on Net Income?

The Texas Constitution does not define the phrase "tax on . . . net incomes," and Allcat proposes three potential definitions. First, the Multistate Tax Compact (MTC), adopted in full by Texas in Texas Tax Code Ann. § 141.001 and in effect at the time the TMT was enacted, defines an "income tax" as "a tax imposed on or measured by net income including any tax imposed on or measured by an amount arrived at by deducting expenses from gross income, one or more forms of which are not specifically and directly related to particular transactions."[2] Under this definition, Allcat argues, the TMT should be classified as a net income tax, because the tax is generally calculated by computing gross income, making specified adjustments, and then deducting either cost of goods sold (COGS) or compensation.[3] Both the COGS and compensation deductions include expenses to be deducted from gross income that are not

[1] Act of May 2, 2006, 79th Leg., 3rd C.S., H.B. 3, § 24. Under the expedited review procedure, the Texas Supreme Court must rule within 120 days of July 29, 2011, the date the *Allcat* petition was filed. H.B. 3, § 24(b).
[2] Tex. Tax Code Ann. § 141.001, art. II, § 4.
[3] The E-Z calculation of the TMT under Tex. Tax Code Ann. § 171.1016, allowing a computation similar to a true gross receipts tax, is effectively irrelevant to the determination of the constitutionality of the TMT, because H.B. 3928 provides that if a court finds the other methods of calculating the TMT are unconstitutional, it must invalidate the E-Z calculation as well. Act of June 15, 2007, 80th Leg., R.S., H.B. 3928, § 39.

"specifically and directly related to particular transactions." For example, the COGS deduction includes items such as utility charges, insurance costs, and employee benefits, all of which are general overhead-type costs unrelated to a specific transaction.[4] Similarly, the compensation deduction includes administrative or back-office staff salaries unrelated to any particular transaction.

Allcat also references similar definitions of an income tax set forth in Black's Law Dictionary (income tax is "a tax on . . . total income from all sources minus deductions, exemptions, and other tax reductions") and by the U.S. Supreme Court[5] (income tax is one that taxes profitable businesses more than unprofitable ones), arguing that all of the definitions of "a tax on net incomes" are satisfied.[6]

Sutherland Observation: The question of whether to characterize the TMT as an income tax has been the subject of substantial debate. Former Texas Comptroller Carole Keeton Strayhorn concluded it was an income tax.[7] Also, other states characterize it as an income tax for purposes of determining whether it is deductible for other states' income taxes (including California, Kansas, Missouri, South Carolina, and Wisconsin).[8] And, the Financial Accounting Standards Board (FASB) concluded it is an income tax for financial accounting purposes.[9] However, others believe that the TMT is *not* an income tax, primarily because companies have to pay the tax even in years when no profit is earned. For example, former Comptroller John Sharp, who chaired the Texas Tax Reform Commission, testified that the TMT was not an income tax because a company could lose money and still pay the tax.[10]

The Attorney General's litigation strategy appears to be to avoid having the court rule on whether the TMT is a net income tax. Rather, the Attorney General's response to Allcat's petition dismisses the issue of whether the tax is an income tax, arguing that it "makes no difference" because the true issue is whether the TMT is a tax "on the net incomes of natural persons" or one imposed on business entities.

Sutherland Observation: A ruling on the issue of whether the TMT is a net income tax could open the door to refund claims by corporate taxpayers claiming protection under P.L. 86-272 or electing to apportion income under the Multistate Tax Compact's three-factor formula, as discussed below.

Tax Target: Is the TMT a Tax on a Person's Share of Partnership Income?

The Bullock Amendment's second element requires that the tax be imposed on the "net incomes of natural persons, including a person's share of partnership and unincorporated association income." Allcat argues that "Texas indirectly imposes the [TMT] on each partner by allocating a share of a partnership's

[4] Tex. Tax Code Ann. § 171.1012.
[5] *U.S. Glue Co. v. Town of Oak Creek*, 247 U.S. 321, 329 (1918).
[6] The Texas Supreme Court may also look to existing Texas case law involving tax classification to determine whether the TMT is an "income tax." *See INOVA Diagnostics, Inc. v. Strayhorn*, 166 S.W.3d 394 (Tex. App. 2005) (holding that P.L. 86-272 does not apply to the net taxable capital component of the former franchise tax because the tax was not imposed on, or measured by, net income); *General Dynamics Corp. v. Bullock*, 547 S.W.2d 255 (Tex. 1976) (holding that the former franchise tax was an income tax for purposes of the federal Buck Act, 4 U.S.C. §§ 105-110, which contained a very broad definition of "income tax").
[7] Letter from Carole Keeton Strayhorn to Attorney General Greg Abbott (Apr. 21, 2006) (making many of the same arguments found in Allcat's petition).
[8] Cal. Tech. Adv. Memo. 2011-03 (Apr. 13, 2011); Kan. Op. Ltr. No. O-2009-005 (Mar. 24, 2009); Mo. Ltr. Rul. No. LR-5309 (Dec. 12, 2008); S.C. Rev. Rul. No. 09-10 (July 17, 2009); Wis. Tax Bulletin No. 156 (Apr. 2008).
[9] Minutes of the August 2, 2006, Board Meeting on Potential FSP: Texas Franchise Tax.
[10] *See* J. Elliot, *Abbott Asked to Rule on Tax Plan's Legality*, Houston Chronicle (Apr. 4, 2006).

profits to each partner" under Texas partnership law.[11] In this regard, the Texas Revised Partnership Act provides that a partnership interest includes "the partner's share of profits and losses" and that "[e]ach partner is entitled to be credited with an equal share of the partnership's profits."[12] Thus, Allcat concludes that because the TMT is paid by the partnership itself, the TMT directly reduces (1) each partner's distributive share of income in proportion to his/her profit and loss interests in the partnership, and (2) each partner's values and liquidation rights in the partnership interests.[13]

The Attorney General counters that the TMT does not run afoul of this element because it "taxes total revenue . . . of 'taxable entities' while that revenue is still maintained in the entity's coffers."[14] Texas law provides that "[a] partnership is an entity distinct from its partners."[15] Under the state's view, because Texas imposes the TMT on entities and does not follow federal tax law passing through income from a partnership to its partners, the TMT is imposed at the entity level and is not a tax on a "person's share of partnership . . . income."[16]

Potential Outcomes and Their Implications for Corporate Taxpayers

If the court finds that the TMT violates the Bullock Amendment, it has two options. First, the state has argued that if the taxpayer is successful, the court should find that those portions of the statutes which impose the TMT on a natural person's share of partnership income are unconstitutional and leave the remaining TMT intact.[17] Even this "limited remedy" could have significant ramifications.

The most extreme possible outcome of a ruling in favor of the taxpayer would be to strike down the *entire* TMT as Allcat has requested. This result may occur if the court determines that invalidating a portion of the TMT prevents the TMT from being applied in a manner consistent with the enacting legislature's intent.[18] This happened, for example, with California's dividends received deduction in the *Farmer Brothers* and *Abbott Laboratories* cases.[19]

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[11] Original Petition at 9.
[12] Tex. Bus. Org. Code Ann. §§ 1.002(68), 152.202(a).
[13] Original Petition at 9-11.
[14] Response to Original Petition at 4. This position is consistent with the Attorney General's initial conclusion regarding the TMT. In a 2006 informal letter, the Assistant Attorney General opined that "although a court may disagree," the TMT is not subject to the Bullock Amendment because it is an entity-level tax. Letter from Barry McBee, First Assistant Attorney General of Texas, to Deirdre Delisi, Chief of Staff of Texas Governor Rick Perry (April 17, 2006).
[15] Tex. Bus. Org. Code Ann. § 152.056.
[16] Response to Original Petition at 5-6.
[17] This approach would be similar to the New Jersey Supreme Court's approach in its recent decision construing the throwout rule, in which it effectively read the statute in a way unsupported by the text but required in order to reach a constitutional result. *Whirlpool Properties, Inc. v. Director, Div. of Tax.*, 2011 WL 3189530 (N.J. July 28, 2011).
[18] *See Dees v. State*, 822 S.W.2d 703, 705 (Tex. App. 1991) ("When part of a statute is unconstitutional, we sustain the remainder only if the result is consistent with original legislative intent"), *aff'd*, 865 S.W.2d 461 (Tex. Crim. App. 1993).
[19] *Farmer Bros. Co. v. Franchise Tax Bd.*, 108 Cal.App.4th 976 (2003) (finding California dividends received deduction partially unconstitutional); *Abbott Laboratories v. Franchise Tax Bd.*, 175 Cal.App.4th 1346 (2009) (refusing to sever invalid portion of statute and thereby striking entire deduction).

Sutherland Observation: The possible invalidation of the entire TMT raises interesting questions. The TMT was enacted by modifying the previous franchise tax, rather than repealing the former tax and replacing it with an entirely new tax. If the TMT's enacting law (H.B. 3, as modified by H.B. 3928) were found to be unconstitutional in its entirety, then the franchise tax statutes may revert back to the previous Texas franchise tax as it existed prior to the enactment of the TMT. Taxpayers subject to the TMT could file refund claims for any TMT paid, but it would appear that the Comptroller could then recompute and assess taxpayers under the old franchise tax.

Another possibility is that Allcat could simply lose its case on all grounds and the status quo would be maintained. However, if the court finds that the TMT is an income tax, either in striking some or all of the TMT or in ruling against Allcat but finding that the first element of the Bullock Amendment is met, such a ruling will have two potentially significant impacts on corporate taxpayers.

The first and most obvious result would be that taxpayers may claim P.L. 86-272 protection (activities limited to the solicitation of sales of tangible personal property) and file refund claims for all taxes paid under the TMT and cease filing prospectively. The TMT itself states that it "is not an income tax, and P.L. 86-272 . . . does not apply."[20] A ruling by the court that the TMT is, in fact, an income tax would make clear that P.L. 86-272 (which is limited by its terms to income taxes) does apply. Combined groups with members able to claim P.L. 86-272 protection would benefit as well because Texas is a *Joyce* state,[21] which means that only members of the combined group with nexus in the state must include sales in the Texas sales factor numerator of the apportionment calculation.

Another potential impact is that taxpayers could be permitted to make an election to apportion their income using a different and potentially more favorable formula. Texas has adopted the MTC in full, and the statute provides an election for taxpayers to apportion their income to Texas using the MTC's equally weighted three factor formula rather than the TMT's single sales factor formula. The MTC election, however, only applies to the TMT to the extent it is an income tax under the definition discussed above. The Comptroller has taken the position that the election "does not apply to the [TMT],"[22] because, in the state's view, the TMT is not an income tax under the MTC definition. However, the court's possible ruling on this issue could foreclose the Comptroller's position and allow taxpayers to make the MTC apportionment election.

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[20] Act of May 2, 2006, 79th Leg., 3rd C.S., H.B. 3, § 21.
[21] Tex. Tax Code Ann. § 171.103(b).
[22] Tex. Tax Policy News (July 2010).

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