TEXAS MARGIN TAX: IS IT TIME FOR THE CURTAIN CALL?

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I. INTRODUCTION[1]

On January 1, 2008, the business landscape changed dramatically for tens of thousands of Texas-based businesses.[2] This change was the result of legislation that made significant revisions to the Texas franchise tax (now commonly called the "margin" tax) by expanding its scope to include entities that never before had been subject to the tax and significantly altering how the tax is calculated.[3] To put it mildly, the margin tax has not been well received,[4] and it is doubtful that it will reach its tenth anniversary.[5]

Since the margin tax's premiere, it has met with poor reviews and been the subject of much criticism,[6] as discussed below in Section III. To make matters worse, revenue from the margin tax has repeatedly failed to meet projections,[7] and the tax has been blamed for impeding the growth of the Texas economy.[8]

The margin tax has survived constitutional challenges in two Texas Supreme Court cases,

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[1] This article expands on the author's article, *An Income Tax by Any Other Name Is Still an Income Tax: The Constitutionality of the Texas "Margin" Tax as Applied to Partnerships and Other Unincorporated Associations*, 62 BAYLOR L. REV. 573 (2010).

[2] *See* ROBERT W. HAMILTON ET AL., 19 TEXAS PRACTICE SERIES: BUSINESS ORGANIZATIONS § 4.3 (2d ed. 2004 & Supp. 2009–2010) ("Beginning with returns due in 2008, the Texas franchise tax is calculated under a completely new system, and entities not previously subject to the franchise tax (such as limited partnerships) are subject to the tax."); Cynthia M. Ohlenforst et al., *Taxation*, 60 SMU L. REV. 1311, 1311 (2007) ("In 2006, Texas legislators enacted the most substantial franchise tax reform the state has seen since 1907 . . . ."); Ira A. Lipstet, *Franchise Tax Reformed: The New Margin Tax Including 2007 Legislative Changes and Final Comptroller Rules,* 42 TEX. J. BUS. L. 1, 1 (2007) ("[T]he Texas Legislature enacted extensive and significant changes to the franchise tax in May 2006 by way of legislation frequently referred to as 'HB 3.'").

[3] *See* HAMILTON ET AL., *supra* note 2; *see also* Jennifer Patterson, *The Margin Tax is Born*, 71 TEX. B.J. 21, 21 (2008) ("The revised franchise tax was dubbed the 'margin tax' both to describe its base, the gross profit margin of a business, and to distinguish it from the former franchise tax on taxable capital and earned surplus. Unlike the old franchise tax imposed only on corporations and limited liability companies, the margin tax is imposed on almost all businesses. Only sole proprietorships, general partnerships owned by natural persons, and certain nonprofit and investment entities are excluded from the tax."); Cynthia M. Ohlenforst et al., *Taxation*, 61 SMU L. REV. 1131, 1135 (2008) (noting that the revised franchise tax is sometimes labeled the "margin tax" since the tax is imposed on a business's "margin"); Lipstet, *supra* note 2 ("The new version of the franchise tax is also referred to as the 'margin tax' because it changes the base of taxation from taxable capital or taxable earned surplus to a new concept of 'taxable margin.'").

[4] *See* Section A, *infra*.

[5] *See* Section VI, *infra*, discussing the overall dislike of the margin tax, research suggesting that it is hampering the Texas economy, calls for elimination of the margin tax, and recent legislation indicating the impending repeal of the franchise tax.

[6] *See* Scott Drenkard, *Special Report No. 226: The Texas Margin Tax: A Failed Experiment*, TAX FOUND. 1, 2 (Jan. 14, 2015), http://taxfoundation.org/sites/taxfoundation.org/files/docs/TaxFoundation_SR226.pdf (observing that "one element of the state's fiscal structure that has created serious controversy is the state's Margin Tax").

[7] *See* Section B, *infra*.

[8] *See* Section A, *infra*.

summarized below in Section IV, and it is still under attack. In addition, lower courts have issued a number of decisions that have impacted the application of the margin tax, some of which are examined later in Section V.

The margin tax saga appears to be nearing its finale. Section VI, below, looks at the effect the margin tax has had on the Texas economy, as well as at calls from many (including taxpayer groups, economists, academics, and lawmakers) to eliminate it. Last year, Governor Abbott signed into law House Bill 32, which states that "[i]t is the intent of the legislature to promote economic growth by repealing the franchise tax."[9] Interestingly, this bill was called the "Franchise Tax Repeal Act of 2015" in a prior version,[10] but its name was changed to the "Franchise Tax Reduction Action of 2015" in the enrolled version.[11]

II. DEBUT OF THE MARGIN TAX IN 2008

A. A Solution Based on Good Intentions

Although the Texas franchise tax has been in existence since 1893,[12] its current incarnation is the product of the legislature's response to the Texas Supreme Court's 2005 mandate for school finance reform.[13] While an examination of the history of the Texas franchise tax and its many transformations throughout the years is outside the scope of this article,[14] the portion of the tax's history that is relevant to this article is summarized as follows.

Briefly stated, the revised franchise tax was intended to provide a long-term and stable solution to a serious school finance problem.[15] Following a 2005 Texas Supreme Court case which declared the State's system for funding public schools to be in violation of the Texas Constitution, lawmakers were faced with the task of revamping the system within a short timeframe.[16] After working feverishly for several months to determine the best alternative for

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[9] Act of June 15, 2015, 84th Leg., R.S., ch. 449 §1(b). House Bill 32 also instructs the comptroller to "conduct a comprehensive study . . . to identify the effects of economic growth on future state revenues" and issue a report that identifies "revenue growth allocation options to promote efficiency and sustainability in meeting the revenue needs of this state . . . upon repeal of the franchise tax." *Id.* at §5.

[10] http://www.capitol.state.tx.us/tlodocs/84R/billtext/pdf/HB00032S.pdf#navpanes=0 (last visited October 31, 2016).

[11] Act of June 15, 2015, 84th Leg., ch. 449, §1(a).

[12] *In re* Nestle USA, Inc., 387 S.W.3d 610, 611–12 (Tex. 2012).

[13] *See In re* Allcat Claims Serv., L.P., 356 S.W.3d 455, 457–59 (Tex. 2011) (discussing the school funding case Neeley v. West Orange–Cove Consol. Indep. Sch. Dist., 176 S.W.3d 746, 753–54 (Tex. 2005) and the events that followed).

[14] For in-depth coverage of the history of the margin tax, see Alyson Outenreath, *Call to the Texas Legislature: The Franchise Tax Needs Substantive Changes, Not Just Rate Reductions*, 47 ST. MARY'S L.J. 351, 353–54, 355–61 (2015); Josh Haney & Bruce Wright, *Fiscal Notes: The History of the Texas Franchise Tax*, TEX. COMPTROLLER OF PUB. ACCOUNTS, 1, 1–6 (May 2015), https://www.comptroller.texas.gov/economy/fiscal-notes/2015/may/fn.pdf; Byron F. Egan, Choice of Entity Decision Tree, Presentation at the State Bar of Texas 13th Annual Advanced Business Law Course, 3, 413–15 (Nov. 2015); Jimmy Martens & Amanda Traphagan, *Margin of Error: Fixing the Texas Franchise Tax After* Allcat, 30 J. ST. TAX'N 37, 37 (2012); Cynthia M. Ohlenforst, *The New Texas Margin Tax: More Than a Marginal Change to Texas Taxation*, 60 TAX LAW 959, 959–62 (2007).

[15] *See In re Allcat*, 356 S.W.3d at 458.

[16] *See id.* at 457–59; *see also* Haney & Wright, *supra* note 14, at 4; Outenreath, *supra* note 14, at 353–54.

financing public education within the time limit set by the courts, the 79th Legislature enacted the amendments to the Texas Tax Code that overhauled the structure of the Texas franchise tax into the version that took effect on January 1, 2008, and still exists today.[17]

B. The Not-So-Basic "Basics" of the Margin Tax Calculation

To understand taxpayers' reaction to the margin tax and the various legal attacks against the tax discussed later in this article, it is helpful to be somewhat familiar with the basics of the margin tax calculation.[18] Prior to 2008, the "old" Texas franchise tax applied only to corporations and limited liability companies—partnerships and other noncorporate entities such as professional associations were not subject to the tax.[19] In contrast, the margin tax, which took effect on January 1, 2008, is imposed on partnerships and other unincorporated entities in addition to corporations and limited liability companies.[20] Under the "old" franchise tax, an entity's franchise tax liability was calculated based on either capital or earned surplus.[21] Beginning in 2008, an entity's liability is calculated as a percentage of its "taxable margin."[22]

Determining an entity's margin tax liability can be an extremely complex task.[23] However, a simple outline of how the margin tax is calculated follows. Generally speaking, the first component of the margin tax calculation is an entity's "total revenue."[24] Once an entity's "total revenue" is determined (which is not as clear-cut as the label indicates!), one of three deductions may be subtracted from "total revenue" to arrive at the second component of the margin tax calculation: the entity's "margin."[25] Some entities can calculate "margin" by subtracting "cost of goods sold" from "total revenue."[26] Entities that are allowed the cost-of-goods-sold deduction are usually (but not always) businesses that sell or manufacture products (in contrast to providing services).[27] Some entities can calculate "margin" by subtracting "compensation" from "total revenue."[28] Businesses that choose the compensation deduction

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[17] *See id.*

[18] Some basic margin tax concepts are discussed in this subsection to assist readers who may be unfamiliar with the tax. This section in no way provides comprehensive coverage of all of the components of the margin tax, and it omits a myriad of factors and exceptions that may apply when calculating margin tax.

[19] *See* HAMILTON ET AL., *supra* note 2.

[20] TEX. TAX CODE ANN. § 171.0002(a) (West 2015); *see* HAMILTON ET AL., *supra* note 2; Ohlenforst, *supra* note 2, at 1319 ("A significant change to the tax is its application for the first time to partnerships."). The revised franchise tax applies to nearly all types of partnerships and unincorporated associations, except for sole proprietorships and general partnerships "the direct ownership of which is entirely composed of natural persons" and "the liability of which is not limited under a statute of this state or another state." TAX § 171.0002(b).

[21] Eric L. Stein, *Texas Revised Franchise Tax*, 2400-2d Tax Mgmt. Multistate Tax Portfolios 2400.02.A.1 (2009) ("The revised franchise tax is calculated based on a taxable entity's 'taxable margin,' instead of the former tax base of taxable capital and taxable earned surplus.").

[22] *Id.*; *see* TAX § 171.002; *see* TAX § 171.101.

[23] *See* Drenkard, *supra* note 6, at 4 (full-page diagram of the margin tax liability calculation).

[24] *See* TAX §§ 171.101(a)(1)(B), 171.1011(c).

[25] *See id.* § 171.101(a)(1). Alternatively, an entity with total revenue of $20 million or less may choose the "E-Z Computation" set forth in § 171.1016. *See* notes 31–33, *infra*.

[26] *See* TAX §§ 171.101(a)(1)(B)(ii)(a)(1), 171.1012.

[27] *See id.* § 171.1012; *see also* Section C. *infra*, discussing cases pertaining to the cost-of-goods-sold deduction.

[28] *See* TAX §§ 171.101(a)(1)(B)(ii)(a)(2), 171.1013.

are typically service providers.[29] Alternatively, rather than computing the statutorily-defined cost-of-goods-sold or compensation deductions to calculate "margin," an entity can simply deduct a flat 30 percent from its "total revenue."[30]

After determining an entity's "margin," an apportionment factor is applied to the "margin" to reach the third component of the margin tax calculation: the entity's "taxable margin."[31] Finally, once an entity's "taxable margin" is calculated, one of two tax rates is applied to the entity's "taxable margin" to arrive at the entity's margin tax liability.[32] The tax rate in effect for 2016 is 0.375 percent for retailers and wholesalers and 0.75 percent for all other businesses.[33]

As may be evident from the preceding outline of the "basic" margin tax calculation, what began as the Texas legislature's idea for a way out of the 2005 school finance dilemma quickly morphed into a major headache for taxpayers and the comptroller alike.[34]

III. THE REVIEWS ARE IN

A. Reaction to the Margin Tax

The drastic changes to the franchise tax discussed above came as a surprise to many Texans.[35] The margin tax was collected for the first time in May 2008, and "[a]t that point, many taxpayers awoke to its implications for the first time."[36] The margin tax has had a significant effect on thousands of individuals who conduct business via partnerships and unincorporated associations.[37] Professionals and small-business owners who had operated for years as partnerships or professional associations were suddenly faced with Texas tax bills in

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[29] *See id.* § 171.1012(a)(3)(B)(ii) (excluding services from the definition of "goods" for purposes of the cost-of-goods-sold deduction).

[30] *See id.* § 171.101(a)(1)(A)(i) (defining an entity's margin as "70 percent of the taxable entity's total revenue," which is mathematically the same as deducting 30 percent of total revenue).

[31] *Id.* § 171.101(a)(2)–(3). To keep this outline of the margin tax calculation simple, it will not include the "other allowable deductions" referenced in subsection (a)(3). *Id.* at (a)(3). For an entity that has chosen the "E-Z Computation," the apportionment factor is applied directly to the entity's total revenue. *See id.* § 171.1016(b)(2).

[32] *Id.* § 171.002(a)–(b). For an entity that has chosen the "E-Z Computation," the statutory rate is applied directly to the entity's total revenue that is apportioned to the state of Texas. *See id.* § 171.1016(b).

[33] *Id.* § 171.002(a)–(b). For taxpayers choosing the "EZ Computation," the rate is .331 percent. *Id.* § 171.1016(b).

[34] *See* Haney & Wright, *supra* note 14, at 1, 5. "[G]iven the sweeping nature of the changes to the franchise tax, virtually every facet of the new system soon faced administrative and legal challenges." *Id.*

[35] Letter from Carole Keeton Strayhorn, Tex. Comptroller of Pub. Accounts, to Rick Perry, Tex. Governor (May 2, 2006) (on file with author) (writing that the revised franchise tax legislation will "require 200,000 Texas businesses that currently do not pay taxes to either file or pay taxes," and that "[m]ost of that astounding number of Texans will not realize they are in this group of new taxpayers until they are told before the tax is due in May of 2008").

[36] Billy Hamilton, *Déjà Vu All Over Again—Texas Considers Property and Business Tax Reform*, 51 ST. TAX NOTES 523 (2009). Billy Hamilton was the deputy comptroller at the Texas Office of the Comptroller of Public Accounts from 1990 until 2006. *Id.*

[37] *Id.* (noting that the new tax, as applied to partnerships and other non-corporate business entities, "made literally thousands of businesses statewide into new taxpayers, and generally they were a disgruntled lot").

2008 for the first time in the history of the State.[38] In addition to the cold reception from businesses that had not previously been subject to the Texas franchise tax, the new margin tax quickly drew criticism from taxpayers and experts across the board.[39] One reason for the criticism of the new margin tax is that Texas is known for being "tax-friendly toward businesses," and Texans are generally not receptive toward new taxes.[40] It has been noted that "[i]n a state that views all taxes with disdain, few levies have drawn more scorn than the Texas [margin] tax."[41]

Aside from Texans' general anti-tax attitude, the margin tax has been severely criticized for being complex in its structure and unfair in its application.[42] The calculation of the tax has been described as being "overly burdensome,"[43] with its "unique structure . . . [being] . . . a problem for taxpayers, legislators, and judges."[44] "The costly, complex nature of the margin tax makes it highly unpopular."[45] Commentators have referred to the "contortions" required to calculate the margin tax[46] and observed that taxpayers "often [devote] more time and resources in determining [the margin] tax bill than what is required to pay the tax itself."[47] One recent report found the margin tax to be inferior to business tax structures found in most other states.[48] Along with criticism of the complicated structure of the margin tax, objections to the margin tax have run the gamut from complaints that it is unfair[49] to allegations that it is

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[38] *See supra* notes 35–37 and accompanying text.

[39] *See* Drenkard, *supra* note 6, at 2 (noting that the margin tax "has attracted criticism from experts in the field, attracted lawsuits from businesses that must comply with it, and attracted legislative changes as political pressure around the tax continues to mount").

[40] Outenreath, *supra* note 14, at 352–53; *see* Haney & Wright, *supra* note 14, at 1 (describing the margin tax as "controversial . . . given the Legislature's consistent focus on maintaining Texas' business-friendly reputation").

[41] Loren Steffy, *Margin of Error*, TEX. MONTHLY (May 2015), http://www.texasmonthly.com/politics/margin-of-error/.

[42] *See* Drenkard, *supra* note 6, at 14 (calling the margin tax "one of the worst business taxes in the country").

[43] Scott Drenkard, *Businesses Love Texas, Except this One Tax that Holds the State Back*, TAX FOUND. (Jan. 8, 2016), http://taxfoundation.org/blog/businesses-love-texas-except-one-tax-holds-state-back; *see also Final Report of the TCCRI State Taxation Task Force*, TEX. CONSERVATIVE COAL. RES. INST., 1, 9 (2013), http://www.txccri.org/wp-content/uploads/2013/01/Franchise-Tax-Report.pdf (describing the margin tax as being "unnecessarily burdensome").

[44] Drenkard, *supra* note 6, at 2.

[45] Vance Ginn, Ph.D. and The Honorable Talmadge Heflin, *Economic Effects of Eliminating Texas' Business Margin Tax*, TEX. PUB. POLICY FOUND., at 4 (Mar. 2015), http://www.texaspolicy.com/library/doclib/MarginTax-CFP.pdf.

[46] Drenkard, *supra* note 43.

[47] Ginn & Heflin, *supra* note 45, at 5.

[48] The Tax Foundation's 2016 State Business Tax Climate Index assigned a rank of 41 to the Texas margin tax, with a rank of 1 being the best and a rank 50 being the worst. *See* Jared Walczak, et al., *2016 State Business Tax Climate Index*, TAX FOUND.; *but see* Maria Garnett, *Fiscal Notes: Starting a New Business*, TEX. COMPTROLLER OF PUB. ACCOUNTS, 1, 3 (Feb. 2016), http://comptroller.texas.gov/fiscalnotes/feb2016/starting.php (discussing a number of other reports giving more favorable reviews of Texas' tax climate); *see also* Raymond J. Keating, *Small Business Tax Index 2015: Best to Worst State Tax Systems for Entrepreneurship and Small Business*, SMALL BUSINESS & ENTREPRENEURSHIP COUNCIL, 3, 4 (Apr. 2015), http://www.sbecouncil.org/wp-content/uploads/2015/04/BTI2015SBECouncil.pdf (assigning Texas a rank of 3 (with a rank of 1 being the best and 50 being the worst) on its 2015 Small Business Tax Index).

[49] *See generally* Joseph Henchman, *Texas Margin Tax Experiment Failing Due to Collection Shortfalls, Perceived Unfairness for Taxing Unprofitable and Small Businesses, and Confusing Rules*, TAX FOUND. 1, 2 (Aug. 17, 2011), http://taxfoundation.org/sites/taxfoundation.org/files/docs/ff279.pdf.

unconstitutional.[50] Unfortunately, the more than 400 bills that have been authored relating to the margin tax since its inception have done little to remedy its shortcomings to the satisfaction of most critics.[51]

B. Dismal Financial Performance

Regrettably for the state's coffers, the position held by opponents of the margin tax has been bolstered by its poor financial performance.[52] Since its inception, the margin tax has "performed considerably below the state's expectations."[53] It has been deemed a "failure"[54] and called the "most counterproductive part of the [Texas] tax code."[55] According to some researchers, the "margin tax is a poor and inefficient mechanism for generating state revenues, placing a tremendous burden on entrepreneurs and small businesses that affects all Texans."[56]

Ultimately, rather than solving the state's school finance crisis as Texas lawmakers had envisioned, the margin tax has frustrated taxpayers across the country, attracted endless criticism, and disappointed stakeholders across the board.[57]

IV. CONSTITUTIONAL CHALLENGES IN THE TEXAS SUPREME COURT

The margin tax has weathered several state and federal constitutional challenges asserted in two Texas Supreme Court cases.[58]

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[50] *See infra* Section IV.

[51] *See* the Bill Search feature of Texas Legislature Online, http://www.capitol.state.tx.us/Search/BillSearch.aspx (last visited Nov. 7, 2016).

[52] *See Final Report of the TCCRI*, *supra* note 43, at 14–15; Michael J. Chow, *Phasing Out the Texas Business Franchise Tax: The Impact on Private Sector Employment*, NFIB RES. FOUND. (Mar. 8, 2013), https://s3.amazonaws.com/NFIB/AMS%20Content/Attachments/2/1-67446-PIPLUS_TX_FRANCHISE_TAX.pdf.

[53] Haney & Wright, *supra*, note 14, at 5.

[54] Sarah Tober, *Franchise Tax Still a Thorn in Small Business Side in Texas*, NAT'L FED'N OF INDEP. BUSINESS (Mar. 30, 2016), http://www.nfib.com/content/news/tax-help/franchise-tax-still-a-thorn-in-small-business-side-in-texas-73486/ (quoting NFIB Executive Director Will Newton); Ginn & Heflin, *supra* note 45, at 4.

[55] Ryan H. Murphy, *Policy Report No. 357: Benefits to the Poor of Texas Franchise Tax Repeal,* NAT'L CTR. FOR POLICY ANALYSIS, 1, 3 (June 2014), http://www.ncpa.org/pdfs/st357.pdf.

[56] *See* Ginn & Heflin, *supra* note 45.

[57] *See* Steffy, *supra* note 41 (writing that "many lawmakers criticize it for generating less revenue than it was supposed to.").

[58] The constitutional challenges in the cases discussed in Section IV were taken directly to the Texas Supreme Court under the special provision included in the legislation revising the Texas Franchise Tax Act, which gives the supreme court exclusive and original jurisdiction over a challenge to the constitutionality of the margin tax. *See* Act of May 2, 2006, 79th Leg., 3d C.S., ch. 1, §24(a), 2006 Tex. Gen. Laws 1, 40 ("The supreme court has exclusive and original jurisdiction over a challenge to the constitutionality of this Act or any part of this Act and may issue injunctive or declaratory relief in connection with the challenge.").

A. *Allcat*

1. Unconstitutional Tax on Natural Person's Share of Partnership Income?

The first constitutional challenge was brought to the Texas Supreme Court in July of 2011 by a limited partnership and its partner in *In re Allcat Claims Serv., L.P.*[59] In *Allcat*, a limited partnership became subject to the margin tax under the new law that went into effect in 2008.[60] Some of the partners were natural persons.[61] The petitioners in *Allcat* claimed that the imposition of the margin tax on the portion of the partnership's margin that represented its natural-person partners' shares of partnership income violated the Texas Constitution.[62]

The petitioners' claim was based on Article VIII, Section 24 of the Texas Constitution, which states the following:

> 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 voting in a statewide referendum held on the question of imposing the tax.[63]

The petitioners in *Allcat* asserted that the margin tax is unconstitutional because it taxes a natural person's share of partnership income but Texas voters did not approve the tax.[64] In support of its assertion that the margin tax imposes a tax on a natural person's share of partnership income in violation of the Texas Constitution, the petitioners advanced a two-pronged argument.[65] The first prong of the petitioners' argument was that the margin tax constitutes an "income tax" because the margin tax calculation accords with the common dictionary definition of income tax, the definition of income tax found in the Texas Tax Code, and the concept of income tax as defined in case law.[66] The second prong of the petitioners' argument was that the margin tax constitutes a tax on a natural person's share of partnership income because it indirectly imposes a tax on the share of partnership income that is allocated to a partnership's natural-person partners.[67] In presenting these arguments to the Court, the petitioners faced the difficult (if not impossible!) task of reconciling accounting concepts with legal principles.

The Court declined to address the first prong and decide whether the margin tax is an

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[59] *See generally* 356 S.W.3d 455, 457 (Tex. 2011).

[60] *Id.* at 459.

[61] Original Petition at 3, *In re Allcat*, 356 S.W.3d 455 (No. 11-0589).

[62] *In re Allcat*, 356 S.W.3d at 459. The petitioners in *Allcat* also brought a claim based on the equal and uniform taxation clause of the Texas Constitution, which was rejected for lack of jurisdiction. *See id.* At 470–71.

[63] TEX. CONST. art. VIII, § 24(a).

[64] Original Petition, *supra* note 61, at 5.

[65] *See id.* at 6–12. *See also* Brief of Amici Curiae Nikki Laing, CPA et al. in Support of Plaintiffs at 16–33, *In re Allcat,* 356 S.W. 3d 455 (No. 11-0589).

[66] Original Petition, *supra* note 61, at 6–9.

[67] *Id.* at 9–12.

income tax.[68] As for the second prong, the Court analyzed the issue in the context of the aggregate versus entity theories of partnership law.[69] The Court noted that "under Texas law the entity theory applies to partnership income and profits. Individual partners do not own any of either while they remain in the partnership's hands and have not been distributed to the partners."[70] The Court further reasoned that, "while a partner's interest in the partnership represents the right to receive the partner's share of partnership profits when they are distributed, it does not follow that for purposes of the Texas franchise tax such right constitutes a partner's 'share' of any partnership income or profits while the partnership retains the income and profits without having distributed any of them to the partner."[71] Based on this reasoning, the Court found that the margin tax constitutes a tax imposed on a partnership as an entity and not on its partners.[72] Because the Court found that the margin tax was not imposed on the natural partners in *Allcat,* the Court held that the margin tax does not violate the Texas Constitution's prohibition (absent voter approval) of a net-income tax on a natural person's share of partnership income.[73]

2. Income Tax?

The *Allcat* case did not answer the question of whether the margin tax constitutes an income tax.[74] The Texas Constitution prohibits, absent voter approval, a "tax on the net incomes of natural persons, including a person's share of partnership and unincorporated association income."[75] Upon the introduction of the margin tax, many tax experts classified it as an income tax.[76] As one commentator stated, "[a]lthough the State of Texas vigorously

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[68] *In re Allcat*, 356 S.W.3d at 463, 469 n.10.

[69] *See id.* at 463–70.

[70] *Id.* at 468.

[71] *Id.* at 468–69.

[72] *Id.* at 470. The Court based its decision on legal concepts such as property ownership and entity versus aggregate theories of partnership law. However, in the author's view, accounting concepts should have been considered, as well. In the author's opinion, "income" can be thought of as purely an accounting concept separate from concepts of property law and claims of ownership—an intangible figure that results from subtracting certain deductions (which may consist of actual cash outlays or artificially-timed expenses such as depreciation or amortization) from revenues (which may consist of actual cash receipts or artificially-timed income recognition) and is used for purposes of calculating items such as taxes and allocations. The term "income" is an intangible number that is used for accounting purposes. "Income" is not equivalent to tangible cash or property that is actually possessed by a partnership or distributed by a partnership to a partner. Therefore, property-law or entity-theory concepts are not necessarily relevant in the analysis of an issue involving a tax on "income."

[73] *Id.* at 457, 470.

[74] *See supra* notes 66, 68 and accompanying text.

[75] TEX. CONST. art. VIII, § 24(a). "'Natural person' means a human being or the estate of a human being. The term does not include a purely legal entity given recognition as the possessor of rights, privileges, or responsibilities, such as a corporation, limited liability company, partnership, or trust." TEX. TAX CODE ANN. § 171.0001(11-a) (West 2015).

[76] *See* Lipstet, *supra* note 2, at 3 n.7 (noting that "the Financial Accounting Standards Board (FASB) has apparently concluded that the margin tax is, for purposes of FASB Statement No. 109 (Accounting for Income Taxes) and financial accounting reporting purposes, an income tax."); Stein, *supra* note 21, at 2400.04 (writing that "[t]he revised franchise tax has the characteristics of an income tax since it is determined by applying a tax rate to a base which takes into account both revenues and expenses, namely cost of goods sold or compensation."); L. A. Lorek, *Business Tax in Eye of the Beholder*, SAN ANTONIO EXPRESS-NEWS, Apr. 5, 2006 (quoting Richard Joseph, Ph.D., JD, and director of the University of Texas professional accounting program, as saying, "With all the deductions the

defends its position that the margin tax is not an income tax, for all practical purposes, the margin tax is, in effect, a veiled income tax."[77]

To understand why the margin tax is considered by some to be a veiled income tax, a condensed explanation of its calculation is necessary. As mentioned previously in Section B, to determine Texas margin tax liability, a taxable entity begins by determining its total revenue.[78] The Texas Tax Code instructs that a taxable entity's total revenue for margin tax purposes is determined by using numbers reported on the entity's federal income tax return.[79] Therefore, an entity's Texas margin tax is calculated using figures taken directly from the entity's federal income tax return.[80] Once a taxable entity determines its total revenue (using figures directly from its federal income tax return), the entity then subtracts certain expenses that it reported on its federal income tax return[81] and other statutorily-defined deductions and exemptions to arrive at its "taxable margin."[82] After an entity has computed its taxable margin, it multiplies its taxable margin by the applicable tax rate in order to calculate the amount of margin tax it owes to the State of Texas.[83]

Compare how the taxable margin is calculated with how net income is calculated, considering that net income is defined as "[t]otal income from all sources minus deductions,

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proposed tax bill allows businesses to take, the new franchise tax begins to look more like an income tax . . . ."); Brad J. Brookner & Russell D. Brown, *Sweeping Texas Franchise Tax Changes: The Margin Tax*, TAX ADVISER, 550–51 (Sept. 2006) (stating that "[w]hile H.B. 3 states that the modified tax is 'not an income tax,' the current view of the authors' firm [(Deloitte Tax LLP)] is that the margin tax is a tax on income . . . ."); Andrew Essington, *Texas Margin Tax: The Impact on Investment Real Estate*, http://www.ainorthtexas.org/store/Essington.pdf (last visited Nov. 7, 2016) (stating that the "[m]argin tax is effectively a state income tax to the ownership entity.").

[77] Jeff Slade, *Drilling Down the Texas Margin Tax: A Gusher or Dry Hole of Taxes for the Oil & Gas Industry?*, 36 TEX. TAX LAW 28, 28 (2008). *See also* Cynthia M. Ohlenforst et al., *Taxation*, 59 SMU L. REV. 1565, 1577 (2006) (observing that the margin tax "was designed to . . . avoid being categorized as a net income tax" and that "[a]lthough there was significant support for the plan in some quarters, others attacked the plan . . . [by] . . . claiming that the tax on gross receipts net of deductions constituted a net income tax of individual partners in limited partnerships, thereby running afoul of the Texas constitutional prohibition on a net income tax on individuals.").

[78] *See* TAX §§ 171.101(a)(1)(B), 171.1011(c).

[79] *Id.* § 171.1011(c)(1) ("[F]or the purpose of computing its taxable margin . . . the total revenue of . . . a taxable entity treated for federal income tax purposes as a corporation [is] an amount computed by [adding]: (i) the amount reportable as income on line 1c, Internal Revenue Service Form 1120; (ii) the amounts reportable as income on lines 4 through 10, Internal Revenue Service Form 1120 . . . ."); *see also id.* § 171.1011(c)(2) ("[F]or a taxable entity treated for federal income tax purposes as a partnership, an amount computed by [adding]: (i) the amount reportable as income on line 1c, Internal Revenue Service Form 1065; (ii) the amounts reportable as income on lines 4, 6, and 7, Internal Revenue Service Form 1065; (iii) the amounts reportable as income on lines 3a and 5 through 11, Internal Revenue Service Form 1065, Schedule K; (iv) the amounts reportable as income on line 17, Internal Revenue Service Form 8825; (v) the amounts reportable as income on line 11, plus line 2 or line 45, Internal Revenue Service Form 1040, Schedule F . . . .").

[80] *Id.* § 171.1011(c)(1)–(2).

[81] *See id.* §§ 171.101(a), 171.1011(c).

[82] *Id.* §§ 171.1012–.1013. As discussed *supra* in note 31 and accompanying text (but not relevant to the analysis of whether the margin tax constitutes an income tax) an apportionment factor is applied to the margin of entity doing business in multiple states. *See id.* § 171.101(a)(2)–(3).

[83] *Id.* § 171.002(a)–(b). For an entity that has chosen the "E-Z Computation," the statutory rate is applied directly to the entity's total revenue that is apportioned to the state of Texas. *See id.* § 171.1016(b).

exemptions, and other tax reductions."[84] In addition, compare the calculation of the margin tax to the Texas Tax Code's definition of income tax: "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 expenses are not specifically and directly related to particular transactions.[85]

As an illustration, assume a Texas service provider (law firm, accounting firm, doctor's office, janitorial service, etc.) has total revenues of $3 million and payroll expenses of $2 million. Following is a simplified example of how the entity's margin tax would be calculated on its 2016 franchise tax report:[86]

Total Revenue as Reported to IRS	$3,000,000
Less: Deductible Payroll Expenses	-2,000,000
Taxable Margin	**1,000,000**
Multiplied by tax rate	.075 %
Franchise Tax	**7,500**

Now, here is a simplified example of how the entity's income tax would be calculated for both federal income tax and financial-reporting purposes:[87]

Total Revenue as Reported to IRS	$3,000,000

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[84] BLACK'S LAW DICTIONARY (10th ed. 2014). The author would point out that nothing in the dictionary definition of net income requires that all possible deductions be subtracted from total income in order to arrive at net income

[85] *See* TAX § 141.001. This is the only definition of income tax found in the Texas Tax Code. Although this definition is not included in the Franchise Tax chapter of the Tax Code, it is found in the Multistate Tax Compact chapter, the purposes of which are to "[f]acilitate proper determination of state and local tax liability of multistate taxpayers," "[p]romote uniformity or compatibility in significant components of tax systems," and "[f]acilitate taxpayer convenience and compliance in the filing of tax returns and in other phases of tax administration." *Id.* Note that the term income tax has been defined in this manner in the Tax Code since 1982, and "[w]ords and phrases that have acquired a technical or particular meaning, whether by legislative definition or otherwise, shall be construed accordingly." TEX. GOV'T CODE ANN. § 311.011(b) (West 2015). Contrast the Tax Code's definition of income tax to its definition of gross receipts tax: "'Gross receipts tax' means a tax . . . which is imposed on or measured by the gross volume of business, in terms of gross receipts or in other terms, and in the determination of which no deduction is allowed which would constitute the tax an income tax." TAX § 141.001. As with the dictionary definition of "net income," the author would point out that nothing in the Texas Tax Code's definition of income tax requires every expense incurred by an entity to be deducted from gross income in order for a tax to constitute an income tax.

[86] Note that this is an extremely simplified illustration showing the tax liability of a service provider taxed at .75 percent (in contrast to a retailer or wholesaler, who would be taxed at 0.375 percent), as computed by the franchise tax calculator available at the Texas Comptroller's website. *See Franchise Tax Calculation*, TEX. COMPTROLLER, https://www.comptroller.texas.gov/forms/hb3calc.pdf (last visited October 19, 2016). The scope of this Article does not allow for a detailed explanation of all aspects of the margin tax calculations, such as the optional "E-Z Computation." *See* TAX § 171.1016. Readers should consult additional sources for guidance on specific calculations, such as Chapter 171 of the Texas Tax Code, the Texas Comptroller of Public Accounts website, Franchise Tax, https://www.comptroller.texas.gov/taxes/franchise/ (last visited Oct. 19, 2016), and the sources cited in this Article.

[87] *See* IRS Form 1120 (2015), INTERNAL REVENUE SERVICE, https://www.irs.gov/pub/irs-pdf/f1120.pdf; *see also* IRS Form 1040 (2015), INTERNAL REVENUE SERVICE, https://www.irs.gov/pub/irs-pdf/f1040.pdf and IRS Form 1040, Schedule C (2015), INTERNAL REVENUE SERVICE, https://www.irs.gov/pub/irs-pdf/f1040sc.pdf (all last visited Nov. 7, 2016).

Less: Deductible Payroll Expenses	2,000,000
Taxable Income	**1,000,000**
Multiplied by tax rate	.15 %
Federal Income Tax	**150,000**

Is there a meaningful difference between the two calculations for purposes of classifying the type of tax imposed on the service provider? The Financial Accounting Standards Board (FASB), the board that sets national accounting standards, did not see a difference.[88] Shortly after the new franchise tax regime was signed into law, upon inquiries from constituents, national accounting firms, and other interested parties, FASB staff "concluded that the Texas Franchise Tax is an income tax because the tax is based on a measure of income."[89] Furthermore, the FASB's Technical Application and Implementation Activities Committee (TA&I Committee) determined that "the Texas Franchise Tax [is] an income tax that should be accounted for under Statement 109 and that there [will] not be diversity in the conclusions reached by preparers, auditors, and regulators on whether the Texas Franchise Tax [is] an income tax."[90]

Perhaps realizing the similarities between margin tax and income tax calculations, the Texas legislature apparently attempted to dispel any constitutional misgivings up front by stating in the original margin tax legislation that it "is not an income tax."[91] However, merely labeling the tax as a margin tax instead of an income tax does not make it so.[92] Experts have recognized that the structure of the margin tax fits the definition of an income tax, calling it "a hybrid of a gross receipts tax and an income tax"[93] and "a badly designed business profits tax."[94] Experts have also noted that the margin tax "is imposed on firms' profits" and "has

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[88] *See* Lipstet, *supra* note 2, at 3 n.7 ("[T]he Financial Accounting Standards Board (FASB) has apparently concluded that the margin tax is, for purposes of FASB Statement No. 109 (Accounting for Income Taxes) and financial accounting reporting purposes, an income tax.").

[89] Minutes of the August 2, 2006 Board Meeting on Potential FSP: Texas Franchise Tax, Financial Accounting Standards Board, http://www.fasb.org/jsp/FASB/Page/08-02-06_texas_franchise_tax.pdf.

[90] *Id.* Because the TA&I Committee did not anticipate disparity in the treatment of the margin tax as an income tax for financial-reporting purposes, at a meeting in 2006, the FASB declined to pursue a project to provide formal guidance to taxpayers regarding the proper treatment of the Texas Revised Franchise Tax. *See id.*; *see also* Byron F. Egan, *Choice of Entity Decision Tree After Margin Tax and Texas Business Organizations Code*, 42 TEX. J. BUS. L. 71, 106 (2008).

[91] *See* Act of May 2, 2006, 79th Leg., 3d C.S., ch. 1, §21, 2006 Tex. Gen. Laws 1, 38 (H.B. 3, which implemented the current margin tax structure, states: "The franchise tax imposed by Chapter 171, Tax Code, as amended by this Act, is not an income tax . . . .").

[92] *See* John Gamino, *So-called 'Margin Tax' Violates Truth in Labeling*, HOUS. BUS. J., Jan. 22, 2007, http://houston.bizjournals.com/houston/stories/2007/01/22/editorial4.html; *see also* Bishop v. District of Columbia, 401 A.2d. 955, 958 (D.C. 1979) ("As to the characterization of a tax, it is fundamental that the nature and effect of a tax, not its label, determine if it is an income tax or not."); *see also* Ohlenforst, *supra* note 14, at 977 ("Legislators worked diligently to draft a tax that will not, they hope, be an income tax for purposes of the . . . Texas constitutional amendment that prohibits the imposition of an income tax on the net income of natural persons unless the tax is approved in a statewide referendum. . . . It appears clear, however, that for generally accepted accounting purposes, the margin tax will be considered an income tax that should be accounted for under FASB Statement No. 109, Accounting for Income Taxes." (footnotes omitted)).

[93] Drenkard, *supra* note 6, at 7 n.17.

[94] John L. Mikesell, *Gross Receipts Taxes in State Government Finances: A Review of Their History and Performance* 4 (Tax Foundation Council On State Taxation, Background Paper No. 53, 2007),

taken on the features of a distortionary income tax on business."[95] Although the Texas Supreme Court managed to skirt the income tax question in *Allcat*,[96] the issue has again reared its head in the recent case *Graphic Packaging Corp. v. Hegar*, discussed later in Section V.B. Business owners, advisors, and academics across the country are watching the *Graphic* case intently to see how the Texas Supreme Court will answer this question.

3. Constitutional When Imposed on Single-Owner Unincorporated Associations?

In addition to leaving the income tax question open, the *Allcat* case did not address the constitutionality of the margin tax as applied to a professional association (PA) or limited liability company (LLC) that has a natural person as its sole owner and is disregarded for federal income tax purposes.[97] LLCs and PAs both fall under the "unincorporated association" umbrella of art. VII, § 24(a) of the Texas Constitution.[98] Therefore, the prohibition against a "tax on the net incomes of natural persons, including a person's share of . . . unincorporated association income" is applicable in the context of LLCs and PAs.[99] If the margin tax meets the definition of an income tax,[100] query how the margin tax, when imposed on a single-member LLC owned by a natural person and taxed as a disregarded entity for federal income tax purposes, is not prohibited absolutely by the constitution as an income tax on a natural person's income.[101]

Although Texas does not have a personal income tax that is labeled as such by the legislature, it can be argued that the margin tax operates as a personal income tax when imposed on a flow-through entity owned entirely by one person.[102] This concept is reflected in

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http://taxfoundation.org/sites/taxfoundation.org/files/docs/bp53.pdf. Professor Mikesell points out that the Texas margin tax is not included in his paper on gross receipts tax because it is more characteristic of a business profits tax than a gross receipts tax. *Id.*

95 *Tax Reform in Texas: Lowering Business Costs, Expanding the Economy*, THE BEACON HILL INSTITUTE 3–4 (Nov. 2012), http://www.beaconhill.org/BHIStudies/TexasFranchise/TXFranchiseTaxReportFinal2.pdf.

96 *See supra* notes 66, 68 and accompanying text.

97 *See* HAMILTON ET AL., *supra* note 2, at § 4.4 ("[T]he treatment of . . . LLCs under the Texas franchise tax differs sharply from their treatment under the Internal Revenue Code. The federal 'check -the -box' regulation authorizes . . . LLCs with two or more members to elect to be taxed either as partnerships under subchapter K or as C or S corporations. Thus, . . . limited liability companies . . . are treated quite differently [under the Internal Revenue Code and] under the Texas franchise tax. The very popular single member LLC . . . is [taxed] as a 'nothing' [under Federal law] but is [fully] subject to the Texas franchise tax." (footnote omitted)). *Accord* Ohlenforst et al., *supra* note 2, at 1321 ("Significantly, limited liability companies that are disregarded and treated as sole proprietorships for federal income tax purposes are not treated as exempt sole proprietorships for margin tax purposes.").

98 *See* TEX. BUS. ORGS. CODE ANN. §§ 1.002(14), (46) & 301.003(2) (West 2015).

99 TEX. CONST. art. VIII, § 24(a).

100 *See supra* notes 76–97 and accompanying text.

101 When an entity owned by a natural person is taxed as a disregarded entity for federal income tax purposes, all of the entity's income is attributable to the entity's owner and reported on the owner's personal federal income tax return. *See* Treas. Reg. §§ 301.7701-1(a)(1), -2(a)–(c), -3(a)–(c). Since the entity's income is entirely attributable to and reportable by the entity's owner, it can be argued that a tax imposed by a state on the income of the entity operates in exactly the same manner as a tax imposed on the income of the owner.

102 The term "flow-through" entity (also sometimes referred to as a "pass-through" entity) describes the tax treatment of an entity whereby income from the entity flows through to the owner(s) and tax on the entity's income is imposed directly on its owner(s). Generally speaking, in the case of a flow-through entity, the entity's income is not

a recent report ranking the business tax climate of the fifty states.[103] In the report, states that do not have an individual income tax were typically assigned a perfect score in the "Individual Income Tax" category.[104] Since Texas does not have an individual income tax, one would expect Texas to receive a perfect score in the Individual Income Tax category.[105] However, in contrast to other states that do not have an individual income tax, Texas did not receive a perfect score in the Individual Income Tax category.[106] One of the report's authors explained that the reason for this is structure of the margin tax and the fact that it is imposed on flow-through entities.[107] Texas received a lower score than other states that do not have an individual income tax because of the individual-income-tax nature of the margin tax when it is imposed on flow-through entities owned by natural persons.[108]

B. *Nestlé*

A few months after the *Allcat* petition was filed, another constitutional challenge was brought to the Texas Supreme Court by Nestlé USA, Inc., Switchplace, LLC, and NSMBA, LP.[109] Due to some procedural hiccups leading up to the filing of the case, the case was dismissed for want of jurisdiction.[110] After following correct procedural steps,[111] Nestlé USA, Inc. (Nestlé) re-filed its case with the Texas Supreme Court.[112]

Nestlé is a Delaware Corporation that, along with thirty-two affiliates, manufactures and distributes food and beverages in the United States.[113] Nestlé and its thirty-two affiliates are required to report as a combined group for purposes of the margin tax.[114] Generally speaking, an entity subject to the margin tax can choose to deduct either cost of goods sold or compensation from its total revenue.[115] As a combined group, Nestlé and its affiliates were all required to choose the same method for the entire group—either the cost of goods sold deduction or the compensation deduction—even if it resulted in no deduction being allowed

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recognized at the entity level. Instead, it is recognized by the entity's owner(s). *See* I.R.C. § 1366.

103 *See* Walczak, et al., *supra* note 48, at 29.

104 *See id.* (explaining that "[s]tates that do not impose an individual income tax generally receive a perfect score" in the Individual Income Tax Component of the report).

105 *See id.*

106 *See id.* at 28–29.

107 *See id.* at 29, 31, 33; *see also* Drenkard, *supra* note 6, at 11 (explaining that "the Margin Tax hurts the state's score in the individual income tax component of the Index as well (the state ranks 6th, instead of a perfect ranking of 1st), because the Margin Tax applies to S corporations and LLCs.").

108 *See id; but see* Keating, *supra* note 48, at 5 (where Texas received a perfect score in the personal income tax category).

109 *See generally In re* Nestle USA, Inc., 359 S.W.3d 207 (Tex. 2012).

110 *See id.* at 209, 212 (dismissing the case because the petitioners had failed to pay their taxes under protest or request a refund from the Comptroller as required by the Texas Tax Code prior to bringing the case to the Texas Supreme Court).

111 *See* Relator's Petition at 5, *In re* Nestle USA, Inc., 387 S.W.3d 610 (Tex. 2012) (No. 12-0518), 2012 WL 3233215.

112 *See generally In re Nestle*, 387 S.W.3d 610.

113 *See* Relator's Petition, *supra* note 111, at 4 and app. 6.

114 Relator's Petition, *supra* note 111, at 4.

115 *See* TEX. TAX CODE ANN. § 171.101(a)(1)(B)(ii) (West 2015). Alternatively, an entity can deduct a flat 30 percent from its total revenue using the EZ Computation method. *See id*. § 171.101(a)(1)(A)(i).

for some entities in the group.[116]

As a company, Nestlé engages in manufacturing, wholesale, and retail activities throughout the United States. However, since none of Nestlé's manufacturing facilities are located in Texas, it conducts only wholesale and retail activities in Texas.[117] Retailers and wholesalers are taxed differently than manufacturers under the margin tax. Under the laws in effect at the time of the *Nestle* case, the rate of the margin tax was one-half percent of an entity's taxable margin for entities primarily engaged in retail or wholesale trade and one percent of an entity's taxable margin for all other types of businesses.[118] So, businesses engaged primarily in retailing or wholesaling were taxed at a lower rate than businesses engaged primarily in manufacturing. Nestlé and its affiliates do not conduct any manufacturing activities in Texas.[119] However, for purposes of the margin tax, Nestlé's manufacturing activities that take place outside of Texas are taken into account when determining whether Nestlé is subject to the half-percent retailer/wholesaler rate or the one-percent manufacturer rate.[120]

For the reasons described above, as well as other components of the margin tax that Nestlé viewed as being arbitrary among taxpayers and not reasonably related to the privilege of doing business in Texas, Nestlé asserted that the margin tax is unconstitutional on four grounds.[121] First, Nestlé contended that the margin tax violates the Equal and Uniform Taxation clause of the Texas Constitution[122] because "it taxes taxpayers disparately based on classifications that have no reasonable relationship to the value of the privilege of doing business in Texas."[123] Second, Nestlé asserted that the margin tax violates the Fourteenth Amendment's Equal Protection Clause by treating similarly-situated taxpayers differently in how the tax base is calculated and in how the tax rate is applied, with such differences having no rational basis and insufficient relationship to the value of the privilege of doing business in Texas.[124] Third, Nestlé argued that the margin tax violates the Fourteenth Amendment's Due Process Clause by imposing a higher tax rate on entities that are classified as "manufacturers" based solely on manufacturing activities that take place outside of Texas than on entities classified as "wholesalers" and "retailers," with no difference in the benefits received from Texas by the higher-taxed entities classified as "manufacturers."[125] Finally, Nestlé claimed that the margin tax violates the dormant Commerce Clause because it discriminates against interstate commerce and is not fairly related to the services provided by Texas.[126]

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116 Relator's Petition, *supra* note 111, at 9. *See also*, TAX. § 171.1014.

117 *See* Relator's Petition, *supra* note 111, at 4–5.

118 *Id.* at 4; *see* TAX § 171.002(a)–(b).

119 Relator's Petition, *supra* note 111.

120 *See* TAX §§ 171.1012, 171.1014; Relator's Petition, *supra* note 111, at 15.

121 *See In re* Nestle USA, Inc., 387 S.W.3d 610, 612 (Tex. 2012).

122 TEX. CONST. art. VIII, § 1(a).

123 Relator's Petition, *supra* note 111.

124 *Id.* at 13.

125 *Id.* at 14.

126 *Id.* at 15.

1. Equal and Uniform Taxation Clause of the Texas Constitution

Nestlé was unsuccessful on all four assertions. As for Nestlé's first argument, the Court pointed out that the Equal and Uniform Taxation clause requires "only that taxation—not taxes—must be equal and uniform, indicating that it is the process, not each individual result, that must satisfy the requirement."[127] In addition, the Court said, "It is important to note that classifying taxpayers for purposes of an occupation tax is not an exception to the Equal and Uniform Clause but a consequence of it."[128] Holding that the margin tax does not violate the Equal and Uniform Clause of the Texas Constitution, the Court concluded that the margin tax's classifications are permitted under the Clause and that the structure of the tax is reasonably related to the value of the privilege of doing business in Texas.[129]

2. Fourteenth Amendment's Equal Protection Clause

The Court held that, since Nestlé fell short of establishing the elements for a successful Equal and Uniform Taxation challenge, its second argument based on Equal Protection necessarily failed because the Equal and Uniform Clause of the Texas Constitution places a stricter standard on a state's tax laws than the Equal Protection Clause of the Fourteenth Amendment does.[130]

3. Fourteenth Amendment's Due Process Clause

Next, the Court quickly dispensed with Nestlé's third argument based on Due Process by citing to a 1939 United States Supreme Court case involving the Texas franchise tax, which held that "the franchise tax did not violate due process because in 'a unitary enterprise, property outside the state, when correlated in use with property within the state, necessarily affects the worth of the privilege within the state.'"[131]

4. Dormant Commerce Clause

The Court delivered the final nail in the coffin by rejecting Nestlé's fourth argument based on the dormant Commerce Clause. In response to Nestlé's claim that the margin tax discriminates against interstate commerce because its tax rates are based on an entity's non-Texas activities (such as when an entity is taxed at the higher manufacturer rate due to its manufacturing activities that occur entirely outside of Texas), the Court explained that "[t]axes do not discriminate when the differing rate stems 'solely from differences between the nature of their businesses, not from the location of their activities.'"[132] The Court concluded that, because the margin tax's rates are based on an entity's activities and not on the location of those activities, the rates do not discriminate against interstate commerce.[133] Responding to

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127 *In re* Nestle USA, Inc., 387 S.W.3d 610, 618 (Tex. 2012).

128 *Id.* at 620.

129 *Id.* at 621–24.

130 *See id.* at 624.

131 *Id.* (quoting Ford Motor Co. v. Beauchamp, 308 U.S. 331, 336 (1939)).

132 *Id.* at 625 (quoting Amerada Hess Corp. v. Dir., Div. of Taxation, N.J. Dep't of Treasury, 490 U.S. 66, 78 (1989)).

133 *See id.*

Nestlé's claim that the margin tax is not fairly related to the services provided by Texas, the Court reasoned that "the franchise tax need not precisely align the tax rate with the value of the Privilege [of doing business in Texas]. It is enough that manufacturing outside of the state will often increase the value of doing business within the state."[134]

V. SIGNIFICANT LOWER-COURT CASES

Although *Allcat* and *Nestle* removed some major hurdles faced by those seeking to implement and enforce the margin tax, seemingly endless challenges still remain.[135] Some significant cases which have impacted the application of the margin tax are discussed next.[136]

A. Can "Net Gain" Be a Negative Number?

As discussed briefly in Section B, *supra*, the margin tax is calculated by applying the appropriate tax rate to an entity's taxable margin.[137] The taxable margin of an entity that does business in multiple states is generally computed by multiplying the entity's margin[138] by the statutory apportionment factor.[139] The apportionment factor is "a fraction, the numerator of which is the taxable entity's gross receipts from business done in [Texas] . . . and the denominator of which is the taxable entity's gross receipts from its entire business."[140] Put simply, the numerator of the apportionment factor is the entity's gross receipts attributable to its activities in Texas, and the denominator of the apportionment factor is the entity's total receipts from its entire business, sometimes referred to as "everywhere receipts."[141] The following is a demonstration of the basic calculation of entity's tax liability using the apportionment factor from Section 171.106 of the Texas Tax Code:

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134 *Id.*

135 *See* Haney & Wright, *supra* note 14, at 1 (referencing the "countless lower court decisions and administrative hearings" that have stemmed from the margin tax).

136 There have been many other significant cases in addition to those examined in this article, including those dealing with the flow-through problem, *see, e.g.,* Titan Transp., L.P. v. Combs, 433 S.W.3d 625 (Tex. App.—Austin 2014, pet. denied); Allcat Claims Serv., L.P. v. Combs, No. D-1-GN-11-002294 (201st Dist. Ct., Travis County, Tex. Aug. 1, 2011); and those clarifying which types of businesses qualify for the lower retail tax rate, *see, e.g.*, Rent-A-Ctr., Inc. v. Hegar, 468 S.W.3d 220 (Tex. App.—Austin 2015, no pet.), to name but a few. In addition, the discussion below does not address thorny nexus issues, which are outside the scope of this Article.

137 *See* TEX. TAX CODE ANN. § 171.002(a)–(b) (West 2015). For 2016, the tax rate is .375 % for retailers and wholesalers and .75 % for all other businesses.

138 *See supra* notes 24–33 and accompanying text for the basic calculation of an entity's margin.

139 *See* TAX § 171.101(a)(2).

140 *Id.* § 171.106(a).

141 Upjohn Co. v. Rylander, 38 S.W.3d 600, 604 n.5 (Tex. App.—Austin 2000, pet. denied) (explaining that "Texas uses an apportionment formula in the form of a fraction to calculate a corporation's Texas business as follows: Texas receipts/Everywhere receipts."); *see also Franchise Tax Frequently Asked Questions: Apportionment*, TEX. COMPTROLLER OF PUB. ACCOUNTS, https://www.comptroller.texas.gov/taxes/franchise/ (last visited Oct. 25, 2016) (explaining that the apportionment factor is calculated "by dividing Texas Gross Receipts by Everywhere Gross Receipts").

Margin[142] x	Texas receipts[143] / Everywhere receipts[144]	=Taxable Margin[145] x	Tax Rate[146]	=Tax Liability[147]

The denominator of the factor (i.e., an entity's "everywhere receipts") includes receipts from the sale of tangible personal property, receipts from services, rentals, and royalties, and receipts from other business.[148] However, the sale of an investment or capital asset by the entity is treated differently.[149] According to the statute, "[i]f a taxable entity sells an investment or capital asset, the taxable entity's gross receipts from its entire business for taxable margin includes only the net gain from the sale."[150] The interpretation of this statutory exception is at the heart of a case that was recently decided by the Texas Supreme Court.[151]

In *Hallmark Mktg. Co., LLC v. Combs*, the taxpayer was a company with nationwide retail activities.[152] The taxpayer was subject to the margin tax due to its business activities in Texas.[153] The taxpayer had substantial gross receipts from its business activities, but recognized huge losses in the sale of investments and capital assets during the year that was the subject of the case.[154] To calculate the denominator of the apportionment factor, the taxpayer added up its gross receipts from its business activities.[155] The taxpayer did not subtract its investment and capital losses from the denominator because the statute directs "that 'only the net *gain* from the sale' of investment or capital assets are included" in the denominator.[156] The taxpayer reasoned that, since its investment and capital transactions resulted in a loss rather than a gain, the resulting negative number should not be included in the denominator.[157]

The Texas comptroller disagreed with the taxpayer's interpretation of the statute.[158] The

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142 *See supra* notes 24–30 and accompanying text.

143 *See* TAX § 171.106(a).

144 *See id.*; *see also id.* § 171.105.

145 *See supra* note 31 and accompanying text.

146 *See supra* notes 32–33 and accompanying text.

147 *See id.*

148 *See* TAX § 171.105(a).

149 *See id.* at (b).

150 *Id.*

151 *See generally* Hallmark Mktg. Co. v. Combs, No. 13-14-00093-CV, 2014 WL 6090574 (Tex. App.—Corpus Christi Nov. 13, 2014), *rev'd sub nom.* Hallmark Mktg. Co. v. Hegar, No. 14-1075, 2016 WL 1516774 (Tex. Apr. 15, 2016).

152 *See id.*

153 "A franchise tax is imposed on each taxable entity that does business in this state." TAX § 171.001(a).

154 *Hallmark Mktg. Co.*, 2014 WL 6090574, at *3 (noting that in 2008 Hallmark had gross receipts totaling more than $4.5 billion and capital losses of more than $600 million).

155 *Id.*

156 *Id.*

157 *Id.*

158 *Id.*

comptroller's calculation of the denominator of the taxpayer's apportionment factor was quite different from the taxpayer's. In computing the denominator of the taxpayer's apportionment factor, the comptroller added up the taxpayer's gross receipts from business activities and then *subtracted* the taxpayer's huge investment and capital losses.[159]

Because the comptroller subtracted the investment and capital losses from the denominator of the apportionment factor, making the number in the denominator smaller than the number that the taxpayer had used for the denominator, the resulting fraction was larger than the fraction used by the taxpayer in determining its apportionment factor.[160] As a result of the higher apportionment factor under the comptroller's interpretation of the statute, the taxpayer owed more franchise tax than the taxpayer had originally calculated and a deficiency was assessed.[161]

The district court granted summary judgment in favor of the comptroller.[162] On appeal, the taxpayer argued (among other things) that the investment and capital losses should not be subtracted from the denominator of the apportionment factor because the plain language of the statute provides that "only the net gain" from the sale of investments or capital assets is included in the denominator of the apportionment factor.[163] The taxpayer reasoned that the ordinary meaning of the word "only" as used in the statute operates to "exclude its net loss, which is not a net gain, from the denominator" of the apportionment factor.[164]

While the taxpayer's plain-language argument primarily focused on four crucial words in the statute ("only the net gain"), the comptroller's position was based on a broader view of the statute in relation to the tax code as a whole, the intent of the legislature, rules adopted by the comptroller, and general consistency in the application of the tax laws.[165] For example, the comptroller argued that, because taxpayers are required to include investment and capital losses in "total revenue from entire business" under Section 171.1011 of the Texas Tax Code, taxpayers are also required to include those losses in "gross receipts from entire business" under Section 171.104.[166] Reasoning that "[n]othing in the statute requires a net gain to be positive,"[167] the comptroller pointed to a Texas case and a Wisconsin apportionment statute for support.[168] Perhaps most convincing to the appellate court was the comptroller's reference to a Comptroller Rule pertaining to apportionment which states that "net gains and losses from

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159 *See id.*

160 *See id.* (comparing the apportionment factor calculated by the comptroller (6.49%) to the apportionment factor originally calculated by the taxpayer (5.54%)).

161 *Id.* at *1, *3.

162 *See id.* at *1.

163 *See* Appellant's Brief at *4, *6, *Hallmark Mktg. Co.*, 2014 WL 6090574 (No. 13-14-00093-CV); TEX. TAX CODE ANN. § 171.105(b) (West 2015).

164 Appellant's Brief, *supra* note 163, at *9.

165 *See* Appellees' Brief at *4–5, *7–14, *Hallmark Mktg. Co.*, 2014 WL 6090574 (No. 13-14-00093-CV).

166 *Id.* at *7–9.

167 *Id.* at *10.

168 *See id.* at *10–12 (citing Calvert v. Electro-Sci. Inv'rs, Inc., 509 S.W.2d 700, 702 (Tex. Civ. App.—Austin 1974, no writ) and WIS. STAT. ANN. § 71.45(2)(b)(l) (West 2015)). The comptroller also pointed to a recent 7th Circuit Posner opinion, which suggested that "net gain" could be a negative number in some situations. *See In re* Fort Wayne Telsat, Inc., 665 F.3d 816, 821, 823 (7th Cir. 2011).

sales of investments and capital assets must be added to determine the total gross receipts from such transactions. . . . If the combination of net gains and losses results in a net loss, the taxable entity should net the loss against other receipts, but not below zero."[169]

In affirming the district court's judgment in favor of the comptroller, the Thirteenth Court of Appeals[170] found that "tax code section 171.105(b) is ambiguous but . . . Rule 3.591 is a reasonable construction of the statute and is in accord with the statute's plain language."[171]

Upon grant of review by the Texas Supreme Court, the taxpayer asserted that the Comptroller Rule is not entitled to deference because it conflicts with the unambiguous language of Section 171.105(b) of the Texas Tax Code.[172] The taxpayer contended that the portion of Comptroller's Rule 3.591 stating that a net loss from sales of investments and capital assets should offset other receipts to determine total gross receipts conflicts with the plain language of Section 171.105(b) of the Texas Tax Code, which states that "gross receipts . . . includes only the net gain from the sale" of investments and capital assets.[173]

In contrast to the taxpayer's interpretation of the statute, the comptroller argued that, because the statute's phrase "net gain" is "subject to multiple understandings," deference should be given to the comptroller's interpretation of this phrase in Rule 3.591.[174] Alternatively, the comptroller suggested that the word "only" as used in the statute is meant to modify the word "net" and not the word "gain," with the phrase being spoken aloud as follows: includes only *net* gain.[175] In other words, the purpose of the word "only" in the statute is to distinguish "gain" from "net gain," and clarify that net gain—not the entire gain prior to deducting basis, expense of sale, etc.—from the sale of investments and capital assets will be included in the denominator of the apportionment fraction.[176]

The comptroller also argued that "account[ing] for [the taxpayer's] loss in determining its 'taxable margin' but not when calculating its apportionment fraction artificially inflates the denominator in the apportionment formula which is intended to reasonably represent the proportion of business conducted everywhere."[177] Along those same lines, the comptroller reasoned that "if an entity takes a loss into consideration when calculating its total revenue under section 171.1011, it must also account for that loss when calculating its apportioned margin under section 171.105."[178] In addition, the comptroller asserted that, reading the statute

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169 TEX. ADMIN. CODE ANN. tit. 28, § 3.591 (West 2016).

170 The case was transferred from the Third Court of Appeals by order of the Texas Supreme Court for docket equalization. *See Hallmark Mktg. Co.*, 2014 WL 6090574, at *1 n.1 (citing TEX. GOV'T CODE ANN. § 73.001 (West 2015)).

171 *Hallmark Mktg. Co.*, 2014 WL 6090574, at *4–5.

172 *See* Petitioner's Brief on the Merits at *22–24, Hallmark Mktg. Co., LLC v. Hegar, 488 S.W.3d 795 (Tex. 2016) (No. 14-1075).

173 *Id.*; TEX. TAX CODE ANN. § 171.105(b) (West 2015).

174 Response to Petition for Review at *13, *Hallmark Mktg. Co., LLC*, 488 S.W.3d 795 (No. 14-1075).

175 Oral arguments in the Texas Supreme Court, Dec. 9, 2015, http://www.search.txcourts.gov/Case.aspx?cn=14-1075&coa=cossup (last visited Nov. 7, 2016).

176 *Id.*

177 Response to Petition for Review, *supra* note 174, at *17.

178 *Id.* at *3.

in the context of other relevant portions of the tax code and considering the intent of the legislature, the taxpayer should be required to subtract the losses from the sale of investments and capital assets from the denominator of the apportionment fraction.[179]

On April 15, 2016, the Texas Supreme Court reversed the Thirteenth Court of Appeals, holding that the phrase "only the net gain" found in Section 171.105(b) of the Texas Tax Code "necessarily excludes a net loss."[180] Addressing the appellate court's finding that the phrase "net gain" is ambiguous, the Texas Supreme Court explained that the issue of whether the phrase "net gain" is ambiguous is irrelevant in the *Hallmark* case because the taxpayer in *Hallmark* "suffered only a net *loss*."[181] The Court further stated that "[t]he statute requires inclusion of 'only the net gain,' and under no reading can 'net gain' include a net loss." Accordingly, we cannot defer to the comptroller's rule requiring inclusion of a net loss in Hallmark's apportionment-factor denominator because it conflicts with the plain language of Tax Code section 171.105(b)."[182]

Along with other issues raised by the parties, the Court disposed of the comptroller's argument that the phrase "'net gain' can be read expansively enough to include a net loss."[183] Reading the phrase "net gain" to include a net loss, said the Court, would impermissibly "add to the statute's plain language" and "effectively write the word 'only' out of the statute."[184]

The Court also rejected the comptroller's claim that other sections of the Texas Tax Code, when examined in concert, require that net losses from the sale of investments and capital assets be included in the denominator of the apportionment factor.[185] In doing so, the Court explained that Section 171.105(b) pertains to a "specific issue—what to do with the proceeds from the sale of an investment when calculating the apportionment-factor denominator—and lays out a clear rule: include 'only the net gain from the sale.'"[186] The Court acknowledged that, if there were a conflict among Section 171.105(b) and the other more general sections of the Tax Code referenced by the comptroller, the more specific section (i.e., Section 171.105(b)) would control.[187] However, the Court observed that, since the general statutes cited by the comptroller did not conflict with Section 171.105(b)'s "only net gain" provision, the general statutes have no impact on Section 171.105(b).[188] Therefore, Section 171.105(b) "means just what it says—'only the net gain from the sale' of investments should be included in the apportionment-factor denominator."[189]

In summary, the parties in *Hallmark* considered the following question: Can "net gain" ever be a negative number in the context of the "everywhere receipts" component of the Texas

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179 *Id.* at *6–7.

180 Hallmark Mktg. Co., LLC v. Hegar, 488 S.W.3d 795 (Tex. 2016).

181 *Id.* at 799.

182 *Id.* at 799–800.

183 *Id.* at 799.

184 *Id.*

185 *Id.* at 800.

186 *Id.*

187 *See id.*

188 *Id.*

189 *Id.* at 801.

franchise tax apportionment factor?[190] According to the Texas Supreme Court, "the answer is obvious and easy: No."[191]

B. If It Walks Like a Duck and Quacks Like a Duck . . .

Is the margin tax an "income tax"?[192] Some commentators believe the margin tax falls within the general definition of an income tax.[193] As discussed previously, the Texas Supreme Court declined to address this question in the *Allcat* case,[194] but the issue has again come to the forefront in a recent apportionment case.[195]

In *Graphic Packaging Corporation v. Hegar*, the taxpayer was a Georgia corporation that sold packaging products nationwide, including within the borders of Texas.[196] Because the taxpayer engaged in retail and wholesale activities in Texas, the taxpayer was subject to the margin tax.[197]

As discussed earlier in this Article, the margin tax liability for an entity that does business in multiple states is determined in part by applying an apportionment factor (to account for the entity's business activities in Texas) to the entity's margin to arrive at the entity's taxable margin.[198] However, rather than use the "single-factor" [199] apportionment formula set forth in Chapter 171 of the Texas Tax Code (the "Franchise Tax" formula) discussed above in Section A to determine taxable margin, the taxpayer in *Graphic* used the "three-factor"[200] apportionment formula found in Chapter 141 of the Texas Tax Code (the "Multistate Tax Compact" formula).[201]

Before looking at the taxpayer's rationale for using the Multistate Tax Compact three-factor apportionment formula rather than the Franchise Tax single-factor apportionment formula, a comparison of the two formulas is helpful. The Franchise Tax apportionment formula divides a taxpayer's gross receipts from business done in Texas by a taxpayer's gross

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[190] Or, as the Court put it, "can net gain sometimes mean net loss if losses outstrip gains?" *Id.* at 799.

[191] *Id.* (stating that "[h]owever net gain is calculated, a statutory net gain cannot simultaneously be a net loss").

[192] It is sometimes incorrectly stated that the Texas Constitution prohibits a state income tax (absent voter approval). However, the Texas Constitution's prohibition applies only to an income tax on natural persons. *See* TEX. CONST. art. VIII, § 24(a) (prohibiting a tax (absent voter approval) on the "net incomes of natural persons, including a person's share of partnership and unincorporated association income"). Contrary to the perception of some, the Texas Constitution's prohibition on a state income tax does not apply to the taxation of business entities. Therefore, a state income tax on businesses is not prohibited by the Texas Constitution. *See id.*

[193] See *supra* notes 76–95 and accompanying text.

[194] *See supra* notes 64–68 and accompanying text.

[195] *See generally* Graphic Packaging Corp. v. Hegar, 471 S.W.3d 138 (Tex. App.—Austin 2015, pet. filed). For a similar case pending in the Third Court of Appeals at the time of publication, see *EMC Corp. v. Hegar,* No. D-1-GN-14-000851 (353 Dist. Ct., Travis County, Tex. Feb 18, 2015), *appeal docketed*, No. 03-15-00113-CV, 2016 WL 4269975 (Tex. App.—Austin 2016).

[196] *Graphic Packaging Corp*., 471 S.W.3d at 139.

[197] *See* TEX. TAX CODE ANN. § 171.001(a) (West 2015).

[198] *See supra* notes 137– 147 and accompanying text.

[199] *See Graphic Packaging Corp.*, 471 S.W.3d at140; *see also* TAX § 171.106.

[200] *Id.*

[201] *Id*.; *see* TAX § 141.001.

receipts from all sources everywhere.[202] It considers only one aspect of the taxpayer's business activities—gross receipts—hence, the "single-factor" label.[203] It does not incorporate any other aspects of the entity's business activities that may be relevant to a fair apportionment of the entity's tax liability among Texas and other states in which the entity does business.[204]

In contrast, the Multistate Tax Compact formula takes three business activities into account in its calculation.[205] In addition to accounting for an entity's Texas sales in relation to the entity's total sales occurring everywhere[206] as is accounted for in the Franchise Tax formula, the Multistate Tax Compact formula accounts for an entity's ownership or use of property in Texas in relation to the entity's ownership or use of property everywhere,[207] as well as the amount of payroll that the entity pays in Texas in relation to the total amount of payroll that the entity pays everywhere.[208] Following is a very basic example comparing the Franchise Tax single-factor apportionment formula with the Multistate Tax Compact three-factor apportionment formula:

Franchise Tax (Chapter 171) **Single-Factor Apportionment Formula**[209]	**Multistate Tax Compact (Chapter 141)** **Three-Factor Apportionment Formula**[210]
$\frac{\text{Texas receipts}}{\text{Everywhere receipts}}$	$\frac{\frac{\text{Texas Property}}{\text{All Property}} + \frac{\text{Texas Payroll}}{\text{All Payroll}} + \frac{\text{Texas Sales}}{\text{All Sales}}}{3}$

In *Graphic*, it was desirable for the taxpayer to use the Multistate Tax Compact three-factor formula because it produced a more favorable result for the taxpayer than using the Franchise Tax single-factor formula.[211] The three-factor formula produced a more favorable result because the taxpayer engaged in retail and wholesale activities in Texas, but it did not conduct any manufacturing activities in Texas.[212] Since the *Graphic* taxpayer did not own or

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202 *See* TAX §§ 171.106(a), 171.103, 171.105.

203 *See Graphic Packaging Corp.*, 471 S.W.3d at 140.

204 *See* ETC Mktg., Ltd. v. Harris Cty Appraisal Dist., 476 S.W.3d 501, 511 (Tex. App.—Houston [1st Dist.] 2015, pet. filed) (explaining that the "central purpose behind the apportionment requirement is to ensure that each State taxes only its fair share of an interstate transaction"); *see also* Home Interiors & Gifts, Inc. v. Strayhorn, 175 S.W.3d 856, 863 (Tex. App.—Austin 2005, pet. denied) (noting that the "fair apportionment requirement attempts to ensure that no State taxes more than its fair share of an interstate transaction").

205 "All business income shall be apportioned to this state by multiplying the income by a fraction, the numerator of which is the property factor plus the payroll factor plus the sales factor, and the denominator of which is three." TAX § 141.001, art. IV.9.

206 *Id.* at art. IV.15.

207 *Id.* at art. IV.10.

208 *Id.* at art. IV.13.

209 *Id.* § 171.106.

210 *Id*. § 141.001, arts. IV.9, IV.10, IV.13, IV.15.

211 Graphic Packaging Corp. v. Hegar, 471 S.W.3d 138, 140 (Tex. App.—Austin 2015, pet. filed).

212 *Id.*

operate any manufacturing facilities in Texas, using the three-factor formula, which equally weighs factors for a taxpayer's Texas property (which was zero for the *Graphic* taxpayer) and a taxpayer's Texas Payroll (which was zero for the *Graphic* taxpayer) with a taxpayer's Texas Sales, produced a lower tax liability than the single-factor formula, which calculates the tax liability based only on Texas receipts and does not take into account a taxpayer's Texas property or Texas payroll.[213]

The *Graphic* taxpayer based its use of the three-factor formula on the premise that the margin tax constitutes an "income tax" on businesses as defined in the Multistate Tax Compact.[214] Under the Multistate Tax Compact, a business entity that is subject to a state income tax in multiple states can choose to apportion its income either in accordance with the laws of the taxing state or by using the three-factor Multistate Tax Compact formula.[215] The Multistate Tax Compact defines "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 expenses are not specifically and directly related to particular transactions."[216]Concluding that the margin tax constitutes an "income tax" for purposes of the Multistate Tax Compact, the *Graphic* taxpayer chose to use the Multistate Tax Compact apportionment formula rather than the formula found in the Franchise Tax chapter of the Texas Tax Code.[217]

The Texas comptroller did not agree with the taxpayer's position and denied the taxpayer's use of the Multistate Tax Compact's apportionment formula.[218] In district court, the comptroller won its motion for summary judgment on the issue of whether the taxpayer properly elected to use the Multistate Tax Compact's apportionment formula rather than the apportionment formula set forth in the Franchise Tax chapter of the Texas Tax Code.[219] On appeal, the crux of the case was whether the margin tax falls within the Multistate Tax Compact's definition of "income tax."[220]

One of the taxpayer's arguments was that the margin tax falls within the meaning of "income tax" found in the Multistate Tax Compact when a taxpayer uses the cost-of-goods-sold method to calculate its margin tax liability (as the taxpayer did in this case) "because a taxpayer may determine its tax base (its margin) . . . by subtracting its cost of goods sold, including indirect costs, and those indirect costs are 'expenses' that are 'not specifically or

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213 *Id.*; *compare* TAX § 141.001 *with* TAX § 171.106.

214 *Graphic Packaging Corp.*, 471 S.W.3d at 141–42.

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> Any taxpayer subject to an income tax whose income is subject to apportionment and allocation for tax purposes pursuant to the laws of a party state or pursuant to the laws of subdivisions in two or more party states may elect to apportion and allocate his income in the manner provided by the laws of such state or by the laws of such states and subdivisions without reference to this compact, or may elect to apportion and allocate in accordance with Article IV.

TAX § 141.001, art. III.1.

216 *Id.* at art. II.4.

217 *Graphic Packaging Corp.*, 471 S.W.3d at 140, 142.

218 *Id.* at 140–41.

219 *Id.* at 141.

220 *Id.* at 143.

directly related to a particular transaction.'"[221] The taxpayer reasoned that, looking at the plain language of the Multistate Tax Compact's definition of "income tax," the margin tax clearly qualifies as an income tax "because its computation begins with gross receipts, which then are reduced by a myriad of exclusions and expense deductions, including indirect (overhead) expenses, at least some of which are not specifically and directly related to particular transactions"[222] Some examples of indirect expenses given by the taxpayer included utilities, insurance, and administrative expenses.[223]

In response, the comptroller argued (among other things) that the margin tax is not an income tax, observing that "[t]he Legislature made this distinction clear when it revised the franchise tax to its current form: 'The franchise tax imposed by Chapter 171, Tax Code, as amended by this Act, is *not an income tax*.'"[224] The comptroller also cited a case where the court defined net income as the "'excess of all revenues and gains for a period over all expenses and losses of the period'"[225] and pointed out that "'margin' never involves deducting 'all expenses and losses.'"[226] Because taxpayers do not deduct *all* expenses to arrive at the margin, the comptroller reasoned that the margin is not equivalent to net income.[227]

The Third Court of Appeals affirmed in favor of the comptroller, finding that the margin tax does not meet the Multistate Tax Compact's definition of "income tax."[228] The court's reasons included the fact that there are methods for determining margin other than deducting expenses from total revenue and, even when the margin is determined by deducting expenses under the cost-of-goods-sold or compensation methods, these methods only allow certain expenses to be deducted.[229] The court also noted that Section 171.106(a) of the Texas Tax

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[221] *Id.* at 143–44.

[222] Brief for Appellant at 50, 53, *Graphic Packaging Corp.*, 471 S.W.3d 138 (No. 03-14-00197-CV).

[223] *Id.* at 52, 55.

[224] Brief of Appellees at 21, *Graphic Packaging Corp.*, 471 S.W.3d 138 (No. 03-14-00197-CV) (quoting Act of May 2, 2006, 79th Leg., 3d C.S., ch. 1, § 21, 2006 Tex. Gen. Laws 1, 38). In contrast to the comptroller's reliance on the label give to the margin tax by the legislature, the Council on State Taxation observed in its amicus brief filed in this matter, "While the Texas Legislature can opine on whether the franchise tax is subject to that federal law, ultimately it is up to the courts to decide whether the franchise tax meets that definition." Brief of Council on State Taxation as Amicus Curiae Supporting Appellant at 14, *Graphic Packaging Corp.*, 471 S.W.3d 138 (No. 03-14-00197-CV).

[225] INOVA Diagnostics, Inc. v. Strayhorn, 166 S.W.3d 394, 401 n.7 (Tex. App.—Austin 2005, pet. denied) (quoting BLACK'S LAW DICTIONARY 1040 (6th ed. 1990)).

[226] Brief of Appellees, *supra* note 224, at 22.

[227] *Id.* Query whether a distinction exists between subtracting "all expenses" from gross revenue (the standard on which the comptroller insists) and subtracting all *deductible* expenses under applicable state or federal law. Under the Internal Revenue Code, taxpayers are not allowed a deduction for *all* expenses—only certain expenses enumerated in the Code. Some types of expenses are required to be capitalized rather than deducted in the period they are incurred. Some valid business expenses may not be deducted in full (for example, business meals limited to 50-percent deduction, business travel expense limited to a deduction based on mileage despite the actual cost of the transportation, compensation paid to employees in excess of the amount the IRS considers to be "reasonable," etc.). Under the definition on which the comptroller relies, a taxpayer could subtract from gross revenue all of the taxpayer's expenses for which the Internal Revenue Code allows a deduction and still not meet the comptroller's definition of "net income" simply because federal law did not allow a deduction for all of the taxpayer's expenses!

[228] *See Graphic Packaging Corp.*, 471 S.W.3d at 144–47.

[229] *See id.* at 144.

Code expressly states that the Franchise Tax formula must be used "[e]xcept as provided by this section" and reasoned that, since the Multistate Tax Compact formula is not listed as an alternative in Section 171.106, it is not a permissible alternative.[230] In addition, the court pointed to the statement made by the legislature at the time the margin tax was enacted: "'[T]he franchise tax imposed by Chapter 171, Tax Code, as amended by this Act, is not an income tax.'"[231]

The taxpayer's petition for review in the Texas Supreme Court is pending as of the time that this article is being published. Given the level of attention garnered by this case in the court below,[232] the impact of the Court's decision on the issues raised in this case will certainly extend beyond the *Graphic* taxpayer.[233]

C. Cost of Goods Sold

As mentioned in Section B, the margin tax is calculated by applying the relevant tax rate to an entity's taxable margin.[234] To calculate an entity's margin, the entity generally figures its "total revenue" and then deducts either its "compensation" expenses or its "cost of goods sold."[235] There have been numerous challenges relating to the Cost of Goods Sold (COGS) deduction.[236] What is a "good" for purposes of the COGS deduction? Who can take the COGS deduction? What is included in the COGS deduction? A few recent cases involving the COGS deduction are discussed next.

1. If You Can't Touch, Hold, or Feel It, Is It a "Good"?

Can a two-hour experience purchased by a customer qualify as a "good" for purposes of the COGS deduction? The Third Court of Appeals recently answered this question in the affirmative. In *American Multi-Cinema, Inc. v. Hegar,*[237] the taxpayer, which owned and

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[230] *See id.* at 145. "Had the legislature intended for chapter 141's three-factor formula to be an alternative for apportioning margin for franchise tax purposes, it could have included it as one of the expressed alternatives in section 171.106." *Id.*

[231] *Id.* at 146 (quoting Act of May 2, 2006, 79th Leg., 3d C.S., ch. 1, § 21, 2006 Tex. Gen. Laws 1, 38).

[232] At least four amicus briefs were submitted to the Third Court of Appeals in this matter. *See* Brief of Council on State Taxation as Amicus Curiae Supporting Appellant, *Graphic Packaging Corp.*, 471 S.W.3d 138 (No. 03-14-00197-CV); Brief of the Interstate Commission for Juveniles, the Association of Compact Administrators of the Interstate Compact on the Placement of Children, and Jeffrey Litwak as Amici Curiae Supporting Appellant, *Graphic Packaging Corp.*, 471 S.W.3d 138 (No. 03-14-00197-CV); Brief of States of Oregon, Alaska, California, Colorado, Hawaii, Michigan, Minnesota, Montana, New Mexico, and Washington as Amici Curiae Supporting Appellees, *Graphic Packaging Corp.*, 471 S.W.3d 138 (No. 03-14-00197-CV); Brief of Multistate Tax Commission as Amici Curiae Supporting Appellees, *Graphic Packaging Corp.*, 471 S.W.3d 138 (No. 03-14-00197-CV).

[233] *See* Brief of EMC Corporation as Amicus Curiae Supporting Petitioner at 1, *Graphic Packaging Corp.*, 471 S.W.3d 138 (No. 03-14-00197-CV), http://www.search.txcourts.gov/SearchMedia.aspx?MediaVersionID=f3080400-f587-49cd-9de3-c948a5393868&coa=cossup&DT=BRIEFS&MediaID=c08b1dfd-76e3-4c86-bbbb-6ed98054b6a7 (last visited Nov. 7, 2016).

[234] *See* TEX. TAX CODE ANN. § 171.002(a)–(b) (West 2015).

[235] *See supra* notes 25–31 and accompanying text for the basic calculation of an entity's margin.

[236] *See* Titan Transp., L.P. v. Combs, 433 S.W.3d 625, 627–29 (Tex. App.—Austin 2014, pet. denied); Combs v. Newpark Res., Inc., 422 S.W.3d 46, 47–48 (Tex. App.—Austin 2013, no pet.).

[237] *See generally* Am. Multi-Cinema, Inc. v. Hegar, No. 03-14-00397-CV, 2015 WL 1967877 (Tex. App.—

operated movie theaters, claimed the COGS deduction for its "costs of exhibiting films and other content (exhibition costs)" on its first two annual franchise tax returns filed under the new margin tax system.[238] On audit, the Texas comptroller disallowed the deduction of the taxpayer's exhibition costs on the grounds that the taxpayer does not sell "goods" for purposes of Texas Tax Code statutes pertaining to the deduction for cost of goods sold, resulting in a substantially higher franchise tax liability than originally calculated by the taxpayer.[239]

In district court, the primary issue in dispute was whether the taxpayer's exhibition of movies in theaters to its customers constitutes "goods" under the Texas franchise tax laws.[240] At a bench trial, the comptroller argued that the taxpayer's exhibition of movies in its theaters "does not fall within the meaning of 'tangible personal property' because it is either 'intangible property' or a movie-viewing 'service,'" both of which are expressly excluded from the definition of "tangible personal property" under the Texas Tax Code.[241] The comptroller reasoned that "[the taxpayer] does not sell the film, but the right to watch the film at a certain time and place."[242] As support for the taxpayer's position, the taxpayer pointed to the plain language of the statutory definition of tangible personal property ("personal property that can be seen . . . or that is perceptible to the senses in any other manner")[243] and argued that the movies shown in its theaters fall squarely within the definition because the movies can be seen and heard by customers (i.e., the movies are perceptible to the senses).[244]

The trial court found that when the taxpayer shows movies in its theaters, "it produces personal property that can be seen, weighed, measured, felt, or touched or that is perceptible to

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Austin Apr. 30, 2015, no pet.) (mem. op).

238 *Id.* at *1. The franchise reports at issue in this case were for tax years 2008 and 2009. *Id.* The controlling statute in this case was subsequently amended to allow movie theaters to claim the COGS deduction for exhibition costs. *See* Act of June 14, 2013, 83d Leg., R.S., ch. 1232, § 10, 2013 Tex. Sess. Law Serv. 3105, 3109 (current version at TAX § 171.1012(t)). Section 171.1012(t) of the Texas Tax Code now provides that

> [i]f a taxable entity that is a movie theater elects to subtract cost of goods sold, the cost of goods sold for the taxable entity shall be the costs described by this section in relation to the acquisition, production, exhibition, or use of a film or motion picture, including expenses for the right to use the film or motion picture.

TAX § 171.1012(t). While the amendment provides an avenue for movie theaters to claim the COGS deduction for exhibition costs, it does not expressly classify the exhibition of movies as "goods."

239 *Am. Multi-Cinema, Inc.*, 2015 WL 1967877, at *1, *3.

240 *Id.* at *1; Under the Texas Tax Code, "'Goods' means real or tangible personal property sold in the ordinary course of business of a taxable entity." TAX § 171.1012(a)(1). "Tangible personal property" is defined as:

> (i) personal property that can be seen, weighed, measured, felt, or touched or that is perceptible to the senses in any other manner; and (ii) films, sound recordings, videotapes, live and prerecorded television and radio programs, books, and other similar property embodying words, ideas, concepts, images, or sound, without regard to the means or methods of distribution or the medium in which the property is embodied, for which, as costs are incurred in producing the property, it is intended or is reasonably likely that any medium in which the property is embodied will be mass-distributed by the creator or any one or more third parties in a form that is not substantially altered.

Id. at (a)(3)(A). "Tangible personal property" does not include intangible property or services. *Id.* at (a)(3)(B).

241 *Am. Multi-Cinema, Inc.*, 2015 WL 1967877, at *5.

242 *Id.*

243 TAX § 171.1012(a)(3)(A)(i).

244 *Am. Multi-Cinema, Inc.*, 2015 WL 1967877, at *5.

the senses in any other manner for sale in its ordinary course of business."[245] The trial concluded that this constituted the production of "goods for sale in the ordinary course of business under Section 171.1012, and [the taxpayer] may therefore include the costs of exhibiting movies and other content to its paying customers in its cost-of-goods-sold deduction under Section 171.1012 of the Texas Tax Code."[246]

On appeal, the comptroller argued that "exhibiting films does not constitute a 'good' because [the taxpayer] does not sell 'tangible personal property' but intangible property, or a film-watching service, or non-property."[247] The comptroller contended that the tickets purchased by the taxpayer's customers were merely licenses, pointing out that "[the taxpayer's] customers leave [the] theaters with experiences and memories but without a copy of the film."[248] Finding that the language of the statute that defines "goods" is not ambiguous, the Third Court of Appeals looked to the plain meaning of the statute.[249] The court observed that the statute "defines 'tangible personal property' broadly to mean 'personal property that can be seen, weighed, measured, felt, or touched or that is perceptible to the senses in any other manner'" and that the definition of tangible personal property "does not have a take-home requirement."[250] The court also noted that the comptroller's characterization of the taxpayer's exhibition of movies as "intangible property" or "services" directly conflicts with portions of the statute.[251] Accordingly, the Third Court of Appeals concluded that the trial court did not err in ruling that the taxpayer was entitled to claim a COGS deduction for its exhibition costs and affirmed in favor of the taxpayer.[252]

The comptroller filed a motion for rehearing in the Third Court of Appeals,[253] and depending on the disposition of that motion, commentators predict this case may be headed to the Texas Supreme Court.[254] The outcome of this case could have broader implications than

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245 *Id.* at *4.

246 *Id.*

247 *Id*.

248 *Id*. at *5.

249 *Id.* at *4–5.

250 *Id.*

251 *Id.* at *6. The courted referred to the following portion of Section 171.1012 of the Texas Tax Code:

> 'Tangible personal property' means . . . films, sound recordings, videotapes, live and prerecorded television and radio programs, books, and other similar property embodying words, ideas, concepts, images, or sound, without regard to the means or methods of distribution or the medium in which the property is embodied, for which, as costs are incurred in producing the property, it is intended or is reasonably likely that any medium in which the property is embodied will be mass-distributed by the creator or any one or more third parties in a form that is not substantially altered.

TEX. TAX CODE ANN. § 171.1012(a)(3)(A)(ii) (West 2015).

252 *Am. Multi-Cinema, Inc.*, 2015 WL 1967877, at *6, *10.

253 *See* Appellees'/Cross-Appellants' Motion for Rehearing and for Reconsideration En Banc, *Am. Multi-Cinema, Inc.*, 2015 WL 1967877 (No. 03-14-00397-CV), http://www.search.txcourts.gov/SearchMedia.aspx?MediaVersionID=08c16541-ebea-442e-b2bd-a188f48dae7b&coa=coa03&DT=Motion&MediaID=dc7fd779-f237-4b9b-bbf9-74cdde282fa4 (last visited Nov. 7, 2016).

254 *See, e.g.,* Josh Haney, *Fiscal Notes: Franchise Tax Lawsuit Could Cost Texas $1.5 Billion a Year*, TEX. COMPTROLLER OF PUB. ACCOUNTS (June–July 2015), https://www.comptroller.texas.gov/economy/fiscal-notes/2015/june/amc-decision.php.

what first meets the eye. Beyond the impact that it would obviously have on movie theaters operating in Texas, the court's interpretation of the statutory definition of goods could be extended to a number of businesses traditionally considered to be in the service industry.[255] The Texas comptroller's office has estimated that such a result could put quite a dent in the state's margin tax revenue.[256] For now, all eyes are on the Third Court of Appeals to see whether the comptroller's request for rehearing will be granted.

2. Does Combined Group's COGS Deduction Include Service-Only Subsidiary's Costs?

When determining cost of goods sold for a combined group, is each affiliate's business considered in isolation or in the context of the combined group's business as a whole? This question was answered by the Third Court of Appeals in *Combs v. Newpark Resources, Inc*.[257] The taxpayer's primary business activity in *Newpark* involved the "manufacture, sale, injection, and removal of 'drilling mud,'" with the taxpayer's several subsidiaries providing various types of support operations, such as manufacturing, sales, and hazardous waste removal.[258] One of the subsidiaries engaged only in service-providing activities and did not sell any goods in the ordinary course of business.[259]

The taxpayer was required to file a single franchise tax return for itself and its subsidiaries as a combined group.[260] In preparing the report, the taxpayer had to select the same deduction (generally the choice is to deduct cost of goods sold or compensation) for the entire group.[261] The taxpayer chose the cost-of-goods-sold deduction for the combined group.[262] In doing so, the taxpayer included expenses incurred by its service-only subsidiary in the combined group's cost-of-goods-sold deduction, even though the subsidiary would not have qualified for the cost-of-goods-sold deduction if it were a stand-alone company.[263]

The Comptroller argued that, because the taxpayer's subsidiary provided only services and did not independently qualify for a cost-of-goods-sold deduction, the taxpayer was not allowed to include the subsidiary's expenses in the combined group's overall cost-of-goods-sold

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[255] *See id*. (positing that "[u]nder the Court of Appeals' interpretation, a clean house could be considered 'perceptible,' so housecleaning might be classified as tangible personal property").

[256] *See id*. (estimating that "the cumulative fiscal impact due to the expanded COGS deduction could rise to $1.5 billion each year" and pointing out that since taxpayers can amend franchise tax returns for up to four years back, the state could be looking at refunds totaling $6 billion).

[257] *See generally* Combs v. Newpark Res., Inc., 422 S.W.3d 46 (Tex. App.—Austin 2013, no pet.).

[258] *Id*. at 48.

[259] *Id*. at 50.

[260] *Id*. at 48.

[261] *Id.*; *see supra* notes 25–29 and accompanying text for a brief look at the cost-of-goods-sold and compensation deductions.

[262] *Newpark Res., Inc.*, 422 S.W.3d at 48–49.

[263] *Id.* at 49–51. Newpark included its subsidiary's expenses in the cost-of-goods-sold deduction on grounds that the subsidiary had furnished labor to a project for the construction or improvement of real property. *See id.* at 53–57; *see also* TEX. TAX CODE ANN.§ 171.1012(i) (West 2015). The taxpayer's inclusion of the subsidiary's expenses on this basis was challenged by the Comptroller, but the court held in favor of the taxpayer on this issue. *Newpark Res., Inc.*, 422 S.W.3d at 57.

deduction.[264] Ruling in favor of the taxpayer, the court noted that, according to the plain language of the statute, the determination of whether an entity that is a member of a combined group qualifies for the cost-of-goods-sold deduction must be made by viewing the combined group's activities as a whole and not the single entity's activities in isolation.[265]

3. What Exactly Can Be Included in COGS Deduction?

a. Labor or Materials Furnished to Project Involving Real Property

An entity that is not typically considered a manufacturer or seller of "goods" under the general definition of the statute may be able to claim a COGS deduction if the entity furnishes "labor or materials to a project for the construction, improvement, remodeling, repair, or industrial maintenance . . . of real property."[266] In *Hegar v. CGG Veritas Services (U.S.), Inc.*, the taxpayer was a geoseismic company that acquired seismic data, processed the data to generate images of the subsurface of the earth, and sold sound recordings and images to oil and gas exploration and production companies.[267] On the taxpayer's initial franchise tax return filed under the new margin tax regime, the taxpayer claimed a COGS deduction of more than a half billion dollars.[268] The Texas comptroller disallowed the entire COGS deduction on the grounds that the taxpayer was a service provider.[269]

In district court, the taxpayer argued that it qualified for the COGS deduction because "the costs it included in calculating its COGS deduction were incurred exclusively for the 'construction, repair, or industrial maintenance of oil and gas wells, which are real property' and therefore includable in the COGS deduction pursuant to Tax Code subsection 171.1012(i)."[270] The comptroller maintained that the taxpayer "provides only services to oil and gas exploration and production companies and does not sell anything that meets the statutory definition of 'goods.'"[271]

Finding, among other things, that the taxpayer's "customers are generally oil and gas exploration and production companies" who "purchase, license, and use [the taxpayer's] seismic and sound recordings and images to determine where to explore and drill for oil and gas" and that the services and products furnished by the taxpayer "are an integral, essential, and direct component of the oil and gas drilling process," the district court concluded that the comptroller improperly denied the taxpayer's COGS deduction because the taxpayer

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[264] *Newpark Res., Inc.*, 422 S.W.3d at 50–51. The Comptroller apparently found it reasonable to force a group of entities to pick one kind of deduction for the whole group based on the group's business activities—even when some members of the group would not independently qualify for that deduction under the tax code—and then deny the group any kind of deduction for the non-qualifying members' expenses.

[265] *Id.* at 51–53.

[266] TAX § 171.1012(i).

[267] Hegar v. CGG Veritas Services (U.S.), Inc., No. 03-14-00713-CV, 2016 WL 1039054, at *2, *4 (Tex. App.—Austin Mar. 9, 2016, no pet.).

[268] *Id.* at *1–2.

[269] *Id.*

[270] *Id.* at *2. The taxpayer's alternate argument was that that the audio and visual recordings it sells qualify as "goods" under Section 171.1012(a)(3)(A). *See id.* The trial court did not rule on this issue. *See id.*

[271] *Id.*

"furnished labor and materials to projects for the construction, improvement, remodeling or repair of oil and gas wells" (i.e., real property).[272]

On appeal, the comptroller argued that "even if [the taxpayer's] activities qualify as 'labor and materials' within the meaning of subsection 171.1012(i), they are too far removed from the construction of an oil and gas well to qualify for [the COGS] deduction."[273] However, the Third Court of Appeals held that there was sufficient evidence on the record to uphold the district court's conclusion that "the seismic data acquisition and processing [the taxpayer] performs for its oil and gas exploration and production company customers is 'labor furnished to a project for the construction of real property,'" and affirmed in favor of the taxpayer.[274] The comptroller was initially expected to file a petition for review in the Texas Supreme Court, but decided against doing so.[275]

b. Labor Costs Attributable to Installation of Goods

Generally, an entity can include in its COGS deduction "all direct costs of acquiring or producing the goods," which includes (among other things) "labor costs," "cost of materials that are an integral part of specific property produced," and "cost of materials that are consumed in the ordinary course of performing production activities."[276] The Texas Tax Code defines "production" to include "construction, installation, manufacture, development, mining, extraction, improvement, creation, raising, or growth."[277] A recent case successfully challenged the Texas comptroller's interpretation of the statutory definition of "production."[278]

In *Autohaus, LP, LLP v. Combs,* the taxpayer was an automotive dealership based in Plano, Texas.[279] On its 2009 Texas franchise tax report, the taxpayer claimed a COGS deduction that included costs that the taxpayer incurred in repairing vehicles ("repair costs").[280] These repair costs consisted of both the cost of materials and the cost of labor for installing automotive parts.[281] Among other things, the comptroller disallowed the taxpayer's deduction for the labor portion of the repair costs attributable to repairs performed on customer-owned vehicles.[282]

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[272] *See id.* at *1, *4.

[273] *Id*. at *4.

[274] *Id*. at *4–5.

[275] On May 31, 2016, the comptroller informed the Texas Supreme Court that it did not intend to file a petition for review in this case. *See* Letter from Ken Paxton, Attorney General of Texas, to Blake A. Hawthorne, Clerk of the Supreme Court of Texas, http://www.search.txcourts.gov/SearchMedia.aspx?MediaVersionID=571b44bc-2079-493b-a656-970415e2d389&coa=cossup&DT=OTHER&MediaID=3d849f78-fcc8-4170-a42f-5dec4a9384a1 (last visited Nov. 7, 2016).

[276] TEX. TAX CODE ANN. § 171.1012(c) (West 2015).

[277] *Id*. at (a)(2).

[278] *See* Autohaus, L.P. v. Combs, No. D-1-GN-13-000989 (419th Dist. Ct. Travis County, Tex. Mar. 22, 2013). This case is currently pending in the Third Court of Appeals. *See* Hegar v. Autohaus, L.P., No. 03-15-00427-CV (Tex. App.—Austin).

[279] Plaintiff's Original Petition at 2, Autohaus, L.P. v. Combs (No. D-1-GN-13-000989.).

[280] *See* Plaintiff's Motion for Summary Judgment and Incorporated Brief at 1–2, Autohaus, L.P. v. Combs (No. D-1-GN-13-000989).

[281] *See id*. at 2.

[282] Plaintiff's Original Petition, *supra* note 279, at 3; Defendants' Response to Plaintiff's Motion for Summary

In district court, the comptroller asserted that the taxpayer could not include labor costs for repair work to customer-owned automobiles in its COGS deduction based on Section 171.1012 of the Texas Tax Code and Comptroller Rule 3.588.[283] To support its assertion, the comptroller argued (among other things) that Section 171.1012 of the Texas Tax Code is ambiguous with respect to "mixed transactions" (i.e., those involving "both the sale of a good and the provision of a service") such as a transaction that involves both selling a replacement automobile part to a customer and installing the part in the customer's automobile.[284] Building on its position that Section 171.1012 of the Texas Tax Code is ambiguous with respect to "mixed transactions," the comptroller maintained that "Subsections (b)(7) and (c)(7) of Rule 3.588 clarify that where there is a mixed transaction involving the service that includes the installation of a product owned by a business into property already owned by a customer, the installation labor retains its character as a service to the customer and so is not deductible as a cost of goods sold."[285]

The taxpayer countered that the language of Section 171.1012(a)(2) setting forth the definition of the term "production" is clear and unambiguous.[286] The statute provides that the term "production" includes "construction, installation, manufacture, development, mining, extraction, improvement, creation, raising, or growth."[287] The Comptroller Rule interpreting Section 171.1012(a)(2) defines "production" as "[c]onstruction, manufacture, *installation occurring during the manufacturing or construction process*, development, mining, extraction, improvement, creation, raising, or growth."[288] The taxpayer pointed out that, in contrast to the statutory definition of "production," the Comptroller Rule's definition of "production" limits the "installation" component of production to "installation *occurring during the manufacturing or construction process*."[289] The taxpayer contended that, because the "Texas Tax Code's definition of 'production' is clear and unambiguous . . . and since Texas Comptroller Rule 3.588(b)(7) . . . attempts to alter an unambiguous statue" by defining "production" differently from the statute, the Rule "is invalid and not entitled to deference."[290]

The district court rendered judgment in favor of the taxpayer, ruling that "Texas Comptroller Rule 3.588(b)(7) as it applies to the term 'production' is unconstitutional and invalid" and that the taxpayer "is entitled to include all of its labor costs associated with Repair

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Judgment, Defendants' Cross-Motion for Summary Judgment, and Defendants' Plea to the Jurisdiction at 88, Autohaus, L.P. v. Combs (No. D-1-GN-13-000989) (filed June 17, 2014).

283 Defendants' Response to Plaintiff's Motion for Summary Judgment, Defendants' Cross-Motion for Summary Judgment, and Defendants' Plea to the Jurisdiction, *supra* note 282, at 12–22.

284 *Id*. at 13–15.

285 *Id*. at 15. Subsection (b)(7) of Rule 3.588 provides as follows: "Production—Construction, manufacture, installation occurring during the manufacturing or construction process, development, mining, extraction, improvement, creation, raising, or growth." TEX. ADMIN. CODE ANN. tit. 34, § 3.588(b)(7) (West 2015). Subsection (c)(7) provides as follows: "Mixed transactions. If a transaction contains elements of both a sale of tangible personal property and a service, a taxable entity may only subtract as cost of goods sold the costs otherwise allowed by this section in relation to the tangible personal property sold." *Id*. § 3.588(c)(7).

286 *See* Plaintiff's Motion for Summary Judgment and Incorporated Brief, *supra* note 280, at 6.

287 TEX. TAX CODE ANN. § 171.1012(a)(2) (West 2015).

288 tit. 34, § 3.588(b)(7) (emphasis added).

289 *Id.*; *See* Plaintiff's Motion for Summary Judgment and Incorporated Brief, *supra* note 280, at 8.

290 Plaintiff's Motion for Summary Judgment and Incorporated Brief, *supra* note 280, at 8. The taxpayer also asserted that the comptroller's denial of the COGS deduction and subsequent assessment of tax violated several provisions of the Texas and United States Constitutions. *See id*. at 14–17.

Costs . . . involved in the installation of automotive parts in its costs of goods sold deduction."[291] Having been appealed by the comptroller, *Autohaus* is pending in the Third Court of Appeals at the time this article is being written. Given the subject matter of *Autohaus*, the scope of its outcome could reach well beyond the *Autohaus* taxpayer and the specific Comptroller Rule that is at issue in this case.

VI. FINAL ACT & CURTAIN CALL?

As discussed previously, the margin tax has met with poor reviews from taxpayers and experts. It has performed dismally and failed at its intended role as the solution to the school funding problem that Texas faced in 2005. Attacks on the tax have consumed untold government resources as staff at the offices of the comptroller and attorney general defend countless challenges with no end in sight.[292] Adding insult to injury, the margin tax has been faulted for putting a damper on the Texas economy.[293]

A. Effect on Texas Economy

A recent report by the National Center for Policy Analysis concluded that the margin tax "directly discourages business and investment by taxing the difference between a business's revenue and certain costs."[294] Researchers at the National Federation of Independent Business Research Foundation and the Tax Foundation have reached similar conclusions.[295] The results of studies performed by the Beacon Hill Institute and Texas Public Policy Foundation correspond with the findings of other researchers.

In 2012, researchers at the Beacon Hill Institute for Public Policy Research at Suffolk University conducted a study to project the impact on the Texas economy of abolishing the margin tax.[296] According to the institute's report, the margin tax "exerts a negative effect on investment, job creation and output that would otherwise take place in its absence."[297] Using a computable general equilibrium modeling program to calculate the "dynamic revenue effects" that would result five years following the elimination of the margin tax, the institute found that eliminating the margin tax would lead to a "significant improvement in the state economy."[298]

The institute's report projected that the change would create tens of thousands of new

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[291] Order Granting Plaintiff's Motion for Summary Judgment at 1, Autohaus, L.P. v. Combs (No. D-1-GN-13-000989) (issued July 22, 2014); Final Judgment at 1, 3, Autohaus, L.P. v. Combs (No. D-1-GN-13-000989) (issued April 29, 2015).

[292] *See* Haney & Wright, *supra* note 14, at 6 (noting that the margin tax "still faces numerous pending legal challenges, touching on everything from how the state calculates the portion of a company's activity that occurs in Texas to which expenses can be deducted from a firm's total revenue" and predicting that the margin tax "will continue to be subject to legislative changes and court challenges for the foreseeable future.").

[293] *See* Drenkard, *supra* note 43 (observing that "Texas' tax code has a lot of desirable elements. . . . What holds the state back, though, is its franchise tax, most commonly called the Margin Tax").

[294] *See* Murphy, *supra* note 55, at 3.

[295] *See* Chow, *supra* note 52; Drenkard, *supra* note 43.

[296] *See Tax Reform in Texas, supra* note 95. The study, which was published in 2012, is based on a model that simulated the economic effects of eliminating the margin tax beginning in the year 2013. *Id*.

[297] *Id*. at 4.

[298] *Id*. at 6.

jobs, increase Texans' real disposable income, and add billions in investments to the state's economy.[299] This projected positive effect on the Texas economy following repeal of the margin tax would come as a result of "businesses [having] more money to make profitable investments in Texas, thus increasing investment and employment, incomes and retail sales which, in turn, push sales, property and other tax collections higher."[300]

Last year, the Texas Public Policy Foundation developed an econometric model to study the effects of eliminating the margin tax.[301] Their analysis indicates that "margin tax substantially depresses real personal income and private sector nonfarm job growth" and "eliminating the margin tax would free resources that would substantially boost the economy after the first year," which would result in the creation of tens of thousands of new jobs and significantly increase Texans' incomes.[302]

B. #ENDTHEMARGINTAX[303]

It appears that the margin tax may be in its final act.[304] Given the poor financial performance of the margin tax and researchers' findings that the tax is hampering the Texas economy, it comes as no surprise that there have been numerous calls for the repeal of the margin tax. One commentator has stated that "it would be in the state's best interest to eliminate the tax entirely in order to reduce the complexity and costliness of the state's tax code."[305] In a report issued by the 2011–12 Texas Conservative Coalition Research Institute's State Taxation and Revenue Task Force (chaired by State Senator Dan Patrick, State Senator Ken Paxton, and State Representative Jim Murphy), lawmakers were urged to "break with the past and advocate for repeal of the Texas franchise tax."[306] The results of a 2013 economic simulation performed by the National Federation of Independent Business Research Foundation showed that phasing out the margin tax would benefit the Texas economy because it would "allow taxable business entities to retain more of their pre-tax income to finance business expansion, build cash reserves, enhance worker compensation, and provide better returns to shareholders."[307] One economist recently predicted that ending the margin tax would give Texas "one of the most competitive tax climates in the country."[308] Earlier this year, lawmakers were encouraged by the Texas Conservative Coalition Research Institute to "stay the course" on a path toward eliminating the margin tax.[309]

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299 *Id*.

300 *Id*. at 5.

301 Ginn & Heflin, *supra* note 45, at 10.

302 *Id*. at 12.

303 TWITTER, https://twitter.com/hashtag/ENDthemargintax?src=hash (last visited Nov. 7, 2016).

304 *See supra* notes 9–11 and accompanying text.

305 Morgan Scarboro, *Texas Legislature Passes $2.56 Billion Tax Cut Package*, TAX FOUND. (Jun. 1, 2015), http://taxfoundation.org/blog/texas-legislature-passes-256-billion-tax-cut-package (noting that eliminating the margin tax would "increase Texas' Business Tax Climate ranking from 10th in the country to an impressive 3rd").

306 *See Final Report of the TCCRI*, *supra* note 43, at 10.

307 Chow, *supra* note 52.

308 Drenkard, *supra* note 6, at 11.

309 *Written Testimony to the Senate Committee on Finance*, TEX. CONSERVATIVE COAL. RES. INST. (Mar. 30, 2016), http://txccri.org/wp-content/uploads/2016/04/Senate-Finance-Testimony-Franchise-Tax-3.30.16.pdf.

Is it time for the curtain to close on the margin tax? Some Texas lawmakers appear to think so. "Nearly 100 bills and resolutions relating to the franchise tax were filed in the 2015 legislative session, 13 of which would repeal it entirely."[310] While the 2015 legislative session did not result in the elimination of the margin tax, it did result in the passage of a bill that significantly reduces the tax burden on taxpayers starting with the 2016 tax year. [311] In the same bill, the legislature clearly signaled intent to repeal the margin tax.[312]

VII. CONCLUSION

The Texas margin tax was introduced to taxpayers in 2008 with the hope that it would resolve the state's serious school finance problems. Instead of welcoming the margin tax as a practical solution for funding Texas' public schools, taxpayers, experts, and other parties impacted by the tax have been outspoken in their disdain for the new tax structure. The critics have been harsh and the tax has garnered opponents from across the country. In addition to the margin tax being the target of widespread dislike, it has underperformed financially and is considered to be responsible for hindering the growth of the Texas economy.

The future of the margin tax is uncertain in light of the numerous legal attacks against it, its disappointing financial performance, and its impact on the Texas economy. Although there have been numerous attempts to fix many of the problems that exist in the structure of the tax, it might be best to scrap it altogether rather than continue futile piecemeal repairs. With little reason to celebrate the approaching tenth anniversary of the debut of the margin tax, its repeal may be the best gift for taxpayers and the comptroller alike. Many would likely agree that it is "time to end this complex, inefficient tax that places a substantial burden on businesses, individuals, and families across the income spectrum and unleash Texas' entrepreneurial spirit so that all Texans, including the working poor, will enjoy the benefits of more jobs and greater economic prosperity."[313] Indeed, it appears the final curtain may be descending on the saga of the Texas margin tax. Perhaps it is time for the Texas margin tax to take a final bow and exit stage left.

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[310] Haney & Wright, *supra* note 14, at 6.

[311] *See* Act of June 15, 2015, 84th Leg., R.S., ch. 449, §1(b) (cutting the tax rate for retailers and wholesalers to.375 percent and to .75 percent for all other business, as well as reducing the EZ Computation rate to .331 percent).

[312] *See id*.

[313] Ginn & Heflin, *supra* note 45, at 4.