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

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I. INTRODUCTION

On January 1, 2008, the business landscape changed dramatically for tens of thousands of Texas-based businesses.[1] This change was the result of the legislation commonly referred to as House Bill 3 (H.B. 3),[2] which made significant revisions to the Texas franchise tax.[3] The tax as revised still is referred to in the Texas Tax Code as the "franchise tax," though it is commonly called the "margin tax."[4] As such, this Comment will refer to the revised franchise tax as the "margin tax." The legislature expanded the scope of the previous franchise tax to include entities that never had before been subject to the tax, and it made significant alterations with respect to how the tax is calculated.[5] Simply put, the new law changed both the

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[1] 19 Robert W. Hamilton et al. *Texas Practice: 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 . . . ."); *see infra* note 13.

[2] Tex. H.B. 3, 79th Leg., 3d C.S. (2006).

[3] 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.'").

[4] Lipstet, *supra* note 3, ("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.'"); *see also*, 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").

[5] *See* 19 Hamilton et al., *supra* note 1; *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

"who" and the "how" of the Texas franchise tax.[6] In doing so without approval by a statewide referendum, the legislature ran afoul of the Texas Constitution's proscription of an income tax on an individual's share of partnership and unincorporated association income.[7]

A. Who Is Subject to the Margin Tax

Prior to 2008, the 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.[8] In contrast, the margin tax, effective as of January 1, 2008, is imposed on partnerships and other unincorporated entities in addition to corporations and limited liability companies.[9]

B. How the Margin Tax Is Calculated

Prior to 2008, an entity's franchise tax liability was calculated based on either capital or earned surplus.[10] Beginning in 2008, an entity's liability is calculated as a percentage of its "taxable margin."[11] Briefly stated, the taxable margin is an entity's total revenue attributable to its Texas operations, less certain statutorily-defined deductions and exemptions.[12]

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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.").

[6] *See* 19 Hamilton et al., *supra* note 1.

[7] This Comment's discussion is limited to the application of the Texas franchise tax to partnerships and unincorporated associations taxed as flow-through entities for federal income tax purposes and owned by natural persons.

[8] *See* 19 Hamilton et al., *supra* note 1, § 4.3.

[9] Tex. Tax Code Ann. § 171.0002(a) (Vernon 2008); *see* 19 Hamilton et al., *supra* note 1, § 4.3; Ohlenforst, *supra* note, 1 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 association, 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." Tex. Tax Code Ann. § 171.0002(b).

[10] 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.").

[11] *Id.*; *see* Tex. Tax Code Ann. § 171.002 (Vernon 2008 & Supp. 2009).

[12] *See* Tex. Tax Code Ann. § 171.101.

C. Reaction to the Margin Tax

This two-pronged change to the franchise tax came as a surprise to many Texans.[13] The 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."[14] The margin tax has had a significant effect on thousands of individuals who conduct business via partnerships and unincorporated associations.[15] Professionals and small-business owners who had operated for years as partnerships or professional associations suddenly were faced with franchise-tax bills for the first time in the history of the State.[16] In addition, the author believes that the two-pronged modification implemented by H.B. 3, when applied to a partnership or unincorporated association owned by individual taxpayers, produces a tax in violation of the Texas Constitution.[17] This Comment will explore the constitutional issues surrounding the margin tax and discuss why the tax should be modified.

II. TEXAS CONSTITUTION: TAX ON A NATURAL PERSON'S SHARE OF PARTNERSHIP OR UNINCORPORATED ASSOCIATION INCOME REQUIRES VOTER APPROVAL

The Texas Constitution prohibits an income tax on an individual's share of income from partnerships and unincorporated associations, absent a

[13] Letter from Carole Keeton Strayhorn, Tex. Comptroller of Pub. Accounts, to Rick Perry, Tex. Governor (May 2, 2006), *available at* http://www.window.state.tx.us/news/60505letter.pdf (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").

[14] Billy Hamilton, *Déjà Vu All Over Again—Texas Considers Property and Business Tax Reform*, 51 ST. TAX NOTES 523, Feb 16, 2009. Billy Hamilton was the deputy comptroller at the Texas Office of the Comptroller of Public Accounts from 1990 until 2006. *Id.*

[15] *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").

[16] *See supra* notes 13–15 and accompanying text.

[17] *See* 19 Hamilton et al., *supra* note 1, § 4.3 ("The constitutionality of the new margin tax is likely to be challenged on the basis that it impermissibly taxes the income of natural persons in partnerships and unincorporated associations in violation of Article VIII, Section 24(a) of the Texas Constitution . . . .").

statewide referendum approving such a tax.[18] It is well established that "Texas has long prided itself on being one of the handful of states that do [sic] not impose income taxes on individuals or businesses,"[19] and the constitutional amendment that enacted this prohibition was passed overwhelmingly by Texas voters in 1993.[20] Just thirteen years later, the Texas legislature passed H.B. 3—a law that violates this prohibition.[21] Although H.B. 3 purports to assess a franchise tax on an entity's "margin," this Comment will explain how the tax is in reality assessed on an entity's income and is therefore an income tax.[22] In addition, as previously mentioned, H.B. 3 extended the scope of the franchise tax to include unincorporated entities such as partnerships and professional associations.[23] This means that many persons' shares of partnership and unincorporated association income are now subject to the tax.[24] Despite the fact that the margin tax, when assessed on certain noncorporate entities,[25] is an income tax on a person's share of partnership and unincorporated-association income, Texas taxpayers were not given the chance to approve the new tax

[18] Tex. Const. art. VIII, § 24(a) ("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.").

[19] 19 Hamilton et al., *supra* note 1, § 4.1.

[20] Legislative Reference Library of Texas, Constitutional Amendments: Amendment Details, http://lrl.state.tx.us/ (follow "Constitutional amendments" hyperlink under "Legislative Information"; then select "73 – R.S. (1993)" from the "Legislative Session" drop down box; then select "8 – Taxation and Revenue" from the "Article" drop down box; then enter "24" in the "Section" box; then follow "View Amendments" hyperlink; then follow "Details" hyperlink) (last visited Apr. 7, 2010) (reporting that the amendment was adopted by a vote of 775,822 to 343,638).

[21] *See* Tex. H.B. 3, 79th Leg., 3d C.S. (2006) (stating in section 171.0002 that a taxable entity means "a partnership, corporation, banking corporation, savings and loan association, limited liability company, business trust, professional association, business association, joint venture"). H.B. 3 taxes partnerships and unincorporated associations but does not require voter approval in order for the tax to take effect. *Id.*

[22] *See* Tex. Tax Code Ann. § 171.002 (Vernon 2008 & Supp. 2009).

[23] *See supra* note 9 and accompanying text.

[24] Mike Seay & Jimmy Martens, *The New Texas Margin Tax*, 70 TEX. B.J. 30, 30 (2007) (discussing how "[m]any businesses and professions that paid no franchise tax, including most law firms, must now pay").

[25] For example, unincorporated associations (limited partnerships, limited liability partnerships, limited liability companies, professional associations, etc.) owned by natural persons.

via a statewide referendum.[26] Some concerned lawmakers proposed legislation to remedy this situation, but such legislation was never enacted.[27] H.B. 3 provides for expedited procedures for constitutional challenges to the margin tax, giving the Texas Supreme Court original and exclusive jurisdiction over any such challenges.[28] However, to the author's knowledge the margin tax has not been challenged yet in court.[29] The author believes that, because the margin tax is (1) an income tax; (2) imposed on partnerships and unincorporated associations comprised of natural persons; and (3) voters have not approved the tax, the tax violates the Texas Constitution.

A. An Income Tax

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."[30] Many accounting experts consider the margin tax to be an income tax.[31] "Although the State of Texas

[26] *See supra* note 21 and accompanying text.

[27] *E.g.*, Tex. S.J. Res. 15, 81st Leg., R.S. (2009) (proposed constitutional amendment providing that Article 8, Section 24(a) of the Texas Constitution does not apply to "a tax imposed on a business entity other than: (1) a sole proprietorship; or (2) a general partnership that is directly owned entirely by natural persons and the liability of which is not limited"); Tex. H.B. 277, 81st Leg., R.S. (2009) (proposed repeal of the margin tax effective January 1, 2014).

[28] Tex. H.B. 3, 79th Leg., 3d C.S. § 24 (2006) ("(a) 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. (b) The supreme court shall rule on a challenge filed under this section on or before the 120th day after the date the challenge is filed.").

[29] *See* Seay & Martens, *supra* note 24, at 31 ("The margin tax statute explicitly states that it's not an income tax. Since the tax is unconstitutional if it's both an income tax and a tax on a natural person's share of partnership or unincorporated association income, this will no doubt be litigated."); *see also* Patterson, *supra* note 5, at 22 (discussing why "challenges to the constitutionality of the margin tax are expected").

[30] 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) (Vernon 2008).

[31] *See* Lipstet, *supra* note 3, 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 10, 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

vigorously defends its position that the margin tax is not a net-income tax (which would violate the Texas Constitution), for all practical purposes, the margin tax is, in effect, a veiled income tax."[32]

1. Comparison of Margin Tax Calculation to Income Tax Calculation

To understand why the margin tax is a veiled income tax, a condensed explanation of its calculation is necessary. To determine Texas margin tax liability, a taxable entity begins by determining its total revenue.[33] 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.[34] In other words, an entity's Texas margin tax return is

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 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), *available at* http://www.aicpa.org/pubs/taxadv/online/sep2006/salt.htm (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 Apr. 7, 2010) (stating that the margin tax "is effectively a state income tax to the ownership entity").

[32] 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 (October 2008); *see* David A. Vanderhider, *A Marginal Tax: The New Franchise Tax in Texas*, 39 ST. MARY'S L.J. 615, 623–24 (2008) ("Despite the legislature's firm stance that the margin tax is not an income tax, many opponents of the margin tax feel that it is an income tax in practical effect.").

[33] Tex. Tax Code Ann. § 171.1011(c) (Vernon 2008).

[34] *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 . . . .").

prepared using figures taken directly from the entity's federal-income-tax return.[35] 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[36] and other statutorily-defined deductions and exemptions to arrive at its "taxable margin."[37] After an entity has computed its taxable margin, it multiplies its taxable margin by the applicable tax rate[38] in order to calculate the amount of margin tax it owes to the State of Texas.[39]

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, exemptions, and other tax reductions."[40] In addition, compare 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 . . . ."[41] As an illustration, assume a Texas service

[35] *Id.* § 171.1011(c)(1)–(2).

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

[37] *Id.* §§ 171.1012–.1013.

[38] *Id.* § 171.002(a)–(b) (The margin tax rate is 0.5 percent for retailers and wholesalers and 1 percent for all other industries.); *see* Cynthia M. Ohlenforst et al., *Taxation*, 59 SMU L. REV. 1565, 1577 (2006) ("This bifurcated plan, as well as a tax rate that would be lower for wholesalers and retailers than for other businesses, was designed to acknowledge the different business models and to avoid being categorized as a net income tax. Although there was significant support for the plan in some quarters, others attacked the plan on both substantive grounds (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) and on policy grounds.").

[39] *See* Tex. Tax Code Ann. § 171.002(a)–(b).

[40] BLACK'S LAW DICTIONARY 832 (8th ed. 2004).

[41] *See* Tex. Tax Code Ann. § 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," "promote uniformity or compatibility in significant components of tax systems," and "facilitate 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) (Vernon 2005). 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

provider (law firm, accounting firm, doctor's office, janitorial service, etc.) has total revenues of $2 million and payroll expenses of $900,000. Here is a simplified example of how the entity's franchise tax would be calculated for 2009:[42]

Total Revenue as Reported to IRS	$2,000,000
Less: Deductible Payroll Expenses	- 900,000
Less: Other Texas Tax Code Deductions	- 100,000
Taxable Margin	**1,000,000**
Multiplied by tax rate	1%
Franchise Tax	**$10,000**

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:[43]

Total Revenue as Reported to IRS	$2,000,000
Less: Deductible Payroll Expenses	- 900,000
Less: Other IRS Deductions	- 500,000
Taxable Net Income	**600,000**
Multiplied by tax rate	30%
Income Tax	**$180,000**

deduction is allowed which would constitute the tax an income tax." Tex. Tax Code Ann. § 141.001.

[42] Note that this is an extremely simplified illustration showing the tax liability of a service provider taxed at 1 percent (in contrast to a retailer or wholesaler, who would be taxed at 0.5 percent), as computed by the franchise tax calculator available at the Texas Comptroller's website. *See* Window on State Government, Franchise Tax Calculation, http://www.window.state.tx.us/taxinfo/taxforms/HB3Calc.pdf. 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* Tex. Tax Code Ann. § 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, Window on State Government, Texas Franchise Tax, http://www.window.state.tx.us/taxinfo/franchise/ (last visited Apr. 7, 2010), and the sources cited in this Comment.

[43] *See* Internal Revenue Service, Dep't of Treasury, IRS Form 1040 (2009), http://www.irs.gov/pub/irs-pdf/f1040.pdf?portlet=3; *see also* Internal Revenue Service, Dep't of Treasury, IRS Form 1040, Schedule C (2009), http://www.irs.gov/pub/irs-pdf/f1040sc.pdf.

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, does not see a difference.[44] Shortly after H.B. 3 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."[45] 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."[46] 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.[47]

Texas Comptroller of Public Accounts Carole Keeton Strayhorn, the officer charged with the task of administering and enforcing H.B. 3 at its inception,[48] also has questioned the difference between the margin-tax calculation and the typical income-tax calculation.[49] In 2006, the

[44] *See* Lipstet, *supra* note 3 at 3 n.7 ("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.").

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

[46] *Id.*

[47] *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).

[48] *See generally*, Tex. H.B. 3, 79th Leg., 3d C.S. (2006) (giving the Comptroller rule-making, collection, and enforcement authority with respect to the revised franchise tax); *see also* Cynthia M. Ohlenforst, *The New Texas Margin Tax: More Than a Marginal Change to Texas Taxation*, 60 TAX LAW. 959, 989 (2007) ("The margin-tax legislation explicitly and repeatedly delegates to the comptroller the authority to enact administrative rules interpreting or implementing many facets of the new tax system.").

[49] *See* Letter from Carole Keeton Strayhorn, Tex. Comptroller of Pub. Accounts, to Rick Perry, Tex. Governor (May 15, 2006), *available at* http://www.window.state.tx.us/news/60515letter.html (calling the margin tax "an unconstitutional income tax on partnerships and unincorporated associations"); *see also* Letter from Carole Keeton

Comptroller repeatedly voiced concern over the constitutionality of the margin tax as applied to partnerships owned by natural persons or "any type of unincorporated association."[50] In fact, Comptroller Strayhorn formally requested an official opinion from the Texas Attorney General "on the question of whether the revised [franchise tax proposed in H.B. 3] will require submission to the voters under Article VIII, Sec. 24(a), Texas Constitution."[51] To date, the Texas Attorney General has not issued an official opinion on the issue.[52]

2. Substance over Form

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 H.B. 3 that the margin tax "is not an income tax."[53] However, merely labeling the tax as a margin tax

Strayhorn, Tex. Comptroller of Pub. Accounts, to Rick Perry, Tex. Governor (May 2, 2006), *available at* http://www.window.state.tx.us/news/60502taxplan.pdf (writing that "[t]axing income from partnerships is strictly prohibited by the Texas Constitution, and I believe when this portion of HB 3 is challenged in court, the State will lose").

[50] *See* Letter from Carole Keeton Strayhorn, (May 2, 2006), *available at* http://www.window.state.tx.us/news/60502taxplan.pdf; *see also* Letter from Carole Keeton Strayhorn, Tex. Comptroller of Pub. Accounts, to the Honorable Greg Abbott, Attorney Gen. of Tex. (April 21, 2006), *available at* http://www.window.state.tx.us/news/60421letter.html.

[51] Request for Opinion RQ-0479-GA (2006), *available at* http://www.oag.state.tx.us/opinions/opinions/50abbott/rq/2006/pdf/RQ0479GA.pdf.

[52] There is no record of a response to RQ-0479-GA. *See* Op. Tex. Att'y Gen. Nos. GA-1 (2002)–GA-0768 (2010), *available at* http://www.oag.state.tx.us/opin/opinions/op50abbott/indexpdf.shtml; *see also* Peggy Fikac, *'Income Tax' Is a Loaded Label for Business Levy/Perry Opponents Get Fired Up After Accounting Board Calls it Just That*, HOUSTON CHRONICLE, Aug. 10, 2006, *available at* http://www.chron.com/disp/story.mpl/headline/metro/4106832.html (reporting that the Comptroller was unsuccessful in seeking a formal opinion from the Attorney General).

[53] Tex. H.B. 3, 79th Leg., 3d C.S. (2006) (H.B. 3 states: "The franchise tax imposed by Chapter 171, Tax Code, as amended by this Act, is not an income tax . . . ."); *see* Olhenforst, *supra* note 48, 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. Whether they succeeded is a question that may well require judicial analysis. Similarly, the question of whether the margin tax is a net-income tax for purposes of Public Law 86-272 may require a judicial determination. 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)).

instead of an income tax does not make it so.[54] According to the United States Supreme Court in *Flint v. Stone Tracy Co.*,[55] "the mere declaration contained in a statute that it shall be regarded as a tax of a particular character does not make it such if it is apparent that it cannot be so designated consistently with the meaning and effect of the act."[56]

In *Galveston, Harrisburg and San Antonio Railway Co. v. State of Texas*, the United States Supreme Court held that substance over form controlled when the Texas legislature attempted to dodge a prohibition on a particular type of gross-receipts tax by labeling the assessment an "occupation tax."[57] *Galveston* involved the prohibition on states against taxing revenue derived from interstate commerce.[58] In *Galveston*, the State of Texas had imposed an occupation tax on railroads that had tracks within the state.[59] The occupation tax imposed on a railroad was calculated as "equal to one per cent [sic] of their gross receipts."[60] The State claimed that the occupation tax was not an illegal gross-receipts tax, but that it was instead a tax imposed purely for the privilege of the continued exercise of their franchises to do business within this State.[61] In addition, the State explained that "[t]he tax here levied was not 'on' gross receipts, but 'equal to' a given percentage 'calculated on the gross receipts.'"[62] In response, the railroad company argued that the tax was in fact an unconstitutional gross-receipts tax, despite it arbitrarily being declared an occupation tax by the Texas legislature.[63]

The Court sided with the taxpayers, with Justice Holmes declaring that "[n]either the state courts nor the legislatures, by giving the tax a particular name or by the use of some form of words, can take away our duty to

[54] *See* John Gamino, *So-called 'Margin Tax' Violates Truth in Labeling*, HOUSTON BUS. J., Jan. 22, 2007, *available at* 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.").

[55] 220 U.S. 107, 145 (1911).

[56] *Id.*

[57] 210 U.S. 217, 227–28 (1908).

[58] *Id.* at 224.

[59] *Id.*

[60] *Id.*

[61] *Id.* at 226.

[62] *Id.* at 223.

[63] *Id.* at 227.

consider its nature and effect."[64] Justice Holmes further stated that an unconstitutional tax "[cannot] be saved by name or form," and that this was "merely an effort to reach the gross receipts, not even disguised by the name of an occupation tax, and in no way helped by the words 'equal to.'"[65]

In *Northwestern Mutual Life Insurance Co. v. Wisconsin*, the United States Supreme Court again held that substance over form controlled when a state's legislature attempted to circumvent federal law by calling a certain prohibited income tax a "license fee."[66] In *Northwestern*, the State of Wisconsin enacted legislation which imposed a license fee on insurance companies.[67] The fee was three percent of an insurance company's gross income, which in some instances included interest that the company received from investments in United States bonds.[68] However, states were prohibited by federal law from taxing the income that taxpayers received from United States bonds.[69] When the license fee was challenged in court, the State insisted that the license fee, although calculated as a percentage of gross receipts (which sometimes happened to include interest from United States bonds), was merely a "privilege or franchise tax"—not an impermissible tax on income from United States bonds.[70] However, the insurance companies argued that, since the license fee was assessed on gross income, and since gross income sometimes included income from United States bonds, the portion of the license fee that was imposed on the bond interest income was in effect an illegal income tax on interest received from United States bonds.[71]

The Court pointed out that the fundamental issue in this case was "whether by the true construction of the statute the assessment must be regarded as a tax upon property or one on privileges or franchise of the corporation."[72] The Court ultimately found in favor of the insurance companies and ruled that, despite the labels assigned to the tax by the Wisconsin legislature ("license fee" and "privilege or franchise tax"), the tax was an income tax and was invalid to the extent that it resulted in a tax

[64] *Id.*

[65] *Id.* at 227–28.

[66] 275 U.S. 136, 138, 141 (1927).

[67] *Id.* at 138.

[68] *Id.* at 138–39.

[69] *Id.* at 140–41.

[70] *Id.* at 139.

[71] *Id.*

[72] *Id.* at 140.

on the income of the taxpayers' United States bonds.[73]

3. Ordinary Meaning

Article VIII, Section 24(a) of the Texas Constitution, enacted by Texas voters in 1993, prohibits a personal-income tax.[74] "In interpreting the constitution, we give words their natural, obvious, and ordinary meanings as they are understood by the citizens who adopted them."[75] Therefore, in construing this provision, the meaning assigned to the terms "income" and "income tax" must be given meaning as understood by ordinary Texans at the time they voted on the provision.[76] In 1993, the average Texas voter would have likely understood the terms "income" and "income tax" as defined as follows in Webster's Dictionary: "income—a gain [usually] measured in money that derives from labor, business, or property;" and "income tax—a tax on the net income of an individual or business concern."[77] Assuming that the average Texas voter would have at least a vague idea of the basic calculations associated with these common terms (either from filing and paying federal-income taxes or operating a small business) is not a far reach, and that the average Texas voter would have a basic understanding of how income is calculated (revenue - expenses = income) when he or she voted on the proposed amendment. Given the similarities between the margin-tax calculation and the commonly-used income-tax calculation, and considering the ordinary meaning of the constitutional provision as understood by Texas voters, the doctrine of substance over form dictates that the tax must be recognized for what it is. Regardless of the label given to the tax in H.B. 3, [78] it is in truth an income tax in violation of the provision which voters added to the Texas Constitution in 1993.

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[73] *Id.* at 141.

[74] Tex. Const. art. VIII, § 24(a). Ballot language for Proposition 4: "The constitutional amendment prohibiting a personal income tax without voter approval and, if an income tax is enacted, dedicating the revenue to education . . . ." H. Research Organization, Spec. Legis. Rep., 1993 Constitutional Amendments: The November 2 Election 17–18 (Aug. 30, 1993).

[75] Armbrister v. Morales 943 S.W.2d 202, 205 (Tex. App.—Austin 1997, no writ).

[76] Tex. Gov't Code Ann. § 311.011(a) (Vernon 2005) ("Words and phrases shall be read in context and construed according to the rules of grammar and common usage.").

[77] THE NEW MERRIAM-WEBSTER DICTIONARY 375 (1989).

[78] Tex. H.B. 3, 79th Leg., 3d C.S. (2006) (H.B. 3 states: "The franchise tax imposed by Chapter 171, Tax Code, as amended by this Act, is not an income tax . . . .").

B. On a Person's Share of Partnership and Unincorporated-Association Income

The Texas Constitution's ban on a personal-income tax without prior voter approval applies to "a tax on the net incomes of natural persons, including a person's share of partnership and unincorporated association income."[79] Some have argued that the margin tax does not violate the Texas Constitution because the tax is imposed on a partnership or unincorporated association at the entity level, rather than being imposed directly on the natural person who is the partner or member.[80] This argument is based primarily on the provision of the Business Organizations Code which states "[a] partnership is an entity distinct from its partners."[81] While the entity designation is important for many purposes such as property ownership[82] and enforcement of liability,[83] the entity concept does not nullify the doctrine of substance over form as interpreted by the courts,[84] and it does not negate the fact that imposing a tax on a partnership is, in economic effect, the same as imposing a tax on its partners.[85] In recognition of the economic relationship between an unincorporated entity and its partners or members, the Constitution refers to a person's share of partnership and unincorporated-association income, thereby elaborating on the concept of "net incomes of natural persons" to encompass a person's share of the income of the entity itself.[86]

[79] *See* 19 Hamilton et al., *supra* note 1, § 4.3.

[80] *See* 19 Hamilton et al., *supra* note 1, § 4.3 (noting that "[p]roponents of the tax argue that the income of natural persons is not being taxed because the tax is effective at the entity level before the individual's share of the income is calculated or distributed"); *see also* Letter from Barry R. McBee, First Assistant Attorney General, to Deirdre Delisi, Chief of Staff, Office of the Governor, (Apr. 17, 2006).

[81] Tex. Bus. Orgs. Code Ann. § 152.056 (Vernon Supp. 2009).

[82] *Id.* §§ 152.101–.102.

[83] *See id.* § 152.306.

[84] *Id.* § 152.003 ("The principles of law and equity and the other partnership provisions supplement this chapter unless otherwise provided by this chapter or the other partnership provisions.").

[85] *See* discussion *infra* Subpart II.B.2.

[86] Tex. Const. art. VIII, § 24(a) (prohibiting a "tax on the net incomes of natural persons, including a person's share of partnership and unincorporated association income").

1. "Including"

Article VIII, section 24(a) of the Texas Constitution prohibits a tax on an individual's net income and then expressly and specifically identifies the scope of the prohibition to include a person's share of partnership and unincorporated association income.[87] According to the Texas Supreme Court, "[t]he language of the Constitution must be presumed to have been carefully selected;"[88] therefore, paying close attention to each word in this provision in order to construe its meaning properly is necessary. The Texas Code Construction Act instructs that the term "including" is a term "of enlargement and not of limitation or exclusive enumeration."[89] In addition, Texas case law tells us that "[i]t is well settled that the term 'including' is generally employed as a term of enlargement rather than a term of limitation or restriction."[90] Construing this section of the Texas Constitution in accordance with established rules of construction and case law[91] (in existence at the time the provision was adopted by Texas voters), the language contained in both the amendment's ballot description[92] and the amendment itself[93] is clear that the provision was meant to prohibit a personal-income tax and that a person's net income protected by this prohibition was comprised of income from various sources, including that person's share of noncorporate business income.

[87] *Id.*

[88] Leander Indep. Sch. Dist. v. Cedar Park Water Supply Corp., 479 S.W.2d 908, 912 (Tex. 1972).

[89] Tex. Gov't Code Ann. § 311.005(13) (Vernon 2005).

[90] R.R. Comm'n of Tex. v. Arco Oil & Gas Co., 876 S.W.2d 473, 492 (Tex. App—Austin 1994, writ denied); *see also* Republic Ins. Co. v. Silverton Elevators, Inc., 493 S.W.2d 748, 752 (Tex. 1973); Peerless Carbon Black Co. v. Sheppard, 113 S.W.2d 996, 997–98 (Tex. Civ. App.—Austin 1938, writ ref'd).

[91] Gragg v. Cayuga Indep. Sch. Dist., 539 S.W.2d 861, 865–66 (Tex. 1976) ("It is our duty in construing the Constitution to ascertain and give effect to the plain intent and language of the framers of a constitutional amendment and of the people who adopted it.").

[92] *See* Tex. S.J. Res. 49, 73rd Leg., R.S., 1993 Tex. Gen. Laws 5570 ("The constitutional amendment prohibiting a personal income tax without voter approval and, if an income tax is enacted, dedicating the revenue to education . . . .").

[93] *See supra* text accompanying note 86.

2. "A Person's Share of Partnership and Unincorporated Association Income"[94]

After considering the importance of the use of the term "including" in the constitutional provision, the next step is to examine what exactly is included—namely, "a person's share of partnership and unincorporated association income."[95] According to the Texas Business Organizations Code, a partnership is "an association of two or more persons to carry on a business for profit as owners."[96] The Code also states that a partner's interest in a partnership "includes the partner's share of profits and losses,"[97] and that "[e]ach partner is credited with an amount equal to: (1) the cash and the value of property the partner contributes to a partnership and (2) the partner's share of the partnership's profits."[98] A share is "an allotted portion owned by, contributed by, or due to someone."[99]

Consider the following hypothetical. Assume a partnership owned by two human beings and taxed as a flow-through entity earns income of $1,000. Under Texas law, each partner's share of the earnings is $500.[100] The partnership will file an information report with the IRS reflecting the total partnership earnings, and then each partner will individually report to the IRS (and pay income taxes on) his one-half share of those earnings.[101] Now, assume further that a state imposes a one-percent tax on the partnership's earnings. When the one-percent state tax is imposed on the $1,000 earnings at the partnership level, it will reduce the partnership's $1,000 earnings by one percent ($10), thereby reducing each partner's $500 share of the earnings by one percent ($5). Before the one-percent state tax

[94] *See* Tex. Const. art. VIII, § 24(a); *see supra* text accompanying note 18.

[95] *See* Tex. Const. art. VIII, § 24(a); *see supra* text accompanying note 18.

[96] Tex. Bus. Orgs. Code Ann. § 152.051(b) (Vernon Supp. 2009).

[97] *Id.* § 1.002(68).

[98] *Id.* § 152.202(a).

[99] BLACK'S LAW DICTIONARY 1500 (9th ed. 2009).

[100] Tex. Bus. Orgs. Code Ann. § 152.202(c). This statement assumes that the partners share profits equally by agreement, or in the absence of any agreement, by virtue of the Texas Business Organizations Code, which provides that "[e]ach partner is entitled to be credited with an equal share of the partnership's profits . . . ." *Id.* § 152.202(c).

[101] 19 Hamilton et al., *supra* note 1, § 4.7 ("[A] partnership is required to file a separate 'information return' to reflect the receipts and expenditures of the business. However, no tax is paid with this return; rather, the net income or loss from partnership operations is allocated among the partners and then carried directly over to each partner's individual tax return.").

is imposed on the partnership's earnings, each partner's share of the earnings is $500. After the one-percent state tax is imposed on the partnership's earnings, each partner's share of the earnings is $495. Therefore, when the one-percent state tax is imposed on the partnership's earnings at the entity level, each partner's individual share of the earnings is also reduced by one percent—just the same as if the one-percent tax had been imposed directly on each partner's individual share. So, even though the tax in the hypothetical was assessed purportedly on the partnership's earnings at the entity level, it essentially flowed through to the partners and was assessed against each partner's one-half share of the partnership's earnings. Therefore, when an income tax is imposed on a Texas partnership's earnings, whether assessed at the individual partner level or at the partnership level, that tax is necessarily an income tax on a person's share of partnership income.[102] The same holds true for unincorporated associations, including professional associations and limited liability companies.[103]

[102] *See* Gamino, *supra* note 54 ("That the Constitutional prohibition goes out of its way to cover a person's 'share of partnership income' is fatal to any argument based on the fact that the checks received by the comptroller will come from partnerships rather than from individual Texans. . . . No matter how clever the sophistry to the contrary, the Constitutional prohibition doesn't turn on whether it's individual partners writing checks to the comptroller, or the partnership writing a single check covering all.").

[103] *See* 19 Hamilton et al., *supra* note 1, § 4.4. The scope of this Article does not allow for a comprehensive examination of the issues involved with the margin tax as applied to limited liability companies (LLCs) and professional associations (PAs). Neither LLCs nor PAs are corporations—both fall under the "unincorporated association" umbrella of art. VII, § 24(a) in the Texas Constitution. *See* Tex. Bus. Orgs. Code Ann. §§ 1.002(14), 1.002(46), 301.003(2). Therefore, when an LLC or PA elects partnership (flow-through) tax treatment, a natural person's share of the LLC's or PA's income should be constitutionally protected from a state income tax. However, under H.B. 3 these entities, and thus their individual members, currently are subject to the margin tax. Query how the margin tax, when imposed on a single-member LLC, a disregarded entity for federal-tax purposes, is not prohibited absolutely by the constitution as an income tax on a person's income. *See* 19 Hamilton et al., *supra* note 1, § 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 1, 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.").

Courts have not hesitated to interpret tax-related statutes as applicable to an entity and its owners in the aggregate, based on a statute's economic substance. When appropriate, courts have done so both in favor of the State as well as in favor of the taxpayer. For example, in *Gragg v. Cayuga Independent School District*, the Texas Supreme Court had the task of interpreting a constitutional amendment that had been enacted by Texas voters a number of years prior to the case.[104] The purpose of the amendment was to provide reduced property tax rates to farmers and ranchers in order to encourage local farming, ranching, and agricultural activities.[105] A landowner's property-tax liability would ordinarily be based on the assessed market value of his land.[106] However, under the amendment, property-tax liability for land "owned by natural persons [and] designated for agricultural use" was based on a lower value that disregarded the commercial or market value of the land.[107] To ensure that only bona fide farmers and ranchers benefitted from the lower tax valuation, the amendment required that, in order for a landowner to qualify, the agricultural activities conducted on the land must be the "primary . . . source of income of the owner."[108]

In *Gragg*, the issue was whether the landowner had been denied wrongfully the "agricultural use designation" for his ranch.[109] While the landowner was a legitimate rancher, he also owned several other profitable businesses structured as various forms of entities—including at least two

[104] 539 S.W.2d 861, 862–63 (Tex. 1976). The constitutional amendment that had been enacted by Texas voters addressed the assessment of lands designated for agricultural use:

> All land owned by natural persons which is designated for agricultural use in accordance with the provisions of this Section shall be assessed for all tax purposes on the consideration of only those factors relative to such agricultural use. "Agricultural use" means the raising of livestock or growing of crops, fruit, flowers, and other products of the soil under natural conditions as a business venture for profit, which business is the primary occupation and source of income of the owner.

Tex. Const. art. VIII, § 1-d(a).

[105] *Gragg*, 539 S.W.2d at 864–65 (discussing the amendment aimed to protect eligible farmers and ranchers from paying high property taxes based on the commercial value of the land, rather than the much lower agricultural value of the land).

[106] *Id.* at 865.

[107] *Id.* at 864–65.

[108] *Id.* at 864 (citing Tex. Const. art. VIII, § 1-d(a)).

[109] *Id.* at 862.

partnerships.[110] These business entities produced higher combined gross receipts than the ranch produced, and the taxing authorities denied the landowner the lower agricultural valuation for his ranch on the grounds that the ranch was not his primary source of income.[111] To reach this conclusion, the taxing authorities included in the landowner's personal income the earnings from all of the landowner's business entities.[112] Even though several of the landowner's businesses were organized as separate legal entities, the court looked to the "legal effect"[113] of the taxing authority's calculation and concluded that it was appropriate to include the gross receipts from all of the business entities in the landowner's personal income for the purpose of determining whether or not the ranch was his primary source of income.[114] As a result, the court held that the landowner was not eligible for the special agricultural assessment.[115]

In *Suburban Utility Corp. v. Public Utility Commission of Texas*, the Texas Supreme Court disregarded the general rule that a corporation is a distinct and separate economic entity from its shareholders when it aggregated the financial activities of a Subchapter S corporation and its shareholders for purposes of interpreting a law regulating the rates utility companies could permissibly charge its customers.[116] Suburban Utility Corporation ("Suburban") was a Texas utility company[117] organized as a Subchapter S corporation[118] and regulated by the Public Utility Commission of Texas ("Commission").[119] Ordinarily, a utility company is allowed to set rates based on the company's operating expenses,[120] and a utility company's federal-income tax usually is included as a component of its operating expenses for the purpose of determining the rate that it may charge its

[110] *Id.* at 863.

[111] *Id.* at 862–63.

[112] *Id.* at 863.

[113] *Id.*

[114] *Id.* at 869.

[115] *Id.* at 870.

[116] 652 S.W.2d 358, 364 (Tex. 1983). "The cost of service of a public utility is defined as a sum total of: (a) reasonable operating expenses, (b) depreciation expense, (c) taxes, and (d) a fair and reasonable return." *Id.* at 362.

[117] *Id.* at 360–61.

[118] *Id.* at 363.

[119] *Id.* at 361.

[120] *Id.* at 362 ("In Texas, a proper rate determination is based upon consideration of three factors: (1) the utility's reasonable operating expenses; (2) the rate base and; (3) a reasonable rate of return.").

customers.[121]

Because Suburban was organized as an S corporation (a flow-through entity for federal income tax purposes) the company did not pay federal-income tax.[122] Instead, Suburban's income was recognized by its shareholders, each of whom reported his or her share of Suburban's income on his or her individual federal-income-tax return.[123] Then, when Suburban calculated its operating expenses for the purpose of setting rates according to Commission guidelines, Suburban included as an operating expense the federal-income tax that its shareholders had paid on Suburban's earnings.[124] However, the Commission disallowed the inclusion of the federal-income tax paid by the shareholders and subsequently ordered Suburban to reduce the rates it charged to its customers.[125]

In deciding this case, the court examined the relationship between an S corporation and its shareholders:

> [T]he income of the Subchapter S corporation is taxable . . . . [but it] is distributed pro rata to the shareholders who must pay taxes on it as ordinary income. Therefore, for purposes of federal income taxation, the shareholders of the Subchapter S corporation are accountable for all that pertains to the corporation.[126]

The court also noted that "the fundamental inquiry is not limited to technical distinctions, but is determined by practical economic facts."[127] For the purpose of construing the statute regarding the inclusion of a company's income-tax expense in its cost of service, the court ignored the S corporation's status as a separate legal entity and focused on the true

[121] *Id.* at 363 ("Under the [Public Utility Commission's] substantive rules, cost of service includes 'income taxes on a normalized basis.'").

[122] *Id.* ("Suburban operated as a Subchapter S corporation under the Internal Revenue Code; therefore, no taxes were paid by the corporation. All profits realized by the utility were paid to the two shareholders as if the corporation were a partnership and the shareholders paid taxes on it as ordinary income.").

[123] *Id.; see supra* discussion accompanying notes 96–102 (discussion of flow-through entities).

[124] *Suburban*, 652 S.W.2d at 363.

[125] *Id.* at 363 ("The [Public Utility Commission], however, refused to allow the federal income tax expense on the basis that hypothetical taxes should not be allowed a corporation having no legal tax liability.").

[126] *Id.*

[127] *Id.* (quoting Moyston v. N.M. Pub. Serv. Comm'n, 412 P.2d 840, 850 (N.M. 1966)).

economic substance of the S corporation's financial relationship with its shareholders.[128] As a result, the court found in favor of Suburban and held that the Commission must allow an S corporation to include in its operating expenses the federal-income taxes paid by its shareholders.[129]

Bishop v. District of Columbia involved a class action suit challenging a tax similar to the revised Texas franchise tax.[130] Several years prior to *Bishop*, Congress passed the Home Rule Act, which prohibited "any tax on the whole or any portion of the personal income, either directly or at the source thereof, of any individual not a resident of the District."[131] In *Bishop*, the District of Columbia Council recently had enacted a new law, Revenue Act of 1975, which imposed a "business tax upon unincorporated professionals and personal service businesses" located in the District.[132] The legislature called the tax "an unincorporated business franchise tax,"[133] and the tax was assessed on a taxable base that consisted of a business's gross receipts reduced by certain statutorily-defined deductions.[134] Similar to the effect of the Texas margin tax, when "the District of Columbia for the first time . . . [imposed an] unincorporated business tax upon unincorporated professionals and personal service businesses, . . . the tax on the income of unincorporated businesses suddenly burdened the personal income of thousands of previously untaxed individuals . . . ."[135]

Two nonresidents practicing law in the District challenged the tax on the grounds that it was a personal income tax in violation of the Home Rule Act.[136] The District of Columbia Court of Appeals recognized that

[128] *Id.*

[129] *Id.* at 364 ("We therefore hold that Suburban is entitled to a reasonable cost of service allowance for federal income taxes actually paid by its shareholders on Suburban's taxable income . . . .").

[130] 401 A.2d. 955, 955–56 (D.C. App. 1979).

[131] *Id.* at 956 (referring to D.C. CODE § 1-147(a)(a5) (1973 & Supp. 1978)).

[132] *Id.* at 955 (referring to D.C. CODE § 47-1574 (1973)).

[133] *Id.* at 959.

[134] *Id.* at 961 n.18 ("In order to determine taxable income, the taxpayer first must determine the gross income of the unincorporated business. From that amount, the taxpayer may exclude items designated as excludable [by the D.C. Code] and deduct amounts allowable under [the D.C. Code] . . . . The taxpayer then takes his wages paid deduction, which cannot be greater than 70% of net income computed without this deduction . . . [reduced by a statutory exemption which depended on whether the taxpayer was in the retail or service industry].").

[135] *Id.* at 957.

[136] *Id.* at 955–56. The case was certified as a class action on behalf of all nonresident professionals subject to the tax and who had paid the tax. *Id.*

"[f]ranchise taxes can be considered property taxes, excise taxes, gross income taxes, and most importantly income taxes, depending on the incidents of taxation."[137] Defining the issue as "whether [the Revenue Act] imposes a tax on the personal income of nonresidents or whether the tax is levied on something other than income (*e.g.*, the privilege of doing business in the District),"[138] the court explained that "[a]s 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."[139] The court then noted that "the [Revenue Act] tax is on unincorporated businesses, and is therefore in reality a tax on the associates or partners who run the business."[140] Discussing similar cases in other jurisdictions, the court pointed out that a "tax on net income is so, regardless of its nomenclature."[141] The court acknowledged that if the case had "dealt . . . with a corporate franchise tax, the result would be different," but "[t]o the extent that we deal with individuals who are professionals and are not protected by the corporate veil, we must find that the tax burdens the taxpayer personally."[142] The court also noted that legislatures in other jurisdictions had "likewise styled their tax a franchise tax only to have the courts intercede to reclassify the tax."[143] The court stated that "Congress specifically provided in the [Home Rule Act] that the District of Columbia could enact no tax which levied upon personal income of nonresidents," and that it could "come to no conclusion other than that the professional tax is such a tax."[144] Finding

[137] *Id.* at 959.

[138] *Id.* at 956.

[139] *Id.* at 958.

[140] *Id.* at 961 n.18.

[141] *Id.* at 960 (quoting Keasbey & Mattison Co. v. Rothensies, 133 F.2d 894, 898 (3d Cir. 1943)).

[142] *Id.* at 961.

[143] *Id.* at 959. The court provided the following examples: Gaulden v. Kirk, 47 So.2d 567 (Fla. 1950) (privilege tax was an excise tax); State ex rel. McKay v. Keller, 191 So. 542 (Fla. 1939) (license tax was an income tax); Comm'rs of Sinking Fund v. Howard, 248 S.W.2d 340 (Ky. 1952), *aff'd*, 344 U.S. 624 (1953) (occupational license tax was an income tax); City of Louisville v. Sebree, 214 S.W.2d 248 (Ky. App. 1948) (license fee was an occupation tax); Carter Carburetor Corp. v. City of St. Louis, 203 S.W.2d 438 (Mo. 1947) (earnings tax was an income or an excise tax). *Id.*

[144] *Id.* at 958. Regarding the Home Rule Act, the court also concluded that "[a]bsent a succinct statement of congressional intent to the contrary, we interpret the words 'impose a tax on the personal income of . . . nonresidents' by reference to their technical meaning as accepted by the courts, legislatures, and the tax bar." *Id.* at 958 n.10.

that the so-called "unincorporated business franchise tax" was in fact an income tax,[145] and that the tax, although purportedly assessed on an unincorporated business, was actually paid by the individual business owners,[146] the court held that the Revenue Act of 1975, when imposed on businesses owned by nonresidents, violated the Home Rule Act.[147]

A noncorporate business generally is considered to be a separate and distinct legal entity from its owners for many purposes.[148] However, when a business is taxed as a flow-through entity for federal-income-tax purposes, the business's earnings are recognized and reported by its owners individually, and thus all income and expense items affect the business and its owners financially as a single unit.[149] Therefore, any tax imposed on such a business impacts the individual owners directly.[150] Given the plain language of the constitutional amendment that prohibits a "tax on the net incomes of natural persons, including a person's share of partnership and unincorporated association income,"[151] and considering that courts repeatedly have interpreted taxation statutes based on the overall economic effect on an unincorporated business and its owners in the aggregate,[152] the margin tax, when assessed on partnerships and other unincorporated associations comprised of natural persons, is a prohibited tax on "a person's share of partnership and unincorporated association income."[153]

C. Voter Approval Required

The Texas Constitution requires that any law imposing a personal-income tax "must provide that the portion of the law imposing the tax not

[145] *Id.* at 959.

[146] *Id.* at 961 n.18.

[147] *Id.* at 961.

[148] Tex. Bus. Orgs. Code Ann. § 152.056 (Vernon Supp. 2009).

[149] *See supra* notes 100–103 and accompanying text.

[150] *See supra* notes 100–103 and accompanying text.

[151] Tex. Const. art. VIII, § 24(a).

[152] *See supra* notes 104–147 and accompanying text.

[153] Letter from Carole Keeton Strayhorn, Tex. Comptroller of Pub. Accounts, to Greg Abbott, Attorney Gen. of Tex. (April 21, 2006), *available at* http://www.cpa.state.tx.us/news/60421letter.html ("[T]he partnership/unincorporated association proviso of the Bullock Amendment refers plainly and simply to 'a person's share' of the income of an unincorporated association as triggering the referendum. Whether the tax is directly on an entity is irrelevant if the only inquiry is whether there is ultimately a tax levied on 'a person's share' . . . .").

take effect until approved by a majority of the registered voters voting in a statewide referendum held on the question of imposing the tax."[154] According to the Texas Code Construction Act, "'must' creates or recognizes a condition precedent"[155] and Texas case law interprets that term to mean "mandatory."[156] The constitution does not disallow an income tax from ever being imposed on Texans—it simply creates a mandatory condition precedent for doing so. A condition precedent is a certain act or event that must happen before another act or event is permitted or required to occur.[157] This means that in order for a personal income tax to be constitutional a statewide vote approving the tax must happen before the law imposing the tax takes effect.[158]

Voters enacted this constitutional amendment with the intent and understanding that unless and until the condition precedent (approval via a statewide vote) occurred, each Texan's income—personal earnings and partnership and unincorporated association earnings—would be protected from a state-imposed income tax.[159] However, H.B. 3 does not require that the margin tax be approved by voters before taking effect, and no such vote occurred prior to the tax on partnerships and unincorporated associations taking effect in 2008.[160] Because the mandatory condition precedent outlined in the Texas Constitution has not occurred, the margin tax, as applied to partnerships and unincorporated associations owned by natural persons, is unconstitutional.

[154] Tex. Const. art. VIII, § 24(a).

[155] Tex. Gov't Code Ann. § 311.016(3) (Vernon 2005).

[156] *See* City of DeSoto v. White, 288 S.W.3d 389, 395 (Tex. 2009) ("The Code Construction Act explains that 'must' creates or recognizes a 'condition precedent,' and we have recognized that 'must' generally means mandatory." (citation omitted)).

[157] BLACK'S LAW DICTIONARY 312 (8th ed. 2004).

[158] Tex. Const. art. VIII, § 24(a).

[159] *See* Egan, *supra* note 47, at 105 ("[T]he Bullock Amendment's language encompasses an income tax on a partnership interest attributable to a natural person, whether imposed at the partnership or individual level, by its reference to 'a person's share of partnership and unincorporated association income.' This plain language makes no distinction between general partnerships, limited partnerships and limited liability partnerships, and applies even if the partnership is viewed as a separate legal entity.").

[160] *See* Patterson, *supra* note 5, at 22 (noting that the margin tax was not submitted to voters for approval).

III. CONCLUSION

In 1993, Texans enacted a constitutional amendment to prevent the legislature from taxing their personal incomes without a statewide referendum first approving the measure.[161] According to the language of the amendment, it was guaranteed (absent prior voter consent) that each Texan's full share of partnership and unincorporated-association earnings would be protected from and undiminished by a state-imposed income tax.[162]

In 2006, the Texas legislature passed H.B. 3, imposing a margin tax on partnerships and other unincorporated entities, to take effect on January 1, 2008.[163] This margin-tax calculation, as explained above, is essentially the same as an income-tax calculation. H.B. 3 should have included a provision requiring a statewide referendum on the tax for two reasons. First, the constitutional amendment passed only a few years prior explicitly prohibits an income tax on a natural person's share of partnership and unincorporated-association income. Second, H.B. 3 imposes a tax on partnership and other unincorporated entities owned by natural persons that consists of the same basic calculations as an income tax. Because H.B. 3 did not include a statewide referendum, and the tax imposed by H.B. 3 was not approved by Texas voters, the margin tax is unconstitutional when applied to the earnings of partnerships and other unincorporated associations owned by natural persons.

[161] Legislative Reference Library of Texas, *supra* note 20.

[162] Tex. H.B. 3, 79th Leg., 3d C.S. (2006).

[163] *Id.*