



1-1-2008

## A Marginal Tax: The New Franchise Tax in Texas Comment.

David A. Vanderhider

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### Recommended Citation

David A. Vanderhider, *A Marginal Tax: The New Franchise Tax in Texas Comment.*, 39 ST. MARY'S L.J. (2008).

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## A MARGINAL TAX: THE NEW FRANCHISE TAX IN TEXAS

DAVID A. VANDERHIDER

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### I. INTRODUCTION

Taxation has long been a point of contention for both individuals and businesses. Political candidates live<sup>1</sup> and die<sup>2</sup> by

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1. See Bernard M. Shapiro, *Presidential Politics and Deficit Reduction: The Landscape of Tax Policy in the 1980s and 1990s*, 50 WASH. & LEE L. REV. 441, 444 (1993) (“George Bush entered the White House having campaigned on two tax-related planks. The first was his infamous statement, ‘Read my lips, no new taxes,’ which was later translated loosely by the Administration as a pledge not to increase individual or corporate income tax rates.” (footnote omitted)).

their promises to lower or raise taxes. Many educated professionals on both sides of the taxation issue have well-informed, yet opposite opinions regarding the nature and extent of taxation. This raises the questions: Why have a tax, and how should that tax be assessed?

Primarily, taxation serves as a convenient and calculated method of allocating precious resources to areas in need. For instance, taxation is a method by which the government can fund state-sponsored programs such as education.<sup>3</sup> Although many states use property taxes and income taxes as the preferred methods for funding these programs,<sup>4</sup> Texas has a constitutional restriction on state taxation of individuals' incomes.<sup>5</sup> Thus, Texas has largely relied on property taxes and business taxes to fund education.<sup>6</sup>

In 1991, trying to avoid an unconstitutional tax on individuals' income, yet recognizing the large revenue and fortunate tax status

2. See Alan B. Morrison, *The Judge Has No Robes: Keeping the Electorate in the Dark About What Judges Think About the Issues*, 36 IND. L. REV. 719, 726 (2003) ("Even when politicians make specific pledges as candidates—see George H. W. Bush, 'Read my lips; no new taxes'—they do not always follow them, and sometimes they pay a price for not doing so." (footnote omitted)); see also Leo P. Martinez, *Tax Legislation and Democratic Discourse: The Rhetoric of Revenue and Politics*, 4 NEV. L.J. 510, 512 (2004) (indicating that George H. W. Bush lost the 1992 presidential election to William J. Clinton in large part due to his failure to keep his promise of no new taxes).

3. See generally Laurie Reynolds, *Skybox Schools: Public Education as Private Luxury*, 82 WASH. U. L.Q. 755, 762–79 (2004) (highlighting state-sponsored education funding inadequacies throughout the United States).

4. See, e.g., Robert C. Huntley, *Public Education School Funding Litigation in Idaho: A Tale of Legislative Irresponsibility and Delay*, 41 IDAHO L. REV. 247, 248 (2005) ("Traditionally, since our nation's founding, public education in the United States has been funded by property taxes."). As property taxes became increasingly disfavored, however, some states, including Idaho, turned to income taxes to fund education. *Id.*

5. See, e.g., TEX. CONST. art. VIII, § 24(a) (indicating that any law that taxes the "net incomes of natural persons, including a person's share of partnership and unincorporated association income," is not effective until approved by a majority of Texas voters in a statewide referendum).

6. See Texas Governor Rick Perry, Report of the Texas Tax Reform Commission, [http://www.governor.state.tx.us/priorities/tax\\_reform/TTRC\\_report](http://www.governor.state.tx.us/priorities/tax_reform/TTRC_report) (last visited Apr. 16, 2008) (reciting that "a record \$6 billion property tax cut for homeowners and employers" and increased taxation of Texas businesses will relieve property tax revenues from bearing the full weight of educational funding in Texas). Although the property tax cut led to an increase in business taxation in order to fund state-sponsored education, Texas still prohibits an ad valorem tax on property. See TEX. CONST. art. VIII, § 1(d)(1) (prohibiting a state-imposed ad valorem tax on personal property not used to produce income and "personal property homestead"). However, local ad valorem taxes are constitutional, even though state regulation of those taxes has been held unconstitutional. See *Neeley v. W. Orange-Cove Consol. Indep. Sch. Dist.*, 176 S.W.3d 746, 754 (Tex. 2005) (holding unconstitutional the State's regulation of local ad valorem taxes).

of many business entities, the Texas Legislature adopted a franchise tax that, with limited changes, remained in effect until January 1, 2008.<sup>7</sup> The franchise tax taxed Texas businesses according to their capital.<sup>8</sup> Because many businesses were exempt from the franchise tax, however, Texas lost potential revenue that could have been used to solve the persistent school funding problem.<sup>9</sup> After the Texas Supreme Court issued an ultimatum to the Texas Legislature to resolve the school funding crisis,<sup>10</sup> a new business tax seemed inevitable. In 2006, therefore, the Texas Legislature adopted the new margin tax, which expands the outdated franchise tax.<sup>11</sup> The margin tax increases the number and kind of entities taxed<sup>12</sup> and, true to its nomenclature, taxes a business's margin, or revenue, instead of mere capital.<sup>13</sup>

7. *See generally* Act approved Aug. 22, 1991, 72d Leg., 1st C.S., ch. 5, §§ 8.01, 8.03, 1991 Tex. Gen. Laws 134, 152–54 (amended 2007) (current version at TEX. TAX CODE ANN. §§ 171.0002, .002 (Vernon 2008)) (indicating the types of taxable entities and applicable rates under the franchise tax).

8. *See* 19 ROBERT W. HAMILTON, ELIZABETH S. MILLER & ROBERT A. RAGAZZO, TEXAS PRACTICE SERIES § 4.1 (2d ed. 2007) (claiming that the Texas Legislature transformed the Texas franchise tax on business profits such that it indirectly created business income tax for limited liability companies and corporations (citing TEX. TAX CODE ANN. § 171.002(a) (Vernon 1992))).

9. *See* John A. Biek, *New Texas “Margin Tax” Will Apply to Most Passthrough Entities*, J. PASSTHROUGH ENTITIES, Sept.–Oct. 2006, at 16–17, available at [http://www.mwe.com/info/pubs/biek\\_jpte0906.pdf](http://www.mwe.com/info/pubs/biek_jpte0906.pdf) (explaining that it was not until the Texas Supreme Court gave the Texas Legislature a June 1, 2006 deadline to reform the state's educational funding that the third called session of the 79th Legislature revised the franchise tax). Presumably, a previous overhaul of the franchise tax not contingent on an ultimatum would have added revenue to the state budget.

10. *See* Neeley, 176 S.W.3d at 797, 799 (Tex. 2005) (ruling that the State's Robin Hood school funding plan was unconstitutional and giving the Texas Legislature until June 1, 2006 to reform educational funding).

11. *See generally* Act approved May 19, 2006, 79th Leg., 3d C.S., ch. 1, §§ 1–27, 2006 Tex. Gen. Laws 1 (amended 2007) (current version at TEX. TAX CODE ANN. §§ 21.02, 171.0001–.401, 313.007 (Vernon 2008)) (indicating, among other items, the types of taxable entities, the tax base, and the applicable tax rate).

12. *See* TEX. TAX CODE ANN. § 171.0002(a) (Vernon 2008) (defining “taxable entity” as “a partnership, corporation, banking corporation, savings and loan association, limited liability company, business trust, professional association, business association, joint venture, joint stock company, holding company, or other legal entity”). House Bill 3928 of the regular session of the 80th Legislature amended House Bill 3, adding “limited liability partnership” as a taxable entity. Act approved June 15, 2007, 80th Leg., R.S., ch. 1282, § 1, 2007 Tex. Gen. Laws 4282, 4284–85 (codified at TEX. TAX CODE ANN. § 171.0002(a) (Vernon 2008)).

13. *See* TEX. TAX CODE ANN. § 171.101(a)(1) (Vernon 2008) (computing a taxable entity's taxable margin based on its total revenue instead of actual earnings or profit).

The controversial nature of the new tax lies in its significant reform. Long-used methods of circumventing the franchise tax, such as business restructuring and asset reallocation, are curtailed by the margin tax.<sup>14</sup> Thus, as one source put it, “[m]any businesses and professionals that paid no franchise tax, including most law firms, must now pay.”<sup>15</sup> This will affect small businesses especially, since small businesses are more likely to feel the financial effects of increased taxation than larger businesses with greater revenue.<sup>16</sup> Another potential effect of the margin tax is that the increased cost of the privilege of doing business in Texas will be passed on to consumers.<sup>17</sup> Despite a record reduction in property taxes for many Texans, it is possible that the true taxpayers under the margin tax will still be Texas consumers. Moreover, distinguishing “revenue” from “income” is a fine line, and many experts feel that the margin tax is simply an unconstitutional means by which the state can assess an income tax

14. See TEX. TAX CODE ANN. § 171.0002(a) (Vernon 2008) (listing the business entities covered under the term “taxable entity,” among which is a “partnership”). The margin tax prevents businesses from restructuring as a partnership or limited partnership by adding “partnership” as a taxable entity. *Id.* In contrast, the former version of the Texas Tax Code, effective until January 1, 2008, lists only corporations, limited liability companies, and state or federal savings and loan associations as taxable entities. Act of June 16, 1991, 72d Leg., R.S., ch. 901, § 53, 1991 Tex. Gen. Laws 3161, 3218 (current version at TEX. TAX CODE ANN. § 171.0002 (Vernon 2008)); Act approved Aug. 22, 1991, 72d Leg., 1st C.S., ch. 5, §§ 8.01, 1991 Tex. Gen. Laws 134, 152 (current version at TEX. TAX CODE ANN. § 171.0002 (Vernon 2008)). The addition of “limited liability partnership” as a taxable entity came as an amendment to House Bill 3 in 2007. Act approved June 15, 2007, 80th Leg., R.S., ch. 1282, § 2, 2007 Tex. Gen. Laws 4282, 4284–85 (codified at TEX. TAX CODE ANN. § 171.0002(a) (Vernon 2008)). The margin tax also prevents asset reallocation by requiring combined reporting for businesses. See TEX. TAX CODE ANN. § 171.1014(a) (Vernon 2008) (“Taxable entities that are part of an affiliated group engaged in a unitary business shall file a combined group report in lieu of individual reports based on the combined group’s business.”). In effect, businesses can no longer shield revenue from the margin tax merely by transferring assets to an out-of-state affiliate. *Cf. id.* (taxing all affiliates as a combined group).

15. Mike Seay & Jimmy Martens, *The New Texas Margin Tax*, 70 TEX. B.J. 30, 30 (2007).

16. See David Hendricks, *Group to Seek Tax Changes*, SAN ANTONIO EXPRESS-NEWS, July 25, 2007, at 1E (asserting that small businesses will be adversely affected by the margin tax to a greater extent than large businesses).

17. See, e.g., Editorial, *Reading Between the Lines of Sprint’s New Surcharge*, AUSTIN AM.-STATESMAN, Jan. 26, 2007, at A16 (“It’s not surprising that a business would try to pass on a new state tax directly to its customers, as Sprint Nextel, the wireless phone carrier, apparently intends to do with the new state margin tax.”).

without calling it an income tax.<sup>18</sup>

On the other hand, the margin tax is widely considered more equitable than the franchise tax because it places nearly all Texas businesses “in the boat of taxation”—it taxes more businesses yet reduces the tax rate for each business as compared to the franchise tax.<sup>19</sup> Texas businesses that paid little or no tax under the franchise tax, yet enjoyed state protection in the form of limited liability, must now rightfully pay for that benefit under the margin tax.<sup>20</sup> The goal of the Texas Tax Reform Commission, which Governor Rick Perry charged with forming the margin tax, was to absorb as many businesses into the tax scheme as possible by spreading the tax burden, providing a lower tax rate, and closing the then-lawful tax avoidance methods so prevalent under the franchise tax.<sup>21</sup> Finally, even though the property tax cut “will benefit property-intensive companies more than others, . . . it still represents a significant offset to the margin tax.”<sup>22</sup>

The first tax returns are due in May 2008;<sup>23</sup> the full effect of the new margin tax remains to be seen. Before analyzing the new margin tax, we must first understand the basic history of business taxation in Texas in order to understand how and why the state

18. See 19 ROBERT W. HAMILTON, ELIZABETH S. MILLER & ROBERT A. RAGAZZO, *TEXAS PRACTICE SERIES* § 4.3 (2d ed. 2007) (“Comptroller Carole Keeton Strayhorn has requested an Attorney General’s opinion on the question of whether the new tax avoids the constitutional prohibition against an income tax on natural persons.”); see also Mike Seay & Jimmy Martens, *The New Texas Margin Tax*, 70 *TEX. B.J.* 30, 30 (2007) (claiming that a tax on an entity’s margin “is a concept similar to taxable income”); Cynthia M. Ohlenforst et al., *Taxation*, 59 *SMU L. REV.* 1565, 1577 (2006) (discussing the argument “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”).

19. Interview with T. Randall Cain, Member, Tex. Tax Reform Comm’n, in San Antonio, Tex. (Feb. 26, 2008).

20. *Id.*

21. *Id.* “[The margin tax] will close loopholes and encompass a broader cross-section of the state economy, providing a fairer way to fund our children’s education.” Texas Governor Rick Perry, Report of the Texas Tax Reform Commission, [http://www.governor.state.tx.us/priorities/tax\\_reform/TTRC\\_report](http://www.governor.state.tx.us/priorities/tax_reform/TTRC_report) (last visited Apr. 16, 2008).

22. Editorial, *Tax Brakes: Legislature Should Put Its Foot Down*, *AUSTIN AM.-STATESMAN*, Jan. 21, 2007, at G2.

23. See Act approved May 19, 2006, 79th Leg., 3d C.S., ch. 1, § 26, 2006 *Tex. Gen. Laws* 1, 40 (“[T]his Act takes effect January 1, 2008, and applies to reports originally due on or after that date.”); 19 ROBERT W. HAMILTON, ELIZABETH S. MILLER & ROBERT A. RAGAZZO, *TEXAS PRACTICE SERIES* § 4.2.5 (2d ed. 2007) (noting that the first returns will be based on 2007 revenue and must be filed by May 15, 2008).

legislature has made this latest change. Furthermore, analyzing the differences between the franchise tax and the margin tax will allow greater understanding of the complicated margin tax and help Texas businesses estimate their new tax liability. By examining the policy and substance behind the changes to the franchise tax, and by comparing the margin tax with business taxes of other states, we can further anticipate problems and ponder the possible solutions to this controversial change in Texas tax law. The margin tax is both positive and problematic, and even more changes should and probably will be made before the first returns are filed.<sup>24</sup> More than anything, however, the Texas Legislature and Comptroller for Public Accounts need to clarify terms, simplify instructions, and provide example calculations—in addition to the online margin tax calculations worksheet—in order to reduce the confusion and ambiguity surrounding the tax.

## II. BACKGROUND

### A. *Business Taxation in Texas*

Not surprisingly, Texas has taxed businesses throughout its history.<sup>25</sup> In 1846, the first Texas Legislature taxed occupations.<sup>26</sup>

24. David Jackson & Jon Wellington, *Major Tax Reform in Texas: An Overview of the State's New Margin Tax*, 16 J. MULTISTATE TAX'N 8, 19 (2006) (commenting that, in addition to clarifications from the Comptroller's Office, "the political landscape in Texas" is likely to change prior to the next legislative session given the pending statewide elections, which could result in further changes to the margin tax).

25. See, e.g., TEX. CONST. of 1845, art. VII, § 27 (granting power to the legislature to "tax all persons pursuing any occupation, trade, or profession" so long as agricultural and mechanical pursuits are not taxed); Act approved Feb. 3, 1845, 9th Cong. R.S., § 2, 1845 Repub. Tex. Laws 95, 95, reprinted in 2 H.P.N. GAMMEL, THE LAWS OF TEXAS 1822–1897, at 1141, 1141 (Austin, Gammel Book Co. 1898) (enacting a tax on "each merchant who sells and disposes of goods and merchandize at retail" in the amount of twenty-five dollars annually).

26. See Act approved Apr. 28, 1846, 1st Leg., § 4, 1846 Tex. Gen. Laws 146, 147–48, reprinted in 2 H.P.N. GAMMEL, THE LAWS OF TEXAS 1822–1897, at 1452, 1453–54 (Austin, Gammel Book Co. 1898) (designating a tax on theatre owners, museums, wholesale or retail traders of goods, wine and liquor venders, billiard table and bowling alley owners, inn keepers, boarding houses, race tracks, brokers, and auctioneers). The 1st Legislature also levied a property tax, providing that "there shall be assessed and collected of all persons within the limits of this State, for the use of the State a direct ad valorem tax, at the rate of twenty cents upon each hundred dollars value of all property real and personal." Act approved Apr. 28, 1846, 1st Leg., § 1, 1846 Tex. Gen. Laws 146, reprinted in 2 H.P.N. GAMMEL, THE LAWS OF TEXAS 1822–1897, at 1452, 1452 (Austin, Gammel

The Texas Legislature revised the taxation on occupations in 1879, creating an annual two hundred dollar flat tax on salesmen or solicitors of trade and a progressive tax on merchants based on their annual purchases.<sup>27</sup> In 1881, the flat tax was lowered to fifty dollars.<sup>28</sup> That same year, attorneys were also taxed at an annual amount of five dollars, paid to their county of residence.<sup>29</sup> In 1907, however, the 30th Legislature repealed occupation taxes for “useful” occupations<sup>30</sup> including merchants, brokers, bankers, land agents, and attorneys, among many others.<sup>31</sup> By 1911, occupation taxes were levied against entities such as wholesale and retail merchants, commercial travelers, clock peddlers, liquor dealers, brewers, hotels, insurance companies, physicians,

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Book Co. 1898).

27. Act approved Apr. 6, 1889, 21st Leg., R.S., ch. 32, § 1, 1889 Tex. Gen. Laws 24, 24, *reprinted in* 9 H.P.N. GAMMEL, THE LAWS OF TEXAS 1822–1897, at 1052, 1052 (Austin, Gammel Book Co. 1898); *see also* Texas Comptroller’s Office: An Inventory of Comptroller’s Office Tax Volumes (Other Than Ad Valorem) at the Texas State Archives, 1870–1873, 1879–1921, undated, <http://www.lib.utexas.edu/taro/tslac/30098/tsl-30098.html#series1> (last visited Apr. 8, 2008) (“In 1846 the 1st Legislature created a state tax on occupations, a law which was revised repeatedly (in 1862, 1864, 1871, 1879, 1881, 1882, 1884, 1885, 1895, 1897, 1905, 1907, 1909, 1911, etc.).”).

28. Act approved Mar. 24, 1881, 17th Leg., R.S., ch. 55, § 3, 1881 Tex. Gen. Laws 53, 55, *reprinted in* 9 H.P.N. GAMMEL, THE LAWS OF TEXAS 1822–1897, at 145, 147 (Austin, Gammel Book Co. 1898); *see also* Texas Comptroller’s Office: An Inventory of Comptroller’s Office Tax Volumes (Other Than Ad Valorem) at the Texas State Archives, 1870–1873, 1879–1921, undated, <http://www.lib.utexas.edu/taro/tslac/30098/tsl-30098.html#series5> (last visited Apr. 8, 2008) (“In 1881 the 17th Legislature lowered the occupation tax on these persons to fifty dollars.”).

29. Act approved Mar. 24, 1881, 17th Leg., R.S., ch. 55, § 3, 1881 Tex. Gen. Laws 53, 55, *reprinted in* 9 H.P.N. GAMMEL, THE LAWS OF TEXAS 1822–1897, at 145, 147 (Austin, Gammel Book Co. 1898).

30. *See* Act approved Mar. 21, 1907, 30th Leg., R.S., ch. 35, § 1, 1907 Tex. Gen. Laws 57, 57–58, *reprinted in* 13 H.P.N. GAMMEL, THE LAWS OF TEXAS 1907, at 57, 57–58 (Austin, Gammel Book Co. 1898) (evidencing the 30th Legislature’s repeal of many of the occupation taxes levied by the 25th Legislature).

31. *Id.*; *see also* Texas Comptroller’s Office, An Inventory of Comptroller’s Office Tax Volumes (Other Than Ad Valorem) at the Texas State Archives, 1870–1873, 1879–1921, undated, <http://www.lib.utexas.edu/taro/tslac/30098/tsl-30098.html#series1> (last visited Apr. 8, 2008) (repealing “occupation taxes on certain ‘useful’ occupations”).

[T]he 30th Legislature, Regular Session (House Bill 128) repealed occupation taxes on certain ‘useful’ occupations, including: merchants, brokers, bankers, non-traveling dentists, photograph galleries, toll bridges, land agents, attorneys and conveyancers, livery stables, vehicles and wagon yards, [and] local insurance agents . . .

Texas Comptroller’s Office, An Inventory of Comptroller’s Office Tax Volumes (Other Than Ad Valorem) at the Texas State Archives, 1870–1873, 1879–1921, undated, <http://www.lib.utexas.edu/taro/tslac/30098/tsl-30098.html#series1> (last visited Apr. 8, 2008).



surgeons, attorneys, barbers, auctioneers, cotton brokers, and pawnbrokers.<sup>32</sup> Texas still has an occupation tax on attorneys; the tax was revised in 1991 to a rate of two hundred dollars per year.<sup>33</sup>

Moving closer toward the creation of a margin tax, in April 1879, the state taxed railroad companies at 1% of their gross receipts from passenger travel within the state, and telegraph companies were taxed at one cent per message.<sup>34</sup> In May 1907, the Texas Legislature added a gross receipts tax for entities such as insurance companies, wholesale dealers, and liquor distributors, requiring these businesses to file quarterly with the Texas Comptroller of Public Accounts.<sup>35</sup> Among the first taxes on business receipts, as opposed to an occupational flat tax, these taxes were surprisingly similar to the current margin tax which taxes gross revenue at a rate of 1% for most businesses.<sup>36</sup>

Finally, article VIII, section 1 of the Texas Constitution authorizes the legislature to “impose occupation taxes, both upon natural persons and upon corporations, other than municipal, doing any business in this State.”<sup>37</sup> However, article VIII, section

32. Texas Comptroller's Office: An Inventory of Comptroller's Office Tax Volumes (Other Than Ad Valorem) at the Texas State Archives, 1870–1873, 1879–1921, undated, <http://www.lib.utexas.edu/taro/tslac/30098/tsl-30098.html#series5> (last visited Apr. 8, 2008).

33. Act approved Aug. 22, 1991, 72d Leg., 1st C.S., ch. 5, § 10.12, 1991 Tex. Gen. Laws 134, 182, *amended by* Act of June 1, 1995, 74th Leg., R.S., ch. 66, § 1, secs. 191.141–.145, 1995 Tex. Gen. Laws 444, 444–45.

34. Act approved Apr. 22, 1879, 16th Leg., R.S., ch. 134, § 3, 1879 Tex. Gen. Laws 143, 147 *reprinted in* 8 H.P.N. GAMMEL, THE LAWS OF TEXAS 1822–1897, at 1443, 1447 (Austin, Gammel Book Co. 1898).

35. *See* Act approved May 16, 1907, 30th Leg., 1st C.S., ch. 18, §§ 8, 11, 1907 Tex. Gen. Laws 479, 482, 485, *reprinted in* 13 H.P.N. GAMMEL, THE LAWS OF TEXAS 1907, at 479, 482, 485 (Austin, Gammel Book Co. 1898) (replacing the 1905 act; levying occupation taxes on certain individuals, companies, corporations, and associations operating in Texas).

36. *See* JOHN C. ALE, PARTNERSHIP LAW FOR SECURITIES PRACTITIONERS § 4:1 n.14 (2007) (explaining that the margin tax applies a 1% rate to gross revenue, except for certain retail businesses, which are taxed at 0.5%).

37. TEX. CONST. art. VIII, § 1(c) (amended 1987); *see* 22B AM. JUR. PL. & PR. FORMS *State and Local Taxation* § 271 (2006) (indicating that a state does not violate the Commerce Clause of the United States Constitution when taxing a business for work performed within that state); TEX. JUR. 3D *Taxation* § 46 (2006) (noting that the Texas Legislature is authorized to levy occupational taxes and intangible personal property taxes subject to article VIII, section 24 of the Texas Constitution). *But see* Grayburg Oil Co. v. Tex., 278 U.S. 582, 582 (1929) (mem. op.) (holding that a state cannot tax federal corporate instrumentalities); *Young & Co. of Houston v. Calvert*, 405 S.W.2d 174, 176 (Tex. Civ. App.—Austin 1966, writ ref'd) (indicating that a discriminatory tax on

24 states that “[a] general law enacted by the legislature that imposes a tax on the net incomes of natural persons, including a person’s share of partnership and unincorporated association income, must . . . not take effect until approved by a majority of the registered voters voting in a statewide referendum.”<sup>38</sup>

These two sections of Article VIII are at the heart of the controversy of the new Texas margin tax. On one hand, the legislature is entitled to tax entities on any business conducted in Texas. On the other hand, the legislature cannot tax individuals on their income—even if that income is from a business partnership or similar entity. One issue surrounding the margin tax will be where that line is drawn, and whether the margin tax is merely a tax on the privilege of doing business in Texas, or an unconstitutional income tax on individuals.<sup>39</sup> 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

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businesses violates both the Texas Constitution and the United States Constitution).

38. TEX. CONST. art. VIII, § 24(a). Interestingly, article VIII, section 24 also indicates that if a tax levied under subsection (a) is approved by a majority of Texas voters, “not less than two-thirds of all net revenues remaining after payment of all refunds allowed by law and expenses of collection from the tax shall be used to reduce the rate of ad valorem maintenance and operation taxes levied for the support of primary and secondary public education.” *Id.* § 24(f). Although the Texas Legislature aimed to avoid section 24(a) of article VIII by claiming that the margin tax was not an income tax on individuals, a primary reason for the margin tax—the reduction of property taxes “levied for the support of primary and secondary public education”—was precisely the manner in which the revenue would be used even if the margin tax was subject to voter approval. *See* Texas Governor Rick Perry, Report of the Texas Tax Reform Commission, [http://www.governor.state.tx.us/priorities/tax\\_reform/TTRC\\_report](http://www.governor.state.tx.us/priorities/tax_reform/TTRC_report) (last visited Apr. 16, 2008) (quoting Texas Governor Rick Perry who asserts that the tax reform plan “substantially improves the school finance system [while providing] a record \$6 billion property tax cut for homeowners and employers”).

39. *See* Act approved May 19, 2006, 79th Leg., 3d C.S., ch.1, § 21, 2006 Tex. Gen. Laws 1, 38 (amended 2007) (“The franchise tax imposed by Chapter 171, Tax Code, as amended by this Act, is not an income tax and Pub. L. No. 86-272 does not apply to the tax.”). Thus, the margin tax, which consists of House Bill 3 (2006) and House Bill 3928 (2007) is not an income tax according to its own terms. *Id.* Nonetheless, other authorities contend that it is a prohibited income tax. *See, e.g.,* PETER M. FASS, MICHAEL E. SHAFF & DONALD B. ZIEF, REAL ESTATE INVESTMENT TRUSTS HANDBOOK § 6:97 (2007) (“Total revenue for the new Texas franchise margin tax is computed under the same method chosen by the entity to report income on its federal income tax return.”); DELOITTE TAX, LLP, SWEEPING TEXAS FRANCHISE TAX CHANGES: THE MARGIN TAX 1 (2006), [http://www.deloitte.com/dtt/cda/doc/content/us\\_tax\\_alert\\_texas\\_margin\\_240506.pdf](http://www.deloitte.com/dtt/cda/doc/content/us_tax_alert_texas_margin_240506.pdf) (explaining that the extent of the deductions applied to the tax base renders the margin tax an income tax).

practical effect.<sup>40</sup>

### B. *The Franchise Tax in Texas*

In 1905, the 29th Legislature required foreign corporations operating in Texas to pay a franchise tax based on the corporation's capital stock.<sup>41</sup> Such a tax is constitutional "when the tax is applied to an activity with a substantial nexus with the taxing State, is fairly apportioned, does not discriminate against interstate commerce, and is fairly related to the services provided by the State."<sup>42</sup> In 1907, the 30th Legislature adopted a uniform franchise tax, which taxed in-state and out-of-state corporations on their Texas receipts for the "privilege" of doing business in Texas and enjoying the protection of state law.<sup>43</sup> Moreover, in 1991,

40. See, e.g., Press Release, Tex. Comptroller of Pub. Accounts, Comptroller Strayhorn Believes Gov. Perry's "Margin Tax" Is an Income Tax; Requests Formal Attorney General's Opinion (Apr. 21, 2006), <http://www.window.state.tx.us/news/60421taxplan.html> (arguing that the margin tax "includes an income tax, pure and simple").

41. Act approved Mar. 1, 1905, 29th Leg., R.S., ch. 19, § 1, 12 Tex. Gen. Laws 1902-1905, at 21, 22. Although out-of-state companies challenged the constitutionality of the first franchise tax in Texas, courts repeatedly upheld the law as a constitutional exercise of state legislative power that did not violate the Commerce Clause. See *Tarrant County v. Rogers*, 125 S.W. 592, 594 (Tex. Civ. App.—Dallas 1910, writ granted) (distinguishing the *Gaar* opinion based on the facts of the case, yet upholding the general principle that a tax upon out-of-state businesses is a constitutional exercise by the state legislature), *modified*, 104 Tex. 244, 135 S.W. 110 (1911); *Gaar, Scott & Co. v. Shannon*, 115 S.W. 361, 364 (Tex. Civ. App.—Austin 1908, writ granted) ("The tax so imposed being equal and alike upon all foreign corporations within the same class, we, therefore, think, cannot be assailed merely upon the ground that a less tax is imposed upon domestic corporations . . . under the law it seems the state has the clear right to do."). *But see* *Woessner v. H.T. Cottam & Co.*, 47 S.W. 678, 680 (Tex. Civ. App.—Austin 1898, writ ref'd) (stating that an 1893 tax on out-of-state businesses unconstitutional was a violation of interstate commerce since it required out-of-state businesses to pay the tax in order to do business in Texas, or to sue or defend in Texas courts).

42. *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274, 279 (1977); see U.S. CONST. art. I, § 8, cl. 3 (noting Congress's authority to regulate activities between states, which has traditionally applied to one state's taxation of an out-of-state business); Philip M. Tatarowicz & Rebecca F. Mims-Velarde, *An Analytical Approach to State Tax Discrimination Under the Commerce Clause*, 39 VAND. L. REV. 879, 883 (1986) (reiterating the four-step analysis proffered by the *Brady* court).

43. Act approved May 16, 1907, 30th Leg., 1st C.S., ch. 23, §§ 1, 2, 1907 Tex. Gen. Laws 502, 502-03, *reprinted in* 13 H.P.N. GAMMEL, THE LAWS OF TEXAS 1907, at 502, 502-03 (Austin, Gammel Book Co., Supp. 1907). Domestic corporations were taxed at fifty cents for every thousand dollars of capital stock, while foreign corporations were taxed at one dollar for every thousand dollars of capital stock. *Id.*; see 19 ROBERT W.

modifications to the franchise tax made Limited Liability Companies (LLCs) organized or doing business in Texas subject to a tax on their “taxable capital.”<sup>44</sup> This tax was not a percentage of capital as a whole, but instead a proportion of businesses’ profits from Texas operations compared to national operations, called the “apportionment factor.”<sup>45</sup> Much like the anticipated legal debate surrounding the margin tax, the franchise tax has had its share of challenges. It has survived challenges by out-of-state companies claiming that it violated the Commerce Clause of the United States Constitution,<sup>46</sup> Equal Protection Clause challenges,<sup>47</sup> and

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HAMILTON, ELIZABETH S. MILLER & ROBERT A. RAGAZZO, TEXAS PRACTICE SERIES § 4.1 (2d ed. 2007) (stating that the granting of the privilege to transact business in Texas confers an economic benefit on corporations, including the ability to invoke protection under Texas law (citing *Bullock v. Nat’l Bancshares Corp.*, 584 S.W.2d 268, 270 (Tex. 1979))).

44. Act of June 16, 1991, 72d Leg., R.S., ch. 901, § 53, 1991 Tex. Gen. Laws 3161, 3218 (current version at TEX. TAX CODE ANN. §§ 171.0002, .002 (Vernon 2008)); *see also* Cynthia M. Ohlenforst & Jeff W. Dorrill, *Taxation*, 45 Sw. L.J. 2093, 2102 (1992) (noting that “each limited liability company that does business” in Texas is subject to the franchise tax).

45. *Nat’l Bancshares*, 584 S.W.2d at 270. The apportionment factor is important in determining the overall tax liability since a state cannot constitutionally tax a business on its out-of-state revenue. CHARLES A. TROST & PAUL J. HARTMAN, FEDERAL LIMITATIONS ON STATE AND LOCAL TAXATION § 12:7 (2d ed. 2007) (“A State is constitutionally forbidden to include the total value of the multistate business activities of a foreign corporation for tax purposes.”). Therefore, states with business taxes allow out-of-state companies to account for business done out-of-state. *Id.*

46. *See Ford Motor Co. v. Beauchamp*, 308 U.S. 331, 334–35 (1939) (affirming that the Texas tax that was based upon a business’s proportion of capital employed and a percentage of the sales made in Texas was a constitutional state exercise); *see also* *INOVA Diagnostics, Inc. v. Strayhorn*, 166 S.W.3d 394, 402–03 (Tex. App.—Austin 2005, pet. denied) (establishing that as long as a company has a physical presence in Texas, that company is subject to the franchise tax without violation of the Commerce Clause); *General Dynamics Corp. v. Sharp*, 919 S.W.2d 861, 867, 869 (Tex. App.—Austin 1996, writ denied) (refusing to hold that the franchise tax violates the Commerce Clause even though Texas employs “a single-factor formula based on gross receipts,” while nearly all other states employ a “three-factor method of apportionment based on payroll, property, and gross receipts”). This was true even though the business owed approximately eleven million dollars more under the franchise tax than it would have owed under the three-tiered system of another state. *General Dynamics*, 919 S.W.2d at 867–68 (“[T]he validity of an apportionment scheme does not depend on the absolute amount of tax at issue nor even on the fairness of the formula as applied.”). *But see* *Home Interiors & Gifts, Inc. v. Strayhorn*, 175 S.W.3d 856, 867 (Tex. App.—Austin 2005, pet. denied) (invalidating the earned surplus throwback provision of the franchise tax as an unconstitutional violation of the Commerce Clause because it fails the fair apportionment requirement); *Rylander v. Bandag Licensing Corp.*, 18 S.W.3d 296, 300 (Tex. App.—Austin 2000, pet. denied) (concluding that where a business lacks physical presence in Texas and instead “conducts its activity solely through interstate commerce,” no sufficient nexus exists with Texas to

ERISA preemption claims.<sup>48</sup> The franchise tax has also survived challenges as an unconstitutional property tax and income tax.<sup>49</sup>

The franchise tax is essential to Texas due to the fact that approximately 45% of the revenue needed to fund the legislative, judicial, and executive branches of the state government, as well as social and economic governmental programs, comes directly from state taxes.<sup>50</sup> Franchise taxes alone represented 7% of state tax revenue in 2004, bringing in nearly two billion dollars.<sup>51</sup>

### C. *Why the Margin Tax?*

Texas has long used both property taxes and business taxes to fund schools.<sup>52</sup> An understanding of the school funding crisis, however, and how it relates to both property taxes and business taxes, is necessary to discern why the Texas Legislature created the margin tax. Unfortunately, “Texas ranks in the bottom half of the

justify the imposition of the franchise tax).

47. See *Rylander v. Palais Royal, Inc.*, 81 S.W.3d 909, 914 (Tex. App.—Austin 2002, pet. denied) (rejecting the corporation’s argument that the franchise tax violated the Equal Protection Clause due to “a disproportionate impact on fiscal-year taxpayers,” and deciding that equal impact among taxpayers is not necessary for a tax to be constitutional).

48. See *Sharp v. Caterpillar, Inc.*, 932 S.W.2d 230, 239 (Tex. App.—Austin 1996, writ denied) (explaining that the franchise tax is a generally applicable tax scheme and only incidentally increases the costs of doing business under some ERISA pension plans). “[T]herefore, the statute’s connection to ERISA plans is too tenuous, remote, and ephemeral to warrant preemption.” *Id.*

49. See *Houston Oil Co. of Tex. v. Lawson*, 175 S.W.2d 716, 723 (Tex. Civ. App.—Galveston 1943, writ ref’d) (rejecting the appellant’s contention that the franchise tax was a de facto property tax given the legislature had a reasonable purpose in levying the tax); *United N. & S. Dev. Co. v. Heath*, 78 S.W.2d 650, 652 (Tex. Civ. App.—Austin 1935, writ ref’d) (explaining that the legislature did not intend the franchise tax as a property tax or income tax, but rather a charge for the privilege of conducting business in Texas, despite the fact that both business property and income are used to compute the tax liability).

50. UNIV. OF TEX. AT AUSTIN, TEXAS POLITICS § 4.1 (2005), <http://texaspolitics.laits.utexas.edu/html/pec/0401.html>; see also Paula Moore, *Robin Hood: To Not Be or How to Be, That Is the Question—An Analysis of the Problems with Texas School Financing Today and a Proposal for a Better Tomorrow*, 38 TEX. TECH L. REV. 455, 471 (2006) (reporting that the franchise tax provides a significant source of state revenue).

51. See UNIV. OF TEX. AT AUSTIN, TEXAS POLITICS § 4.1 (2005), <http://texaspolitics.laits.utexas.edu/html/pec/0401.html> (recounting that the total state tax revenue in 2004 was \$27.91 billion, of which franchise tax revenue was \$1.84 billion).

52. See Texas Governor Rick Perry, Report of the Texas Tax Reform Commission, [http://www.governor.state.tx.us/priorities/tax\\_reform/TTRC\\_report](http://www.governor.state.tx.us/priorities/tax_reform/TTRC_report) (last visited Apr. 16, 2008) (quoting Texas Governor Rick Perry, who asserts that the tax reform plan “substantially improves” school financing in Texas, yet still provides a \$6 billion cut in property taxes for homeowners and employers in order to relieve property tax revenues from bearing the full weight of educational funding in Texas).

fifty states in state-level spending on primary and secondary education. In per capita spending it ranks 33rd and in percent of personal income spent on education it ranks 29th.”<sup>53</sup> In 1949, the Texas Legislature attempted to compensate for school district funding disparities through the Foundation School Program.<sup>54</sup> The Foundation School Program allocated to all school districts a minimum amount of funding per student that the state deemed necessary for proper education, irrespective of that district’s actual property tax revenue.<sup>55</sup> The Texas Supreme Court rejected the school funding law in *Edgewood Independent School District v. Kirby*,<sup>56</sup> a 1991 decision noting the disparities between wealthy and poor school districts in the state.<sup>57</sup> The court held that the Foundation School Program was “an unconstitutionally inefficient use of [the state’s] resources,” since it did not “provide ‘a direct and close correlation between a district’s tax effort and the

53. UNIV. OF TEX. AT AUSTIN, TEXAS POLITICS § 5.3 (2005), <http://texaspolitics.laits.utexas.edu/html/pec/0503.html>.

54. See *Alton Indep. Sch. Dist. v. Cent. Educ. Agency*, 259 S.W.2d 737, 739–40 (Tex. Civ. App.—Austin 1953, no writ) (noting that the 51st Legislature created the Foundation School Program in 1949; the program provided state funds based on the “taxpaying ability” of Texas school districts); see also Liz Kramer, *Achieving Equitable Education Through the Courts: A Comparative Analysis of Three States*, 31 J.L. & EDUC. 1, 26–27 (2002) (indicating that Texas established a foundation program in 1949 to aid poorer school districts). However, “because rich districts could raise money more easily, they could take advantage of the matching more easily, so the program just furthered the existing expenditure gap.” *Id.* at 27.

55. See Mildred Wigfall Robinson, *Financing Adequate Educational Opportunity*, 14 J.L. & POL. 483, 497 n.45 (1998) (“Texas provided minimum foundation grants that were to be supplemented through local school districts’ ad valorem property tax.”). Unfortunately, “[b]ecause of differences in the respective tax bases, spending disparities between school districts in the San Antonio area,” for example, “ranged upwards of three to one.” *Id.* Disparities such as these ultimately led to an overhaul of the school funding program by the Texas Legislature. See generally Paula Moore, *Robin Hood: To Not Be or How to Be, That Is the Question—An Analysis of the Problems with Texas School Financing Today and a Proposal for a Better Tomorrow*, 38 TEX. TECH L. REV. 455, 467 (2006) (analyzing the 1993 Robin Hood school funding plan, which promoted “equity among local school districts” by forcing property-rich school districts to share revenues with poorer school districts).

56. *Edgewood Indep. Sch. Dist. v. Kirby*, 804 S.W.2d 491 (Tex. 1991).

57. See *id.* at 496 (“More money allocated under the present system would reduce some of the existing disparities between districts but would at best only postpone the reform that is necessary to make the system efficient. A Band-Aid will not suffice; the system itself must be changed.” (quoting *Edgewood Indep. Sch. Dist. v. Kirby*, 777 S.W.2d 391, 397 (Tex. 1989))).

educational resources available to it.”<sup>58</sup>

In response, the 73rd Legislature created what was later dubbed the “Robin Hood” school funding system.<sup>59</sup> This legislation required property-rich school districts to share property tax revenues with property-poor school districts in an attempt to alleviate the obvious disparity.<sup>60</sup> In 2001, three hundred school districts brought suit against the state in *Neeley v. West Orange-Cove Consolidated Independent School District*,<sup>61</sup> claiming that the Robin Hood plan amounted to an unconstitutional ad valorem tax that is prohibited by the Texas Constitution.<sup>62</sup> By that time, nearly seven hundred Texas school districts met or were near the maximum tax rate of \$1.50 per \$100 property value.<sup>63</sup> Plaintiff school districts also argued that the Robin Hood plan underfunded public education throughout the state, which amounted to a legislative barrier to the advancement of the “general diffusion of knowledge.”<sup>64</sup> The court struck down the Robin Hood plan as an unconstitutional statewide tax and demanded that the

58. *Id.* (quoting *Edgewood*, 777 S.W.2d at 397).

59. Act approved June 15, 1993, 73d Leg., R.S., ch. 347, § 1.01, 1993 Tex. Gen. Laws 1479, 1479–91, *repealed by* Act approved May 30, 1995, 74th Leg., R.S., ch. 260, § 58(a)(1), 1995 Tex. Gen. Laws 2207, 2498; *see* Liz Kramer, *Achieving Equitable Education Through the Courts: A Comparative Analysis of Three States*, 31 J.L. & EDUC. 1, 29 (2002) (commenting that the Robin Hood school funding plan is the “Texas Legislature’s most recent response to *Edgewood* litigation”).

60. *See* Paula Moore, *Robin Hood: To Not Be or How to Be, That Is the Question—An Analysis of the Problems with Texas School Financing Today and a Proposal for a Better Tomorrow*, 38 TEX. TECH L. REV. 455, 467 (2006) (noting that property-rich school districts shared revenues with poorer school districts in order to foster equity among all Texas school districts); *see also* John A. Biek, *New Texas “Margin Tax” Will Apply to Most Passthrough Entities*, J. PASSTHROUGH ENTITIES, Sept.–Oct. 2006, at 16–17, *available at* [http://www.mwe.com/info/pubs/biek\\_jpte0906.pdf](http://www.mwe.com/info/pubs/biek_jpte0906.pdf) (indicating that the Texas Legislature adopted the Robin Hood system to fund education).

61. *Neeley v. W. Orange-Cove Consol. Indep. Sch. Dist.*, 176 S.W.3d 746 (Tex. 2005).

62. *Id.* at 751.

63. *See id.* at 794 (indicating that “48% of the districts, with 59% of the students, are taxing at the cap, and 67% of the districts, with 81% of the students, are taxing at or above \$1.45,” while only 20% of school districts, representing a mere 10% of Texas students, were taxed at less than \$1.40 per \$100 value of property).

64. *Id.* at 752. The “general diffusion of knowledge” is a constitutional provision charging the Texas Legislature with ensuring that Texas public schools receive proper support and maintenance. TEX. CONST. art. VII, § 1 (“A general diffusion of knowledge being essential to the preservation of the liberties and rights of the people, it shall be the duty of the Legislature of the State to establish and make suitable provision for the support and maintenance of an efficient system of public free schools.”).

legislature solve the constitutional issues regarding school maintenance and funding by June 1, 2006.<sup>65</sup> In effect, the court gave the legislature the difficult task of lowering property taxes while simultaneously raising additional revenue for school maintenance.<sup>66</sup>

#### D. *The Margin Tax: An Overview*

Recognizing that school funding depended largely on now-decreasing property tax revenues, notwithstanding the fact that school funding was already inadequate, the legislature overhauled the franchise tax in a desperate effort to avoid the inevitable school closures that would occur if the Texas Supreme Court's deadline was not met.<sup>67</sup> In doing so, the Texas Legislature passed the largest reduction in property taxes in Texas history and enacted the margin tax to provide nearly one-third of the state's education funding.<sup>68</sup> In 2006, the third called session of the 79th

65. See generally *Neeley*, 176 S.W.3d at 797–99 (concluding that the Robin Hood plan is an unconstitutional ad valorem tax and delaying the effective date of the trial court's injunction to June 1, 2006). The court declared: "To allow the State ample time to fully consider structural changes in the public education system, and to allow the system time to adjust to those changes, we postpone the effective date of the district court's injunction to June 1, 2006." *Id.* at 799.

66. See John A. Biek, *New Texas "Margin Tax" Will Apply to Most Passthrough Entities*, J. PASSTHROUGH ENTITIES., Sept.–Oct. 2006, at 17, available at [http://www.mwe.com/info/pubs/biek\\_jpte0906.pdf](http://www.mwe.com/info/pubs/biek_jpte0906.pdf) ("The Texas Supreme Court gave the Texas Legislature until June 1, 2006, to fix the constitutional problems with the local school maintenance and operations property tax.").

67. JOHN C. ALE, PARTNERSHIP LAW FOR SECURITIES PRACTITIONERS § 4:1 n.14 (2007). Ale poignantly summarized the legislature's dilemma with the following:

Confronting a court-ordered restructuring of school finance and a popular desire to reduce property taxes, the Texas Legislature in 2006 adopted a new franchise tax that will apply to almost all business entities, including most partnerships, beginning with filings made in 2008 for the year 2007. This new tax eliminates the comparative advantage of partnerships over LLCs unless the partnership is in a narrow category of exempt entities; e.g., general partnerships comprised solely of natural persons, certain passive investment partnerships. The methodology of computing the tax also differs dramatically from current law, with the tax based on a "taxable margin," defined to be the excess of gross revenues over either employee expenses or cost of goods sold, but not to exceed 70% of gross revenues. The result is then multiplied by the ratio of Texas receipts to global receipts, much as occurred with the old franchise tax. A 1% tax rate then applies, with certain retail businesses being taxed at 0.5%.

*Id.*

68. See William E. Junell, *The Eyes of Taxes Are Upon You*, 44 HOUS. LAW. 18, 20 (July/Aug. 2006) (reporting that in May 2006, the Texas Legislature passed House Bill 1,



Legislature enacted House Bill 3,<sup>69</sup> which provided a new method of tax calculation<sup>70</sup> and expanded the types of business entities covered by the tax.<sup>71</sup> In 2007, the regular session of the 80th Legislature made further changes to the new margin tax by revising House Bill 3 with House Bill 3928, adding limited liability partnerships as taxable entities.<sup>72</sup> To explain these changes numerically, consider that Texas enjoyed \$1.84 billion in revenue from the franchise tax in 2004,<sup>73</sup> while “the margin tax is projected to raise an additional \$3 to \$4 billion annually.”<sup>74</sup> Texas Governor

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requiring each school district in Texas to “reduce its property tax rate for school maintenance and operations from \$1.50 to \$1.00 per \$100 valuation,” with a statutory ceiling of \$1.30 per \$100 valuation). In addition, House Bill 3 provides a tax on gross receipts for Texas businesses, which “is expected to raise \$53.4 billion and ultimately provide over 50% of the cost of education in Texas.” *Id.*; see also Laura Elder, *Small Business Takes Big Hit with New Tax*, GALVESTON COUNTY DAILY NEWS, Sept. 28, 2007, at B2 (“The new tax is meant to supply almost one-third of school funding lost when Gov. Rick Perry last year declared the largest property tax cut in the state’s history.”).

69. Act approved May 19, 2006, 79th Leg., 3d C.S., ch. 1, §§ 1–27, 2006 Tex. Gen. Laws 1 (amended 2007) (current version at TEX. TAX CODE ANN. §§ 21.02, 171.0001–.401, 313.007 (Vernon 2008)).

70. See Act approved May 19, 2006, 79th Leg., 3d C.S., ch. 1, § 2, 2006 Tex. Gen. Laws 1, 6 (amended 2007) (codified at TEX. TAX CODE ANN. § 171.002(a)–(b) (Vernon 2008)) (establishing a 1% tax on a taxable entity’s net taxable margin for non-retail and non-wholesale businesses, and a 0.5% tax on the net taxable margin of all retail and wholesale businesses). In contrast, the former version of the Texas Tax Code, which expired on January 1, 2008, provided a 0.25% tax on a corporation’s, limited liability company’s, or a state or federal savings and loan association’s net capital in addition to a tax on a business’s net taxable earned surplus. Act approved Aug. 22, 1991, 72d Leg., 1st C.S., ch. 5, § 8.03, 1991 Tex. Gen. Laws 134, 153 (current version at TEX. TAX CODE ANN. § 171.002 (Vernon 2008)).

71. See Act approved May 19, 2006, 79th Leg., 3d C.S., ch. 1, § 2, 2006 Tex. Gen. Laws 1, 3–4 (amended 2007) (codified at TEX. TAX CODE ANN. § 171.0002(a) (Vernon 2008)) (listing the business entities covered under the term “taxable entity,” among which is a “partnership”). Although limited partnerships are not listed as taxable entities in the current version of the Texas Tax Code, the margin tax still applies to such entities through both the general term “partnership” and the phrase “or other legal entity.” *Id.* In contrast, the former version of the Texas Tax Code lists corporations and limited liability companies as taxable entities. Act of June 16, 1991, 72d Leg., R.S., ch. 901, § 53, 1991 Tex. Gen. Laws 3161, 3218 (current version at TEX. TAX CODE ANN. § 171.0002 (Vernon 2008)); Act approved Aug. 22, 1991, 72d Leg., 1st C.S., ch. 5, § 8.01, 1991 Tex. Gen. Laws 134, 152 (current version at TEX. TAX CODE ANN. § 171.002 (Vernon 2008)).

72. Act approved June 15, 2007, 80th Leg., R.S., ch. 1282, § 2, 2007 Tex. Gen. Laws 4282, 4284 (codified at TEX. TAX CODE ANN. § 171.0002(a) (Vernon 2008)).

73. UNIV. OF TEX. AT AUSTIN, TEXAS POLITICS § 4.1 (2005), <http://texaspolitics.laits.utexas.edu/html/pec/0401.html>. In 2005, the state received nearly \$2.2 billion in franchise tax revenue. William E. Junell, *The Eyes of Taxes Are Upon You*, 44 HOUS. LAW. 18, 20 (July/Aug. 2006).

74. John A. Biek, *New Texas “Margin Tax” Will Apply to Most Passthrough Entities*,

Rick Perry, dubbing the margin tax a “School Funding Plan,” argued that “the way we pay for education will be fundamentally fairer because the centerpiece of our proposal—the reformed business franchise tax—is broader, more equitable and assessed at a lower rate than the tax we have today.”<sup>75</sup> The tax reform plan also “makes homeownership more affordable for millions of Texas families by providing the largest property tax cut in Texas history,” and “delivers \$6 billion in relief, which amounts to about a 33% reduction on school maintenance and operations tax bills by the 2007 tax year.”<sup>76</sup>

The addition of partnerships, limited partnerships, and limited liability partnerships as taxable entities under the margin tax is significant because many businesses previously structured themselves as such entities to avoid the franchise tax.<sup>77</sup> For instance, an out-of-state corporation could avoid the franchise tax by forming out-of-state subsidiaries and creating a limited partnership in Texas.<sup>78</sup> This is because “corporate limited partners do not acquire franchise tax nexus in Texas through the business activities that the limited partnership has conducted in Texas.”<sup>79</sup> Thus, a business could create a limited partnership for its Texas business activities as well as an out-of-state subsidiary,

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J. PASSTHROUGH ENTITIES, Sept.–Oct. 2006, at 16, *available at* [http://www.mwe.com/info/pubs/biek\\_jpte0906.pdf](http://www.mwe.com/info/pubs/biek_jpte0906.pdf).

75. Rick Perry & John Sharp, *School Funding Plan Delivers Tax Relief, Tax Reform and Tax Fairness*, [http://www.governor.state.tx.us/priorities/tax\\_reform/TTRC\\_report/op\\_ed](http://www.governor.state.tx.us/priorities/tax_reform/TTRC_report/op_ed) (last visited Apr. 8, 2008).

76. *Id.*

77. See Cynthia M. Ohlenfost et al., *Taxation*, 60 SMU L. REV. 1311, 1316 (2007) (noting that many Texas businesses successfully “planned around the [franchise] tax by operating through partnerships,” which in turn led to the enactment of the margin tax). One source advocating franchise tax planning strategies even suggests organizing a limited partnership for purposes of Texas law, yet organizing “the limited partner under the law of a state other than Texas” in order to avoid taxation under the franchise tax. Steven N.J. Wlodychak, *Select Transactional Issues in State Partnership Taxation*, in *TAX PLANNING FOR DOMESTIC & FOREIGN PARTNERSHIPS, LLCs, JOINT VENTURES & OTHER STRATEGIC ALLIANCES* 673, 678 (Practicing Law Institute 2006).

78. John A. Biek, *New Texas “Margin Tax” Will Apply to Most Passthrough Entities*, J. PASSTHROUGH ENTITIES, Sept.–Oct. 2006, at 16, *available at* [http://www.mwe.com/info/pubs/biek\\_jpte0906.pdf](http://www.mwe.com/info/pubs/biek_jpte0906.pdf).

79. *Id.* at 15; see also 19 ROBERT W. HAMILTON, ELIZABETH S. MILLER & ROBERT A. RAGAZZO, *TEXAS PRACTICE SERIES* § 13.25 (2d ed. 2007) (“Since the corporate or LLC general partner will itself be subject to the franchise tax, the corporate or LLC general partner in a Texas limited partnership typically has an interest of 1% or less. In this way, the franchise tax is minimized or eliminated.”).

then shift most of its assets to the subsidiary and become a low-percentage general partner in the limited partnership—all to successfully avoid franchise taxes in Texas.<sup>80</sup> Ironically, past comptrollers of public accounts encouraged and provided examples of how to achieve similar restructuring so as to avoid the tax, even authoring the ostentatiously titled article *The Texas Franchise Tax: Methods of Tax Avoidance*.<sup>81</sup> This “led some state tax practitioners to joke that the Texas franchise tax had become an ‘elective’ or ‘voluntary’ tax.”<sup>82</sup> Under the margin tax, however, Texas partnerships, limited partnerships, and limited liability partnerships will now be subject to taxation, essentially paying for their limited liability under state law just as other Texas business forms have done and will continue to do under the franchise tax and the margin tax.<sup>83</sup>

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80. John A. Biek, *New Texas “Margin Tax” Will Apply to Most Passthrough Entities*, J. PASSTHROUGH ENTITIES, Sept.–Oct. 2006, at 16, available at [http://www.mwe.com/info/pubs/biek\\_jpte0906.pdf](http://www.mwe.com/info/pubs/biek_jpte0906.pdf). Or, as another source indicates:

It is relatively easy to avoid the Texas franchise tax as it is constituted at the present time. The reason is that general and limited partnerships are not subject to the franchise tax, and one can readily restructure a Texas corporation or Texas limited liability company so that it is a limited partnership that is itself no longer subject to the franchise tax. Indeed, this process has become so generally known and so widely adopted by Texas-based entities that there is a real possibility that amendments to the Franchise Tax Act may be necessary in the future to protect the public fisc.

19 ROBERT W. HAMILTON, ELIZABETH S. MILLER & ROBERT A. RAGAZZO, TEXAS PRACTICE SERIES § 4.6 (2d ed. 2007).

81. John A. Biek, *New Texas “Margin Tax” Will Apply to Most Passthrough Entities*, J. PASSTHROUGH ENTITIES, Sept.–Oct. 2006, at 15, available at [http://www.mwe.com/info/pubs/biek\\_jpte0906.pdf](http://www.mwe.com/info/pubs/biek_jpte0906.pdf). Past comptrollers of public accounts have explained the differences between tax evasion and tax avoidance, noting that restructuring a business as a partnership was a legitimate form of tax avoidance. *Id.*

82. *Id.* at 13.

83. See TEX. TAX CODE ANN. § 171.0002(a) (Vernon 2008) (listing the business entities covered under the term “taxable entity,” among which is “partnership[s]”); see also Act approved June 15, 2007, 80th Leg., R.S., ch. 1282, § 2, 2007 Tex. Gen. Laws 4282, 4284 (codified at TEX. TAX CODE ANN. § 171.0002(a) (Vernon 2008)) (amending House Bill 3; adding “limited liability partnerships” as a taxable entity under the margin tax); Interview with T. Randall Cain, Member, Tex. Tax Reform Comm’n, in San Antonio, Tex. (Feb. 26, 2008) (explaining that limited liability partnerships must now rightfully pay under the margin tax to enjoy limited liability in Texas).

### III. ANALYSIS: THE POTENTIAL EFFECTS OF THE MARGIN TAX

#### A. *New Businesses*

To illustrate the way in which businesses—particularly new businesses—will be hindered by the margin tax, it is helpful to include a hypothetical situation and calculate the tax paid under both the franchise tax and the margin tax using the respective tax worksheets found at the Texas State Comptroller's website.<sup>84</sup> Suppose a Texas corporation offering services (as opposed to goods) makes \$950,000 in total revenue in 2006, but registers expenses of \$1.05 million. The result is obviously a loss of \$100,000 for the taxable year. Now suppose \$350,000 of the expense comes from compensation of employees with benefits, while \$650,000 of the expense represents compensation awarded to independent contractors. The remaining \$50,000 is attributed to other expenses. Under the franchise tax, the company's gross receipts in Texas would be \$950,000 with an apportionment factor of one.<sup>85</sup> The stated capital, however, would be zero since the company did not make a profit and the lowest amount allowed for that line is zero.<sup>86</sup> With no surplus, the total taxable capital and apportioned taxable capital would be zero. With no net taxable

84. See Texas Comptroller of Pub. Accounts, Texas Franchise Tax Forms, <http://www.window.state.tx.us/taxinfo/taxforms/05-form1.html> (last visited Apr. 8, 2008) (providing franchise tax worksheets for various taxable entities); see also Texas Comptroller of Pub. Accounts, New Franchise Tax Calculation, <http://www.window.state.tx.us/taxinfo/taxforms/HB3Calc.pdf> (last visited Apr. 8, 2008) (providing an interactive worksheet for "calculat[ing] taxable margin on a separate entity basis").

85. Cf. TEXAS COMPTROLLER OF PUB. ACCOUNTS, TEXAS CORPORATION FRANCHISE TAX REPORT 1 (2006), available at <http://www.window.state.tx.us/taxinfo/taxforms/05-142.pdf> (accounting for "Gross receipts in Texas" in line three). For purposes of this hypothetical, assume all receipts are gross receipts in Texas, which yield an apportionment factor of one. Under the new franchise tax form, a business divides "Gross receipts in Texas" by the total "Gross receipts everywhere" (line three divided by line four) to arrive at an apportionment factor that is one or less. See *id.* (instructing how to calculate the "apportionment factor" in line five).

86. See TEXAS COMPTROLLER OF PUB. ACCOUNTS, INSTRUCTIONS FOR COMPLETING ANNUAL FRANCHISE TAX REPORTS ORIGINALLY DUE MAY 15, 2007, available at <http://www.window.state.tx.us/taxinfo/taxforms/05-386.pdf> ("NOTE: Item 6 may not be a deficit amount."); TEXAS COMPTROLLER OF PUB. ACCOUNTS, TEXAS CORPORATION FRANCHISE TAX REPORT 1 (2006), available at <http://www.window.state.tx.us/taxinfo/taxforms/05-142.pdf>, (computing "Total taxable capital" as the difference between "Stated capital" and "Surplus").

capital, any tax rate multiplied by zero taxable capital yields zero tax liability.<sup>87</sup>

Suppose the same company produced identical results in fiscal year 2007 under the margin tax. The margin tax provides three options for calculating the taxable margin; the business may elect the option which creates the smallest tax liability. Total revenue in line 1-a would be \$950,000.<sup>88</sup> There is no cost of goods sold, which leaves a cost of goods margin of \$950,000.<sup>89</sup> Option one leaves the company with its entire “revenue” as its tax base, despite losing money for that year.<sup>90</sup>

Option two allows for deduction of wages, cash compensation, and employee benefits. The company can therefore deduct \$350,000, which represents federal W-2 wages and benefits such as health insurance, retirement contributions, and worker's compensation.<sup>91</sup> The company cannot deduct the \$650,000 paid to independent contractors since form 1099 wages are not deductible under the margin tax.<sup>92</sup> This leaves the company with a “compensation margin,” and therefore a tax base, of \$600,000.<sup>93</sup>

87. See TEXAS COMPTROLLER OF PUB. ACCOUNTS, TEXAS CORPORATION FRANCHISE TAX REPORT 1 (2006), available at <http://www.window.state.tx.us/taxinfo/taxforms/05-142.pdf>, (calculating “Tax due on net taxable capital”). Where “Total taxable capital” (line eight) is zero, the “Apportioned taxable capital” (line nine) is zero, resulting in no net taxable capital (line eleven) and zero “Tax due on net taxable capital” (line twelve). *Id.*

88. See Texas Comptroller of Pub. Accounts, New Franchise Tax Calculation, <http://www.window.state.tx.us/taxinfo/taxforms/HB3Calc.pdf> (last visited Apr. 8, 2008) (“Total revenue is determined based on federal income tax reporting.”).

89. See *id.* (calculating the “COGS Margin” (line 1-c) as the difference between “Total Revenue” (line 1-a) and “Cost of Goods Sold” (line 1-b)).

90. See *id.* (outlining three different taxable margin calculation-options). The margin tax allows a choice in calculating the taxable margin by (1) deducting total revenue by cost of goods sold, (2) deducting total revenue by wages and compensation paid, or (3) taking 70% of total revenue as the taxable margin—whichever of the three options is less. *Id.*; see TEX. TAX CODE ANN. § 171.101(a)(1)(B)(ii) (Vernon 2008) (establishing a business's taxable margin as the lesser of: (1) total revenue less cost of goods sold, (2) total revenue less compensation, or (3) 70% of the total revenue).

91. See TEX. TAX CODE § 171.1013(a) (Vernon 2008) (limiting compensation deductions to wages claimed by an employee on the federal Form W-2 Wage and Tax Statement (W-2), and such compensation deductions by an employer business cannot exceed \$300,000 for an individual employee regardless of the actual compensation of such employees).

92. See *id.* (indicating compensation paid to non-employee contractors under federal Form 1099-MISC (1099) are not deductible under the margin tax).

93. See Texas Comptroller of Pub. Accounts, New Franchise Tax Calculation,

Option three allows the company to compute 70% of its total revenue.<sup>94</sup> If the revenue percentage is lower than the cost of goods margin or the compensation margin, that figure can be used to compute the taxable margin.<sup>95</sup> In this case, the revenue percentage would equal \$665,000.

The company would choose the compensation margin of \$600,000 as its tax base, since it is the lowest of the three options.<sup>96</sup> Because the company conducts all of its business in Texas, the apportionment factor is one.<sup>97</sup> This makes the taxable margin the entire \$600,000.<sup>98</sup> A 1% rate applied to the \$600,000 yields a tax liability of \$6,000 for a company that has no annual profit in its pocket to justify the tax.<sup>99</sup> In effect, the company lost \$100,000 and is still being taxed on its revenue. Notwithstanding the fact

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<http://www.window.state.tx.us/taxinfo/taxforms/HB3Calc.pdf> (last visited Apr. 8, 2008) (calculating option two—"Compensation Margin" (line 2-d)—by subtracting both "Wages and Cash Compensation" (line 2-b) and "Employee Benefits" (line 2-c) from "Total Revenue" (line 2-a)).

94. *Id.*; see TEX. TAX CODE ANN. § 171.101(a)(1) (Vernon 2008) (establishing a business's taxable margin as the least of total revenue less cost of goods sold, total revenue less compensation, or 70% of the total revenue).

95. See TEX. TAX CODE ANN. § 171.101(a)(1) (Vernon 2008) (allowing for the subtraction of either the taxable entity's cost of goods sold or compensation from total revenue, if either of those figures is less than 70% of the total revenue, in order to arrive at the tax base under the margin tax).

96. Texas Comptroller of Pub. Accounts, New Franchise Tax Calculation, <http://www.window.state.tx.us/taxinfo/taxforms/HB3Calc.pdf> (last visited Apr. 8, 2008); see TEX. TAX CODE ANN. § 171.101(a)(1) (Vernon 2008) (allowing for the subtraction of either the taxable entity's cost of goods sold or compensation from total revenue, if either of those figures is less than 70% of the total revenue, in order to arrive at the tax base under the margin tax).

97. See Texas Comptroller of Pub. Accounts, New Franchise Tax Calculation, <http://www.window.state.tx.us/taxinfo/taxforms/HB3Calc.pdf> (last visited Apr. 8, 2008) (mirroring the old franchise tax with respect to the apportionment factor; instructing the business to divide gross receipts in Texas by gross receipts everywhere); see also TEXAS COMPTROLLER OF PUB. ACCOUNTS, TEXAS CORPORATION FRANCHISE TAX REPORT 1 (2006), available at <http://www.window.state.tx.us/taxinfo/taxforms/05-142.pdf> (instructing the business to divide gross receipts in Texas by gross receipts everywhere). Under the margin tax form, the "Apportionment Factor" (line seven) is calculated by dividing "Texas Gross Receipts" (line five) by "Everywhere Gross Receipts" (line six). Texas Comptroller of Pub. Accounts, New Franchise Tax Calculation, <http://www.window.state.tx.us/taxinfo/taxforms/HB3Calc.pdf> (last visited Apr. 8, 2008).

98. See *id.* (calculating "Taxable Margin" (line eight) by multiplying the business's "Margin" (line four)—the lowest of the three options—by the "Apportionment Factor" (line seven)).

99. See *id.* (calculating "Tax Due Before Discount or Credits" (line nine) by multiplying a business's "Taxable Margin" (line eight) by either (1) 0.5% for "wholesalers and retailers," or (2) 1% for "all other taxable entities").

that the business now has a taxable margin under the margin tax where no net taxable capital would otherwise have resulted under the franchise tax, the tax rate under the margin tax is 1% for non-retail and non-wholesale companies, while the rate under the franchise tax was 0.25% of net taxable capital.<sup>100</sup> In other words, not only are more and unprofitable businesses taxed under the margin tax, but each business could be taxed at a higher rate than under the old franchise tax.

Taxation of unprofitable businesses has already been discussed at length despite the fact that the first returns will not be filed until May 2008.<sup>101</sup> If nothing else, the margin tax could make entrepreneurs think twice before engaging in business in Texas.<sup>102</sup> This is because many entrepreneurs begin their business knowing that they are not likely to make a profit during the first few years.<sup>103</sup> The cost during this stage of a business is often very

100. The tax rate under the new margin tax is 1% for all taxable entities other than those “primarily engaged in retail or wholesale trade,” which are taxed at 0.50%. *Compare* TEX. TAX CODE ANN. § 171.002(a)–(b) (Vernon 2008) (setting “the rate of the franchise tax [at] one percent of taxable margin” except “for those taxable entities primarily engaged in retail or wholesale trade” whose “franchise tax is 0.5 percent of taxable margin”), *with* Act approved Aug. 22, 1991, 72d Leg., 1st C.S., ch. 5, §§ 8.03, 1991 Tex. Gen. Laws 134, 153 (current version at TEX. TAX CODE ANN. § 171.002 (Vernon 2008)) (“The rates of the franchise tax are (1) 0.25 percent per year of privilege period of net taxable capital; and (2) 4.5 percent of net taxable earned surplus.”). Thus, the rate under the margin tax could double or quadruple that of the old franchise tax depending on the type of business.

101. *See, e.g.,* David Hendricks, *New Tax May Hit Even Money-Losing Firms*, SAN ANTONIO EXPRESS-NEWS, May 2, 2007, at 1E (“Among the several odious aspects of the new Texas business tax, perhaps this one is the most detestable: Companies that lose money still could owe thousands of dollars.”); Posting of Linda Messing to [http://tscpa.typepad.com/my\\_weblog/2007/09/margin-tax-sugg.html](http://tscpa.typepad.com/my_weblog/2007/09/margin-tax-sugg.html) (Sept. 28, 2007, 09:02:43 EST) (advocating a “10-year business loss carry-forward,” which would allow unprofitable businesses to avoid taxation). However, excluding businesses that declare a federal income tax loss may be the best way to provide tax relief for unprofitable businesses, even though “that also could lead to gaming the system.” *Id.*

102. *See* David Hendricks, *New Tax May Hit Even Money-Losing Firms*, SAN ANTONIO EXPRESS-NEWS, May 2, 2007, at 1E (noting that tax liability in conjunction with losing money amounts to a so-called “double jeopardy,” which will hurt small businesses). Typically, new businesses “have small payrolls but large start-up expenses that cannot be deducted.” *Id.*

103. *See* April L. Butler, Comment, *A Look at What the CAT Dragged In: The Problems Inherent in Ohio's Commercial Activity Tax*, 32 U. DAYTON L. REV. 99, 121–22 (2006) (explaining that new entrepreneurs must first invest in their business and make sales before seeing valuable return on their investments, which will hurt businesses under Ohio's business tax). In many instances, a start-up company can take many years to

high, clients or customers are not yet established, and many individuals starting their own businesses must simply learn by trial-and-error in order to become more profitable later.<sup>104</sup> Under the franchise tax system, these entrepreneurs could offset much of the cost by the assurance that they would owe no taxes so long as they had no net taxable capital. Under the margin tax system of taxing gross revenue, however, the added tax liability could be the key factor for many potential entrepreneurs deciding whether to form a business in Texas, not form one at all, or start a business in another state.<sup>105</sup>

### B. *Small Businesses*

Like the margin tax's effect on new businesses, many small businesses will be adversely affected by a sharp increase in tax liability. Fortunately, businesses with revenues of \$300,000 or less owe no tax.<sup>106</sup> Many small businesses, however, have gross receipts higher than \$300,000, but could incur more tax liability under the margin tax than under the franchise tax.<sup>107</sup> Moreover,

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realize a profit. *Id.*; see Trippe S. Fried, *Minimizing Disputes and Maximizing Profits: Five Balancing Acts for New Business Owners*, 4 DEPAUL BUS. & COM. L.J. 401, 401 (2006) (commenting that nearly two-thirds of all new businesses fail within six years). Unfortunately, small business owners often contribute all of their assets and any borrowed funds into their new business, and the failure of that business often leads to financial ruin for the entrepreneur. *Id.*

104. See Simon C. Parker, *Law and the Economics of Partnership*, 28 COMP. LAB. L. & POL'Y J. 695, 703 (2007) (indicating that when starting a new business, high administrative costs decrease employment by reducing the incentive to be an entrepreneur).

105. See H.J. of Tex., 80th Leg., R.S. 2784 (2007) (amending House Bill 3928 to monitor this effect). Amendment 41 to House Bill 3928 establishes the "Small Business Tax Advisory Committee," which will examine, among other items, the number of taxable entities that either stop operating, alter their business organization, or relocate their headquarters as a result of the margin tax. *Id.* However, given the legislature is already contemplating businesses either going out of business or relocating to another state evidences, at least in part, the difficulty of starting a new business under the margin tax.

106. TEX. TAX CODE ANN. § 171.002(d)(2) (Vernon 2008). House Bill 3 creates an exemption for taxable entities with total revenue of \$300,000 or less, or a tax liability of less than \$1,000 for the tax year. Act approved May 19, 2006, 79th Leg., 3d C.S., ch. 1, §§ 1-27, 2006 Tex. Gen. Laws 1 (amended 2007) (current version at TEX. TAX CODE ANN. §§ 21.02, 171.0001-401, 313.007 (Vernon 2008)).

107. See Laura Elder, *Small Business Takes Big Hit with New Tax*, GALVESTON COUNTY DAILY NEWS, Sept. 28, 2007, at B2 (noting that Texas small business owners could see a tax increase of 1000% or more). Interestingly, larger businesses, assuming that they would benefit from the property tax cut, did not contest the margin tax as vehemently as small businesses. *Id.*



small businesses, which often cannot deduct expenses as effectively as large businesses, may thus suffer larger relative tax burdens.<sup>108</sup> Big businesses will also enjoy the corresponding property tax benefit more than small businesses. This is because small businesses are more likely to lease or rent space, or, if they own the property on which they conduct their business, are more likely to have relatively small properties.<sup>109</sup> Thus, small businesses must still pay under the margin tax, yet they may not enjoy the property tax relief like larger businesses.<sup>110</sup>

On one hand, raising the non-taxable limit from \$300,000 to \$1 million would help many small businesses avoid the tax while still allowing capital-rich large businesses to bear the brunt of the tax.<sup>111</sup> In theory, large businesses can take the additional tax liability in stride more easily than small businesses. On the other

108. David Hendricks, *Group to Seek Tax Changes*, SAN ANTONIO EXPRESS-NEWS, July 25, 2007, at 1E.

109. *Id.* In other words, large businesses that own more and larger property will have a higher property valuation on which the reduction in property tax will take effect and offset the margin tax, whereas smaller businesses will experience the increased business tax without the corresponding relief in a smaller property tax. *Id.*

110. H.J. of Tex., 79th Leg., R.S. 891 (2005). Representative Terry Keel provided the following reason for voting against the margin tax:

Large capital-intensive businesses—involving in many instances much wealthier enterprises with relatively few employees—will reap the effects of a property tax reduction windfall while at the same time not sharing equitably with small businesses in any significant new tax burden. Many small businesses that create the bulk of minimum wage and skilled jobs in the service sector such as restaurants, auto repair shops, etc. that perhaps lease their business premises, will be saddled with either a new franchise tax or worse, a payroll tax that will serve as a significant disincentive for them to expand their employee payrolls. Even if they opt for the franchise tax, the new tax burden compared to their gross receipts will be significant. The same will not be true with many larger, wealthier, capital-intensive businesses.

*Id.*

111. See Ronald F. Wilson, *Federal Tax Policy: The Political Influence of American Small Business*, 37 S. TEX. L. REV. 15, 31 (1996) (noting that small businesses cannot raise capital as effectively as large businesses, since they are a greater investment risk). Furthermore, small businesses greatly outnumber large businesses, yet employ the same number of Americans and make a comparatively weak contribution to the country's gross national product when compared to large businesses. *Id.* For these reasons, it is logical to conclude that large businesses in Texas would provide a greater source of tax revenue than small businesses. *But see* David Hendricks, *Group to Seek Tax Changes*, SAN ANTONIO EXPRESS-NEWS, July 25, 2007, at 1E (“An estimated 54,000 businesses started in Texas last year with at least one employee. Small businesses create about two-thirds of new jobs.”).

hand, however, it is unclear how much revenue the state would lose from businesses that produce gross revenues between \$300,000 and \$1 million. It is possible that, when taken in the aggregate, the exemption of these small businesses could cause the state to lose too much revenue to make the tax effective.<sup>112</sup> Ultimately, this could lead the legislature to once again lower the amount of gross revenue applicable under the tax<sup>113</sup> or, even

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112. See Laura Elder, *Small Business Takes Big Hit with New Tax*, GALVESTON COUNTY DAILY NEWS, Sept. 28, 2007, at B2 (asserting that the property tax cuts will leave a \$14.2 billion shortfall in state education maintenance, while the margin tax, increased taxes on cigarettes, and increased taxes on used car sales will provide a combined \$8.1 billion in state revenue, resulting in an overall shortfall of \$6.1 billion). Further, the projected margin tax revenue is already clouded with ambiguity and uncertainty, and adding exemptions for small businesses would only further obscure revenue accountings. Compare Dave Moore & Chad Eric Watt, *New Tax More Expensive Than Some Projected: Boon for State?*, AUSTIN BUS. J., Dec. 14, 2007, at 4 (claiming that margin tax revenue might raise \$54 million more than originally projected), with L.A. Lorek, *Business Tax in Eye of the Beholder*, SAN ANTONIO EXPRESS-NEWS, Apr. 5, 2006, at 1E, available at <http://www.mysanantonio.com/business/stories/MYSA040506.1E.biztax.34e02dd.html> (projecting a total of \$6 billion in revenue under the margin tax, \$4 billion of which is attributed solely to the changes under the margin tax, and \$2 billion of which the current franchise tax already contributes to the state budget), and Paul Wiseman, *Margins Tax Stirs Concern Among Small Businesses and Organizations*, MIDLAND REP.–TELEGRAM, Nov. 4, 2007, <http://www.mywesttexas.com:80/articles/2007/11/04/import/20071104-archive43.txt> (expecting the margin tax to generate \$11.9 billion over two years, which would be twice the revenue raised under the old franchise tax). Although the office of the Comptroller for Public Accounts estimates that the margin tax will provide \$5.95 billion in revenue, State Representative Ken Paxton feels that the comptroller's office historically issues low revenue projections, and the Texas Society of Certified Public Accountants believes that the margin tax will provide more revenue than originally thought or intended. Dave Moore & Chad Eric Watt, *New Tax More Expensive Than Some Projected: Boon for State?*, AUSTIN BUS. J., Dec. 14, 2007, at 4.

113. House Bill 3 of the 79th Legislature, third called session, did not exempt any small businesses with gross revenue of more than \$300,000. Act approved May 19, 2006, 79th Leg., 3d C.S., ch. 1, § 2, 2006 Tex. Gen. Laws 1, 6–7 (amended 2007) (codified at TEX. TAX CODE ANN. § 171.002(d)(2) (Vernon 2008)). House Bill 3928 of the 80th regular session amended House Bill 3 to allow reduced tax liabilities for taxable entities with gross revenues between \$300,000 and \$900,000. Act approved June 15, 2007, 80th Leg., R.S., ch. 1282, § 8, 2006 Tex. Gen. Laws 4291, 4286 (codified at TEX. TAX CODE § 171.0021 (Vernon 2008)) (allowing an 80% discount on tax liability for taxable entities with a total revenue between \$300,000 and \$400,000, a 60% discount for taxable entities with a total revenue between \$400,000 and \$500,000, a 40% discount for taxable entities with a total revenue between \$500,000 and \$700,000, and a 20% discount for taxable entities with a total revenue between \$700,000 and \$900,000). Because the legislature provided small businesses with this tax break under the margin tax, and because projected revenues are just that—mere projections—at this point, it is possible that small businesses could see their discounts lowered should actual revenue from the margin tax fail to exceed expected

worse for small businesses, try to raise the tax rate in an attempt to recover the lost revenue.<sup>114</sup>

In 2007, the Texas Legislature partially addressed these issues by passing an amendment to House Bill 3928 that establishes the Small Business Tax Advisory Committee.<sup>115</sup> This committee will provide a report of the effects of the margin tax on small businesses to the Governor, Lieutenant Governor, and the speaker of the house of representatives by January 1, 2009.<sup>116</sup> While it appears that the Texas Legislature at least notices the possible negative effect on small businesses and knows that the margin tax may need further restructuring after the first returns are filed in May 2008, it is unclear what changes will be necessary and how quickly the legislature will be willing to alleviate the potentially overwhelming tax liability on small businesses.

Although both new and small businesses will be adversely affected by the margin tax, they must inevitably be included in what is largely a fairer, broader tax on more business entities that will enable the state to fund education in the wake of a mandated change in the tax system.<sup>117</sup> It remains to be seen whether the Texas Legislature can strike a balance between a fairer, broader tax, yet still keep businesses and jobs in Texas by alleviating a number of negative effects on new and small businesses.

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revenue.

114. See TEX. TAX CODE ANN. § 171.003 (Vernon 2008) (regulating tax rate increases). The Texas Legislature cannot increase the tax rate under the margin tax without the approval of the majority of registered voters in Texas, and any such referendum must specifically indicate the proposed rate increase. *Id.* However, the amount at which small businesses are exempt from the tax, which starts at \$300,000 in 2008, can be increased or decreased without voter approval based on inflation. See TEX. TAX CODE ANN. § 171.006(b) (Vernon 2008) (providing that the small business exemption will be adjusted every odd-numbered year by factoring the \$300,000 initial exemption from § 171.002(d)(2) with the increase or decrease in consumer price index percentage).

115. H.J. of Tex., 80th Leg., R.S. 2784 (2007).

116. *Id.* Amendment 41 to House Bill 3928 establishes the "Small Business Tax Advisory Committee," which will study job growth and loss under the margin tax, the tax's effect on wages, and the number of taxable entities that either stop operating, alter their business organization, or relocate their headquarters to avoid the margin tax. *Id.*

117. Interview with T. Randall Cain, Member, Tex. Tax Reform Comm'n, in San Antonio, Tex. (Feb. 26, 2008).

### C. *Businesses with Low Compensation or Goods Sold to Revenue Ratios*

Service businesses, which typically have little “cost of goods sold” compared to gross revenue, are likely to have increased tax liability under the margin tax.<sup>118</sup> Further, businesses that hire independent contractors instead of employees will also be penalized under the margin tax.<sup>119</sup> This is because these businesses will be unable to deduct compensation for independent contractors in computing their revenue—the basis of their tax

118. See John A. Biek, *New Texas “Margin Tax” Will Apply to Most Passthrough Entities*, J. PASSTHROUGH ENTITIES, Sept.–Oct. 2006, at 16, 22, available at [http://www.mwe.com/info/pubs/biek\\_jpte0906.pdf](http://www.mwe.com/info/pubs/biek_jpte0906.pdf) (“Service businesses will not be able to utilize the revenues less cost of goods sold tax base, unless, for example, the business is manufacturing computer software or producing films or videotapes.”). Unlike the old franchise tax, which taxed a business’s profits, the margin tax taxes a business’s gross revenue, which is only offset by the lowest of compensation, cost of goods, or 70% of a taxable entity’s total revenue. See TEX. TAX CODE ANN. § 171.101(a)(1) (Vernon 2008) (establishing a business’s taxable margin as the lesser of: total revenue less cost of goods sold, total revenue less compensation, or 70% of the total revenue). *But see* Editorial, *Tax Brakes: Legislature Should Put Its Foot Down*, AUSTIN AM.-STATESMAN, Jan. 21, 2007, at G2 (noting that businesses with low cost of goods, although unable to deduct those costs against total revenue, are actually aided under the margin tax by the \$300,000 total revenue exemption for small businesses, the exemption for less than \$1,000 total tax liability, and the fact that no business can be taxed on more than 70% of its total revenue).

119. High-tech companies, for instance, rarely produce tangible products and often employ independent contractors to create their products. Editorial, *Tax Brakes: Legislature Should Put Its Foot Down*, AUSTIN AM.-STATESMAN, Jan. 21, 2007, at G2. Unfortunately, such companies cannot offset these costs against their total revenue, since they can only deduct compensation for W-2 employees. See TEX. TAX CODE ANN. § 171.1013(a) (Vernon 2008) (“[W]ages and cash compensation’ means the amount entered in the Medicare wages and tips box of Internal Revenue Service Form W-2 or any subsequent form with a different number or designation that substantially provides the same information.”). Independent contractors receive Forms 1099 from the companies for which they provide services; thus, companies cannot deduct payments to independent contractors under the margin tax. By enacting this measure, the legislature hoped to encourage employers to hire their own employees and provide health benefits for those employees. See Texas Governor Rick Perry, Report of the Texas Tax Reform Commission, [http://www.governor.state.tx.us/priorities/tax\\_reform/TTRC\\_report](http://www.governor.state.tx.us/priorities/tax_reform/TTRC_report) (last visited Apr. 16, 2008) (claiming that the margin tax will encourage businesses to provide jobs and benefits, such as worker healthcare and pensions, which will be deductible under the margin tax); see also Editorial, *Tax Brakes: Legislature Should Put Its Foot Down*, AUSTIN AM.-STATESMAN, Jan. 21, 2007, at G2 (“By including health insurance as a deductible benefit, the state is encouraging companies to offer it. The deduction also helps offset a cost disadvantage that a company may incur if it offers health insurance but competitors do not.”).

liability.<sup>120</sup> Limiting compensation deductions to W-2 employees and health benefits undoubtedly encourages employers to both hire long-term employees and provide such benefits in order to maximize their compensation deduction.<sup>121</sup> This is a “highly worthwhile goal” and promises to protect Texas employees.<sup>122</sup> However, some service businesses that already have little or no cost of goods sold are also more efficiently operated using independent contractors.<sup>123</sup> The trucking industry and high-tech industry, for instance, have already threatened to take their businesses out-of-state should the increased liability under the margin tax become too burdensome.<sup>124</sup> If other industries were to

120. See TEX. TAX CODE ANN. § 171.1013(a) (Vernon 2008) (indicating that compensation deductions are limited to W-2 compensation-reporting, which prevents employers from deducting payments to independent contractors); see also David Hendricks, *State's New Tax Policy Could Send the Trucking Industry Fleeing*, SAN ANTONIO EXPRESS-NEWS, Jan. 26, 2007, at 1D, available at <http://www.mysanantonio.com/business/stories/MYSA012707.01D.hendricks.13bf042.html> (conveying that employers can deduct their payroll costs for employees to whom they issue federal Forms W-2, but not the expenses paid to independent contractors to whom the company issued federal Forms 1099).

121. See Editorial, *Tax Brakes: Legislature Should Put Its Foot Down*, AUSTIN AM.-STATESMAN, Jan. 21, 2007, at G2 (“One point of the [margin tax] was to encourage employers to hire workers and offer benefits, including expensive health insurance.”).

122. See, e.g., *id.* (arguing that the margin tax’s incentive to hire employees and offer benefits is “a highly worthwhile goal” that the legislature should maintain); Texas Governor Rick Perry, Report of the Texas Tax Reform Commission, [http://www.governor.state.tx.us/priorities/tax\\_reform/TTRC\\_report](http://www.governor.state.tx.us/priorities/tax_reform/TTRC_report) (last visited Apr. 16, 2008) (“[The margin tax] can protect jobs and encourage employers to invest in their workers’ healthcare and pensions.”).

123. See David Hendricks, *State's New Tax Policy Could Send the Trucking Industry Fleeing*, SAN ANTONIO EXPRESS-NEWS, Jan. 26, 2007, at 1D, available at <http://www.mysanantonio.com/business/stories/MYSA012707.01D.hendricks.13bf042.html> (“The state’s new margin tax will drive away headquarters of Texas-based trucking companies to other states unless the law is changed to allow more payroll deductions.”). Although Hendricks’s article does not explicitly state that service businesses are more efficiently carried out by independent contractors rather than “W-2 employees,” the custom of some service industries is to rely on independent contractors. See *id.* (commenting that almost every Texas motor carrier employs owner-operators of trucks, which allows drivers to be paid as independent contractors). This fact, coupled with the fact that many Texas trucking companies might move their headquarters to avoid the margin tax rather than hire permanent employees with health coverage, suggests that the legislature’s attempt to use the margin tax to encourage more employment and health benefits could actually reduce the number of Texas jobs if these service businesses leave the state.

124. See *id.* (“The Transportation Intermediaries Association . . . said the inability for Texas carriers to deduct their driver payrolls results in tax burdens high enough to make

follow suit, the margin tax could defeat itself in that the excess revenue created for the state would be countered by the overall loss of taxable businesses.<sup>125</sup>

#### D. Consumers

Even though the majority of Texans do not own a business, what many fail to realize is that the increased cost to businesses under the margin tax could very well come out of consumers' wallets.<sup>126</sup> Comptroller Carole Keeton Strayhorn notes that “[d]octors and lawyers who are hit with Gov. Perry’s new tax will be forced to pass that tax on to their patients and their clients . . . . That is like placing a tax on sick people and legal access.”<sup>127</sup> Although the first returns are not due until May of 2008, this passing of the cost is already affecting Texans. In January 2007, which is incidentally the month that started the margin tax accounting process for businesses that start their fiscal year in line with the calendar year, Sprint Nextel added a surcharge of 1% to its wireless bills and labeled the fee the “Texas margin fee reimbursement.”<sup>128</sup>

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carriers move their offices out of Texas.”). Because of this, both trucking and technology industries will “take their fight” to the Texas Legislature in hopes of procuring an amendment altering the definition of compensation under the margin tax to allow a deduction for compensation to independent contractors. *Id.*

125. David Hendricks, *State’s New Tax Policy Could Send the Trucking Industry Fleeing*, SAN ANTONIO EXPRESS-NEWS, Jan. 26, 2007, at 1D, available at <http://www.mysanantonio.com/business/stories/MYSA012707.01D.hendricks.13bf042.html> (describing the state’s dilemma: raising margin tax rates may force companies out of state or out of business and thus decrease tax revenues, but decreasing the margin tax rates on service and high tech companies to keep them in state may also reduce tax revenues). Should the legislature provide relief to trucking companies and high tech companies, Texas “will lose tax revenue already in the next biennial budget.” *Id.* Furthermore, “[t]inkering with the new margin tax could be costly, especially if an attempt to help one segment of one industry opens the door to a stampede of business lobbyists looking for more such help.” Editorial, *Tax Brakes: Legislature Should Put Its Foot Down*, AUSTIN AM.-STATESMAN, January 21, 2007, at G2.

126. See Laura Elder, *Small Business Takes Big Hit with New Tax*, GALVESTON COUNTY DAILY NEWS, Sept. 28, 2007, at B2, available at <http://blogs.galvnews.com/story.lasso?ewcd=48d0483769580ddb9a006fef2820ea4> (quoting Don Reed, Chief Executive Officer of Unicom Technologies, as saying that Unicom will be forced to pass the costs of conducting business in Texas to consumers, and recognizing that all Texans will eventually pay more for goods and services).

127. Press Release, Tex. Comptroller of Pub. Accounts, Comptroller Strayhorn Believes Gov. Perry’s “Margin Tax” Is an Income Tax; Requests Formal Attorney General’s Opinion (Apr. 21, 2006), <http://www.window.state.tx.us/news/60421taxplan.html>.

128. Editorial, *Reading Between the Lines of Sprint’s New Surcharge*, AUSTIN AM.-STATESMAN, Jan. 26, 2007, at A16. “By tacking the margin tax onto bills as a surcharge,

Though Sprint's actions are insignificant when standing alone, the passing of cost to consumers, when taken in the aggregate, means that consumers will pay significantly for the added tax to businesses.<sup>129</sup> The Texas Attorney General, in a lawsuit filed against Sprint Nextel, claimed that the fee was improper since the margin tax was not yet in effect; however, such a challenge was only viable until January 1, 2008.<sup>130</sup> After that date and barring legislative action, Texas businesses can freely pass the increase in tax liability to Texas citizens.

In contrast, it is important to note that doctors, lawyers, and accountants—whose firms are sure to face a high increase in tax liability under the margin tax—are also engaged in competitive fields.<sup>131</sup> These professionals cannot simply raise the price of their services by the total amount of additional tax liability without the obvious risk of losing clients and patients to those businesses that refrain from doing so.<sup>132</sup> Especially for larger businesses that have a presence and pay taxes in multiple states, avoiding the

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it's easier for Sprint to keep its advertised rates competitive with two wireless giants, AT&T and Verizon, which (so far) have not added a similar surcharge." *Id.*

129. See Angelou Economics, Texas Business Climate: Taxes, Technology, and Trends, [http://www.angeloueconomics.com/news\\_rep\\_txbusclimate.html](http://www.angeloueconomics.com/news_rep_txbusclimate.html) (last visited Apr. 8, 2008) (noting the "propensity of small firms" to pass the costs of increased taxation on to customers). However, bigger companies that "face domestic and international competition, and must maintain competitive prices" will be much more likely to "reduce employment in response to tax increases prior to raising prices." *Id.* Thus, not only will consumers see the increased tax liability under the margin tax, but employees might also face negative repercussions of increased tax liability. On the other hand, businesses must sell their goods in order to be profitable, which means that they must still provide consumers with competitive prices despite the added tax liability. James A. Richardson & Susan Kalinka, *Louisiana Taxation of Businesses: Two Alternative Proposals*, 61 LA. L. REV. 763, 777 (2001). In order to ease the burden of increased tax liability, "a business may reduce the amount of compensation it pays to employees, exact lower prices from suppliers, or distribute smaller amounts to investors" instead of merely passing the cost to consumers. *Id.*

130. See Press Release, Tex. Att'y Gen., Attorney General Abbott Takes Legal Action to Halt Sprint Nextel's Deceptive Billings (Feb. 5, 2007), <http://www.oag.state.tx.us/oagnews/release.php?id=1918> (reporting that Attorney General Greg Abbott filed suit against Sprint Nextel Corporation seeking reimbursement for customers from the deceptive billing of the 1% tax). Attorney General Greg Abbott claims that the surcharge "is deceptive because the tax does not become effective until Jan. 1, 2008, and has not been set at a 1% rate." *Id.* After the tax becomes effective and the rate is set, however, there will be little stopping businesses from passing along the additional cost of doing business under the margin tax to Texas consumers.

131. Interview with T. Randall Cain, Member, Tex. Tax Reform Comm'n, in San Antonio, Tex. (Feb. 26, 2008).

132. *Id.*

effects of the margin tax is not as simple as passing the tax costs to consumers in any one state.<sup>133</sup>

### E. *Constitutionality*

A source of contention among many experts is whether the margin tax amounts to an unconstitutional income tax under Texas law or an unconstitutional violation of the Commerce Clause under federal law. Although House Bill 3 specifically indicates that the margin tax is not an income tax,<sup>134</sup> this assertion will probably be litigated.<sup>135</sup> The former Texas Comptroller of Public Accounts, Carole Keeton Strayhorn, viewed the margin tax as nothing more than an income tax in disguise.<sup>136</sup> This is because the Texas Constitution prohibits a tax on income without voter approval, and the statutory definition of income includes “a person’s share of partnership and unincorporated association income.”<sup>137</sup> The margin tax lists partnerships and limited liability partnerships as taxable entities.<sup>138</sup> Thus, the Texas Constitution seems to prohibit the taxation—at least until approved by statewide referendum—of exactly what the margin tax proposes to

133. *Id.*

134. *See* Act approved May 19, 2006, 79th Leg., 3d C.S., ch. 1, § 21, 2006 Tex. Gen. Laws 1, 38 (amended 2007) (“The franchise tax imposed by Chapter 171, Tax Code, as amended by this Act, is not an income tax and Pub. L. No. 86-272 does not apply to the tax.”).

135. *See* Mike Seay & Jimmy Martens, *The New Texas Margin Tax*, 70 TEX. B.J. 30, 31 (2007) (emphasizing that because the new margin tax may be unconstitutional it will undoubtedly be litigated).

136. *See* Press Release, Tex. Comptroller of Pub. Accounts, Comptroller Strayhorn Believes Gov. Perry’s “Margin Tax” Is an Income Tax; Requests Formal Attorney General’s Opinion (Apr. 21, 2006), <http://www.window.state.tx.us/news/60421taxplan.html> (“The people of Texas know an income tax when they see it.”).

137. TEX. CONST. art. VIII, § 24(a). In full, subsection (a) provides:

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.

*Id.*

138. *See* TEX. TAX CODE ANN. § 171.0002(a) (Vernon 2008) (adding “limited liability partnership” as a taxable entity). *But see* Act approved May 19, 2006, 79th Leg., 3d C.S., ch. 1, § 2, 2006 Tex. Gen. Laws 1, 3–4 (amended 2007) (current version at TEX. TAX CODE ANN. § 171.0002 (Vernon 2008)) (listing the business entities covered under the term “taxable entity,” among which is only “partnership[s]”).



tax. Not surprisingly, the issue here will be the meaning given to the language of the statute and the Texas Constitution in determining whether a tax on the total revenue of partnership entities amounts to a tax on each partner's individual income. In her letter to Attorney General Greg Abbott, in which she requests a formal opinion on whether the margin tax is an unconstitutional income tax, Strayhorn suggests that the constitutional language be given its literal meaning.<sup>139</sup> That is, the words should be given "their natural and ordinary meanings as they were understood by the average voter who voted for or against" the amendment.<sup>140</sup> According to Strayhorn, the natural and ordinary meaning of "a person's share of partnership or unincorporated association income" includes a tax on partnerships and unincorporated associations.<sup>141</sup> Because the margin tax taxes unincorporated entities "whose direct ownership is held by natural persons," Strayhorn feels that it is unconstitutional as it fails to provide the necessary statewide referendum.<sup>142</sup> A counterargument interestingly points out that a main criticism of the revenue-based margin tax is that even non-profitable businesses must still pay.<sup>143</sup> However, it is a tax on profits, not revenue, that is the essential justification of any income tax.<sup>144</sup> The fact that the margin tax could apply to a company without profits, therefore, undermines

139. See Letter from Carole Keeton Strayhorn, Tex. Comptroller of Pub. Accounts, to the Honorable Greg Abbott, Attorney Gen. of Tex. (Apr. 21, 2006), available at [http://www.oag.state.tx.us/opinions/Requests\\_ga/rq0479ga.pdf](http://www.oag.state.tx.us/opinions/Requests_ga/rq0479ga.pdf) ("To interpret our Constitution, we give effect to its plain language." (citing *City of Beaumont v. Bouillion*, 896 S.W.2d 143, 148 (Tex. 1995))).

140. *Id.*

141. *Id.*

142. *Id.*

143. See David Hendricks, *New Tax May Hit Even Money-Losing Firms*, SAN ANTONIO EXPRESS-NEWS, May 2, 2007, at 1E ("Among the several odious aspects of the new Texas business tax, perhaps this one is the most detestable: Companies that lose money still could owe thousands of dollars.").

144. See James A. Richardson & Susan Kalinka, *Louisiana Taxation of Businesses: Two Alternative Proposals*, 61 LA. L. REV. 763, 773 (2001) ("[T]he income tax is an excise on a taxpayer's net profits, which are determined after taking into account payment of business expenses."). To put the difference between profits and revenue more literally, one source indicates that "the margin tax will apply to . . . the revenues that [businesses] derive from doing business in Texas, *instead* of on their net income . . . as has been the case with the current franchise tax." John A. Biek, *New Texas "Margin Tax" Will Apply to Most Passthrough Entities*, J. PASSTHROUGH ENTITIES, Sept.-Oct. 2006, at 16, 17 (emphasis added), available at [http://www.mwe.com/info/pubs/biek\\_jpte0906.pdf](http://www.mwe.com/info/pubs/biek_jpte0906.pdf).

the argument that it is an income tax in disguise by eliminating an element necessary to measure income.

Another potential challenge is that the margin tax violates the Dormant Commerce Clause of the United States Constitution.<sup>145</sup> Like the above issue regarding an unconstitutional income tax, House Bill 3 also explicitly states that “Pub. L. No. 86-272 does not apply to the tax.”<sup>146</sup> Although a state is generally able to tax out-of-state businesses doing business in that state, Public Law 86-272 indicates that a state cannot impose an income tax on an out-of-state person if the only business activities within that state are “solicitation[s] of orders” of tangible property as opposed to actual physical presence.<sup>147</sup> It is simple to include language in a state bill claiming that a federal statute does not apply, but whether that is the case remains to be seen. Public Law 86-272 refers to a tax on income, so the issue here will be whether the switch in the tax base—from profits to revenue—is enough to trigger the federal statute. As one source states:

The prior Franchise Tax scheme included “throwback” provisions requiring the gross receipts from sales of tangible personal property shipped from Texas to a purchaser in another state to be added to the gross receipts of business done in Texas for purposes of apportionment. The throwback provisions are designed to capture and tax income that would otherwise go untaxed as a result of Public Law 86-272. In *Home Interiors & Gifts, Inc. v. Strayhorn*, the throwback provisions were held to be internally inconsistent in violation of the relevant U.S. Supreme Court rulings. Given the ruling in *Home Interiors*, a conclusory statutory provision may not be sufficient to fend off similar constitutional attacks on the new Franchise Tax scheme.<sup>148</sup>

A third potential challenge to the margin tax is that it is a violation of the Equal Protection Clause of the United States

145. See generally U.S. CONST. art. I, § 8, cl. 3. (Dormant Commerce Clause).

146. Act approved May 19, 2006, 79th Leg., 3d C.S., ch. 1, § 21, 2006 Tex. Gen. Laws 1, 38 (amended 2007).

147. 15 U.S.C. § 381(a) (2000); Cynthia M. Ohlenforst & Jeffrey W. Dorrill, *Taxation*, 45 Sw. L.J. 2093, 2103–04 (1992).

148. Kal Malik, *The “New” Texas Franchise Tax: A Summary of HB 3*, at 4–5, [http://www.chtmlaw.com/downloads/TX\\_franchisetax\\_HB3\\_Malik.pdf](http://www.chtmlaw.com/downloads/TX_franchisetax_HB3_Malik.pdf) (last visited Apr. 8, 2008).

Constitution.<sup>149</sup> In her letter to Attorney General Abbott, former Comptroller of Public Accounts Strayhorn noted that the “disparate tax rates” under the margin tax provide a tax rate of ½% for wholesalers and retailers and a tax rate of 1% for all other taxable entities.<sup>150</sup> Although no protected classes are affected, the Texas Legislature must nonetheless present a rational basis for this difference in treatment.<sup>151</sup> Strayhorn addresses the rational basis requirement by stating: “No basis has been provided, and none is apparent, for the disparate treatment of businesses from the standpoint of tax rates.”<sup>152</sup> Contrary to Strayhorn’s view, the Texas Tax Reform Commission studied the typical tax liability in proportion to total revenue of many Texas businesses prior to enacting the margin tax.<sup>153</sup> These calculations led to the simple rationale that wholesale and retail businesses, although taxed at a lower rate, are incurring the same relative tax burden as other businesses subject to the higher tax rate.<sup>154</sup>

Finally, the Internet Tax Freedom Act, if renewed by the United States Congress, could preempt the margin tax by disallowing the taxation of Internet access providers doing business in Texas.<sup>155</sup> It is unclear how much tax revenue Texas would lose from such companies, but more important is the possibility that other groups would pressure the legislature for their own exemptions if Internet access companies receive favorable treatment through an

149. See generally U.S. CONST. amend. XIV, § 1 (Equal Protection Clause).

150. Letter from Carole Keeton Strayhorn, Tex. Comptroller of Pub. Accounts, to the Honorable Greg Abbott, Attorney Gen. of Tex. (Apr. 21, 2006), available at [http://www.oag.state.tx.us/opinions/Requests\\_ga/rq0479ga.pdf](http://www.oag.state.tx.us/opinions/Requests_ga/rq0479ga.pdf).

151. *Id.* (citing *Bullock v. ABC Interstate Theatres, Inc.*, 557 S.W.2d 337, 341 (Tex. App.—Austin 1977, writ ref’d n.r.e.)).

152. *Id.*

153. Interview with T. Randall Cain, Member, Tex. Tax Reform Comm’n, in San Antonio, Tex. (Feb. 26, 2008).

154. *Id.*

155. See MICHAEL MAZEROV, CTR. ON BUDGET & POLICY PRIORITIES, RENEWING THE “INTERNET TAX FREEDOM ACT” COULD HAVE AN ESPECIALLY ADVERSE IMPACT ON KENTUCKY, MICHIGAN, OHIO AND TEXAS 1 (2007), available at <http://www.cbpp.org/7-26-07sfp.pdf> (noting that Congress is considering renewing the Internet Tax Freedom Act (ITFA)). The ITFA prohibits “a tax on Internet access, regardless of whether such tax is imposed on a provider of Internet access or a buyer of Internet access,” and should the ITFA be renewed, it “likely would have a disproportionately adverse impact on the state tax revenues of Kentucky, Michigan, Ohio, and Texas.” *Id.*

exemption from the margin tax.

#### F. *Business Tax Systems of Other States*

Other states have enacted similar tax schemes to that of the new margin tax, but results and effects are difficult to ascertain. Illinois Governor Rod Blagojevich recently sought a corporate gross receipts tax from the Illinois Legislature.<sup>156</sup> The proposed tax is similar to the Texas margin tax in that revenue, not profit, is the basis of the tax. The Illinois gross receipts tax would “replace the corporate income tax and help fund a universal health insurance plan and education.”<sup>157</sup> The projected tax rate is 1% for retail, manufacturing, and wholesale businesses, while all other businesses, including service businesses, will be taxed at a rate of 2%.<sup>158</sup> Like the margin tax, Illinois retail and wholesale businesses would receive a reduced tax rate, but the proposed Illinois tax rate is higher than that of Texas. Also, like the margin tax, nearly all Illinois businesses, including partnerships and limited liability corporations, would be subject to the tax.<sup>159</sup>

The purported exemptions under this tax, however, are different than the Texas exemptions. Illinois exemptions include businesses with gross revenues of less than \$2 million,<sup>160</sup> whereas the small-business exemption in Texas begins only at \$300,000 in gross revenue and phases-out at \$900,000.<sup>161</sup> The Illinois tax plan also

156. H.R. Res. 402, 95th Gen. Assem., Reg. Sess. (Ill. 2007), available at <http://www.ilga.gov/legislation/> (follow “0401 – 0500” hyperlink under “House Resolutions”; then follow “HR0402 GRT-SUPPORT/OPPOSE” hyperlink); see generally Jonathan Williams, Tax Foundation, Governor Blagojevich’s Gross Receipts Tax Plan Represents Largest State Tax Increase This Decade (Mar. 19, 2007), available at <http://www.taxfoundation.org/files/ff79.pdf> (discussing the logistics of the proposed Tax Fairness Plan).

157. RSM McGladrey, Inc., State and Local Tax Watch, Income and Franchise Tax (Spring 2007), <http://www.rsmmcgladrey.com/RSM-Resources/Publications/State-Local-Tax/Third-Quarter-2007/Income-and-franchise-tax/>.

158. H.R. Res. 402, 95th Gen. Assem., Reg. Sess. (Ill. 2007), available at <http://www.ilga.gov/legislation/> (follow “0401 – 0500” hyperlink under “House Resolutions”; then follow “HR0402 GRT-SUPPORT/OPPOSE” hyperlink; then follow “Full Text” hyperlink).

159. *Id.* “Governor Blagojevich’s proposed GRT [Gross Revenue Tax] is a privilege tax imposed on virtually all business entities engaged in a trade or business conducted, in whole or in part, within Illinois . . . .” *Id.*

160. *Id.*

161. See TEX. TAX CODE ANN. § 171.0021 (Vernon 2008) (allowing an 80% discount

exempts sales of prescription drugs, life insurance policy receipts, and revenue from goods or services exported from Illinois, while taxing only gains—not gross revenue—from sales of securities and traded commodities.<sup>162</sup> The margin tax, however, does not have these exemptions, nor does it have any provision that would tax gains, or profit, instead of revenue. In theory, then, a Texas company that sells securities and traded commodities could lose money and still pay a tax on its revenue, while the same company in Illinois would have no tax where no profit was made. Although the two taxes are similar, the margin tax contains a lower tax rate, but it is not as generous as the Illinois proposed tax in the number of exemptions or the amount for a small business exemption.<sup>163</sup> Nonetheless, the Illinois tax was vehemently opposed: it failed by a vote of 107-0 with seven legislators voting “present.”<sup>164</sup>

Seeking a similar overhaul of state business taxation, Michigan Governor Jennifer Granholm recently proposed several changes to Michigan's tax structure, including a new Michigan business tax (MBT).<sup>165</sup> The proposed tax would replace the single business tax (SBT), taxing gross receipts and assets at a rate of 0.125% and business income at 1.875%.<sup>166</sup> The MBT would provide a much smaller tax rate on gross receipts than that of the margin tax, and the MBT would place a lighter tax burden on unprofitable

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on tax liability for taxable entities with a total revenue between \$300,000 and \$400,000, a 60% discount for taxable entities with a total revenue between \$400,000 and \$500,000, a 40% discount for taxable entities with a total revenue between \$500,000 and \$700,000, and a 20% discount for taxable entities with a total revenue between \$700,000 and \$900,000).

162. RSM McGladrey, Inc., State and Local Tax Watch, Income and Franchise Tax (Spring 2007), <http://www.rsmmcladrey.com/RSM-Resources/Publications/State-Local-Tax/Third-Quarter-2007/Income-and-franchise-tax/>.

163. *Id.*

164. H.R. Res. 402, H. Roll Call Vote #2, 95th Gen. Assem., Reg. Sess. (Ill. 2007), available at [http://www.ilga.gov/legislation/votehistory/95/house/09500HR0402\\_05102007\\_002000.pdf](http://www.ilga.gov/legislation/votehistory/95/house/09500HR0402_05102007_002000.pdf).

165. See Office of the Governor, State of Michigan, The Michigan Business Tax: A New Tax for a New Economy, [http://annarborchamber.org/business/MBT\\_Overview\\_-\\_Final.pdf](http://annarborchamber.org/business/MBT_Overview_-_Final.pdf) (last visited Apr. 8, 2008) (providing an overview of the Michigan Business Tax).

166. *Id.* at 2; see Steven E. Grob & Wayne D. Roberts, *The Michigan Business Tax Replaces the State's Much-Vilified SBT*, 10 J. MULTISTATE TAX'N 8, 9 (2007) (“Michigan's MGRT is a unique tax that can be classified as something between a gross receipts tax and a gross margin tax.”). Interestingly, “draft tax legislative proposals referenced the Texas gross margin tax as an example of this type of tax, but the enacted MGRT differs substantially from the Texas scheme,” since it is both a tax on gross receipts and a tax on income. *Id.*

businesses in Michigan than would the margin tax for unprofitable businesses in Texas. Michigan's tax on income is similar to the margin tax except for the lower rate. This system seems to allow the state to offset the low tax rate on gross receipts by taxing profitable businesses on their income. Michigan's proposed tax would also exempt businesses with less than \$350,000 in gross receipts.<sup>167</sup> This is close to the \$300,000 exemption in Texas, yet not as generous as the \$2 million exemption originally proffered by Illinois. The proposed Michigan tax would provide an exemption phase-out for businesses grossing between \$350,000 and \$700,000,<sup>168</sup> while the margin tax provides a tiered exemption phase-out for businesses with up to \$900,000 in gross revenue.<sup>169</sup>

Unique to business taxation in the United States, the Kansas Legislature passed a bill providing a five-year phase-out of Kansas's franchise tax.<sup>170</sup> The rate of \$125 per \$100,000 of shareholder value for Kansas corporations is unchanged for 2007, but, beginning in 2008, the rate will be reduced by \$31.25 per \$100,000 each year for the next four years. Starting in 2011, Kansas will not assess a franchise tax.<sup>171</sup>

Although the main reason for levying the margin tax was to comply with the Texas Supreme Court mandate to remedy both the inadequate school funding and the unconstitutional property tax that had been used to provide such funding, even once those problems are solved, Texas businesses are not likely to experience a phase-out similar to that of Kansas.<sup>172</sup> The margin tax, in

167. Office of the Governor, State of Michigan, *The Michigan Business Tax: A New Tax for a New Economy*, at 2, [http://annarborchamber.org/business/MBT\\_Overview\\_-\\_Final.pdf](http://annarborchamber.org/business/MBT_Overview_-_Final.pdf) (last visited Apr. 8, 2008).

168. *Id.*

169. *See* TEX. TAX CODE ANN. § 171.0021 (Vernon 2008) (allowing an 80% discount on tax liability for taxable entities with a total revenue between \$300,000 and \$400,000, a 60% discount for taxable entities with a total revenue between \$400,000 and \$500,000, a 40% discount for taxable entities with a total revenue between \$500,000 and \$700,000, and a 20% discount for taxable entities with a total revenue between \$700,000 and \$900,000).

170. Act of Apr. 19, 2007, ch. 159, § 1, 2007 Kan. Sess. Laws 978 (to be codified at KAN. STAT. § 79-5401 (2006)).

171. *Id.* The act requires taxable entities to pay an annual franchise tax at a rate of 0.125% in 2007, 0.09375% in 2008, 0.0625% in 2009, and 0.03125% in 2010. *Id.*

172. *See* Editorial, *Lawmakers, Please Don't Take the Easy Way Out*, AUSTIN AM.-STATESMAN, Apr. 19, 2006, at A8 (contending that, despite the current surplus, a business tax overhaul is necessary to maintain lower property taxes). According to the authors, Governor Rick Perry is correct in claiming "that just spending the surplus and ducking tax

addition to other recent taxes on items such as cigarettes and used car sales, is expected to provide an additional \$8.1 billion in school revenue, while the figure needed for school district maintenance and operations is a staggering \$14.2 billion.<sup>173</sup> This discrepancy not only suggests that complete budget relief from the margin tax is unlikely, but that the school funding crisis might worsen before it improves.

The recent business tax passed in Kentucky further exemplifies the potential effects of the margin tax. Kentucky introduced a business tax based on net income in 2005.<sup>174</sup> “However, almost immediately after it took effect, [b]usinesses with little or no net profits or even net losses had to lay off workers, sell companies, restructure or divert capital dollars to pay taxes.”<sup>175</sup> By 2006, the Kentucky Legislature passed an exemption for small businesses with \$3 million or less in gross profits.<sup>176</sup> Kentucky’s example should give hope to small businesses in Texas. However, if small business owners in Texas are forced to terminate employees, sell their business in the face of bankruptcy, and spend precious time and resources diverting revenue in order to pay less taxes, the damage will have been done to the Texas economy even if Texas eventually raises the small business exemption threshold.

Finally, Ohio recently enacted the Commercial Activity Tax (CAT),<sup>177</sup> which provides a tax rate of 0.26% on gross receipts from all commercial activity within the state.<sup>178</sup> The CAT supplanted the Corporate Franchise Tax and Tangible Property Tax, which will both be phased-out.<sup>179</sup> Ohio’s small business exemption is only \$150,000, but interestingly, the tax liability for

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reform only postpones our state’s day of reckoning. Lawmakers cannot assume that the economy will generate another big surplus to keep local property taxes low.” *Id.*

173. Laura Elder, *Business: Group Calls on State Lawmakers to Reform Margins Tax*, GALVESTON COUNTY DAILY NEWS, Sept. 28, 2007, at B2.

174. KY. REV. STAT. ANN. § 141.040 (West 2006).

175. April L. Butler, Comment, *A Look at What the CAT Dragged In: The Problems Inherent in Ohio’s Commercial Activity Tax*, 32 U. DAYTON L. REV. 99, 135–36 (2006) (citing Editorial, *Second Stab at Kentucky Tax Reform*, CINCINNATI ENQUIRER, June 22, 2006, at 14C).

176. Jim Jordan & Alex Fontana, *Fletcher Signs Tax Relief Bill: Will Ease Burden on Smaller Businesses*, LEXINGTON HERALD-LEADER, June 29, 2006, at D4.

177. OHIO REV. CODE ANN. § 5751.02 (West 2006).

178. Mark Engel, Bricker & Eckler LLP, *Summary of Ohio’s Commercial Activity Tax and Other Ohio Tax Reform* (June 30, 2005), <http://www.bricker.com/publications/articles/824.asp>.

179. *Id.*

all companies with gross receipts of \$1 million or less is a mere \$150.<sup>180</sup> When the CAT is fully integrated in five years, even companies with over \$1 million in gross revenue will be taxed at a rate of 0.26%.<sup>181</sup> Obviously, Ohio has a lower small business exemption than Texas, yet by including more businesses, Ohio reduced the overall tax burden on each business by providing a low overall tax liability threshold.

As is the case with the margin tax, it is too soon to predict the full effect of the new taxes on the businesses and economies of the aforementioned states. One state, however, has already repealed a tax similar to Ohio's CAT. "Indiana abandoned its version of the CAT in 2002, because the state felt the tax was dissuading businesses from locating in the state . . ."<sup>182</sup> Should this happen in Texas, the increased revenue—though badly needed for school funding—might prove to be the temporary fix, while the margin tax could significantly hinder the Texas economy.

#### IV. CONCLUSION

##### A. *Winners and Losers*

Any businesses that will substantially benefit from the reduced property taxes will likely see a reduction in overall tax liability since the reduction in property taxes is the largest in Texas history.<sup>183</sup> Wholesalers and retailers will enjoy a rate half that of other businesses, which could result in a lower tax liability under the margin tax than under the franchise tax. Sole proprietorships and passive entities are exempt from the margin tax,<sup>184</sup> which should allow them to fare better than under the franchise tax.

180. Patrick Henry Smith, *State Entity-Level Taxation of Single-Member Limited Liability Companies*, 17 J. MULTISTATE TAX'N 18, 23 (2007).

181. *Id.*

182. April L. Butler, Comment, *A Look at What the CAT Dragged In: The Problems Inherent in Ohio's Commercial Activity Tax*, 32 U. DAYTON L. REV. 99, 120 (2006).

183. See William E. Junell, *The Eyes of Taxes Are Upon You*, 44 HOUS. LAW. 18, 20 (July/Aug. 2006) (noting that in May 2006, the Texas Legislature passed House Bill 1, requiring all school districts in Texas to "reduce [their] property tax rate for school maintenance and operations from \$1.50 to \$1.00 per \$100 valuation," with a statutory ceiling of \$1.30 per \$100 in valuation).

184. See TEX. TAX CODE ANN. § 171.0002(b) (Vernon 2008) (exempting both sole proprietorships and passive entities from the nomenclature "taxable entity").



Companies that sell goods or services out-of-state in a location without tax consequences will not pay taxes on those sales under the margin tax, even though the franchise tax required such companies to compute those sales with Texas sales for purposes of the tax.<sup>185</sup>

Businesses that have minimal deductions for employee compensation and little or no cost of goods sold—including service industries such as transportation and rental companies—will have increased liability under the margin tax. Lawyers, doctors, accountants, and other professionals, especially those who are members of partnerships that are not passive entities, also will see increased liability under the margin tax.<sup>186</sup>

Unfortunately, affiliated companies will also face increased liability. This is because the margin tax, unlike the franchise tax, requires combined reporting for groups engaged in a single business.<sup>187</sup> Under the franchise tax, such affiliates did not trigger the nexus requirement in Texas to file tax returns, and therefore were not taxed on their business in Texas.

A positive result of the tax reform is that for many businesses that own the property on which they operate, the property tax cuts will offset the additional margin tax liability. The margin tax is intended to encourage more businesses to hire full-time employees, and provide them with health care benefits, instead of relying on independent contractors. It is also more equitable than the franchise tax, since it prevents many businesses from continuing to circumvent the franchise tax while still enjoying limited liability—in effect providing similar treatment for more Texas businesses instead of giving preferential treatment to a

185. David Hendricks, *Businesses, Wealthy Families Gear Up for the New State Tax*, SAN ANTONIO EXPRESS-NEWS, Oct. 25, 2006, at 1E.

186. Press Release, Tex. Comptroller of Pub. Accounts, Comptroller Strayhorn Believes Gov. Perry's "Margin Tax" Is an Income Tax; Requests Formal Attorney General's Opinion (Apr. 21, 2006), <http://www.window.state.tx.us/news/60421taxplan.html> (asserting that the margin tax is a "sick tax" and a "legal access tax"). The increased tax on doctors and lawyers will be paid, like the increased tax liability of other taxable entities, by Texas consumers, since "[d]octors and lawyers . . . will be forced to pass that tax on to their patients and their clients." *Id.*

187. See TEX. TAX CODE ANN. § 171.1014(a) (Vernon 2008) ("Taxable entities that are part of an affiliated group engaged in a unitary business shall file a combined group report in lieu of individual reports based on the combined group's business.").

select few.<sup>188</sup> As a result, however, more businesses will be taxed under the margin tax than the franchise tax, and many small businesses already taxed under the franchise tax will likely face higher overall tax burdens if the margin tax increase is not offset by the property tax cut.<sup>189</sup> Despite the property tax relief, the margin tax is designed to increase state revenue.<sup>190</sup> The result is a net increase in taxation for Texas businesses that could come out of the pockets of Texas consumers.<sup>191</sup>

Small businesses—a vital component to the Texas economy—as well as new businesses, which provide future stability for the Texas economy, will both face increased taxation under the margin tax. As a result, the margin tax could be inefficient in encouraging economic growth and production in Texas. Similar to the consequences of the Ohio business tax, “[e]ven businesses in industries that will benefit from the tax admit that ‘[f]orcing a company to pay a tax when it is not earning a profit takes cash reserves out of the treasury that could otherwise be spent to update equipment and make the company more competitive,’” not to mention the increased chance of being driven out of business.<sup>192</sup>

188. Interview with T. Randall Cain, Member, Tex. Tax Reform Comm’n, in San Antonio, Tex. (Feb. 26, 2008).

189. *Id.* Mr. Cain indicated that a primary goal of the margin tax was to include more Texas businesses in order to both spread and minimize the relative tax burden. *Id.*; see also David Hendricks, *Group to Seek Tax Changes*, SAN ANTONIO EXPRESS-NEWS, July 25, 2007, at 1E (reporting that small businesses are more likely to lease or rent space, or, if they own the property on which they conduct their business, are more likely to have relatively small properties).

190. See L.A. Lorek, *Business Tax in Eye of the Beholder*, SAN ANTONIO EXPRESS-NEWS, Apr. 5, 2006, at 1E, available at <http://www.mysanantonio.com/business/stories/MYSA040506.1E.biztax.34e02dd.html> (projecting a total of \$6 billion in revenue under the margin tax, \$4 billion of which is attributed solely to the changes under the margin tax, and \$2 billion of which the current franchise tax already contributes to the state budget).

191. See generally Angelou Economics, *Texas Business Climate: Taxes, Technology, and Trends*, [http://www.angelouconomics.com/news\\_rep\\_tbusclimate.html](http://www.angelouconomics.com/news_rep_tbusclimate.html) (last visited Apr. 8, 2008) (noting the “propensity of small firms” to pass the costs of increased taxation on to customers); James A. Richardson & Susan Kalinka, *Louisiana Taxation of Businesses: Two Alternative Proposals*, 61 LA. L. REV. 763, 777 (2001) (arguing businesses must still maintain competitive prices while coping with additional tax liabilities).

192. April L. Butler, Comment, *A Look at What the CAT Dragged In: The Problems Inherent in Ohio’s Commercial Activity Tax*, 32 U. DAYTON L. REV. 99, 121 (2006) (quoting Ohio Steel Report, *Tax Reform Package Would Phase out Taxes That Unfairly Burden the Manufacturing Sector: Approval Sets Stage for Technology Investments, Industry Growth and Job Creation*, at 1 (Spring 2005), available at <http://www.ohiosteel.com>).

Moreover, there are inevitable legal challenges to the margin tax.<sup>193</sup> Many Texans believe that the margin tax taxes individual income in violation of the Texas Constitution.<sup>194</sup> Commerce Clause and Equal Protection Clause challenges are also likely under the arguments that the margin tax fails to clearly define the nexus requirements for businesses to be subject to the margin tax, and the margin tax taxes retailers and wholesalers at a lower rate than other businesses.<sup>195</sup> The Texas Supreme Court “has exclusive and original jurisdiction over a challenge to the constitutionality” of any part of the margin tax and must rule on such a challenge within 120 days of filing.<sup>196</sup>

Although the margin tax closes the tax avoidance schemes that were legal under the franchise tax, there are still ways for Texas businesses to minimize tax liability. General partnerships, because they are owned solely by natural persons, are not considered “taxable entities” under the margin tax.<sup>197</sup> Passive entities are

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org/\_issues%20and%20positions/past\_newsletters/2005\_Spring.pdf).

193. See Mike Seay & Jimmy Martens, *The New Texas Margin Tax*, 70 TEX. B.J. 30, 31 (2007) (emphasizing that because the new margin tax may be unconstitutional it will undoubtedly be litigated).

194. See Letter from Carole Keeton Strayhorn, Tex. Comptroller of Pub. Accounts, to the Honorable Greg Abbott, Attorney Gen. of Tex. (Apr. 21, 2006), available at [http://www.oag.state.tx.us/opinions/Requests\\_ga/rq0479ga.pdf](http://www.oag.state.tx.us/opinions/Requests_ga/rq0479ga.pdf) (arguing that the margin tax is an unconstitutional income tax on individuals).

195. See Kal Malik, *The “New” Texas Franchise Tax: A Summary of HB 3*, at 4–5, [http://www.chtmlaw.com/downloads/TX\\_franchisetax\\_HB3\\_Malik.pdf](http://www.chtmlaw.com/downloads/TX_franchisetax_HB3_Malik.pdf) (last visited Apr. 8, 2008) (“A conclusory statutory provision may not be sufficient to fend off similar [Commerce Clause] constitutional attacks on the new Franchise Tax scheme.”); see also Letter from Carole Keeton Strayhorn, Tex. Comptroller of Pub. Accounts, to the Honorable Greg Abbott, Attorney Gen. of Tex. (Apr. 21, 2006), available at [http://www.oag.state.tx.us/opinions/Requests\\_ga/rq0479ga.pdf](http://www.oag.state.tx.us/opinions/Requests_ga/rq0479ga.pdf) (“No basis has been provided, and none is apparent, for the disparate treatment of businesses from the standpoint of tax rates.”). However, wholesale and retail businesses, although taxed at a lower rate, are incurring the same relative tax burden as other businesses subject to the higher tax rate. Interview with T. Randall Cain, Member, Tex. Tax Reform Comm’n, in San Antonio, Tex. (Feb. 26, 2008).

196. Act approved May 19, 2006, 79th Leg., 3d C.S., ch. 1, § 24, 2006 Tex. Gen. Laws 1, 40 (amended 2007).

197. See TEX. TAX CODE ANN. § 171.0002(a) (Vernon 2008) (defining “taxable entity” as “a partnership, corporation, banking corporation, savings and loan association, limited liability company, business trust, professional association, business association, joint venture, joint stock company, holding company, or other legal entity”). Because general partnerships do not enjoy limited liability status, however, personal liability risks for general partners could easily offset any exemption under the margin tax. See Jane Snoddy Smith, *Four Things Lawyers Should Know About the Margin Tax*, TEX. LAW., Feb. 18, 2008, at 27 (“Given that another concern of most commercial property owners is

also exempt from margin tax,<sup>198</sup> even though they can be structured as “limited partnership[s] or trust[s].”<sup>199</sup> To qualify as an exempt passive entity, a business must be structured properly at the beginning of the taxable year, must have no more than 10% active income, and must have at least 90% passive income.<sup>200</sup> For commercial property owners, capital gains from the sale of property is considered passive income under the margin tax, while rents collected on that property is considered active income.<sup>201</sup> Thus, if a real estate business structures itself as a limited partnership and sells property for a capital gain, it can successfully avoid the margin tax as a passive entity. In order to avoid the margin tax, attorneys are encouraged to inform clients that own commercial property and are organized as an entity other than a limited partnership to convert to a limited partnership prior to January 1 of the year of anticipated sale.<sup>202</sup>

### B. *Potential Changes*

Raising the total revenue exemption amount for small businesses, or even providing an exemption for businesses that do not make a profit, would help both small and new businesses in Texas continue to flourish and provide jobs for Texans while larger and more stable businesses bear the brunt of the tax. On the other hand, more exemptions mean less state revenue, which would further inhibit school funding and eliminate revenue already projected in the state’s budget. Even worse, the margin tax, along with recent sales tax hikes on items such as cigarettes and private-party used car sales, is expected to provide an

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to limit personal liability, individual property ownership may not be a viable option, so owners’ lawyers likely will need to look at other ways to minimize their clients’ margin tax.”).

198. TEX. TAX CODE ANN. § 171.0002(b)(3) (Vernon 2008).

199. *Id.* § 171.0003(a)(1) (restricting passive entities to general partnerships, limited partnerships, and trusts other than business trusts).

200. *Id.* § 171.0003(a) (noting that a passive entity’s “federal gross income” must consist of 90% of the business’s income, which includes “distributive shares of partnership income” and real property gains, among other things, while only 10% of federal gross income can result from “conducting an active trade or business”).

201. *Id.* § 171.0003(b)(1); see Jane Snoddy Smith, *Four Things Lawyers Should Know About the Margin Tax*, TEX. LAW., Feb. 18, 2008, at 27 (“The easy rule of thumb for a commercial property owner is that rent is always active income and therefore subject to the margin tax. The capital gain from the sale of the property is passive income.”).

202. Jane Snoddy Smith, *Four Things Lawyers Should Know About the Margin Tax*, TEX. LAW., Feb. 18, 2008, at 27.

additional \$8.1 billion in school revenue, while the figure needed for school district maintenance and operations is a staggering \$14.2 billion.

Despite these competing ideas, the Texas Legislature has already alleviated the burden somewhat for small businesses. In response to the outrage by small businesses, the 2007 regular session of the Texas Legislature amended House Bill 3 with House Bill 3928, which provides discounts for small businesses that have a total revenue of \$300,000 to \$900,000.<sup>203</sup> Although small businesses want an exemption for all companies with less than one million in total revenue,<sup>204</sup> further altering the small business deduction could have detrimental consequences.<sup>205</sup> Allowing deductions for independent contractors would also help the service, rental, and construction industries.

An exhaustive list of possible solutions to the margin tax is unavailable at this point, since additional changes are likely and effects are widely unknown. However, in order to alleviate the

203. See Act approved June 15, 2007, 80th Leg., R.S., ch. 1282, § 8, 2007 Tex. Gen. Laws 4282, 4286–87 (codified at TEX. TAX CODE ANN. § 171.0021 (Vernon 2008)) (allowing an 80% discount on tax liability for taxable entities with a total revenue between \$300,000 and \$400,000, a 60% discount for taxable entities with a total revenue between \$400,000 and \$500,000, a 40% discount for taxable entities with a total revenue between \$500,000 and \$700,000, and a 20% discount for taxable entities with a total revenue between \$700,000 and \$900,000).

204. See David Hendricks, *Group to Seek Tax Changes*, SAN ANTONIO EXPRESS-NEWS, July 25, 2007, at 1E (indicating that the National Federation of Independent Business (NFIB) unsuccessfully lobbied to have the small business exemption raised to \$1 million in gross revenue during the 2007 session of the Texas Legislature).

205. April L. Butler, Comment, *A Look at What the CAT Dragged In: The Problems Inherent in Ohio's Commercial Activity Tax*, 32 U. DAYTON L. REV. 99, 122 (2006). Although Butler discusses the impact of Ohio's new business tax on small businesses, the Ohio tax exemplifies the potential effect of the margin tax in Texas—because:

[S]mall businesses will be paying most of the profit they earn in taxes, which will discourage small businesses from locating within Ohio. . . . Since small businesses are essential for the creation of new jobs, embodying "99.7 percent of all employers," the CAT [Ohio's business tax] will likely impede job creation rather than promote it.

*Id.* (quoting Press Release, Office of Advocacy, U.S. Small Bus. Admin., *Top 10 Reasons to Love Small Business* (Feb. 13, 2004), <http://www.sba.gov/advo/press/04-06.html>). Thus, the dilemma in Texas is that if the legislature provides further exemptions for small businesses, the state loses revenue; if the state refuses to grant further exemptions and instead maintains the tax on small businesses, the state will inhibit job creation, thereby losing employment and potential revenue.

school funding crisis, the Texas Legislature could enact a statewide “school tax” that is not tied to property owned in any given school district. This would ease the burden on businesses, spread the tax over a greater portion of the population, and still provide additional funding for Texas schools while avoiding the constitutionality issues that plagued the Robin Hood plan. As for changes to the margin tax itself, capping the overall tax liability increase for small businesses at 100% would undoubtedly make the margin tax more palatable for those small businesses who are legitimately worried that the margin tax could drive them out of business. Texas could also follow Ohio’s lead by creating a lower small business exemption, distributing the tax burden over an even greater number of businesses, and providing a low maximum tax liability for small businesses so as not to over-burden any one business. Granted, these changes would decrease the tax revenue under the margin tax, but it is possible that the lost revenue can be gained in ways less cumbersome to the Texas economy as a whole. For instance, the margin tax could provide a progressive tax rate by lowering the rate for companies with smaller gross receipts and increasing the rate for businesses with extremely high gross receipts, similar to the federal income tax on individuals.

Finally, it is unclear whether the margin tax will indeed solve the school funding crisis for which it was orchestrated, although with great tension, to alleviate. According to William E. Junell:

The business tax is not without controversy on this point and has raised a number of serious questions. There is on-going debate as to whether this tax actually will produce the funds necessary to offset the property tax cuts imposed by House Bill 1 and still meet the Supreme Court’s educational requirements. Some authorities have suggested that the revenue growth assumptions are overstated and that the tax will likely fall short of projections. According to Comptroller Strayhorn: “(the lawmakers) passed the largest tax increase in Texas history and it does not balance. They thought they were raising \$12 billion in revenue. I ran the numbers and found they raised about \$8 billion.” The uncertainty may well lie in certain growth and other assumptions that have been made, and the accuracy of those assumptions may not be known until tax collections occur.<sup>206</sup>

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206. William E. Junell, *The Eyes of Taxes Are Upon You*, 44 HOUS. LAW. 18, 20–21

Members of the Texas Tax Reform Commission, however, feel that former Comptroller Strayhorn's revenue estimates were historically too low and believe that Texas will enjoy more margin tax revenue than sources indicate.<sup>207</sup> If so, the margin tax will have accomplished its primary goal of reducing the school funding burden on property taxes.<sup>208</sup> Recognizing that the margin tax might not be a permanent fix to the property tax and school funding issues, T. Randall Cain, a member of the Texas Tax Reform Commission, nonetheless feels that the margin tax was the most equitable and viable solution available given the Texas Supreme Court's ultimatum and the small amount of time within which the Commission was forced to develop the margin tax.<sup>209</sup>

Regardless of whether the Texas Legislature makes further changes to the margin tax, the Comptroller's first priority should be to clarify the recent changes and provide a more in-depth worksheet with example calculations. The margin tax is the new reality, and Texas businesses need to be able to accurately forecast their new tax liability so they can act accordingly.

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(July/Aug. 2006) (citation omitted).

207. Interview with T. Randall Cain, Member, Tex. Tax Reform Comm'n, in San Antonio, Tex. (Feb. 26, 2008).

208. *Id.*

209. *Id.* Mr. Cain noted that large businesses such as Shell, Exxon, AT&T, USAA, Clear Channel Communications, and Zachry Construction all endorsed the margin tax as an equitable solution to the persistent problem, given the time constraints on the Texas Tax Reform Commission to provide their recommendations to Governor Perry and the Texas Legislature. *Id.* These large businesses did not oppose the margin tax despite knowing they would face an increased tax burden under the margin tax. *Id.*