St. Mary's Law Journal

Volume 55 | Number 1 Article 5

1-23-2024

Public Law 86-272 and the Texas Margin Tax

Marvin J. Williams

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Recommended Citation

Marvin J. Williams, *Public Law 86-272 and the Texas Margin Tax*, 55 ST. MARY'S L.J. 261 (2024).
Available at: https://commons.stmarytx.edu/thestmaryslawjournal/vol55/iss1/5

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ARTICLE

PUBLIC LAW 86-272 AND THE TEXAS MARGIN TAX

MARVIN J. WILLIAMS*

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Published by Digital Commons at St. Mary's University, 2024

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INTRODUCTION

State and local income taxation is prevalent in most states and many local governments throughout the United States, and over the years, it has become a major source of revenue for these governmental entities.[1] Most states currently impose some type of tax on the income or gross receipts of business entities.[2] All but eight states impose some type of income tax on individuals.[3] As a result, the ability to levy income or similar taxation at the state and local level is crucial for many taxing authorities.

Businesses incorporated under the jurisdiction of a specific state and businesses operating in a local jurisdiction of a specific state are subjected to the taxation imposed by that jurisdiction.[4] However, it can be uncertain whether a business not incorporated under the jurisdiction of a specific state or not operating in the local jurisdiction of a specific state is subjected to the taxation imposed by these jurisdictions. What generally gives a specific state the ability to impose their taxation on out-of-state businesses falls under the term "nexus."[5] Nexus refers to the level of business activity an out-of-state business has in the state.[6] States define nexus quite differently.[7] Common activities generally constituting nexus are income or sales generated in the state, property owned or leased in the state, and employees present in the state.[8]

1. *See Individual Income Tax as a Proportion of State Tax Revenue*, U.S. CENSUS BUREAU (May 9, 2022), https://www.census.gov/content/dam/Census/library/visualizations/2022/comm/individual-income-tax.pdf [https://perma.cc/5W7J-3ZLE] (outlining the percentages of 2021 state tax revenues across the country).

2. WILLIAM A. RAABE ET AL., SOUTH-WESTERN FEDERAL TAXATION: CORPORATIONS, PARTNERSHIPS, ESTATES & TRUSTS 16-2 (45th ed. 2022) ("Forty-six states and the District of Columbia impose a tax based on a C corporation's taxable income.").

3. JAMES C. YOUNG ET AL., SOUTH-WESTERN FEDERAL TAXATION: INDIVIDUAL INCOME TAXES (45th ed. 2022) 1-16 n.21 ("Alaska, Florida, Nevada, South Dakota, Tennessee, Texas, Washington, and Wyoming do not have an individual income tax.").

4. RAABE ET AL., *supra* note 2, at 16-6 ("Forty-six states and the District of Columbia impose a tax based on a C corporation's taxable income.").

5. *Id.*

6. *Id.*

7. *Id.*

8. *Id.*

I. NORTHWESTERN STATES PORTLAND CEMENT COMPANY V. STATE OF MINNESOTA

In years past, states were aggressive in imposing their income (or similar) taxes on out-of-state businesses.[9] In some cases, out-of-state businesses were surprised to learn that states sought to levy their income taxes on them.[10] An interesting example of this is the case *Northwestern States Portland Cement Co. v. State of Minnesota*,[11] a Supreme Court case involving an Iowa-based business that sold products in Minnesota.[12] In 1933, Northwestern States Portland Cement Company, an Iowa-based cement manufacturer, began selling its product in the neighboring state of Minnesota.[13] Northwestern States Portland Cement Company's home city, Mason City, Iowa, is only forty miles from the nearest Minnesota border.[14] Northwest States Portland Cement Company had a small three-room sales office in Minneapolis, Minnesota, that was leased and paid for out of the Mason City, Iowa, home office.[15] Northwestern States Portland Cement Company owned no real estate in Minnesota and maintained minimal personal property, including a few desks, chairs, a typewriter, filing cabinets, and the salesmen's automobiles.[16] Over the many years that the company sold its product in Minnesota, it had, at the most, six employees working in Minnesota.[17] A secretary and two salesmen worked out of the Minneapolis office, and the rest of the salesmen worked out of their homes throughout the state.[18]

The tasks of hiring, terminating, and establishing wages for employees were performed by supervisory personnel located in Mason City, Iowa.[19]

9. *See* Antonio Di Benedetto, *A Practical Guide to Economic Nexus*, J. OF ACCT. (June 1, 2021), https://www.journalofaccountancy.com/issues/2021/jun/economic-nexus-sales-and-use-tax.html [https://perma.cc/R58Y-UPKL] (explaining various strategies states use to seek out entities establishing nexus).

10. *See* HC&D Moving & Storage Co. v. Yamane, 405 P.2d 382, 385 (1965) (discussing the constitutionality of income tax on out-of-state businesses and arguing the tax should not be applied because they solely did business in one state).

11. Nw. States Portland Cement Co. v. Minnesota, 358 U.S. 450 (1959).

12. *Id.* at 453.

13. *Id.*

14. *Id.*

15. State v. Nw. States Portland Cement Co., 84 N.W.2d 373, 387 (Minn. 1957), (Nelson, J., dissenting), *aff'd*, 358 U.S. 450 (1959).

16. *Id.*

17. *See id.* (stating five salesmen and a secretary were employed in Minnesota).

18. *Id.*

19. *Id.* at 378.

Purchase orders placed in the Minnesota sales office were forwarded to Mason City, Iowa, for approval or rejection.[20] Credit decisions, collections, and claims for adjustment were performed exclusively from the Mason City, Iowa, home office.[21] Price quotations, including freight charges, were sent directly to customers from the Mason City home office, and all price changes were made by the Mason City home office.[22] Approved orders were invoiced and shipped by rail from Mason City, Iowa, directly to the customers in Minnesota (and other states including Iowa).[23]

Minnesota sought to impose the Minnesota income tax on Northwest States Portland Cement Company.[24] Northwest States Portland Cement Company refused to file Minnesota income tax returns.[25] Eventually, the Commissioner of Taxation for the state of Minnesota prepared income tax returns for Northwest States Portland Cement Company based on the information it could gather using an equally weighted three-factor apportionment formula of sales, property, and payroll.[26] These income tax returns were prepared for the years 1933 through 1948.[27] The state of Minnesota adopted its income tax law in 1933.[28]

In 1953, unable to get Northwest States Portland Cement Company to pay the computed taxes, Minnesota initiated legal action to collect the taxes, eventually reaching the United States Supreme Court.[29]

The trial court in this matter ruled in favor of the state of Minnesota in imposing its income taxation laws upon Northwest States Portland Cement Company.[30] The Supreme Court of Minnesota likewise ruled for Minnesota, holding the tax was a general income tax, not an excise, franchise, or

20. *Nw. States Portland Cement Co.*, 358 U.S. at 454.
21. *Nw. States Portland Cement Co.,* 84 N.W.2d at 378.
22. *Id.*
23. *Id.*
24. *Nw. States Portland Cement Co.*, 358 U.S. at 453.
25. *Id.* at 455.
26. *Id.* at 453–54.
27. *Id.* at 453.
28. *See* KATHLEEN A. GAYLORD & SUSAN CHIANELLI JACOBSON, HISTORY OF TAXATION IN MINNESOTA 5 (2nd ed. 1979) (outlining the history of taxes in Minnesota and reasons for adopting state income tax).
29. *Nw. States Portland Cement Co.*, 84 N.W.2d at 375.
30. *Id.*

privilege tax.[31] Northwest States Portland Cement Company appealed to the United States Supreme Court.[32]

The United States Supreme Court was presented with the issue of whether a state violated the Commerce Clause by imposing a tax on out-of-state businesses operating in its jurisdiction.[33] A sharply divided Court ultimately ruled in favor of Minnesota's tax (and a tax in the state of Georgia in a companion case) as an income tax on intrastate commerce within Minnesota and not a regulation or tax on interstate commerce.[34] Northwest States Portland Cement Company argued the imposition of the tax violated the Due Process Clause of the United States Constitution; however, the Supreme Court majority dismissed the argument.[35] The majority and dissenting opinions strongly intimated that Congress needed to act in this area.[36]

II. PUBLIC LAW 86-272

In immediate response to the *Northwest States Portland Cement Co. v. Minnesota* decision, Congress moved quickly in exercising its sole authority under the Commerce Clause of the United States Constitution to regulate interstate commerce by enacting Public Law 86-272.[37] Public Law 86-272 is the legislative guidance on how states may impose income taxation on companies not a domiciliary of a state, or rather how companies not domiciled in a state can avoid the income taxation of that particular state.[38] The legislation provided direction and clarity to the extent an out-of-state company may be subject to the income taxation laws of a given state.[39] This legislative guidance afforded businesses the opportunity to strategically avoid income taxation in many states.[40]

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31. *Id.* at 380.
32. *Nw. States Portland Cement Co.*, 358 U.S. at 452.
33. *Id.*
34. *Id.*
35. *Id.*
36. *See id.* at 457 (implying Congress is not effectively regulating interstate commerce, leaving room for controversy and confusion).
37. *See* Paul J. Hartman, *"Solicitation" and "Delivery" Under Public Law 86-272: An Uncharted Course*, 29 VAND. L. REV. 353, 358–59 (1976) (explaining the aftermath of the decision).
38. *See id.* at 354 (providing an explanation of what Public Law 86-272 set out to accomplish).
39. *See id.* (listing circumstances which provide corporations protection under Public Law 86-272).
40. *See id.* (stating the activities prohibited from taxation imposition).

Public Law 86-272 prevents states from taxing an out-of-state business whose only connection with the state is soliciting orders for sale if the following conditions are met: (1) out-of-state activities are limited to solicitation only, (2) only tangible personal property is sold in the state, (3) the orders are approved outside of the state, (4) the goods are delivered from outside of the state, and (5) the state's tax is based on net income (i.e., income tax).[41]

As described above, Public Law 86-272 applies only to the sale of tangible personal property.[42] Thus, an out-of-state company's sale of real estate gains no relief from income taxation imposed by the state where the sale occurred.[43] Moreover, leases, rentals, services, and the disposition of real estate and intangible properties are not protected by Public Law 86-272.[44]

In addition, nexus is required for an out-of-state company to be subject to the state income tax.[45] Nexus is generally met if any of the following is present: a corporation derives income from sources within the state, a corporation owns or leases property within the state, a corporation has employees within the state, or a corporation has physical or financial capital (assets) within the state.[46]

The first criterion of Public Law 86-272 provides that mere solicitation by a company for sales within a state does not constitute nexus for purposes of losing the protection of Public Law 86-272.[47] Additionally, criteria three and four require the orders for sale to be approved or denied outside of the state and for goods to be delivered by a common carrier outside the state.[48] Nexus is avoided if a business merely solicits orders that are approved or denied outside the state and the approved orders are filled and shipped from outside the state.[49]

The "solicitation only" provision of Public Law 86-272 has been applied narrowly and strictly enforced in several states, and slight deviations from

41. 15 U.S.C. §§ 381–84.

42. *Id.*

43. *See id.* (providing what is explicitly protected under the provision); RAABE ET AL., *supra* note 2, at 16-6 (emphasizing real property, intangible property, and sales of services are not protected).

44. 15 U.S.C. §§ 381–84 (addressing intangible property and its protection under the provision); RAABE ET AL., *supra* note 2, at 16-6.

45. RAABE ET AL., *supra* note 2, at 16-6.

46. *Id.*

47. 15 U.S.C.§§ 381–384; RAABE ET AL., *supra* note 2, at 16-6.

48. 15 U.S.C. §§ 381–384; RAABE ET AL., *supra* note 2, at 16-6.

49. RAABE ET AL., *supra* note 2, at 16-6.

solicitation may include offering repair and maintenance service (or contracts for repair and maintenance service) or conducting training sessions for purchasers of goods (and their employees).[50] These deviations would effectively establish nexus, causing the protection of Public Law 86-272 to be null and void.[51] As such, out-of-state businesses that do not strictly adhere to a state's construction of the solicitation only provision of Public Law 86-272 may be subject to the income taxation provisions of that state.[52]

Despite states efforts to narrow the scope and interpretation of the solicitation only provision of Public Law 86-272, the United States Supreme Court broadened the provision in *Wisconsin Department of Revenue, Petitioner, v. William Wrigley, Jr., Co.*[53]

In *Wisconsin Department of Revenue*, the Respondent, William Wrigley Jr. Company (Wrigley Company), a chewing gum manufacturer based in Chicago, Illinois, sold its products from 1973 to 1978 in Wisconsin through a sales force consisting of a regional manager and various field representatives.[54] The orders obtained in Wisconsin were sent to Chicago for acceptance or rejection, and the approved orders were filled by shipment through a common carrier from outside Wisconsin.[55] In 1980, the Wisconsin Department of Revenue concluded that Wrigley Company's in-state business activities were sufficient to impose a franchise tax.[56] Respondent objected, arguing it was immune under 15 U.S.C. § 381(a) (a provision under Public Law 86-272), which "prohibits a State from taxing the income of a corporation whose only business activities within the State consist of 'solicitation of orders' for tangible goods, provided that the orders are sent outside the State for approval and the goods are delivered from out of state."[57] The United States Supreme Court disagreed with the petitioner's argument and reversed the fully favorable ruling received by petitioner in the lower courts.[58] The Supreme Court held:

50. *See id.* at 16-7 (providing examples of generally sufficient to establish Nexus).
51. *See id.* (providing examples of generally sufficient to establish Nexus).
52. *Id.* (providing examples of factors which may and may not be sufficient to establish Nexus).
53. Wis. Dep't of Revenue v. William Wrigley, Jr., Co., 505 U.S. 214 (1992).
54. *Id.* at 216–18.
55. *Id.* at 219.
56. *Id.*
57. *Id* at 216.
58. *Id.* at 235.

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> Section 381(a)(1) confers immunity from state income taxes on any company whose "only business activities" in that State consist of "solicitation of orders" for interstate sales. . . . We think it evident that in this statute the term includes, not just explicit verbal requests for orders, but also any speech or conduct that implicitly invites an order. Thus, for example, a salesman who extols the virtues of his company's product to the retailer of a competitive brand is engaged in "solicitation" even if he does not come right out and ask the retailer to buy some.[59]

As such, the solicitation only provision has been broadened to include ancillary sales or solicitation activities, such as providing salespersons with a company car or a stock of free samples as "part of the 'solicitation of orders,'" because it facilitates the requests for purchases.[60] Additionally, "[I]n-state recruitment, training, and evaluation of sales representatives and its use of hotels and homes for sales-related meetings" are deemed ancillary activities "in facilitating solicitation."[61] However, the United States Supreme Court limited the extent of solicitation only, excluding other activities of salespersons, such as repairs or service of the customers' products, training, credit services, and assessing inventory needs of customers.[62] The Supreme Court justifies its limitation of the provision by providing that the excluded activities are not ancillary to solicitation of orders but are performed by the salespersons for the customer's convenience.[63] Accordingly, salespersons must be cautious when considering the services they wish to provide to out-of-state customers.

Regarding Public Law 86-272, by introducing a *de minimus* rule, the Court created additional immunity from nexus in circumstances where limited immaterial activity beyond solicitation occurs, determined by subjective review of relevant facts.[64]

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59. *Id.* at 223.
60. *Id.* at 229.
61. *Id.* at 234.
62. *See id.* at 229 ("Contrariwise, employing salesmen to repair or service the company's products is not part of the 'solicitation of orders,' since there is good reason to get that done whether or not the company has a sales force.").
63. *See id.* (distinguishing "requesting purchases" from "increasing purchases").
64. Raabe et al., *supra* note 2, at 16-6.

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III. TEXAS MARGIN TAX

Before 2021, seven states had no individual income tax of any kind: Alaska, Florida, Nevada, South Dakota, Texas, Washington, and Wyoming.[65] Historically, Tennessee and New Hampshire taxed investment income (interest and dividends only), though recently, both states have introduced legislation to remove taxation on individuals altogether.[66] As of January 1, 2021, Tennessee completely eliminated its investment income tax on individuals, and New Hampshire is scheduled to do the same on January 1, 2027.[67] Thus, at that time, there will be nine states with no individual income tax.[68]

Regarding taxation of business entities, four states presently have no business tax: Nevada, South Dakota, Washington, and Wyoming.[69] Unlike its opposition to imposing income taxation on individuals, Texas does impose a form of business taxation.[70] This unique tax on business is more commonly known as the Texas "margin" tax, although technically and statutorily, it is the Texas franchise tax, which has been imposed since 1907.[71] The Texas franchise tax has experienced relatively minor changes since its initial existence.[72] The State of Texas faced a dwindling tax base through the late 1980s.[73] Furthermore, in 2005, the Texas Supreme Court held its school finance system unconstitutional, which forced significant modification of the Texas franchise tax, creating the current tax structure for business

65. *See* Jim Probasco, *9 States with No Income Tax: But Don't Assume That Living There Will Cost Less*, Investopedia, https://www.investopedia.com/financial-edge/0210/7-states-with-no-income-tax.aspx#:~:text=Key%20Takeaways,Alaska%2C%20Florida%2C%20Nevada%2C%20South%20Dakota%2C%20Tennessee%2C%20Texas,other%20taxes%20or%20reduced%20services [https://perma.cc/Q6GY-ZWT7] (Mar. 21, 2023) (identifying the states with no individual income tax prior to 2021).

66. *Id.*

67. *Id.*

68. *Id.*

69. RAABE ET AL., *supra* note 2, at 16-2 n.2.

70. *See The History of the Texas Franchise Tax*, COMPTROLLER.TEXAS.GOV (May 2015), https://comptroller.texas.gov/economy/fiscal-notes/2015/may/franchisetax.php [https://perma.cc/ACQ3-8DJ9] ("Texas' primary tax on business, the franchise tax, is an important revenue source . . . [but] a controversial one, given the Legislature's consistent focus on maintaining Texas' business-friendly reputation.").

71. *Id.*

72. *See id.* (discussing the "relatively minor changes" of the franchise tax after its inception).

73. *See id.* (acknowledging the state's diminished franchise tax revenues following the *Bullock v. Sage Energy* decision).

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taxation.[74] This new tax structure, the Texas margin tax, took effect January 1, 2008.[75]

The Texas margin tax is imposed on corporations, limited liability companies (LLCs), partnerships—except general partnerships if direct ownership is constructed entirely of natural persons (other than limited liability partnerships), trusts, and other legal entities.[76] Thus, sole proprietorships (except for single-member LLCs) are not subject to the Texas margin tax.[77]

The Texas margin tax is unique because of how it is determined. The Texas margin tax is based on the taxable entity's margin, not its income.[78] The taxable entity's margin is computed in one of four ways: (1) total revenue times 70%, or total revenue minus 30% of total revenue, (2) total revenue minus cost of goods sold, (3) total revenue minus compensation, and (4) total revenue minus $1 million (beginning January 1, 2014).[79]

Total revenue is determined from the revenue shown on the taxable entity's federal income tax return minus certain exclusions (most notably dividends and interest from federal obligations and Form 1120 Schedule C Dividends).[80]

Cost of goods sold is traditionally for tangible personal property or real estate sold within the course of business (i.e., inventory).[81] The cost of goods sold may include up to 4% of "indirect or administrative overhead costs . . . allocable to the acquisition or production of goods," provided the allocated amount is not deducted elsewhere.[82] Cost of goods sold may also be adjusted (negative or positive) for undocumented worker compensation, active-duty personnel compensation, and aerospace costs.[83] Taxable entities providing only services will generally not "have a cost of goods sold deduction."[84]

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74. *Id.*
75. *Id.*
76. *Franchise Tax Overview*, COMPTROLLER.TEXAS.GOV, https://comptroller.texas.gov/taxes/publications/98-806.php [https://perma.cc/29XT-NUUM].
77. *Id.*
78. *Id.*
79. TEX. TAX CODE § 171.101.
80. *See id.* at § 171.1011 (listing exclusions to be subtracted).
81. *Id.* at § 171.1012(a)(1).
82. *Id.* at § 171.1012(f).
83. *See id* at § 171.1012(e)(14) (explaining circumstances when cost of goods may be adjusted).
84. *Franchise Tax Overview*, *supra* note 76.

Compensation is defined as "wages and cash compensation paid by the taxable entity to its officers, directors, owners, partners, and employees," including net distributive income from flow through entities, and stock awards or "stock options deducted for federal income tax purposes."[85] The total computed amount is limited annually (indexed for inflation).[86] The limit for the years 2022 and 2023 is $400,000 per person, increasing $10,000 from the years 2021 and 2020.[87]

In addition to the above computed amount, compensation includes employee benefits, such as: worker's compensation, health care, and retirement benefits.[88] Employee benefits are not subject to the annual limit described above.[89] Compensation may also be adjusted (negative or positive) for undocumented worker compensation or active-duty personnel compensation and aerospace costs.[90]

There are four mechanisms to calculate an entity's margin or its tax base.[91] This tax base is applied to the tax rates to determine the Texas margin tax for a taxable entity.[92] However, an annual (inflation adjusted) no tax due threshold applies for the Texas margin tax.[93] The no tax due threshold for the years 2022 and 2023 is $1,230,000.[94] Thus, no Texas margin tax is due if a taxable entity's margin is less than $1,230,000 for the years 2022 and 2023.[95]

For the years 2022 and 2023, the Texas margin tax rate is 0.75% for all taxable entities other than retail or wholesale entities and 0.375% for retail or wholesale entities.[96] Thus, retail or wholesome entities experience a tax rate of one-half compared to other taxable entities.[97]

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85. TAX § 171.1013.

86. *See id.* (providing requirements based on annual federal income taxes).

87. 34 TEX. ADMIN. CODE § 3.589.

88. *Id.*

89. *See id.* ("A taxable entity is allowed to subtract the cost of all benefits to the extent deductible for federal income tax purposes . . . .").

90. TEX. COMPTROLLER OF PUB. ACCTS., 2022 TEXAS FRANCHISE TAX REPORT INFORMATION AND INSTRUCTIONS 18 (2022).

91. *Id.* at 3.

92. *See id.* at 3–4 (establishing basis for determining Texas franchise tax).

93. *Id.* at 4.

94. *Id.*

95. *Id.*

96. TEX. TAX CODE § 171.002.; *Franchise Tax*, COMPTROLLER.TEXAS.GOV., https://comptroller.texas.gov/taxes/franchise/ [https://perma.cc/JC3Q-B9N9].

97. *See Franchise Tax, supra* note 96 (listing tax rates for 2022 and 2023).

In lieu of computing the Texas margin tax as described above (Long Form (Form 05-158-A and 05-158-B)), certain taxable entities that qualify may file the EZ Computation Report (Form 05-169).[98] To be eligible for the EZ Computation Report, the taxable entity, including a combined group, must have an annualized total revenue of $20 million or less.[99] The EZ Computation Report tax rate is 0.331% for the years 2023, 2022, 2021, and 2020.[100] This tax rate is applied to the apportioned revenue because no deductions (offsets) are allowed when using the EZ computation method, in contrast with the Long Form Report.[101] Under the EZ Computation Report, the taxable entity faces a higher tax base but a lower tax rate.[102] Depending on the combination of the total apportioned revenue and the four offsets allowed for the Long Form Report, either the Long Form Report or the EZ Computation Report can yield the lowest Texas margin tax.[103] Thus, an eligible taxable entity can compare the tax due under both the Long Form Report and the EZ Computation Report to determine which report is more beneficial for the taxable entity.[104]

To determine the taxable margin (under the Long Form Report or the EZ Computation Report), "[m]argin is apportioned to Texas using a single-factor apportionment formula based on gross receipts," for example, Texas gross receipts is the numerator and total gross receipts (everywhere) is the denominator (Texas Gross Receipts/Total Gross Receipts).[105] "Gross receipts" is defined in the Texas Tax Code as "all revenues reportable by a taxable entity on its federal tax return, without deduction for the cost of property sold, materials used, labor performed, or other costs incurred."[106] This, in essence, is total revenue as shown on Line 10 on the Long Form Report and the EZ Computation Report, and Line 7 of the No Tax Due Report discussed below.[107]

98. TEX. COMPTROLLER OF PUB. ACCTS., *supra* note 90, at 18.

99. TAX § 171.016; TEX. COMPTROLLER OF PUB. ACCTS., *supra* note 90, at 18.

100. TEX. COMPTROLLER OF PUB. ACCTS., *supra* note 90, at 4.

101. *Id.*

102. *See id.* ("No margin deduction . . . is allowed when choosing the EZ computation method.").

103. *See generally id.* (providing examples of determining an entity's eligibility under the EZ computation requirements).

104. *See id.* at 3 (summarizing Texas franchise tax law applicable to taxable entities).

105. TEX. TAX CODE § 171.106(a); TEX. COMPTROLLER OF PUB. ACCTS., *supra* note 90, at 14.

106. TAX § 171.1121(a).

107. TEX. COMPTROLLER OF PUB. ACCTS., *supra* note 90, at 14.

Under the Long Form Report or the EZ Computation Report, if the total Texas margin tax is less than $1,000 (Line 35 of the Long Form Report or Line 17 of the EZ Computation Report), the payment is not required to be made.[108] In this case, the tax forms are filed without payment.[109] In addition, if the total gross receipts of the entity is below the annual threshold amount, $1,230,000 for the years 2022 and 2023, no Texas margin tax is required.[110] The form used to report a no tax due situation is Form 05-163 (No Tax Due Report).[111]

Forms 05-158-A, 05-158-B, 05-169, and 05-163 are accompanied with Form 05-102, the Public Information Report, identifying the officers, directors, management, and others of the entity.[112] Forms 05-158-A, 05-158-B, and 05-169 can be accompanied with Form 05-170, the Payment Form, identifying amount paid.[113] These forms can also be accompanied with Form 05-164, the Extension Request, requesting extra time to file.[114] In addition, limited credits may be allowed against the Texas margin tax (up to a maximum of fifty percent for the total tax due before credits) and are available only if the Long Form (Forms 05-158-A and 05-158-B) is used and reported on Form 05-160, the Texas Franchise Tax Credits Summary Schedule.[115] The filing period for the Texas margin tax (Franchise Report) generally coincides with the dates of the entity for the federal income tax return with some minor variations.[116] The due date of the Texas franchise tax is usually May 15, after the end of the tax year, unless extensions or special circumstances apply.[117]

Nexus is required to be subject to the Texas franchise tax.[118] In light of the changes in sales activity in the internet environment, the Texas's Comptroller amended Rule 3.586, *Margin: Nexus*, for franchise tax reports due on or after January 1, 2020 to read: "[A] foreign taxable entity has nexus in Texas . . . even if it has no physical presence in Texas, if during that federal

108. *Id.* at 4.
109. *Id.*
110. *Id.*
111. *Id.*
112. *Id.* at 12.
113. *Id.* at 27.
114. *Id.* at 23.
115. *Id.*; TEX. TAX CODE § 171.658.
116. TEX. COMPTROLLER OF PUB. ACCTS., *supra* note 90, at 14.
117. TAX § 171.152(c).
118. 34 TEX. ADMIN. CODE § 3.586(c).

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income tax accounting period, it has gross receipts from business done in Texas of $500,000 or more . . . ."[119] Several other states have adopted similar provisions for nexus.[120] In addition, "[a] foreign taxable entity with a Texas use tax permit is presumed to have nexus in Texas and is subject to Texas franchise tax."[121]

IV. ILLUSTRATIONS OF THE TEXAS MARGIN TAX

To properly illustrate the application of the Texas margin tax, consider the following: [122]

A. *Example 1: Forms 05-158-A and 05-158-B*

Viola Corporation, not a retailer or wholesaler, conducts business in Texas and reported the following in its 2021 Federal Income Tax Return:

Sales revenue	$1,720,000
Dividends	$80,000
Capital Gains	$60,000
Cost of Goods Sold	$420,000
Compensation	$120,000 (limit applied: $390,000 for 2021)
Apportionment Factor	1.00 or 100% (indicating Viola Corporation only does business in Texas)

Gross receipts are determined as follows:

$1,720,000 + $80,000 + $60,000 - $80,000 = $1,780,000. (dividends are excluded from gross receipts)

No Extension was filed and, therefore, no advanced payment of the Texas margin tax has been made.

The Texas margin tax is computed as follows:

119. *Id.* at § 3.586(f)(1).

120. *Economic Nexus State by State Chart*, SALES TAX INST. (Aug. 9, 2023), https://www.salestax-institute.com/resources/economic-nexus-state-guide [https://perma.cc/6XRM-WPTN].

121. 34 ADMIN. § 3.586(e).

122. The following illustrations use the tax rates, thresholds, and deduction limits for the year 2021.

1. Total revenue times seventy percent: $1,780,000 x 70% = $1,246,000
2. Total revenue minus cost of goods sold: $1,780,000 - $420,000 = $1,360,00
3. Total revenue minus compensation: $1,780,000 - $120,000 = $1,660,000
4. Total revenue minus $1,000,000: $1,780,000 - $1,000,000 = $780,000

The lowest of the four computations is $780,000. The apportionment factor of 1.00 (100%) yields a taxable margin of $780,000 ($780,000 x 100%). The taxable margin times the tax rate of .0075[123] equals a margin tax due of $5,850.00.[124]

B. *Example 2: Form 05-169*

Assume the same facts from Example 1, except Viola Corporation elects to use the EZ Computation Report.

As such, the four computations are not required as no deductions are allowed against the gross receipts. The apportionment factor of 1.00 (100%) yields a taxable margin of $1,780,000 ($1,780,000 x 100%). The taxable margin times the tax rate of .00331 equals a margin tax due of $5,892.00, which is only slightly more than the Long Form.[125]

C. *Example 3: Form 05-163*

Assume the same facts from Example 1 above, except Viola Corporation has a sales revenue of $720,000.

Gross receipts are determined as follows:

$720,000 + $80,000 + $60,000 - $80,000 = $780,000. (dividends are excluded from gross receipts)

Since the gross receipts are less than the annual threshold amount of $1,180,000 (for 2021), no Texas margin tax is required. Form 05-163, the No Tax Due Report, would be filed to reflect that no margin tax is due.[126]

As seen by the illustrations and discussions of the Texas margin tax, this tax is quite generous to small businesses. The low rates coupled with the

123. The tax rates for the year 2021 are the same as the year 2022.
124. *See* Exhibit 1 for the related tax forms.
125. *See* Exhibit 2 for the related tax forms.
126. *See* Exhibit 3 for the related tax forms.

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various deductions against gross receipts for the Long Form Report and the annual threshold amounts, many small businesses doing business in Texas are not impacted by the Texas margin tax.[127] The Texas margin tax is, by and large, paid by medium to large business entities.[128] However, it is possible for a business entity to have a net loss for financial accounting purposes, federal income tax purposes, or both, but still be subject to the Texas margin tax as the tax is imposed largely on gross receipts and non-traditional net income.[129]

V. PUBLIC LAW 86-272

The protection of small businesses from the Texas margin tax has been shown in the application of the Texas margin tax.[130] An additional consideration is whether the Texas margin tax is further limited by the application of Public Law 86-272. In the earlier discussion of Public Law 86-272, the last criteria listed for the requirements of Public Law 86-272 was that the tax of the state is based on net income.

As shown in the illustrations, the gross receipts of a taxable entity is reduced by four different items on the Long Form Report, none of which yields the net income (loss) for the entity.[131] As such, the Texas margin tax, in its uniqueness of application, is not an income tax. Accordingly, out-of-state businesses are not protected from the imposition of the Texas margin tax by Public Law 86-272.[132] Out-of-state businesses, particularly medium to large business entities, need to be fully aware of this lack of protection before engaging in business activity within Texas. In addition, the Texas Administrative Code, Rule 3.586(i), specifically states "Public Law 86-272 (15 United States Code §§ 381–384) does not apply to the Texas franchise tax."[133]

Despite the somewhat apparent clarity that the Texas Franchise Tax is not an income tax, a recent 2017 challenge to this notion took place in the

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127. TEX. TAXPAYERS & RSCH. ASS'N, UNDERSTANDING THE TEX. FRANCHISE—OR "MARGIN"—TAX 2 (Oct. 2011).

128. *Id.*

129. *See* 34 TEX. ADMIN. CODE § 3.591(b)(14)(c) (outlining the way Texas margin tax is apportioned using gross receipts).

130. TEX. TAXPAYERS & RSCH. ASS'N, *supra* note 127, at 3.

131. *Franchise Tax Overview*, *supra* note 76.

132. 34 ADMIN. § 3.586(i).

133. *Id.*

case of *Graphic Packaging Corp. v. Glenn Hegar*.[134] This case was primarily pursued by petitioner, Graphic Packaging Corporation, to be able to use the three-factor apportionment formula of the Multistate Tax Compact, which Texas adopted under Section 141,001 of the Texas Tax Code in lieu of the single-factor apportionment formula (Gross Receipts only) as provided in Section 171.106 of the Texas Tax Code.[135] The Multistate Tax Compact provision states:

> Any taxpayer subject to an income tax whose income is subject to apportionment and allocation for tax purposes pursuant to the laws of a party state or pursuant to the laws of subdivisions in two or more party states may elect to apportion and allocate his income in the manner provided by the laws of such state or by the laws of such states and subdivisions without reference to this compact, or may elect to apportion and allocate in accordance with Article IV.[136]

Section IV.9 provides for a three-factor apportionment formula that is equally weighted for property, payroll, and sales.[137] Thus, if the petitioner could be successful in persuading the courts that the Texas Franchise Tax was indeed an income tax, the three-factor apportionment formula offered by the Multistate Tax Compact would be an option for computing its franchise tax liability in Texas.[138] Petitioner used this formula in 2010, and amended its 2008 and 2009 tax returns to do the same.[139] However, all three calculations were rejected by the Texas Comptroller office which led to the filing of this lawsuit.[140]

The legal arguments clearly support that Public Law 86-272 did not apply to the Texas franchise tax.[141] In an uncodified 2006 Texas Act, "the [Texas] Legislature stated: 'the franchise tax imposed by Chapter 171, Tax Code, as amended by this Act, is not an income tax and Pub[lic] L[aw] N[umber] 86-272 does not apply to the tax.'"[142] As such, the Texas Legislature clearly

134. Graphic Packaging Corp. v. Hegar, 538 S.W.3d 89 (Tex. 2017).
135. *Id.* at 92*;* TEX. TAX CODE § 141.001, arts. III.1, IV.9 ; TAX § 171.106(a).
136. TAX § 141.001, arts. III.1, IV. 9.
137. *Graphic Packaging Corp.*, 538 S.W.3d at 92.
138. *Id.* at 93.
139. *Id.*
140. *Id.*
141. *Id.* at 95.
142. Act of May 2, 2006, 79th Leg., 3d C.S., ch.1, § 21, 2006 TEX. GEN. LAWS 1, 38.

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intended to preclude Public Law 86-272 from applying to the Texas franchise tax, and to differentiate the Texas franchise tax from an income tax.[143]

The trial court granted summary judgment for the State of Texas, and the Court of Appeals affirmed, stating: "chapter 141's income-apportionment provisions do not apply to the franchise tax because it is not an 'income tax.'"[144] After careful deliberation, the Texas Supreme Court also affirmed the trial court's ruling.[145] As such, the three-factor apportionment formula of the Multistate Tax Compact does not override the single-factor apportionment formula codified by the State of Texas.

VI. CONCLUSION

This Article described in fair detail the application of Public Law 86-272 and situations where it may or may not apply. Businesses that engage in interstate commerce must be cognizant of income taxes levied in states in which they do business. States are aggressive and eager to impose their income tax system on as many businesses (in-state businesses as well as out-of-state businesses) that they possibly can. As such, it is of utmost importance that out-of-state businesses carefully comply with the provisions of Public Law 86-272, especially given that courts narrowly construe and interpret Public Law 86-272. The United States Supreme Court has provided clear guidance as to the extent an out-of-state business may conduct business to keep their activities under the umbrella protection of Public Law 86-272.

Additionally, this Article described the uniqueness of the Texas margin tax, which applies to taxable entities doing business in the State of Texas. This Article covered how the Texas margin tax is unique in that is uses a four-part approach. Furthermore, an EZ Computation option is provided for qualifying taxable entities and provides an alternate way to determine the tax due under the Texas margin tax. This Article further explained that Texas margin tax is generous to small businesses because it provides for an annual threshold amount and only taxes revenue over $1,000. Finally, this Article highlighted that the Texas margin tax is not a tax on the income of a business entity. Therefore, it is not an income tax. Because Public Law 86-272 applies only to states that impose an income tax, there is no protection

143. *Id.*

144. *Graphic Packaging Corp.*, 538 S.W.3d at 94.

145. *Id.* at 93.

https://commons.stmarytx.edu/thestmaryslawjournal/vol55/iss1/5

under Public Law 86-272 for out-of-state businesses that conduct business within Texas. Accordingly, out-of-state businesses should be aware that if they conduct business in Texas, the Texas margin tax (Texas franchise tax) will apply, and taxation may be imposed for having the privilege to do business in Texas.