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Texas Supreme Court hears oral arguments in Texas franchise tax constitutional challenge

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Overview

On Monday, October 24, the Texas Supreme Court heard oral arguments in *In re: Allcat Claims Service, L.P. and John Weakly*, No. 11-0589. Allcat's suit alleges that the Texas franchise tax violates Texas' constitutional provision on enacting a state tax on individual income without voter approval. Each side in the case had 30 minutes to present arguments, and opposing counsel were interrupted frequently from the bench, with all nine Justices posing questions.

Margin tax: Individual tax on partner

The bulk of the arguments, and the Justices' questions, centered on the taxpayers' contention that imposition of the revised franchise tax on a partnership amounts to a tax on the individual partners because, in effect, they own a share of partnership income while it is in the hands of the partnership. The Texas Business Organizations Code (the "Code"), which credits each partner with their share of partnership profits, was cited as authority for this position.

The State argued that since a partnership, as provided in the Code, is an entity distinct from its partners, a direct tax on the partnership's income does not equate to a tax on the partners' incomes. It was further contended that partnership income belongs to the partnership until it is distributed to the partners, at which point it becomes personal income.



Opposing counsel countered that a partnership is a separate entity for some purposes, but not when it comes to income. Counsel argued that a partner's share of partnership income can only be deemed a "share" when it is a part of the whole held by the partnership. In short, the taxpayers' position is that partnership income becomes partner income as it is earned, in contrast with the State's position that it becomes partner income when it is distributed.

Jurisdiction

Arguments were also presented as to whether the Texas Legislature properly granted original jurisdiction to the Supreme Court over challenges to the revised franchise tax. Allcat counsel argued that the Texas Constitution, as amended, permits the Supreme Court to hear the case directly, as prescribed by the revised franchise tax legislation, by directing the Court to exercise the judicial power of the State except as otherwise provided in the Constitution. Before amendment, this provision limited the Court's authority to appellate jurisdiction only. When questioned on this issue, the State took no formal position but remarked that accepting the case would be inconsistent with prior decisions in which the Court had ruled that the Constitution limits original jurisdiction to specific instances.

Unconstitutional income tax?

There was very little argument about whether the revised franchise tax is an income tax. Counsel for Allcat pointed out that all income taxes are taxes on gross revenue less statutorily allowed deductions, as under the revised franchise tax. There did not seem to be any attempt to counter that argument, with the State's attorney concentrating on the business entity taxation premise.

Fiscal impact & prospective relief

Towards the end of the session, the Justices questioned both parties about the fiscal impact of finding the tax unconstitutional. The attorneys on both sides agreed that a ruling against the state would cost it money, but neither the state nor its challengers had an estimate of how much money was in question. Danica Milios, who represented the State, said such a ruling "would obviously send the Legislature back into a special session."

Attorneys for Allcat noted, under the *Carrollton-Farmer's Branch ISD v. Edgewood ISD* case, the Texas Supreme Court could find the tax (or a portion of it) unconstitutional but apply its ruling only prospectively. This means that the state would not be able to impose the tax on natural persons going forward, but taxpayers could not claim refunds of taxes paid.

In *Carrollton-Farmer's Branch ISD*, the Court held that the school financing system in issue violated three different constitutional provisions, but it applied its decision only prospectively. The Court applied three factors to determine whether it could apply its decision only prospectively:

1. The decision must establish a new principle of law or decide an issue of first impression;
2. Applying the decision only prospectively must not undermine the constitutional principles in question; and

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3. Applying the decision retroactively must produce substantial inequitable results.

With respect to the second factor above, the Court could apply a decision finding the franchise tax unconstitutional only prospectively under *Carrollton-Farmer's Branch ISD* if it concludes that the detrimental financial impact of applying its decision retroactively would outweigh the harm the unconstitutionality of the tax caused.

Next steps

The statute giving the Texas Supreme Court exclusive jurisdiction to hear and decide this case requires it to rule within 120 days of the suit's filing. Therefore, the Court will likely rule by November 28, 2011.

The arguments were recorded and are available on the [Texas Supreme Court's website](#)

View a copy of [Allcat's Brief on the Merits](#) filed on September 13, 2011. View a copy of [Allcat's Reply Brief](#) filed on October 13, 2011.

PwC Observes

A threshold argument before the Court is whether it has jurisdiction in the case, since it has not been heard by any lower court as yet. It is entirely possible that the Court could rule that, despite the Legislature's intent that the Court take the case directly, it needs to go through the system like any other lawsuit would.

Furthermore, if Plaintiffs are right and any tax imposed on a partnership is an indirect tax on the net income of the partners, this could mean that the State of Texas may not lawfully impose any tax on any business entity, including a corporation. If the Court finds the tax unconstitutional, the remedy could range from a targeted exemption for partnerships, which is what Allcat is requesting, to invalidating the tax for all businesses.

Independent of Allcat's complaint, there has been substantial criticism of the revised franchise tax, and the tax could be overhauled by the Legislature once again. Many businesses have argued that the tax is costly, unnecessarily complicated, and unfair.

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