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*Texas Supreme Court holds
franchise tax does not violate
constitution's "Bullock
Amendment"*

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On November 28, 2011, the Texas Supreme Court held that the Texas franchise tax is not a tax imposed on the net incomes of individual partners and thus does not facially violate the Bullock Amendment to the Texas Constitution. [[In re Allcat Claims Service, L.P. and John Weakly, Relators](#), Tex., No. 11-0589, 11/28/2011]

Background

Allcat Claims Service, L.P., is a Texas limited partnership that provides adjusting services to property insurers. Allcat's limited partners include natural persons. For tax years 2008 and 2009, Allcat filed franchise (or "margin") tax returns, then filed suit in the Texas Supreme Court seeking a refund of taxes paid to the extent the tax applied to Allcat's income allocated to its natural-person partners.

Allcat claimed that the franchise tax is unconstitutional because it is a tax on the net incomes of its natural-person partners that was not approved in a statewide referendum (facial challenge). Allcat also claimed that the franchise tax, as applied to Allcat and its partners, violates the Texas constitutional requirement that taxation be equal and uniform (as-applied challenge).



Specifically, with respect to the first claim, the Texas Constitution contains a provision, known as the Bullock Amendment, which provides that a statute imposing a "tax on the net income of natural persons, including a person's share of partnership...income" must be approved by a statewide referendum.

Jurisdiction

First, the Supreme Court established that it had jurisdiction to hear and decide Allcat's case. Under the Texas Constitution, "The Legislature may confer original jurisdiction on the Supreme Court to issue writs of... mandamus in such cases as may be specified..." The Court found that this provision permits a grant of original jurisdiction where mandamus is a "proper or necessary process for enforcement of the right asserted." In this case, the Court found that it had original and exclusive jurisdiction to consider Allcat's facial challenge to the constitutionality of the franchise tax because a finding on such a facial challenge is necessary "to determine whether mandamus should issue directing the Comptroller to refund taxes that Allcat paid under protest."

With respect to Allcat's as-applied challenge to the franchise tax, the Court found that it was not authorized to exercise "original jurisdiction over challenges to how the Comptroller assesses, enforces, or collects the franchise tax." Consequently, the Court dismissed Allcat's as-applied challenge for lack of jurisdiction.

Franchise tax withstands constitutional challenge

Allcat argued that the franchise tax is, in effect, an income tax because the income of a partnership is allocated to each partner and the franchise tax is applied to each partner's allocated share of Allcat's income. Thus, the franchise tax is a tax on the net incomes of its natural-person partners and violates the Bullock Amendment because it was not approved by a statewide referendum.

The Comptroller argued that the franchise tax is not a tax on net income because it can result in tax due, even if an entity loses money. Moreover, because Texas adopts the entity theory of partnership law, the tax is imposed on the partnership and not on the net incomes of the partnership's individual partners. (Note: Under the entity theory of partnership law, the partnership is an entity separate and distinct from its partners.)

The Court agreed with the Comptroller. The Court found that Texas law states "without equivocation that partnership income remains property of the partnership entity until it is distributed." Further, the Court emphasized that the Bullock Amendment "does not preclude the taxation of business entities for the privilege of doing business in Texas." The Court held that the franchise tax constitutes a tax on Allcat as an entity and not on the net income of Allcat's natural-person limited partners. As such, the Court found the franchise tax did not violate the Bullock Amendment and upheld the constitutionality of the tax.

PwC Observes

"While this decision was in line with most observers' expectations, we should not forget that the tax is still being challenged in a petition filed in October in *Nestle USA*,

Inc., Switchplace LLP and NSBMA LP," notes Bill Essay, PwC SALT partner in Houston, Texas.

"While in this case Allcat focused on whether the tax was a personal income tax, the taxpayers in the *Nestle* case take a different tact in contesting the tax," notes Essay. "They point to examples of the inequities for similarly situated taxpayers inherent in the franchise tax (e.g., COGS deduction qualification, rate differential, management company qualification) and argue that the Equal and Uniform requirement of the Texas Constitution and the Due Process and Commerce Clauses of the U.S. Constitution may be violated. It remains to be seen how the Court will react, but it is statutorily required to rule before February 10, 2012. The case is set for oral argument on January 12."

"It's also interesting to note that although both parties put forth competing arguments about whether the franchise tax is an income tax, the Court chose not to address those arguments because it believed that the arguments did not affect its analysis," adds Scott Fischer, PwC SALT partner in Dallas, Texas. "This leaves the franchise tax open to additional challenges related to the three factor election under the Multistate Tax Compact and the application of P.L. 86-272."

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