



CRAIG T. ENOCH  
JUSTICE (RETIRED)

P.O. Box 50283  
AUSTIN, TEXAS 78763-0283  
(512) 370-2883

March 29, 2006

Chairman John Sharp  
Texas Tax Reform Commission  
Insurance Building  
1100 San Jacinto Blvd., Suite 1.300  
Austin, Texas 78701

Re: Proposed legislation amending Texas' franchise tax

Dear Mr. Sharp:

You asked me to advise you whether I thought the Texas Tax Reform Commission's proposed legislation (attached) that would amend Texas' franchise tax law implicates Article 8, Section 24(a) of the Texas Constitution, which prohibits the legislature from imposing a personal income tax on Texas citizens without voter approval. Based on my reading of the proposed legislation, I do not think a personal income tax is being imposed.

In November 1993, the Texas Constitution was amended to prohibit legislation creating a state personal income tax without approval by Texas voters. The Texas Constitution 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. The referendum must specify the rate of the tax that will apply to taxable income as defined by law.

TEX. CONST. Art. 8, Sec. 24(a) (the "Bullock Amendment").

Under the Commission's proposal, the current franchise tax law would be amended and applied to "Taxable Entities." Taxable Entities are defined in the proposal as "a partnership, corporation, banking corporation, savings and loan association, limited liability company, business trust, professional association, business association, joint venture, joint stock company,

March 29, 2006

Page 2

holding company, or other legal entity." TEX. TAX CODE § 171.002(a) (proposed amendment). A natural person is not listed as a Taxable Entity. And notably sole proprietorships and general partnerships owned entirely by natural persons, though possibly included in the broad general categories of "Taxable Entity", are specifically excluded. TEX. TAX CODE § 171.002(b) (proposed amendment).

As well, the franchise tax (one percent (1%) of the entity's "Taxable Margin") is calculated on the Taxable Entity's total revenues less *either* cost of goods sold *or* compensation (payroll), at the taxpayer's election. The resulting amount is then apportioned between the Taxable Entity's gross receipts in Texas and total gross receipts. And then, the Taxable Entity is permitted certain deductions.

By the proposal's terms, this tax is not rendered on the personal income of Texas citizens. Consequently, the Bullock Amendment requiring any personal income tax be approved by a statewide referendum is not involved.

I conclude that the Bullock Amendment does not prohibit the Commission's proposal primarily because of the Bullock Amendment's specific language. For one, the Bullock Amendment refers directly to efforts to impose a tax on the "net incomes of natural persons." The Austin court of appeals recently held that the capital component of Texas' current franchise tax is not a "net income" tax under Public Law 86-272 though net income is a factor used in calculating the franchise tax. *Inova Diagnostics, Inc. v. Strayhorn*, 166 S.W.3d 394, 401 (Tex. App.—Austin 2005, pet denied), *cert.* filed (March 1, 2006). Arguably, the Commission's proposed tax does not even factor in "net income" to determine Taxable Margin because the proposed tax permits entities to choose between deducting either cost of goods sold or payroll from their total revenues. And "net income" is defined as the excess of all revenues and gains over all expenses and losses. *Inova Diagnostics, Inc.*, 166 S.W.3d at 401 n.7.

In the Bullock Amendment, "net incomes of natural persons [includes] a person's share of partnership and unincorporated association income". This inclusion raises questions because the Commission's proposal includes partnerships (not wholly owned by natural persons, but presumably covering partnerships partially owned by natural persons) as Taxable Entities and traditionally the federal government captures partnership income through assessment against the individual partners' ownership share. But from the text of the Bullock Amendment, it is readily apparent that the Bullock Amendment intends to prohibit a tax assessment against the distributive (net income) share of the natural person partner rather than the more general interest the partner has in the partnership's revenues.

As a quick example, all of the money that flows into a partnership does not become part of the individual partners' distributive share. Partnerships, like other business entities, pay ordinary expenses associated with the cost of doing business. The fact that individual partners remain personally liable for those debts is not the relevant point. Rather, it is only what is left after the partnership pays its debts and expenses that the individual partners' share of partnership

March 29, 2006

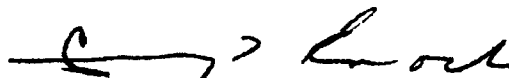
Page 3

income can be determined and distributed. As with other partnership business expenses, the Commission's proposed franchise tax is the responsibility of the partnership to pay as part of the cost of doing business in Texas. The individual partners' share of the partnership's income will be determined after the franchise tax and other expenses are paid.

Moreover if, as some may argue, the fact that the proposed franchise tax is based, in part, on a partnership's gross revenues which under partnership law passes through to the individual partners makes it a tax on the net income of the partners of the partnership, then all taxes paid by a partnership could likewise be classified as income tax on the partners. For example, partnerships pay sales taxes. Necessarily, that cost affects each partners' share of partnership income. But that does not transform the sales tax into an income tax on the individual partners. Likewise, the franchise tax is not an income tax on individual partners.

Comparing the text of the Commission's proposal with the language in the Bullock Amendment, I do not think the Bullock Amendment prohibits without state-wide voter approval the tax contemplated by the proposal.

Sincerely,



Craig T. Enoch  
Justice (Ret.)

CTE:lh