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April 21, 2006

The Honorable Greg Abbott
Attorney General
State of Texas
Post Office Box 12548
Austin, Texas 78711-2548

Dear General Abbott:

I respectfully request your official opinion on the question of whether the revised Chapter 171, Tax Code, as proposed in House Bill (H.B.) No. 3, filed by Chairman Keffer for consideration by the 79th Texas Legislature during its 3rd called session, will require submission to the voters under Article VIII, Sec. 24(a), Texas Constitution.

I request that you expedite your opinion so that I can provide the most dependable information to the members of the Legislature as they consider this bill. If the legislation is unconstitutional without voter approval, it will significantly impact the revenue from the legislation and, therefore, the spending decisions made by the Legislature. It is my duty to ensure that the State's pay-as-you-go requirements are met, and I have grave concerns over any provision that could undermine the integrity of our State's finances.

I note that your First Assistant has recently issued an informal letter on this subject, which should facilitate issuance of an expedited opinion. However, regardless of his views, I am persuaded that this proposal raises obvious and fundamental questions and concerns to the extent it is proposed to be applied to any type of unincorporated association, and I respectfully request that you consider the following.

Background

H.B. 3 as filed would revise the current corporate franchise tax law to enact a form of a business tax (described as a "margin tax") to be predicated on the taxpayer's gross receipts minus either (i) cost of goods sold; or (ii) compensation (payroll and employee benefits, subject to per employee limits). The legislation would tax unincorporated associations other than general partnerships whose entire direct ownership is held by natural persons.

The requirement for voter approval

Article VIII, Sec. 24(a), commonly known as the Bullock Amendment, provides in pertinent part:

> "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." (Emphasis supplied).

Article VIII, Sec. 24(a) resulted from Senate Joint Resolution (SJR) 49 in the 73rd Legislature to ensure against a state income tax without a referendum of the Texas voters. The resolution caption, and the ballot language, both reflect that a prohibition against "a personal income tax" without voter approval was the proposition submitted to the voters. SJR 49 was approved by 70 percent of the electorate in 1993.

Though neither the courts nor the Attorney General have interpreted Article VIII, Sec. 24(a), Texas law is clear—the Bullock Amendment must be construed giving its words their natural and ordinary meanings as they were understood by the average voter who voted for or against it. See *City of Beaumont v. Bouillion*, 896 S. W. 2d 143 (Tex. 1995); *Armbrister v. Morales*, 943 S. W. 2d 202 (Tex. App.—Austin 1997, no pet.); Op. Tex. Att'y Gen. No. JM-666 (1987), quoting from Opinion O-5135 at pages 4-5 ["In construing a constitutional provision it should be construed as it was understood by the average voter when he cast his ballot for or against it."] In short, the words used are to be understood as people generally understood them. *Spradlin v. Jim Walter Homes, Inc.*, 34 S. W. 3d 578 (Tex. 2000); *Stringer v. Cendant Mortgage Corp.*, 23 S. W. 3d. 353 (Tex. 2000).

Literal Reading

The literal wording of the Bullock Amendment is that a tax on the net income of natural persons, including a person's share of partnership or unincorporated association income, must include a statewide referendum. The phrase "a person's share" logically modifies the words "income of natural persons" and read literally and as an average voter would understand it, this provision would mean that, unless approved by the voters, no tax may be levied on any income that a person receives from any unincorporated association. That interpretation is entirely consistent with the caption and ballot language of SJR 49, which refer to a prohibition against a "personal income tax."

"A person's share" of the income of an unincorporated association, whether it be a limited partnership or a professional association, is determined first by the agreement between the principals, and absent one, is governed by the statutes that apply to those entities. The "share" does not have to be predicated on the "net income" of the unincorporated association. However calculated or derived, the share received by the natural person that becomes a part of his or her "net income" cannot be taxed without voter approval, period.

Alternative Net Income Interpretation
An alternative interpretation of the partnership/unincorporated association proviso for which supporters of the legislation may contend would read into the proviso the word "net" so that, they would say, to trigger the referendum the tax would have to be on a person's share of partnership or unincorporated association "net income." In other words, under this much more restrictive interpretation, only a tax on the net income of a partnership or unincorporated association, from which a natural person received a share, would trigger the required referendum. Interpolation of words into a constitutional provision should not be utilized where it would defeat the overriding intent evidenced by the provision. *Mauzy v. Legislative Redistricting Board*, 471 S. W. 2d 570 (Tex. 1971). Interpolation of the word "net" in this proviso materially changes its meaning and would not be consistent with the caption and ballot language. The electorate voted on whether a personal income tax was to be approved by the Legislature without voter approval, and nothing suggests that it is only taxation of "net income" of the unincorporated association that was so objectionable as to require further voter approval.

And even if it were otherwise, the restrictive Texas law is that constitutional amendments such as Article VIII, Sec. 24(a) are adopted with reference to the law in effect at the time the amendment is adopted unless they are inconsistent with the constitutional provision. See *Collins v. Tracy*, 36 Tex. 546 (1872). Chapter 141, Texas Tax Code, adopts the Multistate Tax Compact, and was in effect at the time the Bullock Amendment was adopted. Article II, Paragraph 4 of the Compact defines "income tax" as follows:

> "Income tax" means a tax imposed on or measured by net income including any tax imposed on or measured by an amount arrived at by deducting expenses from gross income, one or more forms of which expenses are not specifically and directly related to particular transactions.

This provision means that if the tax is determined by deducting from gross income any items of expense that are not specifically and directly related to transactions that created the income, it is an income tax. And, if it is an income tax, it is within the Bullock Amendment. Proposed Section 171.1012 (relating to the cost of goods sold deduction) and 171.1013 (relating to the compensation deduction) clearly include indirect and overhead costs of production and/or compensation that make the margin tax an income tax under this preexisting Texas definition found in Chapter 141, thereby invoking the Bullock Amendment.

Further, if the more restrictive view of the Bullock Amendment were to be applied, a much less technical definition of "net income," and one more likely to have been within the average voter's frame of reference, is that provided by Black's Law Dictionary, Fifth Edition, which defines "net income" as "income subject to taxation after allowable deductions and exemptions have been subtracted from gross or total income." The "margin" that is the tax base under the proposed legislation, whether resulting from deduction of cost of goods sold or labor related charges, may reasonably be said to be within the Black's Law Dictionary definition of "net income," because it results from income subject to taxation after some "allowable deductions" are subtracted.

There is no reference in the Bullock amendment that links its application to any specific external standard. The presence of any "allowable deduction" will result in a "net" income tax. Thus, using this definition the margin tax would fall squarely within Article VIII, Sec. 24(a). Absent a referendum it cannot be adopted to the extent it purports to include unincorporated associations of any kind.

Certainly it is the case that not all expenses are deducted under the margin tax concept, and thus under some technical accounting definitions the margin tax would not be on "net income" as that term is sometimes used in accounting parlance (i.e., the concluding item on an income statement). But the amendment contains no link to accounting standards or definitions and it hardly could be said that an average voter in 1993 knew about, or cared about, the technicalities of accounting definitions—no tax on his or her net income, including on income that is received from partnerships or unincorporated associations, was what was being prohibited, technicalities aside.

Entity Concept Does Not Insulate Margin Tax

Proponents of the margin tax will no doubt assert that the margin tax does not invoke Article VIII, Sec. 24(a) because the tax would be assessed against entities, not against individuals, and particularly entities that under the law provide liability insulating protection to their owners or investing principals just like corporations. But as noted, the partnership/unincorporated association proviso of the Bullock Amendment refers plainly and simply to "a person's share" of the income of an unincorporated association as triggering the referendum. Whether the tax is directly on an entity is irrelevant if the only inquiry is whether there is ultimately a tax levied on "a person's share" of some distribution.

All words in constitutional provisions are presumed to have been used for a purpose, and in construing them all words must be given meaning and effect. *Eddins-Walcher Butane Co. v. Calvert,* 298 S.W.2d 93, 96 (Tex. *1957); see also Cameron v. Terrell & Garrett, Inc.,* 618 S.W2d *535, 540* (Tex. 1981). The careful effort made by the Legislature to expressly refer to "a person's share" of income of unincorporated associations in SJR 49 and ultimately in Article VIII, Sec. 24(a) as adopted by the voters, had to have a purpose and the obvious purpose was to make sure all voters understood, and that the law became crystal clear, that the prohibition and referendum provisions also applied to any tax on the receipts a natural person receives as a result of being a partner in a partnership, a limited partner, or a member of a professional association. The express reference to "a person's share of partnership or unincorporated association income" would not exist and would be unnecessary surplusage if it were not so.

And, further answer to the proposition that taxation of insulating entities is permissible without triggering the Bullock Amendment is that the entity concept of partnerships in Texas was enacted in the Texas Revised Partnership Act by the same Legislature that passed SJR 49. Its action in adopting the entity concept for partnerships in the 73rd Session and contemporaneously in that same session sending to the voters a proposed prohibition against any tax "including on a person's share of partnership or unincorporated association income" (i.e., including on money received from an unincorporated entity) demonstrates that what was presented to the voters included a prohibition against a tax on a natural person's income, regardless of whether the tax was on the entity from which the natural person's income is derived. The Legislature well knew that partnerships and unincorporated associations were entities when it chose to make a special recognition that "a person's share" of those entities' income was also included.

Moreover, any attempt to avoid Article VIII, Sec. 24(a) by claiming the tax is at the entity level could not survive the economic substance of the tax. Compare *Suburban Utility Corporation v. Public Utility Commission of Texas*, 650 S. W. 2d 358 (Tex. 1983) [allowing inclusion of taxes of a Subchapter S utility in the rate base even though passed on and paid by the Subchapter S shareholders predicated on the economic substance of the transactions, not the taxing formalities]; and *Gragg v. Cayuga Independent School District*, 539 S. W. 2d 861 (Tex. 1976) [construing a "natural persons" constitutional provision to include net income of a partnership]; *Bishop v. District of Columbia*, 401 A. 2d 955 (D. C. 1979) ["nature and effect of the tax, not its label, determine if it is an income tax or not" and concluding that a tax on an unincorporated business is a tax on the associates or partners who run the business.].

Past business tax legislation considered by the Legislature that included non-corporate entities has been accompanied by resolutions recognizing the applicability of the referendum requirements of Article VIII, Sec. 24(a). H.B. 4 and House Joint Resolution 4, 75th Legislature, Regular Session, which would have extended the franchise tax to partnerships and other unincorporated entities except proprietorships are clear evidence of the Legislature's own past recognition that any tax on the income of an unincorporated association is a tax on the income of a natural person, and requires voter approval.

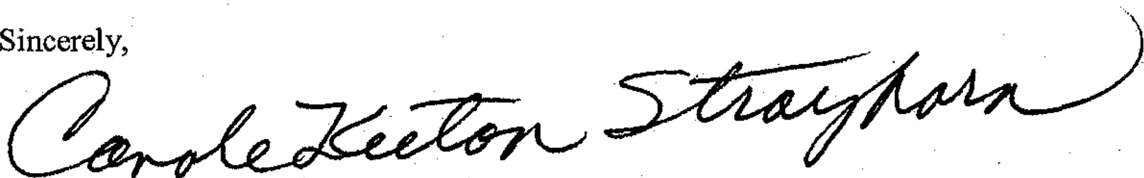
I believe the proposed margin tax would likewise require a referendum under Article VIII, Sec. 24(a), precluding any adoption absent voter approval.

Other Concerns

I also seek your opinion of whether the disparate tax rates found in this legislation as proposed are permissible. As presently conceived, retailers and wholesalers would pay the margin tax at the rate of ½ of 1 percent on their chosen tax base, and all other taxable entities would pay at the rate of 1 percent.

An obvious issue is whether any rational basis exists for taxing retailers and wholesalers at a rate substantially different from the rate that would apply to all other businesses. I question whether this approach is valid based on fundamental principles of equal treatment under the law. I recognize that as a very general matter, the Legislature has significant discretion to create exemptions and to create differences in treatment, but the requirement nonetheless remains that there be a rational basis for the distinctions. See *Kahn v. Shevin*, 416 U. S. 351,355 (1974); *Hurt v. Cooper*, 110 S. W. 2d 896, 901 (Tex. 1937); *Bullock v. ABC Interstate Theatres, Inc.*, 557 S. W. 2d 337, 341 (Tex. Civ. App.—Texarkana 1977, writ ref'd n.r.e, cert. denied 439 U. S. 894 (1978). No basis has been provided, and none is apparent, for the disparate treatment of businesses from the standpoint of tax rates.

Sincerely,



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