

SUBJECT: Restructuring the Texas franchise tax

COMMITTEE: Ways and Means — committee substitute recommended

VOTE: 7 ayes — J. Keffer, Villarreal, Grusendorf, Luna, Ritter, Smithee, Woolley

1 nay — Paxton

1 absent — Edwards

WITNESSES: For — Bill Allaway, Texas Taxpayers and Research Association; John Hawkins, Texas Hospital Association; Paul Kennedy, Texas Dental Association; Scott Norman, Texas Association of Builders; Karen Reagan, Texas Federation of Drug Stores; Steve Stagner, Texas Council of Engineering Companies; Heather Vasek, Texas Association for Home Care, Inc.; Kristie Zamrazil, Texas Pharmacy Association

Against — Hayes Fuller, Texas Association of Defense Counsel

On — Karey Barton, James LeBas, Texas Tax Reform Commission; Chuck Courtney, Texas Retailers Association; John W. Fainter, Jr., Association of Electric Companies of Texas, Inc.; Jay Harvey, Texas Trial Lawyers Association; Steve Kuntz, Glen Rosenbaum, Law Firm Legislative Coalition; David C. Palmer, International Council of Shopping Centers

BACKGROUND: Under Tax Code, ch. 171, the state levies the corporate franchise tax, Texas' primary business tax, in exchange for granting the privilege (franchise) of doing business in Texas. The tax applies only to for-profit corporations and, since 1991, to limited liability companies (LLCs) chartered or organized in Texas, as well as to foreign corporations and LLCs based or doing business in the state. As such, franchise taxpayers include professional corporations, banks, savings and loan associations, state-limited banking associations, and professional LLCs, but not limited partnerships, sole proprietorships, or non-corporate associations.

Insurance and open-end investment companies (e.g., mutual funds) and most non-profit corporations are excepted, as are corporations with gross

receipts less than \$150,000 and firms owing \$100 or less in tax. Major exemptions and exclusions include interest earned on federal securities, business loss carryover, and officer/director compensation paid by companies with 35 or fewer shareholders.

A dual calculation method determines the amount of tax liability. Taxpayers pay the greater of a 0.25 percent tax on taxable capital (assets' net worth) or a 4.5 percent tax on earned surplus (modified net income). The income component generates the most revenue and is paid by about 75 percent of franchise taxpayers.

In fiscal 2004-05, the franchise tax made up about 7.5 percent of state tax revenue, generating more than \$4 billion. For fiscal 2006-07 the tax is projected to increase by 17.2 percent to \$4.7 billion, including \$2.3 billion in fiscal 2006 and \$2.4 billion in fiscal 2007. Franchise tax payments are due on May 15 of each year, and all revenue goes into the general revenue fund.

In recent years, some large Texas-based firms have reorganized as partnerships under state law. As such, they no longer must pay the franchise tax. Examples include Dell Computer and SBC Communications (now AT&T). Firms accomplish this by forming wholly owned out-of-state subsidiaries, usually in tax-friendly states such as Delaware – hence, the resulting entity has been nicknamed “the Delaware sub.” Typically, the subsidiaries enter into limited partnerships wherein the general corporate partner owns 0.1 percent of the operating assets in Texas and the limited partners own 99.9 percent. Under the comptroller’s administrative rules, foreign corporations acting as limited partners are not considered to be doing business in Texas for tax purposes and thus are not subject to the franchise tax. The franchise tax liability of the general partner corporation typically is zero because its 0.1 percent interest fails to generate total receipts greater than the \$150,000 income threshold.

A second accounting method used by some large firms is termed the “Geoffrey” loophole, named after the Toys R Us Inc. giraffe mascot. Under this method, corporations establish a subsidiary in another state that charges the Texas operations for the use of certain intangible assets, such as corporate trademarks. This method diverts money out of the Texas operations, and the franchise tax is applied only to what remains.

Insurance Code, ch. 4 imposes insurance premium taxes on the amount of gross premiums written by insurance companies, with the rates varying depending on the type of insurance. In fiscal 2004-05 the state collected \$2.4 billion in insurance premium taxes.

DIGEST: CSHB 3 would establish a new mechanism for calculating the franchise tax and revise the base of the entities subject to the tax. The revised tax would take effect January 1, 2008.

Overview of the revised franchise tax. Under CSHB 3, the base of taxable entities subject to the revised franchise tax would include businesses in Texas that enjoy state liability protection. The bill would exclude sole proprietorships, general partnerships that were owned directly by individual persons, certain unincorporated passive entities that only receive a limited amount of income from active business, and entities such as non-profit organizations that currently are exempt from the franchise tax. Businesses with no more than \$300,000, indexed for inflation, in total revenue would be exempt from the tax, as would businesses that owed less than \$100 under the tax.

The revised tax would be computed by determining a taxable entity's total revenue. From this amount the entity could choose to deduct either its cost of goods sold or total compensation, up to \$300,000 per employee, indexed to inflation. If the entity's margin after making its deduction was greater than 70 percent of its total revenue, the business would be taxed on only 70 percent of its total revenue. The business then would apportion to Texas the amount of revenue from business done in this state and would subtract any other allowable deductions to determine the entity's taxable margin.

Once the business's taxable margin had been determined, a rate of 1 percent would be applied to that margin for all taxable entities that were not engaged in retail or wholesale trade. For a taxable entity that was engaged primarily in retail or wholesale trade, a rate of 0.5 percent would be applied to the entity's taxable margin.

Taxable entities. CSHB 3 would define "taxable entity" as a partnership, corporation, banking corporation, savings and loan corporation, limited liability company, business trust, professional association, joint venture, joint stock company, holding company, or other legal entity. The definition of taxable entity would not include:

- a sole proprietorship;
- a non-corporate general partnership (i.e., a partnership directly owned by one or more individuals); or
- a passive entity.

The definition of taxable entity also would exclude an entity currently exempt from the existing franchise tax. This would include insurance companies required to pay insurance premium taxes, non-profit corporations, cooperatives, and credit unions. In addition, the definition of taxable entity would exclude an entity that was not a corporation but that would qualify for exemption under current law if it were a corporation, such as a nonprofit organization.

A taxable entity would not be subject to the new tax if it owed less than \$100 under the tax or if the entity's total revenue was less than or equal to \$300,000. On January 1 of each odd-numbered year beginning in 2009, this \$300,000 threshold would be recalculated based on the percent change in the consumer price index during the preceding fiscal biennium, and the resulting amount would be rounded to the nearest \$10,000.

Exemption for passive entities. Passive entities would be exempt from the new franchise tax. The bill would define "passive entity" as an entity that was a general or limited partnership or trust, other than a business trust, at least 90 percent of whose income came from investments, excluding rent or income received from mineral properties that were under a joint operating agreement in which a member of the group was the operator under that agreement. No more than 10 percent of the passive entity's federal gross income could come from active business. A royalty interest or non-operating working interest in a mineral right would not be considered "active business." Compensation payment to individuals for financial and legal services that were necessary for the entity's operation also would not constitute active business.

The bill would establish a test to determine whether an entity was conducting active business. Under the test, a business would be considered to have conducted active business if the entity's activities included operations that earned income and if the entity performed active management and operational functions. Activities performed for the entity by an individual such as an independent contractor would be considered activities performed by the entity if the individual performed services that constituted some part of the entity's business. If an entity used its assets in

the business of a related entity, then that activity would be considered active business.

Definition of total revenue. A taxable entity's tax liability under CSHB 3 would be determined by computing the entity's "taxable margin." An entity's "total revenue" would be the base from which the entity's taxable margin was calculated. Upon determining an entity's total revenue, the entity would deduct either cost of goods sold or compensation to determine its taxable margin.

For a corporation, partnership, or other taxable entity, total revenue would be the sum of gross receipts and other income such as dividends, interest, rents, royalties, and capital gain income. From this amount, the entity would subtract items such as bad debt, foreign royalties and dividends, deductions allowed by the Internal Revenue Service, and distributive income from partnerships, limited liability corporations, and "S" corporations, and certain other amounts.

If a taxable entity had an interest in a passive entity, that taxable entity would include its share of income from the passive entity, but only to the extent that the passive entity's net income was not generated by a separate taxable entity.

Total revenue exclusions. The bill would enumerate several expenses and "flow-through funds," or funds passed through a taxable entity to another entity, that would be excluded from the total revenue of a taxable entity. This would include specific exclusions relevant to legal services entities and staff leasing entities. A taxable entity belonging to an affiliated group could not exclude such payments if they were made to another member of that group.

An amount excluded from total revenue could not be deducted as cost of goods sold or compensation in a taxable entity's determination of its taxable margin. Dividends from federal obligations and bonds would be excluded from total revenue.

Health care deduction. Health care providers could exclude some payments from total revenue for the purposes of calculating their business tax obligation. Providers could exempt the total amount of payments from Medicaid, Medicare, the Children's Health Insurance Program (CHIP), workers' compensation, and the TRICARE military health system. In

addition, the cost of uncompensated services, at rates set by the comptroller, could be excluded from total revenue as long as audit requirements were met. Health care institutions, including hospitals, assisted living facilities, and others, could exempt 50 percent of those amounts.

Determination of taxable margin. A taxable entity's margin would be determined by deducting either cost of goods sold or compensation from the entity's total revenue. Once a year, an entity would make an election on its annual report to subtract either cost of goods sold or compensation. If the difference after deduction was less than 70 percent of the entity's total revenue, that amount would be the entity's margin. If the difference was greater or equal to 70 percent of the entity's total revenue, the entity's margin would be 70 percent of its total revenue.

Upon determining its margin, an entity would determine its "apportioned margin" by apportioning to Texas the proportion of business performed in this state, according to the bill's apportionment rules. From this amount, the entity would subtract any other allowable deductions. The result would be the entity's "taxable margin."

An entity could change its election of which deduction it chose by filing an amended annual report.

Cost of goods sold. If an entity chose the cost of goods sold deduction in determining its taxable margin, the bill would authorize deductions of all direct costs associated with the acquisition or production of goods. These would include costs for such direct expenses as labor, materials, handling costs, storage costs, equipment leasing, depreciation associated with production of the goods, research, design, equipment maintenance, geological exploration costs, taxes stemming from the cost of production, and electricity costs.

The bill also would allow for deduction of a contribution to a partnership partially owned by a taxable entity for activities that otherwise would be eligible for deduction as cost of goods sold. This provision would apply only if those costs were related to goods obtained, rather than sold, by the taxable entity. Various other costs also would be deductible, including deterioration and obsolescence of goods, certain preproduction costs, insurance costs related to the goods, utility costs used in production of the goods, quality control costs, and licensing costs. The bill would specify

several costs that could not be included in cost of goods sold, including officer compensation.

Indirect and administrative overhead costs could be subtracted if the costs were allocated to the production of the goods. Such deductions could not exceed 4 percent of the entity's total indirect and administrative overhead costs. A lending institution could deduct interest expenses as cost of goods sold.

Compensation deduction. If an entity chose the compensation deduction in determining its taxable margin, the bill would authorize the deduction of wages and cash compensation and benefits for each employee of an entity.

Wages and cash compensation would include the amount entered in the Medicare wages and tips box on an employees' W-2 tax form, as well as net distributive income accruing to a natural person from partnerships, trusts, limited liability corporations, and "S" corporations. Stock awards and options also would qualify for deduction as wages and cash compensation. An entity could deduct no more than \$300,000 in wages and cash compensation per employee. On January 1 of each odd-numbered year beginning in 2009, the \$300,000 cap on the wages and cash compensation deduction would be adjusted based on the percent change in the consumer price index during the preceding fiscal biennium, and the resulting amount would be rounded to the nearest \$10,000.

In addition to the wages and cash compensation deduction, an entity could deduct all benefits provided to its employees, including workers' compensation, health care, and retirement benefits. The benefits deduction would not be subject to the \$300,000 cap.

Calculation of tax. Under the bill, the revised franchise tax would be computed by applying one of two rates to a taxable entity's taxable margin, depending on the type of business activity in which the taxable entity primarily was engaged. If a taxable entity primarily was engaged in retail or wholesale trade, a rate of 0.5 percent would be applied to the entity's taxable margin. If the entity was not engaged primarily in retail or wholesale trade, a rate of 1 percent would be applied to the entity's taxable margin.

An entity primarily would be engaged in retail or wholesale trade if:

- the total revenue from its retail and wholesale trade activities was greater than its total revenue from other activities;
- less than 50 percent of its total revenue in retail or wholesale trade came from the sale of products it produced (excluding eating and drinking establishments); and
- the entity did not provide utilities, including telecommunications, electricity, or gas.

Combined reporting. Under CSHB 3, a group of two or more taxable entities would have to report as a single entity if the entities were part of an affiliated group as defined by a common ownership test and were engaged in a unitary business. The combined group would determine its total revenue and elect to deduct either cost of goods sold or compensation to establish the group's taxable margin.

Apportionment. A taxable entity's proportion of business performed in Texas would be apportioned to the state to determine the entity's tax liability. The taxable entity's margin would be apportioned to Texas by multiplying the entity's margin by the quotient of:

- the taxable entity's gross receipts from business done in Texas; divided by
- the taxable entity's gross receipts from its entire business.

A combined group would include in its gross receipts from business done in Texas the gross receipts of each taxable entity that was a member of the combined group that had nexus in Texas. In determining a combined group's total gross receipts, the combined group would include the gross receipts of each entity that was a member of the group, whether or not the member had nexus in Texas.

In apportioning margin, exclusions taken by an entity when determining the entity's total revenue could not be included in the entity's receipts in Texas or receipts from the entity's entire business. Receipts from the sale of property between one member of a combined group with nexus in Texas and another member of the combined group with nexus outside Texas would be included in the receipts of business done in Texas of the taxable entity, provided that the member that did not have nexus in Texas resold the property to a purchaser in Texas.

Penalties. The comptroller would be authorized to forfeit the right of a taxable entity to transact business in the state in the same manner that the comptroller can forfeit a corporation's corporate privileges under current law.

Transition provisions, reporting, and other provisions. A taxable entity that owed the franchise tax under the bill would have to file an initial informational report with the comptroller and an annual report containing information necessary to compute the tax on the taxable entity.

The comptroller would require an information report from each of the 1,000 entities that paid the most franchise tax in calendar year 2005 under the existing franchise tax, the 1,000 entities that had the greatest gross receipts in 2005, and the 1,000 entities with the most employees in the state in 2005. This information would be used by the comptroller to report to the governor, the lieutenant governor, and the Legislature the amount of revenue that would have been generated from the entities if the new franchise tax had been in effect on January 1, 2006. This report would be delivered by April 1, 2007.

The bill would establish provisions for the transition of existing franchise taxpayers to the new franchise tax established under the bill. Franchise tax credits existing under current law would be repealed. Certain outstanding credits eligible to be carried forward under current law could be applied to an entity's tax burden under the bill, including those under a written agreement between a taxpayer and the Department of Economic Development.

A lawsuit contending that the new franchise tax established under CSHB 3 was unconstitutional would be heard in Travis County district court. The bill specifies that the franchise tax as amended by CSHB 3 is not an income tax and federal law (Pub. L. No. 86-272) concerning state taxation of income from interstate commerce does not apply.

Revenue from the tax imposed under the bill would go into the state's general revenue fund. The bill would appropriate \$2 million in general revenue to the comptroller for fiscal 2006-07 for audit and enforcement activities.

The tax imposed under the bill would take effect January 1, 2008, and would apply to reports due on or after that date.

The bill would take effect June 1, 2006, if finally passed by a two-thirds record vote of the membership of each house. Otherwise, it would take effect September 1, 2006.

SUPPORTERS
SAY:

CSHB 3 would replace the current franchise tax, which has become a voluntary and divisive corporate income tax, with a fairer, more broadly based business levy.

The current franchise tax no longer tracks growth in the state's economy, mainly because the burgeoning service sector uses business structures not subject to the tax. Avoidance has become commonplace, especially among large corporations that have restructured themselves as out-of-state partnerships to take advantage of the so-called "Delaware sub." Closing that loophole is made problematic by legitimate out-of-state partnerships doing business in Texas that never have paid the tax. Even if that problem were corrected, the franchise tax has other loopholes.

Rather than try to plug this leaky fiscal dike, the state should scrap the franchise tax for a reformed franchise tax based on an entity's margin — a measure of revenue that allows for the deduction of certain business costs. This would raise about \$3.4 billion in state revenue in fiscal 2008, and more than \$4 billion annually by fiscal 2011, according to the Legislative Budget Board (LBB). A broad-based, low-rate tax based on margins would track economic growth and help the state deal with inflation, providing a stable and predictable stream of revenue.

The reformed franchise tax or margins tax would balance the state's revenue needs with the cost of doing business while providing new state revenue that could be used to reduce school property taxes, which are burdensome for Texas families and economically inefficient for Texas businesses. Even though Texas would collect more revenue from businesses under the new tax, businesses would benefit from a significant reduction in property taxes. HB 2 by Pitts, also on today's calendar, would dedicate to school property tax reduction any increased revenue over current rates generated by a new broad-based business tax enacted during the third called session.

By taxing all entities that enjoy the benefit of liability protection from the state, CSHB 3 would return the franchise tax to its original intent. Since liability protection was extended to partnerships in the 1980s, many businesses have been able to reorganize to avoid the corporate franchise

tax. Although they contribute nothing to franchise tax revenues, these businesses benefit from the state's educational system and from other state services. CSHB 3 would correct this disparity by covering service-sector businesses more effectively and would track growth within the Texas economy much more accurately than does the current franchise tax. Texas has a growing population with expanding needs, and CSHB 3 presents a golden opportunity to establish a stable revenue source to pay for state services.

A business's margin as defined under CSHB 3 would be a more appropriate base for the franchise tax than the current base, which requires a firm to pay taxes on the greater of either earned surplus or taxable capital. The bill would provide businesses with a choice of deducting either cost of goods sold or compensation, a feature that would enable businesses with very different structures, expenses, and profit margins to thrive under the tax. While a manufacturing firm that produces goods for sale likely would choose to deduct the costs associated with producing those goods, a service-based business would be able to deduct its primary expense, which is employee wages. The compensation deduction would be a particularly desirable aspect of the reformed franchise tax because a business could reduce its tax liability by offering higher salaries, hiring more employees, and expanding health care benefits.

By imposing a lower tax rate of 0.5 percent on retailers and wholesalers, CSHB 3 would take into account the smaller profit margins under which these firms typically operate. While a retailer or wholesaler may collect a large amount of total revenue relative to other entities, only a small percentage of that amount may actually be profit. Since the tax under the bill would use total revenue as part of its base, it would be appropriate to tax firms with historically smaller margins at a lower rate, and doing so would bring the tax liability of those firms into line with other sectors.

The bill would use a widely accepted definition of total revenue based on federal corporate and partnership income tax definitions while excluding foreign income and revenue that already had been taxed elsewhere. These provisions are necessary to avoid the double taxation of some types of receipts. The bill's combined reporting provisions would ensure that entities were not double-taxed on joint assets and also would prevent entities from reorganizing into untaxed structures similar to those that exist under the current franchise tax.

The only tax that would allow a firm to escape taxation when it took a loss would be a tax on profit. Due to the constitutional prohibition against taxation of income, a business tax on the profits of partnerships would be unconstitutional without approval by the voters in a statewide referendum. Thus, the state must choose between taxing partnerships or profit, because it cannot do both. The choice of deducting cost of goods sold or compensation provided to a taxable entity would establish the entity's taxable margin, a concept that is entirely dissimilar to gross receipts.

CSHB 3 would establish the most fair and equitable business tax under the limitations provided by the Texas Constitution. By excluding sole proprietorships, the bill would avoid conflict with the constitutional prohibition against an income tax. The attorney general has indicated that this plan would not constitute an income tax and likely would be upheld in court.

The bill would provide a reasonable 70 percent limit on the amount of a business's total revenue that would be subject to taxation. This limit would be fair to a business whose cost of goods sold or compensation deduction did not provide a meaningful limitation on the business's taxable margin. In addition, a generous small business exemption in the bill would allow a business with less than \$300,000 in total revenue to remain exempt from taxation. This exemption would be twice the exemption under the current franchise tax and would be indexed to inflation.

The bill would retain Texas' favorable rules for apportionment of revenue. Under these provisions, Texas isolates and taxes in a straightforward manner business activity done only within the state, an approach favored by many firms that operate in multiple states.

The bill would eliminate the unfair "throwback rule," under which sales of items shipped from a corporation doing business in Texas to a state in which the corporation is not subject to taxation are "thrown back" to Texas and taxed under the franchise tax. Corporations can avoid taxation by locating in a state without a throwback rule and delivering their goods to Texas, escaping taxation in both Texas and the origination state. Repealing the throwback rule would allow Texas to provide an incentive for corporations to locate in the state.

The credit for providers of health care services under the state and federally funded programs would serve an important policy goal of

encouraging provider participation in these programs. While for-profit health care providers should be required to pay the new tax, the state also should recognize that compensation rates for government-funded programs are very low. Medicaid and Medicare, for example, pay providers between 40 percent and 60 percent of the reimbursement paid by commercial plans. Thus, the bill would ensure that providers who take these partially funded cases would not be taxed excessively. The offset of uncompensated care costs also would encourage health care providers and institutions to continue to serve as a vital part of the Texas safety net, which is very important considering that 25 percent of the state's population is uninsured.

OPPONENTS
SAY:

CSHB 3 would launch an unprecedented and untested business tax scheme in Texas that is unlike any other in the nation, with unknown economic and legal consequences for the state. By bringing in thousands of firms that currently have no tax liability, the bill could cause a substantial disruption in the state's economy, potentially undermining the impressive growth in revenue that the sales tax and existing franchise tax have yielded in the last year. Lawsuits challenging the tax would be inevitable, and the resulting legal process could throw the state's revenue system into question. With all of the uncertainties facing the Texas economy and school finance system, now simply is not the time to adopt a radically revised business tax.

With more than \$8 billion in surplus revenue available, it is precisely the wrong time to embark on a risky and massive expansion of the business tax. All taxes have economic consequences, and all business taxes ultimately are passed on to consumers in the form of higher prices and lower wages. According to the LBB, CSHB 3 would represent an increase of close to 50 percent in fiscal 2008-09 over revenues that would have been collected under the existing franchise tax. While some businesses would profit from a reduction in property tax liability, many businesses undoubtedly would be worse off under the proposed system. Rather than expanding business taxes to pay for a reduction in school property taxes, the Legislature should expend the balance of the state surplus on property tax reduction and reduce spending on state services to eliminate over-taxation in the future.

By using total revenue as the base in calculating the tax, the revised franchise tax under CSHB 3 essentially would be a modified gross receipts tax — an unfair tax that does not take into account a taxpayer's ability to

pay. Even if a business lost money, that entity's taxable margin would be based on the total revenue of the business. Although a business could deduct either cost of goods sold or compensation, there would be no guarantee that the taxable liability of the entity reasonably was related to an entity's income. It is possible that an entity that lost money in a given year still could be forced to pay tax to the state.

Even if the Legislature significantly reduced school property taxes, CSHB 3 likely would represent a substantial increase in the tax liability of private industry in Texas and would mark a shift in the tax burden from individuals to businesses. The Comptroller's Office has estimated that the revised franchise tax on average would translate to a levy of 7 percent of business net income. This rate would be substantially higher than the 4.5 percent rate on earned surplus under the existing franchise tax, and the tax would allow for too few deductions. Every industry is unique, and many forms of business have specific costs and assets that might not work under the broad outlines contained in this bill.

Offering an exclusion for all government-funded health care programs would fail to recognize that rates for the same service may vary widely among programs and that some providers may be compensated at near market rates. For example, TRICARE may pay more for a service than Medicaid. A better way to encourage participation in government-funded programs would be to adequately reimburse for services in programs under the state's control, such as Medicaid, CHIP, and workers' compensation.

OTHER
OPPONENTS
SAY:

A broad-based business tax should apply to all businesses, regardless of the manner in which they choose to organize. Many sole proprietorships and partnerships that generate a great deal of business would remain untaxed under CSHB 3. Leaving some organizations untaxed would create an incentive for businesses to reorganize into untaxed entities. In addition, the state would be forgoing a substantial amount of revenue by excluding passive entities from taxation. These entities should be taxed as well, although perhaps at a lower rate.

Certain service-sector business such as law firms have almost no cost of goods sold as defined under the bill and would be left with no choice other than the compensation deduction. Because compensation would be capped at \$300,000, the taxable margin of many of these firms would be higher than the average margin on which other businesses were taxed. For

service-sector professions that fall into this category, additional deductions should be authorized, such as a higher cap on the compensation deduction or an allowance for such expenses as rent, utilities, or employer Social Security contributions.

Not all retailers operate under small profit margins, and it would be inappropriate to group them all together and allow them to be taxed at half the rate of other businesses. The bill should provide some test or further refinement of the definition of retailers and wholesalers who would be eligible to apply the 0.5 percent tax rate to the taxable margin. For the sake of equity, the bill should make an allowance for firms whose revenue structures more closely resemble those of firms taxed at the rate of 1 percent.

Under Article VIII, Sec. 24(a) of the Texas Constitution, no law enacted by the Legislature could impose a tax on a person's net income, including a person's share of partnership and unincorporated association income, unless a majority of Texas voters approved such a tax in a statewide referendum. CSHB 3 likely would run afoul of this prohibition, given that revenue from unincorporated partnerships would be taxed under the bill. Because a tax would be levied on the margins of unincorporated partnerships from which the income of individuals was derived, a court could find the revised franchise tax under CSHB 3 to be in violation of the personal income tax prohibition.

If health care providers are to be granted a tax credit for the cost of uncompensated care under CSHB 3, it only would be fair to offer a similar credit to attorneys who provide pro bono legal services. Just as the health care credit would encourage participation in state and federal health care programs, a credit for attorneys would create an incentive for lawyers to provide vital free and reduced cost legal services to low-income Texans.

NOTES:

According to the Legislative Budget Board, CSHB 3 would cost the state \$2 million in general revenue-related funds in fiscal 2007 due to an appropriation to the comptroller for the performance of audit and enforcement activities. In fiscal 2008-09 the bill would result in a net increase of \$6.95 billion in general revenue-related funds.

HB 3 as introduced would not have allowed deductions for health care providers of payments from state and federal health care programs and costs of uncompensated care. The committee substitute also made limited

changes to sections dealing with passive entities, cost of goods sold, wages and cash compensation, and apportionment.

On April 21, the House adopted a Calendars Committee rule requiring all amendments to HB 3 be filed by 5 p.m. Saturday and their fiscal impact be determined by the LBB with assistance from the Comptroller's Office.