ARTICLE

CALL TO THE TEXAS LEGISLATURE: THE FRANCHISE TAX NEEDS SUBSTANTIVE CHANGES, NOT JUST RATE REDUCTIONS

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INTRODUCTION

Texas is generally known as a tax-friendly state for businesses.[1] For example, the Tax Foundation recently ranked Texas tenth in its 2015 State Business Tax Climate Index, which ranks the fifty states from best to worst based on the most competitive tax systems.[2] Some may also recall former Governor Rick Perry's television advertisements and road shows where he marketed Texas as pro-business and the state where businesses should relocate.[3] One of the items Perry touted in these marketing efforts was Texas's low business taxes.[4] Indeed, in a radio ad played throughout California in 2013, Perry hyped: "See why our low taxes, sensible regulations and fair legal system are just the thing to get your business

1. Scott Drenkard & Joseph Henchman, *2015 State Business Tax Climate Index*, TAX FOUND. (Oct. 28, 2014), http://taxfoundation.org/article/2015-state-business-tax-climate-index.

2. *Id.* The top ten states on the list included: Wyoming, South Dakota, Nevada, Alaska, Florida, Montana, New Hampshire, Indiana, Utah, and Texas. The ten worst states on the list included: Iowa, Connecticut, Wisconsin, Ohio, Rhode Island, Vermont, Minnesota, California, New York, and New Jersey.

3. *See* Sheryl Jean, *Texas a Bold Recruiter of Businesses, Jobs*, DALL. MORNING NEWS (June 3, 2013, 11:53 AM), http://www.dallasnews.com/business/headlines/20130601-texas-a-bold-recruiter-of-businesses-jobs.ece (discussing Perry's efforts to bring businesses to Texas); Tami Luhby, *Texas to California Businesses: Move Here!*, CNN MONEY (Feb. 4, 2013, 10:36 PM), http://money.cnn.com/2013/02/04/ news/economy/texas-california-businesses/ (detailing Perry's business recruitment campaign in California).

4. Josh Sanburn, *Why Is Texas Governor Rick Perry in Illinois?*, TIME, Apr. 24, 2013, http://business.time.com/2013/04/24/why-is-texas-governor-rick-perry-in-illinois (referencing Texas's low taxes as one of Perry's selling points for attracting businesses to the state); John Wagner, *Rick Perry Knocks Martin O'Malley, Courts Md. Businesses in Ongoing Ad Campaign*, WASH. POST (Sept. 11, 2013), www.washingtonpost.com/local/md-politics/rick-perry-knocks-martin-omalley-courts-md-businesses-in-ongoing-ad-campaign/2013/09/11/39f2c6fa-1afe-11e3-82ef-a059e54c49d0_story.html (reporting Perry's criticism of Maryland's high taxes); *see also* Adam Edelman, *Texas Gov. Rick Perry Touring New York, Connecticut to Convince Employers to Move to Lone Star State*, N. Y. DAILY NEWS (June 17, 2013, 4:31 PM), http://www.nydailynews.com/ news/politics/texas-gov-perry-touring-new-york-connecticut-convince-employers-move-texas-article-1.1375111 (profiling Perry's emphasis on low taxes during his business recruitment tour across New York and Connecticut).

moving to Texas."[5] One of Perry's more brazen tag lines to other states included "get out while there's still time."[6]

Because Texas has a reputation for being tax-friendly toward businesses, many may not realize that Texas actually imposes a tax on businesses organized or otherwise operating in Texas.[7] This is done by way of the Texas franchise tax system.[8] The Texas franchise tax, in various forms, has been in place since 1907.[9]

As background to the issue presented in this Article, the Texas franchise tax was put on center stage between 2005 and 2008.[10] At the beginning of this time period, Texas's public school finance system was declared unconstitutional by the Texas Supreme Court in *Neeley v. West Orange-Grove Consolidated Independent School District*.[11] The court's ruling was largely based on the public school finance system being funded with an overreliance on local property taxes.[12] This overreliance created a constitutional issue because it effectively caused a statewide property tax system to exist, which is prohibited under the Texas Constitution.[13] Additional state revenues were needed to fund public schools in order to solve the problem.[14] The

5. Jim Christie, *Texas and California Spar over Jobs and Taxes*, REUTERS (Feb. 13, 2013, 12:48 PM), http://www.reuters.com/article/2013/02/13/us-usa-jobs-texas-californiaidUSBRE91C0PZ20130213.

6. Jean, *supra* note 3. Perry also touted Texas's lack of a personal income tax system as a reason for businesses to relocate to Texas. Indeed, he once tweeted to professional golfer Phil Mickelson: "Hey Phil . . . . Texas is home to liberty and low taxes . . . we would love to have you as well!!" Luhby, *supra* note 3. Perry sent the tweet in response to Phil Mickelson's public remarks concerning California's high tax rates. *See* Larry Bohannan, *Phil Mickelson Talks Taxes, 'Drastic Changes'*, USA TODAY (Jan. 20, 2013, 9:32 PM), http://www.usatoday.com/story/sports/golf/2013/01/20/humana-challenge-phil-mickelson-taxes/1850265 (noting Mickelson's concerns with the tax structure scheme in California and in the country). Mickelson later apologized. *See* Chris Dufresne, *Phil Mickelson Apologizes Again for Comments on Taxes*, L.A. TIMES (Jan. 23, 2013), http://articles.latimes.com/2013/jan/23/sports/la-sp-sn-phil-mickelson-taxes-20130123 ("Following up on a statement he issued late Monday night, Mickelson offered a personal apology for comments he made about California's tax system.").

7. *See* TEX. TAX CODE ANN. § 171.001 (West 2015) (enacting a state franchise tax on businesses).

8. *Id.* Although statutorily titled a franchise tax, Texas's franchise tax system is not a typical franchise tax as seen in Delaware, which is further explained in Part I.A.

9. *See* Josh Haney & Bruce Wright, *The History of the Texas Franchise Tax: The Complex Evolution of Our Main Business Tax*, FISCAL NOTES, May 2015, at 1, http://comptroller.texas.gov/fiscalnotes/may2015/fn.pdf (delineating the history of Texas's franchise tax).

10. *See id.* at 5 (illustrating the "sweeping nature of the changes to the franchise tax" by the state government from 2005 to 2008).

11. Neeley v. West Orange-Cove Consol. Indep. School Dist., 176 S.W.3d 746 (Tex. 2005).

12. *Id.* at 756.

13. *Id.* at 794.

14. *Id.* at 800.

Texas Supreme Court gave the legislature a six-month deadline to create the additional revenues.[15]

To help find a solution, Governor Perry organized the Texas Tax Reform Commission (Commission) in November 2005.[16] The Commission was tasked with studying the funding issue and providing a recommendation.[17] The Commission studied the issue from November 2005 through March 2006 and delivered its report to Perry on March 29, 2006.[18] In its report, the Commission recommended that the additional state revenues be generated through a complete overhaul of the Texas franchise tax.[19] The Texas Legislature agreed and incorporated the Commission's recommendations into H.B. 3, which passed in a whirlwind sixteen-day special legislative session.[20] H.B. 3 was signed into law by Perry on May 19, 2006, just days short of the court-imposed six-month deadline.[21] Pursuant to the terms of the legislation, H.B. 3 had a delayed effective date of January 1, 2008.[22]

Due to the short timeframe surrounding the passage of H.B. 3, it was not surprising that the newly-overhauled Texas franchise tax system had some substantive problems that required adoption of regulatory rules and the issuance of other interpretive guidance by the Texas Comptroller of Public Accounts (Texas Comptroller).[23] It is also not surprising, that in

15. *Id.*

16. *See* Press Release, Tex. Tax Reform Comm'n, Gov. Perry Names 24-Member Texas Tax Reform Commission (Nov. 4, 2005), http://govinfo.library.unt.edu/ttrc/press_releases/2005_11_04-1.html ("Gov. Rick Perry today named the membership of the Texas Tax Reform Commission, a bipartisan group of 24 Texans who will develop proposals to modernize the state tax system and provide long-term property tax relief as well as sound financing for public schools.").

17. *Id.*

18. TEX. TAX REFORM COMM'N, TAX FAIRNESS: PROPERTY TAX RELIEF FOR TEXANS 18–24 (2006), http://govinfo.library.unt.edu/ttrc/files/TTRC_report.pdf [hereinafter TAX FAIRNESS]; *see* Jimmy Martens & Amanda Traphagan, *Margin of Error: Fixing the Texas Franchise Tax After* Allcat, J. ST. TAX'N, Mar.–Apr. 2012, at 37, 37 (summarizing the Texas Tax Reform Commission's margin tax proposal).

19. TAX FAIRNESS, *supra* note 18, at 18–24.

20. *See* Cynthia M. Ohlenforst, *The New Texas Margin Tax: More Than a Marginal Change to Texas Taxation*, 60 TAX LAW. 959, 959–60 (2007) (highlighting the legislature's efforts to make "sweeping changes to the long-standing Texas franchise tax").

21. *See History of HB 3*, TEX. LEGISLATURE ONLINE, http://www.capitol.state.tx.us/BillLookup/History.aspx?LegSess=793&Bill=HB3 (last visited Dec. 17, 2015) (noting Perry signed H.B. 3 into effect on May 19, 2006).

22. *See* Tex. H.B. 3, 79th Leg., 3d C.S. (2006) (declaring an effective date of January 1, 2008).

23. *See* TEX. ADMIN. CODE § 3.581 (West 2015) (codifying the Comptroller's guidance on the franchise tax into Texas Administrative Code); Adam Chisholm, *Texas Comptroller Provides Rules on the Texas Franchise Tax*, TAX ADVISER, Aug. 2008, at 499, 499–503 (acknowledging the short timeframe and expressing surprise that the bill passed on its first draft).

certain circumstances, problems that arose required subsequent legislation.[24]

What is surprising, though, is the Texas Legislature no longer seems keen on addressing remaining substantive problems that still exist in the Texas Franchise Tax Code post H.B. 3.[25] Rather, as illustrated by the latest session, the Texas Legislature's concerns with the Texas franchise tax appear limited only to lowering the rate.[26]

Several substantive issues persist in the Texas Franchise Tax Code that require the legislature's attention.[27] This Article addresses one of those issues.[28] With the next legislative session set to begin in early 2017, the hope is this Article will serve as a call to the Texas Legislature to focus on addressing substantive issues in the Texas Franchise Tax Code rather than just simple rate reductions. Substantive changes are needed to ensure taxpayers are being subjected to a tax system that is fair, equitable, and that makes sense.

I. TEXAS FRANCHISE TAX: BACKGROUND AND RELEVANT PROVISIONS

A. *Overview*

The State of Texas has imposed a tax on certain business entities for almost 100 years.[29] This is done by way of the Texas franchise tax, the provisions of which are contained in Subtitle F, Chapter 171 of the Texas Tax Code (referred to herein as the Texas Franchise Tax Code).[30]

Prior to 2008, the Texas franchise tax was imposed only on corporations and limited liability companies.[31] The tax was effectively a

24. *See* Tex. H.B. 3928, 80th Leg., R.S. (2007) (enacting a technical corrections bill further amending H.B. 3).

25. *See* Tex. H.B. 32, 84th Leg., R.S. (2015) (addressing no substantive changes to the Texas Franchise Tax Code).

26. *See id.* (providing only rate reductions to the Texas Franchise Tax Code).

27. *See infra* Parts III–IV.

28. As discussed in Part III, rental income should not be considered passive under some circumstances for purposes of the passive exemption.

29. Ira A. Lipstet, *Franchise Tax Reformed: The New Margin Tax Including 2007 Legislative Changes and Final Comptroller Rules*, 42 TEX. J. BUS. L. 1, 1 (2007); *see also* Haney & Wright, *supra* note 9, at 3 (summarizing the history of the Texas franchise tax, the primary tax on business entities).

30. TEX. TAX CODE ANN. § 171.001 (West 2015).

31. *Id.* § 171.001(a) (West 2006). Citations to the 2006 Texas Franchise Tax Code are intended to refer to the statute in effect for tax years prior to January 1, 2008. While H.B. 3 was enacted in 2006, the relevant year is 2008 because the bill did not become effective until January 1, 2008. *See* Tex. H.B. 3, 79th Leg., 3d C.S (2006) (stipulating the effective date of the changes to the tax code as January 1, 2008).

fee imposed on the greater of: (i) 0.25% of the entity's GAAP net worth with certain adjustments (previously defined in the Texas Franchise Tax Code as "taxable capital"); or (ii) 4.5% of the entity's federal taxable income, with certain adjustments, plus officer and director compensation (previously defined in the Texas Franchise Tax Code as "earned surplus").[32] In either instance, tax was computed on an apportioned basis by multiplying the entity's tax base by a single-factor ratio of gross receipts from business done in Texas to gross receipts from business done everywhere.[33]

Limited partnerships were not subject to tax under the pre-2008 Texas franchise tax system.[34] Because limited partnerships were not subject to tax, many described the pre-2008 Texas franchise tax system as a voluntary one because businesses could avoid the tax altogether by simply operating in a limited partnership form, including as a limited liability partnership (LLP), rather than as another state law entity type (e.g., limited liability company or corporation).[35] Thus, at least for Texas franchise tax purposes, there was an incentive for new businesses to form as limited partnerships or LLPs.[36] Furthermore, there was an incentive for existing businesses initially formed as limited liability companies or corporations to convert into limited partnerships or LLPs for state law purposes.[37] Indeed, the Texas Comptroller's Office issued an administrative ruling in 1996, effectively blessing such conversion transactions:

32. TAX §§ 171.002, 171.101, 171.110. Cynthia M. Ohlenforst recognizes this taxing process was unique:

> The Texas franchise tax differs in multiple respects from other states' franchise and income taxes, in part because of the bifurcated formula that has been in place for several years for calculating the amount due. Although once imposed solely on taxable capital, the tax has included an alternative "earned-surplus" calculation, based loosely on federal taxable income, since a 1991 legislative expansion of the tax.

Ohlenforst, *supra* note 20, at 959.

33. TAX § 171.106.

34. "Both the pre- and post-1991 tax applied to corporations, limited liability companies, and banking corporations but . . . not to partnerships or to limited partners whose only connection with Texas is a limited partnership interest"—at least not until 2008, when the 2006 amendments finally went into effect. Ohlenforst, *supra* note 20, at 959.

35. *See* TAX FAIRNESS, *supra* note 18, at 18 ("[T]he vast majority of [Texas] businesses . . . escape the franchise tax, either through deliberate use of tax defeating organizational structures, or simply avoid the corporate form altogether . . . and compete with taxpaying companies while contributing nothing to franchise tax revenues.").

36. *Methods of Franchise Tax Avoidance: Prepared at the Request of the Ways and Means Committee*, TEX. COMPTROLLER OF PUB. ACCOUNTS (June 1996), http://aixtcp.cpa.state.tx.us/opendocs/open13/1417a11l.html.

37. *Id.*

> The first type of tax avoidance occurs when businesses elect to organize as an LP or an LLP rather than as a corporation. This tax avoidance can occur either as a conversion of an exiting corporation, or as the start-up of a new LP or LLP in lieu of a corporation . . . . In electing the pass-through organization, the firm precludes taxation under the franchise tax . . . . This type of tax avoidance is particularly appealing to law firms. Prior to the creation of LLPs, many law firms organized as professional corporations, which are taxable under the franchise tax (although many other law firms remained simple partnerships) . . . . Organization as an LLP provides the operational flexibility and limitations from liability these ventures require along with franchise tax avoidance.[38]

These conversion transactions (commonly known as "franchise tax conversions") were quite popular because, if properly structured, federal income tax consequences could be avoided as well.[39] This was accomplished by having the post-conversion limited partnership or LLP make a check-the-box election under the federal entity classification regulations on IRS Form 8832, Entity Classification Election, to continue to be taxed as a corporation for federal income tax purposes.[40] The effect of this election caused the transaction to be a nontaxable "F reorganization" for federal income tax purposes.[41]

Because of the above described "voluntary" nature of the pre-2008 Texas franchise tax system and other perceived problems, the Texas Legislature attempted for a period of more than ten years to enact significant changes to the pre-2008 Texas Franchise Tax Code.[42] In 2006, the Texas Legislature finally succeeded, passing H.B. 3.[43]

H.B. 3 implemented extensive changes to the pre-2008 Texas Franchise

38. *Id.*

39. *See* I.R.C. § 368(a)(1)(F) (2012) (defining reorganization as a change in form of one corporation); Treas. Reg. § 301.7701-3 (2006) (portraying the types of business entities eligible for franchise tax conversions and the requirements for reclassifications); *see also* INTERNAL REVENUE SERV., FORM 8832, ENTITY CLASSIFICATION ELECTION (2013), http://www.irs.gov/pub/irs-pdf/f8832.pdf [hereinafter I.R.S. FORM 8832] (providing the means to change a current classification).

40. *See* Treas. Reg. § 301.7701-3 (permitting an elective change in classification provided proper requirements are met); *see also* I.R.S. FORM 8832, *supra* note 39 (illustrating the form where the post-conversion entity may affirmatively elect to be taxed as a corporation).

41. *See* I.R.C. § 368(a)(1)(F) (allowing this type of reorganization to occur with "a mere change in identity, form, or place of organization").

42. *See* Lipstet, *supra* note 29, at 3 (stressing the numerous failed attempts over a period of ten years, which prompted the Texas Legislature to enact significant changes to the Texas Franchise Tax Code).

43. This legislation is commonly known as "H.B. 3." Nikki Laing, Comment, *An Income Tax by Any Other Name Is Still an Income Tax: The Constitutionality of the Texas "Margin" Tax as Applied to Partnerships and Other Unincorporated Associations*, 62 BAYLOR L. REV. 573, 573 (2010).

Tax Code.[44] Some scholars have gone so far as to suggest the legislation "rewrote Texas business tax law."[45] The impetus of the legislation was the Texas Supreme Court's decision in *Neeley v. West Orange-Cove Consolidated Independent School District*.[46] In *Neeley*, the court declared the system used by Texas to fund its public schools unconstitutional.[47] The reason for the decision, in part, was due to the public school finance system's overreliance on local property tax revenues.[48] The overreliance caused Texas to have, in effect, a state-wide property tax system instead of a local property tax system, which is prohibited under the Texas Constitution.[49]

As part of the *Neely* case, the Texas Supreme Court gave the legislature a six-month deadline to find a solution, so the public school finance system could pass constitutional muster.[50] In short, this meant the Texas Legislature had to find an additional source of revenue to fund public schools.[51] The Texas franchise tax was an easy place to start.

44. Lipstet, *supra* note 29, at 3.

45. WILLIAM D. ELLIOTT & J. SCOTT MORRIS, TEXAS TAX CODE ANNOTATED 1008 (2011 ed. 2011) ("The 2006 Legislature enacted House Bill 3, which rewrote Texas business tax law.").

46. Neeley v. W. Orange-Cove Consol. Indep. Sch. Dist., 176 S.W.3d 746, 799–800 (Tex. 2005) (giving the legislature a deadline to determine a new avenue to fund public schools).

47. *Id.* at 746. As Ms. Ohlenforst stated:

> Although the 1991 shift to a bifurcated tax brought a temporary respite from legislative expansion of the tax, 2006 brought new pressure for legislators to expand the tax again—not only to reach previously nontaxable entities (including partnerships) but also to fund property tax relief. The Texas Supreme Court accelerated the push for tax reform by holding, in *Neeley v. West Orange-Cove Consolidated Independent School District*, that Texas's method of funding public education violates the Texas [C]onstitution. The court's mandate that the legislature find a solution by its June 2006 deadline, coupled with legislative frustration at the large number of entities that successfully planned around the tax by operating through partnerships, set the stage for sweeping changes to the long-standing Texas franchise tax.

Ohlenforst, *supra* note 20, at 959 (citations omitted); *see also* Martens & Traphagan, *supra* note 18, at 37 (emphasizing the role of *Neely* in forcing the legislature to find a new tax system).

48. *See* TAX FAIRNESS, *supra* note 18, at 11 (stating the Texas Supreme Court in *Neeley* determined the Texas school funding scheme created a "*de facto* state property tax . . . prohibited under Article VIII of the state constitution"); *see also* Martens & Traphagan, *supra* note 18, at 37 (referencing the *Neely* opinion because it "declared Texas's system for funding its public school unconstitutional, based in part on its over-reliance on local property taxes").

49. TEX. CONST., art. VIII, § 1-e ("No State ad valorem taxes shall be levied upon any property within this State.").

50. *Neeley*, 176 S.W.3d at 799.

51. *See* Martens & Traphagan, *supra* note 18, at 37 (commenting on the Texas Legislature's scramble to find a new revenue source to fund Texas schools); *see also* TAX FAIRNESS, *supra* note 18, at 11 ("The Supreme Court has given the Legislature a June 1, 2006 deadline to solve this problem. It was in this environment that the Tax Reform Commission began its work and under which the

To aid in the process of finding a solution, Governor Perry appointed twenty-four individuals to serve on a newly-created Texas Tax Reform Commission.[52] The Commission was chaired by former Texas Comptroller John Sharp.[53] The charge of the Commission was to make recommendations for reforming the Texas tax system with a "focus on the goals of lowering property taxes, ensuring greater tax fairness, and providing a long-term, reliable source of funding for public schools."[54]

At the outset, the Commission considered expanding the pre-2008 Texas franchise tax system to tax limited partnerships and thereby do away with the voluntary nature of the pre-2008 system.[55] Ultimately, though, the Commission went an even broader direction by proposing a brand new franchise tax system.[56] Not only did the Commission's proposal expand the Texas franchise tax to limited partnerships, it also did away with the "earned surplus" and "taxable capital" base components and replaced them with a "kind of" gross receipts tax base.[57] The Commission's proposal was thereafter implemented in H.B. 3.[58] H.B. 3 passed through the Texas Legislature in a two-and-a-half week special session.[59] Perry

79th Legislature must act.").

52. Martens & Traphagan, *supra* note 18, at 37; Press Release, Texas Tax Reform Comm'n, *supra* note 16.

53. Press Release, Texas Tax Reform Comm'n, *supra* note 16. The other twenty-three members included: Truman Arnold (Texarkana), William B. Blaylock (Dallas), A.J. Brune III (Midland), T. Randall Cain (San Antonio), Alonzo Cantu (McAllen), James D. Dannenbaum (Houston), Printice L. Gary (Dallas), Wendy Lee Gramm (Helotes), Jodie J. Jiles (Houston), Hunter Hunt (Dallas), Woody L. Hunt (El Paso), Kenneth M. Jastrow II (Austin), Victor E. Leal (Canyon), Judith A. Lindquist (San Antonio), William A. McMinn (Houston), Ernest A. Morales (Devine), Jan Newton (Austin), Dennis Patillo (Houston), John V. Roach (Fort Worth), Robert Rowling (Irving), Ronald G. Steinhart (Dallas), Dr. David Teuscher (Beaumont), and Howard Wolf (Austin). *Id.*

54. *Id.*

55. Martens & Traphagan, *supra* note 18, at 37 ("Initially, the Commission considered expanding the existing Texas franchise tax to other business entity forms, including partnerships.").

56. *See* TAX FAIRNESS, *supra* note 18, at 18–24 (explaining the franchise tax reform and the new franchise tax system); *see also* Martens & Traphagan, *supra* note 18, at 37–38 (exploring the Commission's initial proposal, which would tax previously untaxed entities).

57. TAX FAIRNESS, *supra* note 18, at 18–24. As modified, the Texas franchise tax is oftentimes referred to as a modified gross receipts tax because it is more like a gross receipts tax (although not entirely) than an income tax or any other type of tax system. Lipstet, *supra* note 29, at 3.

58. Tex. H.B. 3, 79th Leg., 3d C.S. (2006); *see* Ohlenforst, *supra* note 20, at 959–60 ("The commission's recommendations formed the basis for what became House Bill No. 3, and included an entirely new tax that combines elements of a gross receipts tax with elements of a net income tax.").

59. *See* Martens & Traphagan, *supra* note 18, at 38 ("The Legislature hurriedly pushed the Commission's proposed tax through the House and Senate in a two-and-a-half-week special session."). Ms. Ohlenforst provided the following prospective on H.B. 3's passage:

In part because of the Texas Supreme Court's deadline and in part because of the political signed H.B. 3 into law on May 19, 2006, just short of the Texas Supreme Court's June 1, 2006 deadline.[60] Although H.B. 3 was signed into law in 2006, it had a delayed effective date of January 1, 2008.[61]

To delineate between the Texas franchise tax system in effect prior to January 1, 2008—and the system in effect beginning January 1, 2008, when H.B. 3 became effective—many refer to the current Texas franchise tax system as the "Texas margin tax."[62] This is because the tax base is a taxable entity's "margin," as such term is defined in the Texas Franchise Tax Code.[63] Notably, though—and maybe confusingly—the Texas franchise tax, as amended by H.B. 3, continues to be statutorily titled a

> environment, the House quickly passed House Bill No. 3 with very few amendments. Although many House members undoubtedly expected to see the bill again in conference committee, the Senate passed the House version without making any amendments, another effect of the court's deadline and the political pressures. An advantage of the [L]egislature's prompt action is the timely enactment of a reformed tax; a disadvantage is the confusion that arises from the enacted language, including from some ambiguities and drafting errors that legislators did not have the opportunity to fix before the session ended.

Ohlenforst, *supra* note 20, at 959–60.

60. *See History of HB 3*, *supra* note 21 (indicating H.B. 3 was signed by the Governor on May 19, 2006); *see also* Martens & Traphagan, *supra* note 18, at 38 ("The governor signed the bill into law on May 19, 2006, shortly before the Texas Supreme Court's deadline, and the Texas margin tax was thus born.").

61. Section 22 of H.B. 3 had an effective date of January 1, 2008 and applied to Texas franchise tax reports originally due on or after that date. *See* Tex. H.B. 3928, 80th Leg., R.S. (2007) (serving as a technical corrections bill to H.B. 3). Notably, Texas's public school finance system continues to suffer from problems even after the implementation of H.B. 3. In September 2014, in an almost 400-page opinion, Texas district court Judge John Dietz held that Texas's school finance system was again operating in an unconstitutional manner because of inadequate funding and flaws in the way distributions are made to public school districts, as well as the system continuing to create a de facto state property tax that is prohibited under the Texas Constitution. Tex. Taxpayer & Student Fairness Coal. v. Williams, No. D-1-GN-11-003130, 2014 WL 4254969 (Travis Cty. Dist. Ct. Aug. 28, 2014); *see* Morgan Smith, *AG to Appeal School Finance Ruling to Supreme Court*, TEX. TRIB. (Sept. 26, 2014, 5:22 PM), http://www.texastribune.org/2014/09/26/judge-issues-school-finance-ruling (noting the lawsuit "arose after lawmakers cut roughly $5.4 billion from state public education funding in 2011").

62. *See* TEX. TAX CODE ANN. § 171.101(a)(1), (a)(2), (a)(3) (West 2015) ("The taxable margin of a taxable entity is computed by[] determining the taxable entity's margin, . . . apportioning the taxable entity's margin to this state . . . and subtracting . . . allowable deductions . . . ."); Lipstet, *supra* note 29, at 3 ("The new version of the franchise tax is commonly referred to as the 'margin tax' because it changes the base of taxation from taxable capital or taxable earned surplus to a new concept of 'taxable margin.' The margin tax is, in essence, a modified gross receipts tax, with some deductions allowed.").

63. *See* TAX § 171.101(a)(1) (instructing how to compute an entity's margin); Ohlenforst, *supra* note 20, at 959–60 ("The new law . . . imposes an entirely new 'margin tax' on taxpayers, subjects additional businesses to this franchise tax, and fundamentally changes the way the tax is calculated . . . . [T]he tax reaches back to 2007—and even earlier for some taxpayers."); *see also* Laing, *supra* note 43, at 573 ("The tax as revised still is referred to in the Texas Tax Code as the 'franchise tax,' though it is commonly called the 'margin tax.'").

"Franchise Tax" in the Texas Tax Code.[64] Thus, this Article will refer to the post-2008 system as the "Texas franchise tax."[65]

As it exists today, the Texas franchise tax is imposed on what is statutorily referred to as a "taxable entity" that is either formed in Texas or otherwise doing business in the state.[66] More specifically, Section 171.001[67] states:

> (a) A franchise tax is imposed on each taxable entity that does business in this state or that is chartered or organized in this state.[68]
> (b) The tax imposed under this chapter extends to the limits of the United States Constitution and the federal law adopted under the United States Constitution.[69]
> (c) The tax imposed under this section or Section 171.0011 is not imposed on an entity if, during the period on which the report is based, the entity qualifies as a passive entity as defined by Section 171.0003.[70]

The purpose of the Texas franchise tax is to charge taxable entities a price for the privilege of doing business in Texas under the protection of a liability shield.[71]

Pursuant to Section 171.0002(a), the term "taxable entity" means:

> a partnership, limited liability partnership,[72] corporation, banking

64. *See generally* TAX § 171.0001 (identifying the chapter on franchise and state tax).

65. *Id.*

66. *See id.* §§ 171.0002, 171.001 (defining the types of entities implicated by the tax and delineating the jurisdictional scope of the tax).

67. All section references in this Article are to the Texas Franchise Tax Code unless otherwise indicated.

68. This subparagraph involves the tax term "nexus." Nexus denotes the existence of enough minimum contacts in a state to be constitutionally subject to tax in such state. *See* Complete Auto Transit Inc. v. Brady, 430 U.S. 274, 287–88 (1977) (establishing the constitutionality of state taxation of foreign companies when sufficient contacts within the taxing state exist); *see also* WALTER HELLERSTEIN ET AL., STATE AND LOCAL TAXATION 22–23, 49–50, 98–103 (9th ed. 2009) (exploring the constitutional and statutory limitations to state taxation of foreign entities). Nexus also determines where corporations are taxed. *See generally* Ethan D. Millar, *Overview of State and Local Taxation*, *in* TAX LAW & PRACTICE (PLI Corp. Tax Prac., Course Handbook Ser. No. 19890, 2009) ("If the corporation has nexus with the state, then the state has the jurisdiction to tax it. In general, a corporation will have nexus wherever it owns or leases property, and wherever it conducts certain activities."). A detailed discussion of nexus is beyond the scope of this Article.

69. This subparagraph also involves nexus.

70. TAX § 171.001. The exemption for entities qualifying as "passive entities" is the subject of this Article.

71. *See* TAX FAIRNESS, *supra* note 18, at 18 (stating "[t]he original purpose of the franchise tax—and that which the Commission finds is still valid— was to collect a modest levy in return for the tremendous value afforded to businesses that chose to benefit from a state-provided liability shield").

72. Not surprisingly, limited partnerships (and LLPs) are now subject to Texas franchise tax

> corporation, savings and loan association, limited liability company, business trust, professional association, business association, joint venture,[73] joint stock company, holding company, or other legal entity.[74]

Section 171.0002(b) then provides a list of certain entities that are *not* considered taxable entities.[75] Section 171.0002(b) states:

> (b) "Taxable entity" does not include:
> (1) a sole proprietorship;
> (2) a general partnership:
> (A) the direct ownership of which is entirely composed of natural persons; and
> (B) the liability of which is not limited under a statute of this state or another state, including by registration as a limited liability partnership;
> (3) a passive entity as defined by Section 171.0003; or
> (4) an entity that is exempt from taxation under Subchapter B.[76]

Section 171.0002(c) then further expands the list of entities *not* considered taxable entities, to include: (1) certain grantor trusts; (2) certain estates; (3) escrows; (4) certain real estate investments trusts (REITs), as such are defined in Section 856 of the Internal Revenue Code, and certain qualified REIT subsidiaries, as such are defined for federal income tax purposes in Section 301.7701-4(b) of the Treasury Regulations; (5) real estate mortgage investment conduits, as such are defined in Internal Revenue Code Section 860D; (6) certain trusts, including nonprofit self-

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under the post-2008 system unless otherwise exempt. *See* TAX § 171.0002(a) (providing a list of legal entities covered by the term "taxable entity," including "other legal entit[ies]"). Special rules apply to general partnerships. *See id.* § 171.0002 (b)(2)(A) (excluding from taxation certain general partnerships). Subsection (b) also discusses limited partnerships that are considered exempt "passive entities" for Texas franchise tax purposes. *Id.* § 171.0002 (b)(2)(B). Ms. Ohlenforst thoroughly examined the change to partnerships:

> A significant change to the tax is its application, for the first time, to partnerships. Although not all partnerships are subject to the tax, the legislature—after many unsuccessful efforts during prior sessions—successfully extended the tax to most limited partnerships. Because operating in partnership form has been a key component of Texas franchise tax planning for years, expanding the tax to partnerships is expected to bring large numbers of taxpayers into the tax net.

Ohlenforst, *supra* note 20, at 962 (citations omitted).

73. The term "joint venture" does not include joint operating or co-ownership arrangements that meet the requirements of Treasury Regulation, Section 1.761-2(a)(3), and "that elect out of federal partnership treatment" under Section 761(a) of the Internal Revenue Code. TAX § 171.0002(a); 34 TEX. ADMIN. CODE § 3.581(b)(10), (c)(10) (West 2015).

74. TAX § 171.0002; 34 ADMIN. § 3.581(c).

75. TAX § 171.0002(b).

76. *Id.*; 34 ADMIN. § 3.581(d).

insurance trusts; and (7) certain unincorporated entities that are organized as political committees.[77]

Section 171.0002(d) also contains a special rule for entities classified as disregarded entities for federal income tax purposes.[78] Section 171.0002(d) states:

> (d) An entity that can file as a sole proprietorship for federal tax purposes is not a sole proprietorship for purposes of Subsection (b)(1) and is not exempt under that subsection if the entity is formed in a manner under the statute of this state, another state, or a foreign country that limit the liability of the entity.[79]

Based on the foregoing, if an entity is a taxable entity under Section 171.0002 and has nexus with Texas, then such entity is subject to Texas franchise tax even if such entity is disregarded for federal income tax purposes.[80]

The Texas franchise tax is imposed on certain gross revenues, minus the highest of four allowable deductions.[81] The four allowable deductions include: (1) cost of goods sold;[82] (2) compensation;[83] (3) what is commonly called a 30% standard deduction;[84] and (4) a $1,000,000 standard deduction.[85] Because the starting point for computing the tax is gross revenues—and deductions are limited solely to those four and, thus, may not include all deductions allowed for federal income tax purposes—the Texas franchise tax has characteristics of a gross receipts tax.[86] Some

77. TAX § 171.0002(c); 34 ADMIN. § 3.581(d).

78. The term "disregarded entity" means an entity that exists for state law purposes but is not distinguished from its owner for federal income tax purposes and, therefore, is considered disregarded (i.e., as if it doesn't exist) and treated as an entity separate from its owner for federal income tax purposes. *See* Treas. Reg. § 301.7701-1(a)(1), -2(a)–(c), -3(a)–(c) (2006) (providing definitions for a disregarded entity).

79. TAX. § 171.0002(d).

80. *See Franchise Tax Frequently Asked Questions: Taxable Entities*, TEX. COMPTROLLER OF PUB. ACCOUNTS, http://comptroller.texas.gov/taxinfo/franchise/faq_tax_ent.html (last updated Apr. 10, 2008) (answering questions about the Texas franchise tax, specifically at Question 13).

81. TAX § 171.101(a).

82. *Id.* § 171.1012.

83. *Id.* § 171.1013.

84. *Id.* § 171.101(a)(1)(A).

85. *Id.* § 171.101(1)(A)(ii), (1)(B)(i). It is somewhat confusing to have two standard deductions: the 30% standard deduction and the $1,000,000 standard deduction. The existence of two standard deductions is due to each being passed in different legislative sessions and the legislature having a desire to enact legislation favorable to small businesses.

86. *See* Ray Langenberg, Texas Margin Tax Overview and Update, Presentation at the University of Texas School of Law Margin Tax Conference (Nov. 29, 2007), *in* 2007 TEXAS MARGIN TAX: A PRACTICAL GUIDE FOR LAWYERS AND ACCOUNTANTS 1, 1 (2007) ("Effective January 1, 2008, the current franchise tax will be replaced by a 'margin' tax, which is in effect, a modified gross

describe it as a "modified gross receipts tax."[87]

After taking the highest available deduction, the resulting amount is referred to in the Texas Franchise Tax Code as "margin."[88] A taxable entity's margin is apportioned to Texas based on a single factor ratio of Texas gross receipts over gross receipts from everywhere.[89] The apportioned amount, known as "apportioned margin,"[90] is then subject to tax at a rate of 1%,[91] with lower rates and discounts applying in certain enumerated situations.[92] Recent legislation in 2015 reduced the 1% rate by 25% to 0.75%.[93]

The chart below provides an illustrative example, and some additional information regarding how the Texas franchise tax is computed.[94]

Starting Point:	Total Revenues[95] Section 171.1011 defines this term by first including specific line items of income reported by a taxable entity on its federal income tax return, depending on whether such taxable entity is treated for federal income tax purposes as a corporation, partnership, or disregarded entity.[96] Certain enumerated subtractions are allowed.[97]
Minus:	Either: Cost of goods sold,[98] as such term is defined in Section 171.1012, and which is allowed only for non-service industry taxpayers, such as retailers selling goods;[99] or

receipts tax—there are some deductions, but they are more limited than the federal net income tax deductions.").

87. *Id.*

88. TAX § 171.101(a)(1).

89. *Id.* § 171.106(a).

90. *Id.* § 171.101(a)(2), (a)(3).

91. *Id.* § 171.002.

92. *Id.* §§ 171.002, 171.0021. Certain circumstances allow tax payable to be reduced to zero. *Id.* § 171.002(d).

93. Tex. H.B. 32, 84th Leg., R.S. (2015).

94. *Cf.* Cynthia M. Ohlenforst et al., *Taxation*, 60 SMU L. REV. 1311, 1316–22 (2007) (discussing similar calculations for franchise tax).

95. TAX. § 171.1011.

96. *Id.*

97. *Id.* § 171.1011(e), (f), (g), (g-1), (g-2), (g-3), (g-4), (g-6), (k), (m), (m-1), (n), (o), (q), (r).

98. *Id.* § 171.101(a)(1)(B)(ii)(a).

99. *Id.* § 171.1012(a)(1), (a)(2), (c).

	total cash compensation,[100] as such term is defined in Section 171.1013 and is limited to $300,000 per individual, the cap of which includes net distributive income from partnerships and other pass-through entities;[101] or 30% standard deduction;[102] or $1,000,000 standard deduction.[103] Note: Elections can be changed on an annual basis.[104]
Equals:	**Gross Margin**[105]

100. *Id.*§ 171.101(a)(1)(B)(ii)(b).

101. *Id.* § 171.1013.

102. Gross margin is limited to 70% of total revenue, which creates the so-called 30% standard deduction. *Id.* § 171.101(a)(1)(A).

103. *Id.* § 171.101(a)(1)(A)(i); *see also id.* § 171.101(1)(A)(ii) (regarding the existence of two standard deductions).

104. *Id.* § 171.101(d). Some legislators voted against H.B. 3 because only limited deductions are allowed:

> [T]he new income tax will result in the crippling of many new businesses. New companies generally lose money during their first years of operation, yet such businesses will nevertheless owe taxes to the state under this new tax scheme. Unlike the federal tax system that grants businesses a means by which to record losses and carry them forward against future profits, this new tax would require a complex tax payment regardless of actual losses. I cannot in good conscience support a bill that has the effect of penalizing entrepreneurs and that discourages the creation of new businesses.
>
> . . . [T]his new tax will have the effect of punishing many businesses that have unexpected expenses. For example, a service company that has a gross revenue of $1 million and payroll expenses of half a million dollars will pay a new income (franchise) tax of [one] percent of $500,000, or $5,000. Suppose that this company was frivolously sued and spent half a million dollars defending itself. This company would likely sustain a net operating loss in the year that it was sued but would nevertheless owe the State of Texas a franchise tax on income that was never realized. In addition, HB 3 does not take into consideration the numerous other expenses that are not related to payroll. For example, rent, phones, advertising, maintenance contracts on business equipment, casualty insurance, key man insurance, property taxes on real estate and business equipment, bank interest on notes, lease payments on equipment, occupancy taxes, filing fees, and a myriad of other expenses are not deductible under this new tax scheme.
>
> . . . .
>
> HB 3 was touted as a fair and equitable solution to our outdated tax system. We were told by the members of the Ways & Means Committee and the Texas Tax Commission that this restructured tax system would bring more businesses into our state tax system. As the process moved forward, it became apparent that this bill would not strive to be fair or equitable. It would not attempt to treat all businesses similarly.

H.J. of Tex., 79th Leg., 3d C.S. 141–42 (2006). With respect to the last point, under the Texas Franchise Tax Code, as modified by H.B. 3, it is only non-service businesses that can take a cost of goods sold deduction, and even then, this cost of goods sold deduction may not mirror the deduction the entity gets to take for federal income tax purposes. TAX § 171.1012(c).

105. *See* TAX § 171.101(a)(1) ("determining the taxable entity's margin").

Multiplied By:	Texas apportionment factor[106] This is a single factor formula of: Texas Gross Receipts[107] Total Gross Receipts[108]
Equals:	**Taxable Margin**[109]
Multiplied By:	1% tax rate[110] Note: Recent legislation reduces the 1% rate by 25% to 0.75%.[111] The lower rate becomes effective on January 1, 2016, and applies to Texas franchise tax reports originally due after that date.[112]
Equals:	**Tax payable**[113]

B. *Passive Entity Exemption*

As discussed above in Part I.A, generally all entities having state law limited liability protection that are organized in Texas or otherwise doing business in Texas, even if disregarded for federal income tax purposes, are considered taxable entities for Texas franchise tax purposes and subject to tax unless a specific exclusion or exemption applies.[114] Exemptions from

106. *Id.* § 171.101(a)(2), (3).

107. *Id.* § 171.103.

108. *Id.* § 171.105.

109. *Id.* § 171.101(a), (b).

110. *Id.* § 171.002(a). Lower rates and discounts apply in certain situations. *See id.* § 171.0022 (providing for temporary permissive rates for 2014); *see also id.* § 171.0023 (providing for temporary permissive rates for 2015).

111. Tex. H.B. 32, 84th Leg., R.S. (2015).

112. *Id.*

113. Taxpayers that meet a certain gross revenue threshold are not required to pay the tax. *See* TAX § 171.002(d)(2) (illustrating when certain revenues are earned, a taxable entity is not required to pay any tax). For the 2015 Texas Franchise Tax Report, this revenue threshold is $1,080,000. *See id.* § 171.002(d)(2) ("A taxable entity is not required to pay any tax and is not considered to owe any tax for a period if . . . the amount of the taxable entity's total revenue from its entire business is less than or equal to $1,000,000 or the amount determined under Section 171.006 per 12–month period on which margin is based."); *see also* TEX. COMPTROLLER OF PUB. ACCOUNTS, FORM 05-163, TEXAS FRANCHISE TAX NO TAX DUE INFORMATION REPORT (2013), http://comptroller.texas.gov/taxinfo/taxforms/05-163-a-14.pdf (reporting mechanisms for identifying total revenue when no tax is due if threshold requirements are met). This exemption from tax is commonly known as the small business exemption.

114. Ohlenforst, *supra* note 20, at 962 (stating that, while some describe the Texas franchise tax as "applicable to all entities that have limited liability under state law, the list of taxable entities is more specific than, and sometimes inconsistent with that description" (citing TAX § 171.0002 (West Supp. 2007))).

Texas franchise tax exist for certain charitable entities,[115] certain small businesses,[116] and entities generating a substantial amount of passive income.[117] It is this last exemption, the exemption from taxable entity status for what are statutorily defined as "passive entities," that is the subject of this Article.[118] More specifically, this Article discusses the passive entity exemption as applied to entities generating passive *rental* income.[119]

To be an exempt passive entity for Texas franchise tax purposes, Section 171.0003(a) provides the entity must: (1) be a general partnership, limited partnership, or trust (other than a business trust)[120] and (2) during the period upon which tax is computed, the organization's federal gross income must consist of at least 90% of certain defined passive income.[121]

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115. *See generally* TAX § 171.063 (providing a list of nonprofit corporations exempt from federal income tax and the rules governing such exemptions).

116. *See id.* § 171.002(d) (stating a taxable entity is not required to pay any tax if the amount of tax owed is less than $1,000 or the entity's total revenue from its entire business is less than or equal to a threshold amount).

117. *See id.* §§ 171.0002(b)(3), 171.0003, 171.001(c) (stating a franchise tax is not imposed on entities qualifying as passive entities).

118. Because an entity meeting the requirements for passive entity status under Section 171.0003 is *excluded* from the definition of taxable entity, it may be more appropriate to refer to Section 171.0003 as an exclusion rather than an *exemption*. *See, e.g.*, Ohlenforst, *supra* note 20, at 967 (observing that, even though a passive entity is defined as one not subject to the tax, the statute confusingly lists four categories of specific passive entities that are not included in the definition of a taxable entity so long as additional criteria are met). That being said, because most commentators and practitioners refer to Section 171.0003 as the passive entity *exemption*, this Article will likewise refer to Section 171.0003 in such manner.

119. *See supra* Part III.

120. TAX § 171.0003(a)(1); 34 TEX. ADMIN. CODE § 3.582(c)(1) (West 2015). Although not specifically set forth in the statute, the Texas Comptroller takes the position that LLPs can be passive entities. *Franchise Tax Frequently Asked Questions: Passive Entities*, TEX. COMPTROLLER OF PUB. ACCOUNTS, http://comptroller.texas.gov/taxinfo/franchise/faq_pass_ent.html (last visited Dec. 17, 2015) (noting in Question 2, an LLP "may qualify as a passive entity" (citing TAX § 171.0003(a)(1))). Limited liability companies, however, cannot be exempt passive entities. *See* TAX § 171.0003(a)(1) (listing general partnerships, limited partnerships, and trusts, other than a business trust, as entities that qualify as a passive entity); *see also* 34 ADMIN. § 3.582(c)(1) (indicating the entities that qualify as a passive entity); *Franchise Tax Frequently Asked Questions: Passive Entities*, *supra* (interpreting, at Question 3, Section 171.0003(a)(1) not to include LLCs). Notably, the federal income tax classification of the entity is irrelevant for passive entity status purposes. *See* TAX § 171.0003(a)(1) (limiting the types of entities that qualify as passive entities). Thus, an entity classified and taxed as a partnership for federal income tax purposes cannot be classified as a passive entity for Texas franchise tax purposes unless such entity is also organized as a partnership for state law purposes. *Id.*; *see* Daniel J. Micciche, Real Estate and Passive Entities: Special Margin Tax Issues, Presentation at the University of Texas Margin Tax Conference (Feb. 11, 2010), *in* 2010 TEXAS MARGIN TAX: A TAX ADVISOR'S GUIDE TO THE TOUGH ISSUES 1, 10 (2010)("Limited liability companies cannot qualify as passive entities even if they are taxable as partnerships for federal income tax purposes.").

121. TAX § 171.0003(a); 34 ADMIN. § 3.582(c).

Section 171.0003(a) defines the term "passive income" to include:

> (1) dividends, interest, foreign currency exchange gain, periodic and nonperiodic payments with respect to notional principal contracts, option premiums, and cash settlement or termination payments with respect to a financial instrument;
> (2) income from a limited liability company and distributive share income from a partnership;
> (3) capital gains from the sale of real property, gains from the sale of commodities traded on a commodities exchange, and gain from the sale of securities; and
> (4) royalties, bonuses, or delay rental income from mineral properties and income from other nonoperating mineral interests.[122]

In addition, to be a passive entity for Texas franchise tax purposes, Section 171.0003(a)(3) provides the entity must not receive more than 10% of its federal gross income from conducting an active trade or business.[123] The definition of "conducting an active trade or business" is set forth in Section 171.0004(b).[124] This section provides an entity conducts an active trade or business if:

> (1) the activities being carried on by the entity include one or more active operations that form a part of the process of earning income or profit; and
> (2) the entity performs active management and operational functions.[125]

Section 171.0004 also sets forth three specific activities that are not considered conduct of an active trade or business.[126] Activities falling outside of the active trade or business category include: "(1) ownership of a royalty interest or a nonoperating working interest in mineral rights[,] . . . (2) payment of compensation to employees or independent contractors for financial or legal services reasonably necessary for the operation of the entity[,] . . . and (3) holding a seat on the board of directors of an entity."[127]

In addition to these three enumerated activities not being considered the conduct of an active trade or business for purposes of the 10% test,

122. TAX § 171.0003(a)(2); 34 ADMIN. § 3.582(c)(2). Federal definitions of passive income do not apply for purposes of Section 171.0003. *See* Micciche, *supra* note 120, at 7 ("Federal definitions of 'passive' income are not applicable. And intuitive notions of the meaning of 'passive entities' (such as the incorrect assumption that corporations that are pure holding companies are passive entities) are not helpful and tend to confuse taxpayers.").

123. TAX § 171.0003(a)(3); 34 ADMIN. § 3.582(e).

124. TAX § 171.0004(b).

125. *Id.*

126. *Id.* § 171.0004(e).

127. *Id.*; 34 ADMIN. § 3.582(f).

the Texas Franchise Tax Code further provides income statutorily defined as "passive income" in Section 171.0003(a)(2) is not treated as income from the conduct of an active trade or business for purposes of the 10% test.[128]

Because income classified as passive for purposes of the 90% test is not counted toward the 10% active trade or business test, it is unclear whether the 10% active business test serves any real purpose.[129] There does not appear to be any situation where a taxable entity could meet the 90% passive income test but fail to satisfy the 10% active business test.[130] In fact, based on how the statute is currently written, it seems mathematically impossible.[131] For example, putting the two tests together, if, at a minimum, an entity has 90% in federal gross revenues from the certain enumerated passive sources and such passive income cannot be counted within the 10% active trade or business test, an entity might have 10% of income that would fit within the 10% active trade or business test, but it could never have "more than 10[%]."[132]

It is speculated this disconnect in Section 171.0003 resulted from the Texas Legislature combining multiple draft bill provisions without having a sufficient amount of time to review and redraft due to the time constraints associated with the enactment of H.B. 3.[133] Notably, early versions of H.B. 3928, the technical corrections bill to H.B. 3, proposed deleting the 10% active trade or business test.[134] However, in the end, the

128. TAX § 171.0003(a-1); 34 ADMIN. § 3.582(e).

129. *See* Ohlenforst, *supra* note 20, at 967 ("It appears unclear whether a taxable entity could ever meet the 90%-passive test but fail the ten-percent-active-test. The overlapping definitions apparently resulted from combining multiple draft provisions without the time or redrafting that typically accompanies major tax legislation."). A technical corrections bill was passed after the passage of H.B. 3, but it did not address the issue of the 90% passive and 10% active tests under the passive entity exception. Tex. H.B. 3928, 80th Leg., R.S. (2007).

130. Ohlenforst, *supra* note 20, at 967.

131. *See* TAX § 171.0003(a) (mentioning an entity is a passive entity if its federal gross income consists of at least 90% of income, such as from dividends, capital gains, or royalties, and the entity does not receive more than 10% of its federal gross income from an active trade or business).

132. *Id.* § 171.0003 (a)(2)–(3), (a-1).

133. Ohlenforst, *supra* note 20, at 967. The Senate Journal shed light on the time constraints associated with H.B. 3:

> Senator Ogden requested that the following remarks be reduced to writing for the purpose of establishing legislative intent on H.B. 3: Senator Averitt: Senator Ogden, isn't it true that we are trying not to amend this bill so we can be sure to get our work done in this brief special session? Senator Ogden: Yes.

S.J. of Tex., 79th Leg., C.S. 91 (2006). See *supra* note 59 and accompanying text for a discussion on the short timeframe involved in the passage of H.B. 3.

134. *See* Ohlenforst, *supra* note 20, at 967 (noting early versions of the technical corrections bill

10% active trade or business test was not repealed and continues to remain part of the Texas Franchise Tax Code.[135]

Despite the statutory prohibition in Section 171.0003(a-1) stating that income specifically classified as passive for Texas franchise tax purposes cannot be treated as active trade or business income for purposes of the 10% active trade or business test, the Texas Comptroller proposed an administrative rule in October 2009 (approximately a year and a half after the effective date of H.B. 3) seeking to broaden the scope of the 10% active trade or business test beyond the statutory language.[136] The proposed administrative rule sought to cause income specifically defined as passive income in Section 171.0003(a)(2) to lose its passive status unless it was merely an investment and not generated as part of the entity's operations.[137] The proposed rule also sought to make income received as part of an investment in another entity not passive, even if otherwise enumerated as passive income in the statute and if the investing entity, affiliate thereof, or individual controlled the investee.[138] The Texas Comptroller's proposed language, which was to be added in Comptroller Rule 3.582, is set forth below (underlined portion denoting the proposed language):

> (e) Conducting an active trade or business. To be considered a passive entity, an entity may not receive more than 10% of its federal gross income for the period on which margin is based from conducting an active trade or business. Income described by subsection (c)(2) of this section, may not be treated as income from conducting an active trade or business, <u>if the income is not part of the receiving entity's operations and is merely an investment. If the investment is in another entity, the investing entity or an affiliated entity or individual, may not control the investee. For example, if a partnership buys bonds issued by an entity, interest income from the bonds would be considered as passive income. However, if a partnership is in the business of making loans, interest income from the loans would not be considered passive income</u>.[139]

The State Bar of Texas Tax Section and the Texas Society of Certified Public Accountants opposed the amended rule and recommended it not be added to Comptroller Rule 3.582(e) because the language went beyond

proposed removing the "not more than ten percent" active income requirement).

135. *See* TAX § 171.0003(a)(3) ("[T]he entity does not receive more than 10[%] of its federal gross income from conducting an active trade or business.").

136. 34 Tex. Reg. 7559 (2009) (codified at 34 TEX. ADMIN. CODE § 3.583 (West 2015)).

137. *Id.*

138. *Id.*

139. *Id.*

the plain language of the statute, Section 171.0003(a-1), which defines certain types of income as passive without giving any circumstances when such income would not be considered passive for purposes of the passive entity exception.[140] The Texas Comptroller ultimately withdrew the proposed language.[141] The withdrawal appeared to be an acknowledgement by the Texas Comptroller that income meeting the definition of passive income in Section 171.0003(a)(2) cannot also be active trade or business income for purposes of the 10% active trade or business test without a statutory amendment to Section 171.0003.[142] The Texas Comptroller's Office specifically stated:

> Although the comptroller believes that the legislature did not intend for income from active operations to be included in passive income, she agreed that the current language of the statute does not provide this differentiation and has withdrawn the amendment.[143]

Based on the foregoing, the types of income classified as passive income for purposes of the passive entity exemption are quite broad. As broad as it is, however, certain income is not considered passive under any circumstances.[144] Income fitting into this category include: "(1) rent[,][145] [and] (2) income received by a nonoperator from mineral properties under a joint operating agreement if the nonoperator is a member of an affiliated

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140. Matthew Larsen, *State Bar of Texas Section of Taxation State and Local Tax Committee's Comments Concerning the Texas Comptroller's Draft Rule 3.582 as Published in the Texas Register, October 30, 2009*, TEX. TAX LAW., Winter 2010, at 70, 70–78, http://www.texastaxsection.org/Content/Newsletters/Winter_2010.pdf (publishing concerns the State and Local Tax Committee submitted months earlier to the Comptroller).

141. 34 TEX. ADMIN. CODE § 3.582(e) (West 2015).

142. One Texas law firm client alert described the rule change:

> [T]he Comptroller's apparent capitulation on the issue of whether passive income can also be active income is the first written acknowledgment by the Comptroller of something that many practitioners have suspected since the margin tax was implemented—that the active business provisions in [Section 171.0003(a)(3)] have little practical significance.

Update on Rule Changes for the Texas Passive Entity Exemption, BAKER BOTTS LLP (Feb. 3, 2010) (on file with the *St. Mary's Law Journal*).

143. 34 Tex. Reg. 7559 (2009) (codified at 34 TEX. ADMIN. CODE § 3.583 (West 2015)).

144. TEX. TAX CODE ANN. § 171.0003(b) (West 2015); 34 ADMIN. § 3.582(d).

145. *See* TAX § 171.0003(b)(1) (providing that rent, and income from mineral properties in certain circumstances, is not considered passive income); *Franchise Tax Frequently Asked Questions: Passive Entities*, *supra* note 120 (explaining in response to Question 1, "[r]ent is not considered passive income for the Texas franchise tax"). Note, however, that the generation of some rental income will not disqualify an entity from being an exempt passive entity—the key is the entity meets the 90% passive income requirement. *See* TAX § 171.0003(a)(2) ("[D]uring the period on which margin is based, the entity's federal gross income consists of at least 90[%] of the following income . . . ."); Micciche, *supra* note 120, at 10 ("[I]f an entity meets the criteria as a passive entity, the entity may qualify as passive even if the entity has some rental income.").

group and another member of that group is the operator under the same joint operating agreement."[146]

The prohibition against rental income ever being considered passive income for purposes of the passive entity exemption is the subject of this Article.[147]

Before moving any further, it is important to note the passive entity exemption is not a complete exemption from tax to the extent there are owners of the passive entity (direct or indirect) that are taxable entities with nexus in Texas and the subject passive income has not been previously taxed.[148] This results from Section 171.1011(e), which provides

> [a] taxable entity that owns an interest in a passive entity shall exclude from the taxable entity's total revenue the taxable entity's share of the net income of the passive entity, but only to the extent the net income of the passive entity was generated by the margin of any other taxable entity.[149]

The corresponding Comptroller Rule 3.587(c)(4) similarly provides "[a] taxable entity will include its share of net distributive income from a passive entity, but only to the extent the net income of the passive entity was not generated by any other taxable entity."[150] The effect of these provisions is that a passive entity is only a permanent "stopper" of taxation when the owners of the passive entity are individuals, entities that are not taxable entities for Texas franchise tax purposes, or entities that do not have a nexus with Texas for franchise tax purposes.[151]

It is also important to note the passive entity exemption applies only if the entity qualifies during the period in which the Texas franchise tax report is based.[152] Texas franchise tax reports (both under the pre-2008 tax system and the current tax system) are filed and tax, if any, is paid on a prospective basis for the privilege of doing business for what is called a "privilege period," but the tax computation is based on operating results

146. TAX § 171.0003(b)(2).

147. *See supra* Parts III–V.

148. TAX § 171.1011(e); 34 ADMIN. § 3.587(c)(4) ("A taxable entity will include its share of net distributive income from a passive entity, but only to the extent the net income of the passive entity was not generated by any other taxable entity.").

149. TAX § 171.1011(e).

150. 34 ADMIN. § 3.587(c)(4).

151. *See* TAX §§ 171.001(c), 171.0003(a)(2), 171.1532 ("The tax imposed under this section or Section 171.0011 is not imposed on an entity if, during the period on which the report is based, the entity qualifies as a passive entity as defined by Section 171.0003.").

152. *Id.* § 171.001(c).

from the prior period.[153] Thus, to determine whether an otherwise taxable entity is exempt from Texas franchise tax under the passive entity exemption for purposes of a 2016 Texas Franchise Tax Report due in May 2016, such entity would have to determine whether it met the 90% passive income qualification requirements based on operating results from 2015.[154]

II. APPLICATIONS OF THE PASSIVE ENTITY EXEMPTION

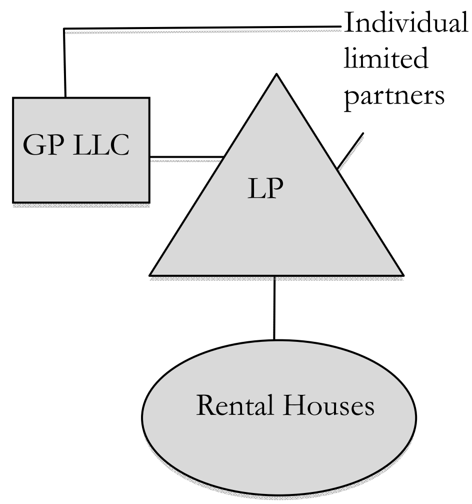
To fully understand the passive entity exemption, it is helpful to see how it works (or perhaps does not work, depending on the circumstances) through some examples. Because this Article focuses on rental income not being considered passive for Texas franchise tax purposes under any circumstances, the examples below center on rental income. In all examples assume the entity is operating solely in Texas.

Example A

Consider a limited partnership (LP) that owns various rental houses in Houston, Texas. LP leases the rental houses to various tenants. LP has a 1% general partner and five individual limited partners. The general partner interest is held by a limited liability company (LLC) that is owned, pro rata, by the individual limited partners. The rental houses are LP's sole assets, and LP's revenues consist solely of rental income. The individuals formed LP as an investment. LP and LLC have a December 31 year-end. This structure is illustrated below:

153. *See id.* §§ 171.0003(a)(2), 171.1532 (requiring a computation of 90% of federal gross income for the period on which margin is based); *see also* TEX. COMPTROLLER OF PUB. ACCOUNTS, 2014 TEXAS FRANCHISE TAX REPORT INFORMATION AND INSTRUCTIONS 3 (2013), http://comptroller.texas.gov/taxinfo/taxforms/05-900.pdf [hereinafter FRANCHISE TAX REPORT INFORMATION] (stating the passive entity exemption is determined if the 90% passive income requirement is satisfied "for the period upon which the franchise tax report is based").

154. *See* TAX §§ 171.0003(a)(2), 171.1532 (indicating 90% of the entity's federal gross income must be composed of particular items); FRANCHISE TAX REPORT INFORMATION, *supra* note 153, at 3 (stipulating the time frame that must be considered for passive entity exemption).



Even though the individuals formed LP solely as an investment, and therefore, the income would commonly be thought of as passive income, such is not the case for Texas franchise tax purposes.[155] Because rent is per se not passive, LP will not be exempt as a passive entity under the passive entity exemption.[156] Thus, LP will be subject to Texas franchise tax at the entity level.[157]

Example B

Assume the same structure as in Example A, except further assume LP sells all the rental properties in January 2015. Because the sale of the rental properties occurred in January 2015, further assume LP did not generate a significant amount of rental income during 2015 (calendar year 2015 being the period upon which passive entity status is determined for the 2016 Texas Franchise Tax report). Also assume LP had no other income during 2015 except a gain from the sale of the rental properties (which we will assume is treated as capital gain income for federal income tax purposes under the dealer/non-dealer status rules)[158] and the small amount rental

155. *See supra* Part I.B.

156. TAX § 171.0003(b)(1); *see also Franchise Tax Frequently Asked Questions: Passive Entities*, *supra* note 120 ("Rent is not considered passive income for the Texas franchise tax.").

157. *See supra* Part I.B. While LP is subject to Texas franchise tax, the individual partners will not be subject to tax because Texas does not have a personal income tax system.

158. *See infra* Part IV.

income attributed to the portion of January 2015 that LP still owned the rental properties. To put numbers to it, assume the rental income comprises 2% of LP's total income for 2015 and the capital gain income from the sale of the rental properties comprises the remaining 98% of LP's total income.

Section 171.0003 provides capital gain income from the sale of real property constitutes passive income.[159] Thus, even though LP could not be an exempt passive entity in Example A, in the year of sale of the rental properties, it is possible for LP to qualify as an exempt passive entity for the 2016 reporting period.[160] This often can happen in situations, such as in Example B, when the sale of the properties occurs at the beginning of the year (in our example, January 2015), thereby limiting the amount of non-passive rental income included in the 90% testing period.[161]

Example C

Assume the same structure as in Example A, but instead of the individuals investing in rental properties, they decide to invest in houses they will renovate and sell. Assume they will not be considered dealers in real property and the sale of the houses will generate capital gain income for federal income tax purposes.[162] Unlike the result in Example A, the facts in Example C will lead to LP being exempt from the Texas franchise tax as a passive entity, not because the underlying assets are different but because the revenue stream is different.[163] An odd result considering in both examples the individuals are earning investment income, which is typically considered passive income, and the investment properties in both Example A and Example C are the same.

Example D

Assume the same structure as in Example A, except now assume LP is a hedge fund with 1,000 employees and $50 billion in annual revenues. The types of income generated by LP include interest, dividends, and gains

159. TAX § 171.0003(a)(2)(C).

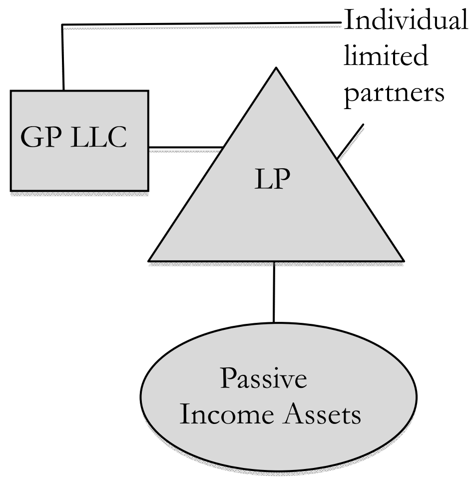
160. *See id.* ("An entity is a passive entity if . . . income consists of at least 90[%] of the following income . . . capital gains from the sale of real property.").

161. *See id.* § 171.0003 (indicating non-passive income is limited if the gross federal income is at least 90% of the sale of real property for the year).

162. *See infra* Part IV.

163. *See* TAX § 171.0003(a)(2)(C) (establishing capital gains from the sale of real property as a type of passive income but not establishing the same for rent); *see also* 34 TEX. ADMIN. CODE § 3.582 (West 2015) (restating the sale of real property requirement for passive entities under the Texas Tax Code).

from the sale of securities.[164] This structure is illustrated below:



Because interest, dividends, and gains from the sale of securities are considered passive income for purposes of the passive entity exemption, LP will be exempt from the Texas franchise tax as a passive entity.[165] It does not matter that LP is conducting an active business with employees because income that meets the definition of passive is not considered active for purposes of the 10% active trade or business test even if an active trade or business is being conducted.[166]

Example D highlights a result of the passive entity exemption that is likely not intuitive. An entity conducting an active trade or business can be exempt from the Texas franchise tax under the passive entity exemption if the business generates the "right" type of income, even if that income is from an active trade or business rather than by way of investment.[167]

164. Interest, dividends, and gains from the sale of securities are considered passive for purposes of the passive entity exemption. TAX § 171.0003(a)(2). Notably, the passive income designation for gains from the sale of securities is not limited to capital gains. *Id.* § 171.0003(a)(2)(C) ("[T]he entity's federal gross income consists of at least 90[%] . . . [of] gains from the sale of securities.").

165. *See id.* (evaluating elements such as interest, dividends, and gains from the sale of securities when determining the classification of a passive entity under the Texas Tax Code).

166. *See* ADMIN. § 3.582(e) ("Income described [as passive] . . . may not be treated as income from conducting an active trade or business."); *see also* TAX § 171.0003 (defining a passive entity based on its federal gross income rather than the type of business conducted).

167. *See* ADMIN. § 3.582 (requiring an entity to qualify as a passive entity based solely upon its

Although odd, the result is supported by the plain language of Section 171.0003.[168] If LP in Example D can be exempt from Texas franchise tax under the passive entity exemption, then it would seem LP in Example A (a limited partnership formed solely for an investment purpose) should also be able to obtain an exemption from the Texas franchise tax as a passive entity since it exists for an actual investment or passive purpose.

III. TREATMENT OF RENTAL INCOME NEEDS RETHINKING

The focus of this Article is on rental income and how it is not considered passive under any circumstances for purposes of the passive entity exemption. This section concludes the current treatment of rental income is incorrect and requires rethinking. The Texas Legislature should address the issue by amending the Texas Franchise Tax Code to allow certain types of rental income to be considered passive for purposes of the passive entity exemption. Subsections A and B below provide the reasoning behind this conclusion.

A. *Common Definitions of Rent and Passive Income*

A good starting point for arguing why the Texas Franchise Tax Code currently takes the wrong approach with respect to rental income is to look at the common definitions of "rent" and "passive income."

Black's Law Dictionary defines rent as:

> Consideration paid, usu[ally] periodically, for the use or occupancy of property (esp[ecially] real property).
>
> . . . .
>
> . . . A compensation or return made periodically by a tenant or occupant for the possession and use of lands or corporeal hereditaments; money; chattels, or services issuing usu[ally] annually out of lands and tenements as payment for use.
>
> . . . .
>
> . . . A contract by which one party conveys to another party a tract of

income and not on the type of business conducted so that a business conducting active trade may still be exempt if the income qualifies as passive).

168. Because the focus of this Article is solely rental income under the passive entity exemption, this Article does not address a legislative amendment involving Section 171.0003(a-1) to foreclose the result in Example D by changing the way the 10% active trade or business requirement currently works. This Article focuses on the treatment of rental income for purposes of the passive entity exemption. *See infra* Parts III–VI.

> land or other immovable property, to be held by the other party as owner and in perpetuity, in exchange for payment of an annual sum of money or quantity of fruits.[169]

Notably, the definition does not indicate that rent constitutes per se non-passive income.

Similarly, the definition of "rental" in *Black's Law Dictionary* makes no such indication.[170] According to *Black's Law Dictionary*, rental means: "The amount received as rent[,] . . . . income received from rent[,] [or] record of payments received from rent."[171]

The *Black's* definition of "passive income" is more instructive: "Income derived from a business, rental, or other income-producing activity that the earner does not directly participate in or has no immediate control over."[172]

Notably, in this definition of passive income, rent is specifically included as a possible type of passive income.[173]

B. *Treatment of Rent for Federal Income Tax Purposes*

For federal income tax purposes, the Internal Revenue Code generally treats rental income as per se passive income—the exact opposite of how the Texas Franchise Tax Code treats rental income—or classifies rental income as either passive or active depending on underlying circumstances.[174] There are several provisions in the Internal Revenue Code that illustrate these approaches. These include Internal Revenue Code Sections 469, 904, 1297, 7704, 512, 1362, 1375, 1411, 1244, and 543.[175] These Internal Revenue Code provisions are each discussed separately below.

1. Internal Revenue Code § 469

Section 469 is likely the federal income tax provision that first comes to

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169. *Rent*, BLACK'S LAW DICTIONARY (10th ed. 2014).

170. *Rental*, BLACK'S LAW DICTIONARY (10th ed. 2014) (lacking any mention of passive income in the definition of "rental").

171. *Id.*

172. *Passive Income,* BLACK'S LAW DICTIONARY (10th ed. 2014).

173. *Id.*

174. *Compare* INTERNAL REVENUE SERV., PUBL'N NO. 925, PASSIVE ACTIVITY AND AT-RISK RULES 3 (2015), https://www.irs.gov/pub/irs-pdf/p925.pdf ("A rental activity is a passive activity even if you materially participated in that activity . . . ."), *with* 34 TEX. ADMIN. CODE § 3.582 (West 2015) ("The income described by subsection (c)(2) of this section [qualification of a passive entity], does not include: (1) rent . . . .").

175. I.R.C. §§ 469, 512, 543, 904, 1244, 1297, 1362, 1375, 1411, 7704 (2012).

mind when the concept of passive income is mentioned.[176] Section 469 involves the ability (or not) of certain taxpayers to take loss deductions generated from passive activities.[177] In a nutshell, it provides that losses generated from passive activities cannot be used to offset income from non-passive activities.[178] Section 469 was enacted as part of the Tax Reform Act of 1986 and was aimed at preventing tax shelter abuse activity.[179] Prior to the Act of 1986, there were few limitations on a taxpayer's ability to use losses from one activity to offset income from other activities, which encouraged many taxpayers to invest in tax shelters.[180] Many tax shelters were specifically created to produce substantial losses from passive activities that could then be used to offset non-passive income, including wage income.[181] The provisions of Section 469, which are commonly known as the "passive loss rules," impede such sheltering by providing that losses from passive activities can only be used to offset passive income.[182]

In classifying what is considered passive income, Section 469 generally treats rental income as per se passive.[183] An exception to passive status exists for real estate activities conducted by real estate operators.[184] The rationale for Section 469's treatment of rental income is discussed in Part IV.

2. Internal Revenue Code § 856

Section 856 applies to real estate investment trusts (commonly referred to as REITS).[185] If an entity qualifies as a REIT, it is entitled to

176. *See id.* § 469 (defining what qualifies as a passive activity).

177. *See id.* (citing special rules for the determination of income or loss from passive activity).

178. *See id.* (disallowing losses resulting from passive activity); *see also* Daniel N. Shaviro, *Passive Loss Rules*, 549 2d Tax Mgmt. (BNA) Portfolio, at A-1 ("To impede such sheltering, the rules establish a category of 'suspect' activities (passive activities), the losses and excess credits from which generally cannot be used to shelter income from other types of activities (nonpassive activities).").

179. Shaviro, *supra* note 178, at A-1.

180. *See id.* (discussing tax shelters prior to the Tax Reform Act of 1986).

181. *See id.* ("[S]helters were designed to produce substantial tax losses and excess credits that could be used against positive income from sources such as salary, interest, and dividends.").

182. *Id.*

183. *See* I.R.C. § 469 ("Passive activity includes any rental activity."); *see also* Shaviro, *supra* note 178, at A-34 (treating rental income in such manner because it generally produces losses for tax purposes even if the activity is profitable and, in certain cases, even when the amount of work required to conduct the activities does not require material participation).

184. *See* I.R.C. § 469 (outlining the tax treatment of individuals in the real property business); *see also* Shaviro, *supra* note 178, at A-34 (noting this provision was added to the Internal Revenue Code in 1993).

185. *See* I.R.C. § 856 ("For purposes of this title, the term 'real estate investment trust' means a

preferential pass-through tax treatment and, therefore, avoids entity-level taxation.[186] Congress enacted the REIT provisions in 1960 "to provide a tax-preferred method by which average investors could invest" in real estate assets that were professionally managed.[187] There are many requirements that must be satisfied to constitute a REIT.[188] One requirement involves two income tests, which mandate a sufficient amount of the REIT's income come from real estate investment-type income (i.e., passive income).[189] Qualifying income includes rent from real property, among other types of income.[190]

3. Internal Revenue Code § 904

Section 904 provides certain limitations on taking foreign tax credits.[191] Pursuant to Section 904, the total amount of foreign tax credits taken cannot exceed the same proportion of the tax against which such credit is taken—which the taxpayer's taxable income from sources outside the United States (but not in excess of the taxpayer's entire taxable income) bears to the taxpayer's entire taxable income for the same tax year.[192] This limitation is applied separately with respect to passive income versus what is known as general category income.[193] The term "passive income" is defined by reference to Internal Revenue Code Section 954(c), which includes rent, among other types of income.[194]

Subsection (c)(2)(A) of Section 954 then provides an exception to passive income classification in certain circumstances.[195] Under this exception, passive income classification does not extend to rents derived in the "active conduct of a trade or business" and received from a person other than a related person.[196]

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corporation, trust, or association . . . .").

186. *Id.*; *see also* Anna T. Pinedo et al., *Frequently Asked Questions About Real Estate Investment Trusts*, MORRISON & FOERSTER, http://media.mofo.com/files/Uploads/Images/FAQ_REIT.pdf (last visited Dec. 17, 2015) ("An entity that qualifies as a REIT under the Code is entitled to preferential tax treatment. It is a 'pass-through' entity that can avoid most entity-level federal tax . . . .").

187. Pinedo et al., *supra* note 186.

188. *See* I.R.C. § 856 (defining a REIT).

189. *See id.* § 856 (c)(2), (3) (detailing the income requirements for REITs).

190. *See id.* (providing for the qualification of income from real property).

191. *See id.* § 904 (discussing the limitations imposed on the taking of foreign tax credits).

192. *Id.*

193. *Id.*

194. *Id.* § 954(c).

195. *Id.* § 954(c)(2)(A).

196. *Id.*

Thus, by way of Section 954(c), Section 904 distinguishes between rental income earned from active operations and a passive investment.[197] The definition of passive income from Section 954(c) is further discussed immediately below.

4. Internal Revenue Code § 1297

Section 1297 provides rules related to passive foreign investment companies (commonly called PFICs).[198] Congress enacted the rules related to PFICs in 1986 with the intent of limiting the ability of U.S. persons to make investments through foreign corporations and, therefore, avoiding U.S. taxation.[199] Generally, a foreign corporation is a PFIC if 75% or more of its gross income for the taxable year comes from what is defined as "passive income."[200] The term passive income for this purpose generally means the same income defined in Section 954(c) as "foreign personal holding company income."[201] This includes, but is not limited to, dividends, interest, royalties, rents, annuities, and net gains from the sale or exchange of property (except inventory) that produce dividends, interest, royalties, rents, or annuities.[202] Accordingly, the rules related to PFICs treat rent, by default, as passive income.[203] However, there are exceptions.[204] Rent is not considered passive if received from the active conduct of a trade or business.[205] Further, certain rents received from related persons are not considered passive.[206] Thus, as is discussed above with respect to Section 1297, the rules related to PFICs recognize certain streams of rental income are properly categorized as

197. *Compare id.* § 954(c) (excepting rent from active business), *with id.* § 904 (allowing rent to be treated as passive under certain circumstances).

198. I.R.C. § 1297 (2012).

199. *See* STAFF OF J. COMM. ON TAXATION, 99TH CONG., GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1986, at 1023 (Comm. Print 1987) ("Congress did not believe that tax rules should effectively operate to provide U.S. investors tax incentives to make investments outside the United States rather than inside the United States."); *see also* H.R. REP. NO. 99-841, at 641 (1986) (Conf. Rep.) (discussing the conference agreement and general rule applied to U.S. shareholders in PFICs).

200. I.R.C. § 1297.

201. *Id.*

202. *See id.* § 1297(b)(2) (providing interest, dividend, rent, or royalty received from a related person are not passive income).

203. *See id.* § 1297(b) ("'Passive' income means any income which is of a kind which would be a foreign personal holding company income as defined in [S]ection 954(c).").

204. *See id.* § 1297(b)(2) (stipulating the exceptions to the general definition of passive income).

205. *See id.* (providing passive income does not include income "derived in the active conduct of a banking business" or "derived in the active conduct of insurance business").

206. *Id.* § 1297(b)(2)(C).

passive income, and other streams are properly categorized as active income.[207]

5. Internal Revenue Code § 7704

Section 7704 provides rules related to publicly traded partnerships.[208] Section 7704 treats certain entities that are not corporations for state law purposes (e.g., a limited partnership) as corporations for federal income tax purposes.[209] The term "publicly traded partnership" generally means any partnership where the interests in the partnership are (1) "traded on an established securities market" or (2) "readily tradable on a secondary market."[210] However, there is an exception to corporate treatment for partnerships that meet a gross income test.[211] The gross income test requires, for any taxable year, 90% or more of the gross income of the partnership consist of certain passive income (commonly known and statutorily called "qualifying income").[212] Qualifying income includes, but is not limited to, interest, dividends, real property rents, gain from the sale or other disposition of real property, and certain gains from the sale or disposition of capital assets.[213] The term "real property rent" for this purpose, in turn, means certain amounts that would qualify as rent from real property pursuant to Internal Revenue Code Section 856(d).[214] Again, a recognition that some types of rental income are properly treated as passive income.

6. Internal Revenue Code § 512

Section 512 provides the rules regarding unrelated business taxable income earned by charitable organizations in which the unrelated business income tax is imposed.[215] Certain types of passive income are exempted

207. *See id.* § 1297 (outlining specifications of passive income as well as exceptions).

208. *Id.* § 7704.

209. *See id.* § 7704(a) (providing a publically traded partnership "shall be treated as a corporation").

210. I.R.C. § 7704(b) (2012).

211. *See id.* § 7704(c) (establishing a publically traded partnership need not be treated as a corporation if it does not meet gross income requirements).

212. *See id.* (providing a partnership meets defined gross income requirements if, during any taxable year, "90[%] or more of the gross income" consists of qualifying income).

213. *See id.* § 7704(d) ("[T]he term 'qualifying income' means . . . interest . . . dividends . . . real property rents . . . gain from sale or other disposition of property . . . any gain from the sale or disposition of a capital asset . . . .").

214. *See id.* ("The term 'real property rent' means amounts which would qualify as rent from real property under section 856(d) . . . .").

215. *Id.* § 512.

from being treated as unrelated business taxable income and are therefore not subject to the unrelated business income tax.[216] Rental income is included within this category of passive income, as well as dividends, interest, and other types of investment income.[217]

7. Internal Revenue Code §§ 1362, 1375, 1411, 1244, 543

Section 1362(d)(3)(C) provides that "passive investment income" means "gross receipts derived from royalties, rents, dividends, interest, and annuities."[218]

Similarly, Section 1375, by cross reference to Section 1362, defines "passive investment income" as "gross receipts derived from royalties, rents, dividends, interest, and annuities."[219]

Likewise, Section 1411, which is a somewhat new tax imposed on net investment income, classifies rental income to be passive income.[220]

Furthermore, Section 1244, related to ordinary losses on small business stock, treats rent as passive income.[221] And finally, Section 543, relating to personal holding companies, treats certain types of rental income as passive income.[222]

* * *

As illustrated above, it is deeply entrenched in federal income tax law for rental income to be generally treated as passive income, or for there to be a dichotomy between rental income being classified as passive income or active income depending on underlying circumstances.[223]

This creates an initial interesting question for purposes of this Article. Recall that the starting point for computing Texas franchise tax is federal gross income. Pursuant to Section 171.1011, subsections (c), (d), and (e), the computation of total revenue (i.e., the starting point for computing

216. *See id.* (providing modifications to taxable income, such as "dividends, interest, payments with respect to securities loans," annuities, and royalties).

217. *See id.* ("[T]here shall be excluded all dividends, interest, payments with respect to securities loans . . . all rents from real property . . . all rents from personal property . . . .").

218. *Id.* § 1362.

219. *Id.*

220. *See* I.R.C. § 1411(c)(1) (2012) (providing "net investment income" means the excess of the sum of "gross income from interest, dividends, annuities, royalties, and rents, other than such income which is derived in the ordinary course of a trade or business not described in paragraph (2)").

221. *See id.* § 1244 (explaining rent is treated as "passive income" because a domestic corporation, to be considered having stock under the meaning of Section 1244, must have "derived more than 50[%] of its aggregate gross receipts from sources other than royalties, *rents*, dividends, interests, annuities, and sales or exchanges of stocks or securities" (emphasis added)).

222. *Id.* § 543.

223. *See supra* Part III.B.

Texas franchise tax) begins with certain federal gross revenue line items that carryover from an entity's federal income tax return.[224] For example, for a taxable entity that is a corporation for federal income tax purposes, Section 171.1011(c) directs that total revenue is determined by adding the amount reportable on line 1c of the entity's IRS Form 1020 and the amounts reportable as income on lines 4 through 10 of the entity's IRS Form 1020.[225] Certain subtractions are then made, many of which are also geared off of federal income tax principles and specific Internal Revenue Code provisions.[226] The Texas Franchise Tax Code also makes other references to the Internal Revenue Code in computing the amount of tax due and even defines the term "Internal Revenue Code."[227]

An initial query then is whether an argument can be made that the various passive income provisions from the Internal Revenue Code should carryover as well for Texas franchise tax computation purposes, either generally and/or for purposes of the passive entity exception.[228] Any argument that federal income tax principles apply to the passive entity exemption, however, breaks down when you look at the specific definitions of passive income contained in Section 171.0003,[229] which were discussed in Part I.

Thus, even though certain federal income tax concepts and provisions carryover to the Texas franchise tax, the specific definitions related to passive income in Section 171.0003 trump and debunk any argument that passive income definitions from the Internal Revenue Code apply to the passive entity exemption.[230]

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224. TEX. TAX CODE ANN. § 171.1011(c), (d), (e) (West 2015).

225. *See id.* § 171.1011(c) (explaining the method of computing the total revenue of a taxable entity). Section 171.1011(c)(1)(A)(iii) also references the addition of "any total revenue reported by a lower tier entity as includable in the taxable entity's total revenue under Section 171.1015(b)." *Id.* § 171.1011(c)(1)(A)(iii). This relates to the special rules in the Texas Franchise Tax Code for tiered partnerships. A discussion of tiered partnerships is beyond the scope of this Article.

226. *See id.* § 171.1011(c)(1)B) (providing the necessary items that must be subtracted). In turn, when the Texas Franchise Tax Code references the Internal Revenue Code, it is defined to mean "the Internal Revenue Code of 1986 in effect for the federal tax year beginning on January 1, 2007, not including any changes made by federal law after that date, and any regulations adopted under that code applicable to that period." *Id.* § 171.0001(9).

227. *See id.* ("'Internal Revenue Code' means the Internal Revenue code of 1986 in effect for the federal tax year beginning on January 1, 2007, not including any changes made by federal law after that due date, and any regulations adopted under that code applicable to that period.").

228. *See id.* § 171.0001 (providing a franchise tax imposed under this section will not be imposed on a passive entity as defined by Section 171.003).

229. *See id.* § 171.0003 (providing the definition of a passive entity).

230. *See* Micciche, *supra* note 120, at 7 ("Federal definitions of a 'passive' income [are] not applicable. And intuitive notions of the meaning of 'passive entities' (such as the incorrect

IV. STATUTORY CHANGE NEEDED: SUGGESTED PROPOSAL

Part III illustrates that the common definition of passive income includes rent.[231] It further shows the Internal Revenue Code broadly treats rental income as passive and/or recognizes a dichotomy between rental income being classified as either passive or active income based on the underlying activities related to the generation of the income. Treating rent in these ways is opposite to the treatment of rent for purposes of the passive entity exemption under the Texas Franchise Tax Code where rent is not considered passive under any circumstances.[232]

Because it seems clear that rental income can be passive, at least in certain circumstances, the Texas Franchise Tax Code should be amended to treat rent in this way for purposes of the passive entity exemption.[233] Not only would this change bring the treatment of rental income more in line with how such income is generally treated for federal income tax purposes but also, more importantly, it would create a rule that accurately depicts rental income as passive income in some cases, based on the activities of the taxpayer.[234]

This change in law would require legislative action because Section 171.0003 appears clear on its face that rental income is not to be treated as passive and there are no circumstances indicated in the statute that an exception is ever appropriate.[235] Legislative history also indicates legislative action is required to make the change suggested in this Article.[236] For example, the Texas Tax Reform Commission Report, which was written by the Texas Tax Reform Commission and formed the

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assumption that corporations that are pure holding companies are passive entities) are not helpful and tend to confuse taxpayers.").

231. *See* I.R.C. § 1244 (2012) (delineating the rules associated with losses on small business stock); *see also id.* § 543 (communicating how any royalties from business computers are not to be treated as passive income).

232. *Compare* TAX § 171.0003(b)(1) (noting how rent is not included in the definition of passive entity), *with Franchise Tax Frequently Asked Questions: Passive Entities*, *supra* note 120 ("Rent is not considered passive income for the Texas franchise tax.").

233. *See supra* Part III (proposing how the Texas legislature should amend the Texas Franchise Tax Code, so that certain types of rental income can be considered passive under the passive entity exemption).

234. *See supra* Part III.B (stating how the Internal Revenue Code typically treats rental income as per se passive income).

235. *See* TAX § 171.0003 (noting how rent is not included in the definition of passive entity).

236. *See* TAX FAIRNESS, *supra* note 18, at 11–17 (providing legislative history for the current Section 171.0003); *see also* TEX. TAX REFORM COMM'N, SECTION BY SECTION BILL ANALYSIS TAX REFORM 1–6 (2006), http://govinfo.library.unt.edu/ttrc/ (follow "Tax Reform Analysis" hyperlink) (last visited Dec. 17, 2015) [hereinafter SECTION BY SECTION BILL ANALYSIS] (outlining the reformed franchise tax calculation).

basis for H.B. 3, unequivocally provided that rent was not to be treated as passive income.[237] The Texas Tax Reform Commission Report stated:

> Exemptions: The following businesses are exempt from tax:
> - sole proprietorships;
> - general partnerships owned entirely by natural persons;
> - passive unincorporated investment entities, where at least 90% of revenue is from passive investments *(rent is not considered passive income)*;
> - non-profit and other organizations currently exempt from the franchise tax; and
> - businesses with $300,000 or less in total revenue.[238]

This same intent was seen in the Commission's initial analysis when they determined rent was not to be treated as passive under any circumstances:[239]

> Definition of passive entity: Passive entity is a general or limited partnership or trust, other than a business trust, where at least 90% of federal gross income from investments such as dividends, interest, distributive shares of partnership income, capital gains, and royalties. . . . *Rent income would not be considered passive income*.[240]

With it seemingly clear legislative action would be required for rent (that is, certain types of rent, as recommended in this Article) to be considered passive income for purposes of the passive entity exemption under the Texas Franchise Tax Code, the question then becomes: What is the recommended change to the current statutory language?

When first embarking on this project, the idea was to link Section 171.0003 to Internal Revenue Code Section 469.[241] The thought behind this idea was if rental income would be considered passive income for purposes of Internal Revenue Code Section 469, then such income should also be considered passive for purposes of the passive entity exemption.[242] Linking Section 171.0003 to Internal Revenue Code Section 469 would create a fairly easy system since a large majority of entities that can avail themselves to the passive entity exemption

237. *See* TAX FAIRNESS, *supra* note 18, at 24 (laying out the various business franchise tax exemptions and not including rent in a passive income calculation).

238. *Id.* (emphasis added).

239. *See* SECTION BY SECTION BILL ANALYSIS, *supra* note 236, at 2 (illustrating rent in a similar manner by noting it is not a passive entity).

240. *Id.* (emphasis added).

241. *See* TEX. TAX CODE ANN. § 171.0003 (West 2015) ("The income described by Subsection (a)(2) does not include . . . rent.").

242. *See* I.R.C. § 469 (2012) ("Passive activity includes any rental activity.").

(i.e., limited partnerships and trusts) are likely subject to, and therefore familiar with, Section 469 of the Internal Revenue Code.[243] But after further review, it was determined that making Section 469 the benchmark, while administratively convenient, would not be the best approach because of its underlying purpose.[244]

Congress enacted Section 469 in response to the extensive use of tax shelter structures by taxpayers.[245] In particular, Congress responded to tax shelter structures involving taxpayers who had losses from passive sources (e.g., from investments) that were used to offset active-source income (e.g., wage income).[246] To obstruct these structures, Section 469 created a category of what was known as suspicious activities (called passive activities) and made losses from such activities usable only to offset income from those activities.[247] Stated differently, Section 469 mandates losses from passive activities cannot be used to shelter income from non-passive activities.[248]

With respect to rent, Section 469 generally treats rental income as per se passive.[249] The significance of this treatment is that rental income is treated as passive income without regard to whether the taxpayer has materially participated or whether the activities involve the conduct of a trade or business, which are two requirements generally required to negate application of Section 469.[250] The thought process behind treating rental income as per se passive involved two underlying rationales: (1) rental activities usually produce tax losses even when profitable;[251] and (2) the amount of work needed to conduct rental activities is generally minimal so the material participation requirement would not serve to obstruct the tax

243. *See id.* (containing provisions dealing with limited partnerships and trusts).

244. *See supra* Part III.B.1.

245. *See* STAFF OF J. COMM. ON TAXATION, 99TH CONG., GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1986, at 210 (Comm. Print 1987) ("Extensive shelter activity contributed to public concerns that the tax system was unfair, and to the belief that tax is paid only by the naïve and the unsophisticated.").

246. *See* I.R.C. § 469 (noting in some circumstances, passive losses may offset active income).

247. *See id.* (stating how passive activities are generally handled).

248. *See id.* ("Treatment of former passive activities").

249. *See* Fitch v. Comm'r, 104 T.C.M. (CCH) 828, Nos. 157-10, 27401-10, 27417-10, 2012 WL 6698701, at *18–19 (Dec. 26, 2012) (interpreting I.R.C. § 469(c)(2), finding rental income is "generally treated as per se passive").

250. *See id.* (regarding rental income as passive under I.R.C. § 469(c)(2), "regardless of whether the taxpayer materially participates").

251. *See generally* SMALL BUS. TAXES & MGMT., SPECIAL REPORT: TAX IMPLICATIONS OF INVESTING IN RENTAL PROPERTIES (2014), http://www.SMBIZ.com/sbspec513.html (commenting, generally, on passive activity losses, specifically in regards to rental property).

sheltering Section 469 was designed to impede.[252]

The purpose behind Section 469, and more specifically its treatment of rental income, is much different from the underlying purpose and rational of the Texas Franchise Tax Code's passive entity exemption. The intent of the passive entity exemption in Section 171.0003 is not to prevent tax shelter activities but instead to provide an exemption from Texas franchise tax to entities that generate predominately passive income.[253] It has nothing to do with curbing tax shelter activities.[254] With the rationales behind Section 469 of the Internal Revenue Code and the passive entity exemption not being aligned, it would not be appropriate to use Section 469 to amend Section 171.0003. Thus, the original theory was abandoned.

The better approach is to use the rules related to determining whether a taxpayer is a dealer in real estate or securities as a backdrop and the dealer rules related to installment sales to create a fact-intensive test similar to the test for deciding dealer versus non-dealer status for federal income tax purposes.[255]

The addition of a fact-intensive test should not be unworkable from either the Texas Comptroller's viewpoint or that of taxpayers because at least one statutory fact-based test already exists in the Texas Franchise Tax Code.[256] For example, Section 171.1014, which creates a combined group-reporting requirement for affiliated entities, contains a unitary condition that involves a fact-intensive test.[257] This test is built within several sections.[258] First, Section 171.1014(a) provides, "Taxable entities that are part of an affiliated group engaged in a unitary business shall file a combined group report in lieu of individual reports based on the combined group's business."[259] The "unitary" prong of Section 171.1014

252. *See* Shaviro, *supra* note 178, at A-1 to A-2 (describing the application of passive loss rules to various losses and credits from certain passive activities).

253. *See* TAX FAIRNESS, *supra* note 18, at 19 (explaining the tax would apply to active businesses while exempting businesses with passive incomes); SECTION BY SECTION BILL ANALYSIS, *supra* note 236, at 1–6 (describing the specifics of the franchise tax reform and defining the appropriate terms).

254. *See* TAX FAIRNESS, *supra* note 18, at 18 ("The clear intention of the law's original framers—that the franchise tax should be imposed in exchange for the state's liability shield—remains the guiding light for the Commission's recommendation.").

255. *Cf.* United States v. Winthrop, 417 F.2d 905, 909–10 (5th Cir. 1969) (outlining the most common factors to be considered in determining the identity of an individual's property).

256. *See* TEX. TAX CODE ANN. § 171.0001(17) (West 2015) (establishing the factors to consider when determining whether a unitary business subsists); *Id.* § 171.1014(c) (incorporating multiple factors to determine a group's total revenue).

257. *See id.* § 171.1014 (requiring an affiliated group to file as a single entity).

258. *E.g.*, *id.* (instituting factors to consider in assessing the total revenue of a unitary business).

259. *Id.* § 171.1014(a).

is where the fact-intensive test comes into play.[260] Subsection 17 of Section 171.0001 defines "unitary" as:

> [A] single economic enterprise that is made up of separate parts of a single entity or of a commonly controlled group of entities that are sufficiently interdependent, integrated, and interrelated through their activities so as to provide a synergy and mutual benefit that produces a sharing or exchange of value among them and a significant flow of value to the separate parts. In determining whether a unitary business exists, the comptroller shall consider any relevant factor, including whether:
>
> (A) the activities of the group members are in the same general line, such as manufacturing, wholesaling, retailing of tangible personal property, insurance, transportation, or finance;
>
> (B) the activities of the group members are steps in a vertically structured enterprise or process, such as the steps involved in the production of natural resources, including exploration, mining, refining, and marketing; or
>
> (C) the members are functionally integrated through the exercise of strong centralized management, such as authority over purchasing, financing, product line, personnel, and marketing.[261]

Likewise, to solve the issue addressed in this Article, a fact-intensive test could be similarly built into Section 171.0003 and the definitional provisions of Section 171.0001.

This could easily be accomplished with only three amendments to the Texas Franchise Tax Code. First, amend Section 171.0003(a)(2) to add a new subsection (E) providing that passive income includes certain types of passive rent (as a defined term).[262] Second, amend Section 171.0003(b) to provide that rent is not passive if it does not meet the requirements for being classified as the defined term passive rent.[263] Third, add a new defined term in Section 171.0001, as subsection (19), to provide the defined term "passive rent," which would be the key provision as it would provide for the types of rental income that would be considered passive for purposes of the passive entity exemption.[264]

Example proposed language is set forth below (underlining indicates

260. *See id.* § 171.1014(b) (noting an affiliated group will be considered a single entity).

261. *Id.* § 171.0001(17).

262. *Compare id.* § 171.0003(a)(2) (listing what should be considered an entity's federal gross income), *with id.* § 171.0003(b)(1) ("The income described in Subsection (a)(2) does not include . . . rent . . . .").

263. *See id.* § 171.0003(b) (discounting rent as a form of income).

264. *See generally id.* § 171.0001 (offering definitions to terms used throughout Chapter 171 of the Tax Code).

additions to the existing statutory language):

Proposed Statutory Amendment to Section 171.0003(a)(2):[265]
"(E) passive rent as defined by Section 171.0001(19)."

Proposed Statutory Amendment to Section 171.0003(b)(1):[266]
"(b)(1) rent unless included within the definition of passive rent as set forth in Section 171.0001(19)."

Suggested Statutory Amendment to Section 171.0001:[267]

> (19) 'Passive rent' means rental income generated from passive activities. Passive rent is determined on a property-by-property basis and not collectively by looking at a taxpayer's entire portfolio of rental properties. In determining whether rental income is passive income, no one factor is controlling, and the comptroller shall consider any relevant factor, including the following:
>
> (A) the nature and purpose of the acquisition of the rental property;
> (B) use of a business office to lease the rental property;
> (C) whether or not the taxpayer engages in a trade or business separate from the rental property;
> (D) whether or not the rental property would generate a capital gain for federal income tax purposes if sold;
> (E) whether a broker was used to lease the rental property;
> (F) extent of advertising;
> (G) the time and effort the taxpayer habitually devoted to the rental property;
> (H) the character and degree of supervision or control exercised by the taxpayer over any representative involved in renting the property; or
> (I) whether or not the taxpayer regularly purchases property to rent to customers in the ordinary course of a trade or business.

Undoubtedly, regulations would be necessary to provide guidance on the terms "trade or business," "ordinary course," "habitually," and other terms and issues related to the statutory language.

The key to the above proposal is the added definition of passive rent as new subsection (19) to Section 171.0001. As indicated above, the proposed definition is built from the rules in the Internal Revenue Code that determine whether a taxpayer is a dealer or non-dealer for federal income tax purposes, specifically using as a backdrop the rules related to

265. *See id.* § 171.0003(a)(2) (providing a list of income classified as passive income for the passive entity exemption).

266. *See* TEX. TAX CODE ANN. § 171.0003(b)(1) (West 2015) (providing that rent, under no circumstances, is considered passive income for the passive entity exemption).

267. *See generally id.* § 171.0001 (outlining the general definitional section of the Texas Franchise Tax Code).

determining whether a taxpayer is a dealer in real estate, securities, or for installment sales purposes.[268]

Some background with respect to these federal income tax provisions may be useful to show their relevance to the proposed definition of "passive" rent. As background, with respect to real estate dealer versus non-dealer status principles, these federal income tax rules largely go toward determining whether a taxpayer qualifies for capital gains rates upon the sale of real property.[269] The determination is a factual one because it is necessary to make an inquiry into the taxpayer's motivation for owning the property.[270] The factors listed below were set forth in *United States v. Winthrop*,[271] and are often cited as the relevant factors:

> 1. [T]he nature and purpose of the acquisition of the property and the duration of the ownership;
> 2. the extent and nature of the taxpayer's efforts to sell the property;
> 3. the number, extent, continuity, and substantiality of the sales;
> 4. the extent of subdividing, developing, and advertising [the property] to increase sales;
> 5. the use of a business office . . . ;
> 6. the character and degree of supervision or control exercised by the taxpayer over any representative selling the property; and
> 7. the time and effort the taxpayer habitually devoted to the sales.[272]

No one factor controls. The Fifth Circuit stated in *Biedenharn Realty Co. v. United States*:[273]

> No one set of criteria is applicable to all economic structures. Moreover, within a collection of tests, individual factors have varying weights and magnitudes, depending on the facts of the case. The relationship among factors and their mutual interaction is altered as each criteria increases or

268. *See, e.g.*, Todd D. Golub & Richard M. Lipton, Preserving Capital Gains in Real Estate Transactions, Presentation at the William & Mary Annual Tax Conference (Nov. 13, 2008), *in* 54 ANN. TAX CONF. 1, 3 (2008), http://scholarship.law.wm.edu/cgi/viewcontent.cgi?article=1045&context=tax (indicating the courts have utilized factors in determining the identity of a taxpayer—dealer or non-dealer).

269. *See id.* (asserting the more difficult areas of tax law are determining whether an individual's real property is held as a capital asset or for investment and whether the same individual is a dealer or non-dealer).

270. *See id.* (specifying factors to consider when determining a taxpayer's motivation for his or her real property).

271. United States v. Winthrop, 417 F.2d 905 (5th Cir. 1969).

272. *Id.* at 910; *accord* Golub & Lipton, *supra* note 268, at 3 (acknowledging the factors, outlined in *Winthrop*, used to determine whether an asset is capital).

273. Biedenharn Realty Co. v. United States, 526 F.2d 409 (5th Cir. 1976).

diminishes in strength, sometimes changing the controversy's outcome.[274]

Courts (including the Fifth Circuit in *Biedenharn Realty*) have noted, however, the most important factor is frequency and substantiality of sales.[275]

The Fifth Circuit, in *Suburban Realty Co. v. United States*,[276] built upon the factors by developing three questions to be answered in applying the various factors:

> 1. [W]as taxpayer engaged in a trade or business, and, if so, what business?
> 2. [W]as taxpayer holding the property primarily for sale in that business?
> 3. [W]ere the sales contemplated by taxpayer "ordinary" in the course of that business?[277]

Although abundant case law interprets these three questions and the relevant factors, the above cases lay out the basic framework.[278]

Because a fact-based analysis is used for determining dealer versus non-dealer status, Section 453 of the Internal Revenue Code is also relevant to the proposed definition of passive rent.[279] Section 453 addresses the installment method of income tax accounting with respect to the disposition of property if one or more payments are to be received after the end of the tax year in which the disposition of the property occurs.[280] Dealers in real or personal property, however, are not entitled to use the installment method.[281] This rule is similar to that discussed above where dealers in real property are not entitled to beneficial capital gain rates. A "dealer" transaction is one that is engaged in by a taxpayer who "regularly sells or otherwise disposes of personal property of the same type on . . . [an] installment plan . . . [or] [a]ny disposition of real property

274. *Id.* at 415.

275. *See id.* at 416 (giving this factor "preeminent ground" in the court's analysis); Golub & Lipton, *supra* note 268, at 3 (noting *Biedenharn*'s analysis and the agreement of other courts).

276. Suburban Realty Co. v. United States, 615 F.2d 171 (5th Cir. 1980).

277. *Id.* at 178.

278. *See generally* Fahs v. Crawford, 161 F.2d 315, 317 (5th Cir. 1947) (deciding a sale by a lawyer who held one subdivision for a period of time and then sold it did not qualify as "in the ordinary course of business" because he was not regularly in the real estate business); Flood v. Comm'r, 104 T.C.M. (CCH) 217, No. 29379-08, 2012 WL 3656317, at *11 (Aug. 27, 2012) (holding "[t]he preponderance of credible evidence supports a conclusion that the Floods' real-estate transactions were conducted in the ordinary course of a trade or business and not for investment); Golub & Lipton, *supra* note 268, at 3–12 (discussing factors, methodology, and inquiries used to determine dealer versus investor status).

279. *See* I.R.C. § 453 (2012) (laying out the method for differentiating dealers from non-dealers).

280. *See id.* (defining installment sale accounting and the scope of its application).

281. *See id.* § 453(b)(2)(A) (excluding dealers specifically).

which is held by the taxpayer for sale to customers in the ordinary course of the taxpayer's trade or business."[282]

The following factors, which are similar to those discussed above with respect to capital gain rates and dealers in real property sales, are used by the courts to determine if a taxpayer is a dealer in personal property for Section 453 purposes: (1) number and frequency of installment sales; (2) ratio of installment sales to total sales; and (3) whether the taxpayer advertises to the public the availability of installment sales.[283] With respect to Section 453 and real estate dealers, the courts use the following factors, which are also similar to those already discussed: (1) frequency, continuity, and number of sales; (2) extent that the taxpayer engages in sales activities; (3) length of time the property was held by the taxpayer; (4) ratio of income from real property sales to the taxpayer's total income; (5) extent of advertising; (6) taxpayer's purpose in acquiring the property; and (7) whether a real estate broker was used to sell the property.[284]

Also analogous are the rules related to securities dealers found in Section 475.[285] Section 475 generally requires dealers to mark to market their securities, except for those properly identified as not for sale or held for investment.[286] The term "securities" generally includes: (1) stock; (2) partnership interests in "widely held or publicly traded partnership[s]"; (3) notes and bonds; (4) interest rates, currencies, or equity notional principal contracts; (5) evidence of an interest, or a derivative financial instrument, or certain hedges, related to one of the foregoing securities.[287] Subsection (c)(1) of Section 475, in turn, defines a "dealer" in securities to include taxpayers who "(A) regularly purchase[] securities from or sell securities to customers in the ordinary course of a trade or business; or (B) regularly offer to enter into, assume, offset, assign, or otherwise terminate positions in securities with customers in the ordinary course of . . . business."[288] The key element for dealer status under Section 475 is a customer relationship.[289]

282. *Id.* § 453(l)(1)(A)–(B).

283. *See, e.g.*, Lisa Marie Starczewski, *Installment Sales*, 565 3d Tax Mgmt. (BNA) Portfolios, at A-6 (demonstrating how courts utilize Section 453).

284. *See id.* (noting the factors used to determine a real estate dealer for capital gain versus ordinary income purposes are similar to those used for Section 453 purposes).

285. *See* I.R.C. § 475 (outlining the accounting method for securities dealers).

286. *See id.* § 475(a), (b) (describing securities and exceptions to the accounting requirement).

287. *Id.* § 475(c)(2).

288. *Id.* § 475(c)(1).

289. *See, e.g.*, Arberg v. Comm'r, 94 T.C.M. (CCH) 215, No. 15376-05, 2007 WL 2416230, at *11 (Aug. 27, 2007) ("Dealers are those who are engaged in the business of buying and selling securities and whose business involves sales to customers.").

Regulations indicate the existence of a customer relationship is to be determined by looking at "all of the facts and circumstances."[290] Dealer status under Section 475 is also dependent on the taxpayer engaging in activities in the "ordinary course of a trade or business."[291] Neither Section 475 nor the regulations thereunder define the term "trade or business," but court decisions provide insight. Generally, courts have considered two primary factors in making this determination: (1) the continuity, extent, and frequency of the activities; and (2) the taxpayer's intent to produce income or make a profit.[292] The trade or business must also be carried on in the "ordinary course."[293] This is also a determination that is to be made based on all facts and circumstances.[294] Section 475 also contains a regularity requirement.[295] The term "regularly" is not defined for Section 475 purposes, but it has been defined in other contexts. For example, the rules associated with unrelated business income tax provide that the term "regularly" must be interpreted by giving proper regard to the "frequency and continuity with which the activities . . . are conducted."[296] Activities occurring sporadically will generally not meet the threshold for being considered regularly carried on.[297]

The reason for providing the above detail is to show the relevance of the federal dealer versus non-dealer status rules to the Texas franchise tax passive entity exemption and why it makes sense to use these rules in developing the definition of "passive rent," which forms the basis of the proposal set forth in this Article. In particular, the federal dealer versus non-dealer rules are generally focused on determining whether a taxpayer is earning income from the conduct of an active trade or business or from

290. Treas. Reg. § 1.475(c)-1(a) (1996).

291. I.R.C. § 475(c)(1).

292. *See, e.g.*, Comm'r v. Groetzinger, 480 U.S. 23, 35 (1987) (defining an activity as a trade or business where the taxpayer is "involved in the activity with continuity and regularity and . . . [where] the taxpayer's primary purpose for engaging in the activity . . . [is] for income or profit").

293. I.R.C. § 475(b)(1)(B).

294. *See* Guardian Indus. Corp. v. Comm'r, 21 F.3d 427, 427 (6th Cir. 1994) (unpublished table decision) (affirming the tax court's finding of fact regarding whether property was held for sale in the ordinary course of the petitioner's trade or business); Reinach v. Comm'r, 373 F.2d 900, 904 (2d Cir. 1967) (affirming, after a thorough review of the facts, that the taxpayer's sale was not within the ordinary course of a trade or business).

295. *See* I.R.C. § 475(c)(1) (defining a dealer as one who engages in certain activities "regularly").

296. Treas. Reg. § 1.513-1(c)(1) (1983).

297. *See, e.g.*, Suffolk Cty. Patrolmen's Benevolent Assoc. v. Comm'r, 77 T.C. 1314, 1321 (1981), *acq.*, 1984-2 C.B. 2 ("[S]ome activities occur so infrequently that neither their recurrence nor the manner of their conduct will cause them to be considered regularly carried on.").

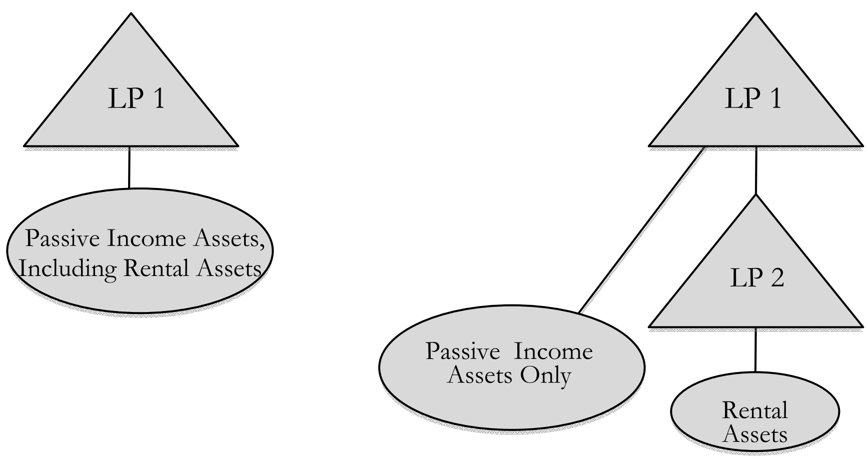
passive investment activities.[298] Similarly, the intent of the passive entity exemption in Section 171.0003 is to exempt taxpayers who earn predominantly passive income from Texas franchise tax.[299] Building the proposed new definition of "passive rent" around the federal dealer versus non-dealer rules should lead to a result where rental income generated from a passive investment is classified as passive income and counted toward the 90% passive income test.[300] This outcome would solve the problem presented in this Article.

V. WHAT ABOUT THIS STRUCTURE? DOESN'T IT SOLVE THE PROBLEM WITHOUT LEGISLATIVE ACTION BEING REQUIRED?

A structure currently used to take advantage of the passive entity exemption, even when rental income (or other non-passive income) exceeds the allowable threshold, involves carving out rental income by moving the rental income-generating assets into a subsidiary limited partnership.[301] This structure is illustrated below.[302]

ILLUSTRATION:

Before *Post-restructuring*



298. Golub & Lipton, *supra* note 268, at 3.

299. *See supra* Part I.B.

300. *See supra* text accompanying notes 267–69 (proposing amendments to Sections 171.0001 and 171.0003).

301. *See, e.g.*, Ray Langenberg & Karey W. Barton, Planning Opportunities and Pitfalls, Presentation at the University of Texas School of Law Margin Tax Conference (Feb. 11, 2010), *in* 2010 TEXAS MARGIN TAX: A TAX ADVISOR'S GUIDE TO THE TOUGH ISSUES 1, 13 (2010).

302. *Id.*

Using this "carve-out" structure, newly created LP 2 that directly holds the rental income generating assets would be a taxable entity for Texas franchise tax purposes.[303] But LP 1, post-restructuring, would be able to qualify for the passive entity exemption since, after the transfer of the rental income generating assets to LP 2, LP 1's income consists entirely of passive income for Texas franchise tax purposes (i.e., distributive share income from LP 2 and a stream of passive income from LP 1's direct ownership of the other passive income assets).[304]

The present ability to use this structure, however, does not solve the issue presented in this Article. First, as previously illustrated herein, some rental income is, in fact, passive.[305] Taxpayers should not be forced to incur the increased costs of creating more complicated than necessary structures in order to cause what truly is passive income to be classified as passive income for purposes of the passive entity exemption of Section 171.00003.[306]

Second, because rental income is, in fact, passive income in certain circumstances, such income should help qualify an entity for the passive entity exemption by being part of the 90% passive income computation.[307] Instead, under existing rules, not only does passive rental income not help an entity qualify for passive entity status, it hinders the entity's ability to qualify. The "carve out" structure described above does nothing to solve that issue.

Third, assuming an entity only generates passive rental income and has no other revenue streams, the "carve out" structure described above does nothing to solve the problem presented in this Article.

VI. CONCLUSION

The Texas Legislature recently completed another legislative session.[308] On the tax front, the legislature passed House Bill (H.B.) 32, known as the Franchise Tax Reduction Act of 2015.[309] It was signed by Governor Greg Abbott on June 15, 2015 and becomes effective on January 1, 2016.[310] Remarkably, the only thing accomplished by H.B. 32 was a

303. *Id.* at 13–14.

304. *Id.*

305. *See supra* Part III.

306. *See supra* Part III.

307. *See supra* Part I.B.

308. *Dates of Interest: 84th Legislature*, TEX. LEGISLATURE ONLINE, http://www.tlc.state.tx.us/dates/dates%20of%20interest.pdf (last visited Dec. 17, 2015).

309. H.B. 32, 84th Leg., R.S. (2015).

310. *Id.*

simple rate reduction, which reduced the 1% rate by 25% to 0.75%.[311]

The Franchise Tax Reduction Act of 2015 did not address the many substantive issues that exist within the Texas Franchise Tax Code. These problems require the Texas Legislature's attention.[312] This Article addresses one of those issues: the prohibiting of rent from being classified as passive income for purposes of the passive entity exemption in Section 171.0003 under any circumstance. Not classifying rent as passive income under any circumstance goes against how rent is categorized and treated for federal income tax purposes and also how rent is commonly classified and treated generally in non-tax legal contexts. While, at least in this author's opinion, it would not make sense to treat all rental income as passive income for purposes of the passive entity exemption, it does make sense to treat some rental income as passive income. Indeed, the underlying purpose of the passive entity exemption is to exempt passive investors from tax, and some passive investors invest in rental property thereby earning rental income.[313]

This issue, addressed herein, can be solved only by legislative amendment to the Texas Franchise Tax Code. This Article provides proposed language to implement the legislative amendment. With the next legislative session set to begin in early 2017, the hope is this Article will serve as a call to the Texas Legislature to focus on addressing substantive issues in the Texas Franchise Tax Code, including the one addressed in this Article.[314] Real changes, not just simple rate reductions, are needed.[315] Substantive changes are necessary to ensure the tax system is fair, equitable, and makes sense.

311. Other rates, such as the reduced rate for wholesalers, were likewise reduced. *Id.*

312. *See id.* (providing only rate reductions and no substantive changes to Texas franchise tax).

313. *See supra* Part I.B.

314. *See supra* Parts III–V.

315. *See, e.g.*, H.B. 32, 84th Leg., R.S. (2015) (addressing no substantive changes to Texas franchise tax).