

No. 12-0518

In The Supreme Court of Texas

IN RE NESTLE USA, INC., *Relator*

Original Proceeding

RELATOR'S MOTION FOR REHEARING

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TO THE HONORABLE SUPREME COURT OF TEXAS:

Until the opinion issued in this case on October 19, 2012 (the “Opinion”), this Court had never opined on the requirements of the Equal and Uniform Clause with respect to a franchise tax. Nestle takes no exception to the considerations and criteria for an equal and uniform franchise tax pronounced by the Court in the Opinion. Nestle moves for rehearing, however, because certain provisions of the franchise tax fail the very tests for equality and uniformity pronounced by the Court. The Opinion states, “Nestle has not established that the franchise tax violates the Equal and Uniform Clause.” Opinion at p. 23. Nestle files this motion for rehearing to explain the violations of the Equal and Uniform Clause within the franchise tax under the tests pronounced in the Opinion and to ask the Court to modify the Opinion to declare unconstitutional, under both the Equal and Uniform Clause of the Texas Constitution and the Equal Protection Clause of the Fourteenth Amendment to the United States Constitution, the specific provisions of the franchise tax that fail the equal and uniform test pronounced by the Court.

I. Certain provisions within the franchise tax fail the test for equal and uniform taxation stated in the Opinion.

The Court concludes that the Equal and Uniform Clause permits but limits the Legislature’s authority to create classifications within the franchise tax, which authority the Court concludes is narrower than the rational basis test of Equal Protection. Opinion at p. 19. Rejecting a rational basis test, the Court sets out its own test under the Equal and Uniform Clause for a franchise tax. First, the Court states as a general principle that

the Equal and Uniform Clause permits classifications in tax legislation that pursue tax policy goals, but not other policy goals. Opinion at p. 20. Under that general principle, the Equal and Uniform Clause permits the Legislature to use the franchise tax “to advance policies relating to doing business in Texas” but not to pursue goals—even tax goals—external to the franchise tax. Opinion at p. 20 (“[I]t cannot be used, for example, to circumvent the requirement that the ad valorem property tax be based strictly on property value.”) Second, the Equal and Uniform Clause requires franchise tax classifications to “attempt to group similar things and differentiate dissimilar things.” *Id.* Third, the Equal and Uniform Clause requires franchise tax classifications to “relate to differences in doing business that affect the value of the privilege.” *Id.* Various provisions of the franchise tax fail one or more of these criteria.

A. Having rejected the rational basis test under the Equal and Uniform Clause, the Opinion improperly dismisses Nestle’s complaints with a rational basis analysis.

The Opinion rejects the rational basis test of Equal Protection advanced by the State because “it would reduce the Equal and Uniform Clause to a prohibition against irrational legislation.” Opinion at pp. 19-20. Yet, on page 22, the Opinion denies two of Nestle’s complaints with a rational basis analysis.

First, the Opinion rejects Nestle’s complaint that the Legislature excluded independent contractors from the Compensation deduction because “the Legislature could certainly conclude that employers’ burdens—like compensation, unemployment insurance, and vicarious liability—are greater than those for a business whose work is done by independent contractors.” Opinion at p 22. This is a rational basis standard. *See*

Nordlinger v. Hahn, 505 U.S. 1, 11 (1992). Furthermore, the rational basis attributed by the Court to the Legislature—that employers’ burdens are greater than those who engage independent contractors—is contradicted by other provisions of the franchise tax statute. Although the Legislature excluded independent contractors from the Compensation deduction, it did not exclude them from the Cost of Goods Sold (COGS) deduction. “Labor costs” are included in COGS, without regard to whether the labor is performed by employees or independent contractors.¹ Even more to the point, the Legislature expressly allowed a deduction from Total Revenue for payments to independent contractors working as salesmen² and performing artists³ and for independent contractors providing services to destination management companies⁴ and to courier and logistics companies.⁵ The Legislature could not rationally disallow a Compensation deduction for independent contractors generally and, at the same time, allow a COGS deduction and a Total Revenue deduction for certain independent contractors.

Next the Opinion rejects Nestle’s complaint that it is taxed at the higher rate for a manufacturer because “the Legislature could conclude . . . that such a taxpayer’s Texas business would benefit from its manufacturing activities out-of-state.” Although the rational basis test is concerned with what facts the Legislature rationally may have considered to be true, *see Nordlinger, supra*, the test for equal and uniform

¹ TEX. TAX CODE § 171.1012(c)(1) (West 2008).

² *Id.* § 171.1011(g)(1), (l).

³ *Id.* § 171.1011(g-5).

⁴ *Id.* § 171.1011(g-6).

⁵ *Id.* § 171.1011(g-7).

classifications within the franchise tax pronounced by the Court is whether the classifications advance policies relating to the privilege of doing business in Texas, whether they relate to the value of that privilege, and whether they group similar things and differentiate dissimilar things. As explained more fully below, the higher tax rate imposed on Nestle as an out-of-state manufacturer does not satisfy the Court’s test.

B. Provisions within the franchise tax that do not advance policies relating to the privilege of doing business in Texas violate the Equal and Uniform Clause.

The Opinion confirms that the franchise tax is unchanged with respect to its object—the privilege of doing business in Texas in entity form (the “Privilege”). Opinion at p. 20 (citing *Bullock v. National Bancshares Corp.*, 584 S.W.2d 268, 270 (Tex. 1979) (“The granting of the privilege to transact business in this state confers economic benefits, including the opportunity to realize gross income and the right to invoke the protection of local law. The Texas franchise tax is a tax on the value of this privilege.”) and *Gen. Dynamics Corp. v. Bullock*, 547 S.W.2d 255, 257 (Tex. 1976). *See also Ford Motor Co. v. Beauchamp*, 308 U.S. 331, 334 (1939) (“[The franchise tax] is obviously payment for the privilege of carrying on business in Texas.”)). Thus, the first test for equal and uniform taxation within the franchise tax is whether the Legislature has used the franchise tax to advance policies relating to the Privilege. Opinion at p. 20.

All Taxable Entities exercise the same Privilege—the opportunity to realize revenue in Texas as a legal entity separate and distinct from its owners. With the passage of the current franchise tax statute in 2006, the Legislature reinforced the object of the tax by newly imposing the tax on partnerships that exercise the Privilege and by expressly

excluding passive entities and quasi-entities such as estates, trusts, and escrow accounts from the definition of Taxable Entity.⁶ The 2006 legislation left in place complete exemptions from the tax for entities engaged in nonprofit, cooperative, charitable, religious, and educational pursuits.⁷ The excluded and exempted entities and quasi-entities do not exercise the Privilege, either because they are not legal entities separate from their owners, or because they do not realize economic benefits in that form, or both.⁸ These classifications represent *the very line* between entities that exercise the Privilege and those that do not.

The different deduction and tax rate schemes of the franchise tax advance no policy relating to the Privilege. The franchise tax allows a choice of General Deduction⁹ to Taxable Entities based on whether they sell goods or services, but that classification is simply unrelated to the Privilege. Taxable Entities that sell goods exercise the same Privilege as Taxable Entities that sell services. The limitation of the Compensation deduction to employees and owners of a business, to the exclusion of independent contractors,¹⁰ also is unrelated to the Privilege. Taxable Entities exercise the same

⁶ *Id.* § 171.0002.

⁷ *Id.* §§ 171.051-171.088.

⁸ The exemption in Section 171.052 for certain insurance companies is an exception to this general statement but is consistent with the object of the franchise tax. The exempted insurance companies operate in a market regulated by the State of Texas and therefore do not exercise the same privilege as Taxable Entities operating in an unregulated market. The privilege of regulated insurance companies is subject to insurance premium tax under Chapters 221-226 of the Texas Insurance Code.

⁹ The choice of General Deduction is only thinly veiled as a choice. By definition, only sellers of real and personal property have Cost of Goods Sold. TEX. TAX. CODE § 171.1012. All other taxpayers have zero COGS and are relegated to the Compensation deduction or the 30% cap. Thus, only sellers of real and personal property have a meaningful choice of deductions.

¹⁰ TEX. TAX CODE § 171.1013.

Privilege whether they employ workers or contract with workers. The different tax rates within the franchise tax also advance no policy related to the Privilege, as Taxable Entities that retail and wholesale goods exercise the same Privilege as all other Taxable Entities. All of these classifications fail the first criterion of the Court's equal and uniform test because they are unrelated to the rights or existence of Taxable Entities under state law and are unrelated to the opportunity of Taxable Entities to realize income in Texas.

C. Classifications within the franchise tax that do not attempt to group similar things and differentiate dissimilar things violate the Equal and Uniform Clause.

The second criterion pronounced in the Opinion for equal and uniform taxation within the franchise tax is that classifications must attempt to group similar things and differentiate dissimilar things. Opinion at p. 20.

The classification within the franchise tax that allows a Cost of Goods Sold deduction to lessors of heavy construction equipment, railcars, and automobiles, but not to lessors of other types of personal property, fails this criterion.¹¹ Although all lessors of personal property have expenses associated with the acquisition and ownership of the personal property leased, the franchise tax statute permits lessors of only these specific types of equipment to deduct those expenses as cost of goods sold. To allow a deduction only for certain, enumerated types of personal property leased, such that lessors of every other kind of personal property are not allowed a deduction for the same costs, does not group similar things.

¹¹ *Id.* § 171.1012(k-1).

The Opinion accepts the COGS limitation as a classification that increases equality and uniformity by noting that “in the House floor debate in 2006, legislators expressed concern that lessors of construction equipment would be treated unequally without the exclusion” Opinion at p. 23. While that is true, the House floor debate also reveals that the members understood fairness would have been uniformly and equally served if the provision had been expanded to include lessors of other capital-intensive equipment or not adopted at all. Representative John Otto moved to table the provision with this explanation:

What this amendment attempts to do is to basically give a deduction in cost of goods sold for motor vehicle rental, heavy construction equipment rental, and railroad rolling stock. I’m gonna have to make a motion to table for this reason: Why stop there? Because the intent of fairness is to treat everyone the same. And if we adopt this amendment, then someone else is going to come forward and say, wait a minute, I rent equipment in my trade or business. Let me put it in my cost of good sold. So for that reason, therefore, under the fairness doctrine, and not singling out anyone in particular to give them a benefit that other people do not have, I’m gonna make a motion to table this amendment.”¹²

The representatives understood that the amendment was discriminatory and that a tax which was equal and uniform would be more expensive:

Hartnett: This amendment lets a car rental company take depreciation, just like you can on an income tax. But there are lots of businesses, there are thousands of businesses, that would like to have this exact same deduction.

Otto: There are many businesses out there. The reason the fiscal note is so low on this items is that it has been limited to

¹² Debate on Tex. H.B. 3 on the Floor of the House, 79th Leg., 3rd C.S., Amendment No. 37, part 6, minute 22 (April 24, 2006), available at <http://www.house.state.tx.us/video-audio/chamber/#79>.

these items. If you were to put all the items that are subject to rental in this category, you're looking at a much higher fiscal note. That's my concern.¹³

Also:

Smith: Does this provision exclude barge rentals and ship rentals? It appears to me that this amendment would address particular businesses but not cover the wide spectrum of businesses that we might have.

Otto: You're correct Representative Smith and that's why I'm asking for the leeway to let the conference committee review this.

Smith: As you know and I know, the barges and the ships move more goods than anything else in the state of Texas. So I think it's being unfair to all industries. If you're gonna do it, you gotta include 'em all. If not, let's don't do it.

Otto: I agree with you.¹⁴

The House floor debate demonstrates that this provision fails the Court's second criterion under the Equal and Uniform Clause. The legislative process was not able to achieve equality and uniformity in this instance by grouping similar things, even though the House members were well aware that they had failed to do so and of the resulting unfairness. Legislation which attempts to address inequities in the franchise tax for only a fraction of affected taxpayers is the very definition of unequal and nonuniform treatment. Where the legislative process is unable to achieve equality and uniformity in spite of its effort, the Equal and Uniform Clause and the court should provide a backstop. That backstop in this instance is for this Court to declare this provision of the franchise

¹³ *Id.* at minutes 34-35.

¹⁴ *Id.* at minutes 40-41.

tax unconstitutional.

D. Classifications within the franchise tax that do not “relate to differences in doing business that affect the value of the privilege” violate the Equal and Uniform Clause.

The third criterion pronounced in the Opinion for an equal and uniform franchise tax is that classifications within the tax must relate to differences in doing business that affect the value of the Privilege. Although the Opinion extrapolates occupation tax concepts to the franchise tax in concluding that the Equal and Uniform Clause permits classifications within the franchise tax, Opinion at pp. 17-18, the franchise tax is imposed on the Privilege, and not on occupations. The value of the Privilege—which is the opportunity to realize income in Texas as a Taxable Entity—is not controlled by the line of business or the particular business activities of a Taxable Entity. To the extent a particular taxpayer makes more or less—that revenue factor is equally and uniformly accounted for by applying the same definition of revenue to all taxpayers.¹⁵ The value of the opportunity to realize a dollar of revenue is the same regardless of the business activity from which the dollar is earned, as the market has already accounted for every relevant factor (e.g., supply, demand, risk, cost of capital).

The Opinion notes that the classification in *Bullock v. Sage Energy Co.*¹⁶ “based on federal accounting requirements was invalid *because it bore no relation to doing business in Texas.*” Opinion at page 21 (emphasis added). *Sage Energy* stands for the proposition that, in valuing the privilege of two different corporations, a dollar of expense

¹⁵ TEX. TAX CODE § 171.1011(c).

¹⁶ 728 S.W.2d 465 (Tex.App.—Austin 1987, writ ref’d, n.r.e.).

is a dollar of expense. One corporation's intangible drilling costs are equivalent to another corporation's intangible drilling costs. *Sage* at 468 ("Irrespective of the class of accounting maintained by a corporation, intangible drilling costs have the same value to a corporation."). The difference in accounting methods that required Sage to capitalize IDCs and allowed another corporation to expense them resulted in a different—and unconstitutional—valuation of the privilege of doing business.

While only one type of expense was at issue in *Sage Energy*, the *Sage* reasoning is applicable to all income and expenses of a business under the franchise tax. The franchise tax is imposed in exchange for the opportunity to realize income as a Taxable Entity. In calculating income realized from exercising the Privilege, no item of expense is different from any other expense, so long as the expense is legitimate; and no item of income is different from any other item of income. Economically, these items of expense and income are the same, and legally, they should be treated as equal and uniform.

Thus, the difference in business activity that is the basis for allowing a Compensation deduction with respect to employees but not independent contractors does not affect the value of the Privilege. A dollar of expense related to an employee is equivalent to a dollar of expense related to an independent contractor; both reduce the income earned from the exercise of the Privilege by one dollar.

Similarly, a dollar of income earned by a wholesaler or retailer is equivalent to a dollar of income earned by a manufacturer. A dollar of income earned by a manufacturer does not have twice the value of a dollar of income earned by a retailer or wholesaler, and the Privilege does not have twice the value to a manufacturer, as the tax rate

classifications with the franchise tax would presuppose. It cannot be said that the value of the privilege to high profit margin retailers of luxury items is only one-half the value of the privilege to low profit margin manufacturers of mardi gras beads.

When the franchise tax departs from equal treatment of each dollar of income and each dollar of expense, it departs from the only characteristic of a business that signifies the value of the Privilege. The Privilege is the opportunity to realize income in Texas as a Taxable Entity, and the value of that Privilege is the income realized. If the legislature calculates the franchise tax differently according to particular business activities in which a corporation is engaged, the tax no longer values the Privilege, but instead values particular business activities. Classifications within the franchise tax based on certain business activities do not rationally correlate to the value of the Privilege and fail the third criterion of the Court's test for equal and uniform taxation.

II. Because certain franchise tax classifications violate the Equal and Uniform Clause of the Texas Constitution, they also violate the Equal Protection Clause of the United States Constitution.

Because the classifications within the franchise tax fail the requirements of the Equal and Uniform Clause, the classifications are unconstitutional under the Equal Protection Clause of the Fourteenth Amendment to the United States Constitution. *See Allegheny Pittsburgh Coal v. Webster County*, 488 U.S. 336 (1989).

PRAYER

Nestle's challenge to the franchise tax is a case of first impression as to both the constitutional questions presented and the statute under examination. The Opinion is the first decision of this Court that speaks to the requirements of the Equal and Uniform

Clause with respect to the franchise tax. The franchise tax statute is a lengthy and complex law that contains a measure of the tax not only new to Texas, but also unique among franchise taxes in the United States. Nestle prays the Court, now having determined the limitations of the Equal and Uniform Clause on classifications within the franchise tax, modify the Opinion to apply the newly-pronounced test to the classifications within the franchise tax and to declare those classifications unconstitutional under the Equal and Uniform Clause of the Texas Constitution and the Equal Protection Clause of the Fourteenth Amendment to the United States Constitution. While Nestle appreciates the demand on the Court's resources presented by this case, the same urgency that prompted the Legislature to grant the Court exclusive, original jurisdiction in this proceeding now calls for the precise application of the test for equality and uniformity pronounced by the Court to the classifications within the franchise tax.

