

Texas Court Upholds Single Sales Factor – Rejects Use of Multistate Tax Compact Evenly-weighted, Three-factor Apportionment Election for Texas Franchise Tax

January 24, 2014

Overview

On January 15, 2014, the District Court of Travis County, Texas, 353rd Judicial District (“District Court”) issued an Order granting a Motion for Partial Summary Judgment brought by the Texas Comptroller (“Comptroller”), enjoining Graphic Packaging Corporation (“Graphic”) from using the Multistate Tax Compact (the “Compact”) evenly-weighted, three-factor apportionment formula to compute Texas Franchise Tax (commonly referred to as the “Texas Margin Tax”).¹ Also, on that same date, the District Court denied Graphic’s Motion for Summary Judgment, asking the court to confirm Graphic’s right to use the Compact three-factor formula.² Graphic had filed a petition in District Court on September 27, 2012, challenging the Comptroller’s earlier rejection of the use of the three-factor formula. The cross-motions for summary judgment followed Graphic’s filing of its petition in the case.

In this Tax Alert we summarize the proceedings and arguments presented by the parties.

Background

In its Motion for Summary Judgment, Graphic sought confirmation of its right to apportion its margin to Texas under the Franchise Tax using the evenly-weighted, three-factor formula provided by the Compact and as adopted into law in Texas Tax Code (“TTC”) Chapter 141.³ Graphic’s primary arguments supporting the use of the three-factor formula were: 1) the Franchise Tax is subject to the Compact because it is calculated by deducting indirect expenses from gross income and, accordingly, meets the definition of an income tax per the Compact;⁴ and 2) TTC Sec. 171.106, which requires the use of single-sales-factor apportionment, does not supersede the three-factor formula election available under the Compact as adopted by Texas in TTC Chapter 141. Graphic also argued that the Compact is enforceable law in Texas because the state has not repealed TTC Chapter 141. Graphic reasoned that since TTC Chapter 141 embodies an interstate compact, it may only be modified by the process provided by the Compact that requires, per TTC Sec. 141.001.Art.X.2, repeal of the Compact for Texas to withdraw.

In its Motion for Partial Summary Judgment, the Comptroller argued that TTC Sec. 171.106 supersedes the Compact’s three-factor formula and that TTC Sec. 171.106 (single-sales-factor) established the specific apportionment formula to be used in calculating tax due. Further, the Comptroller argued that the Compact is not a regulatory interstate compact, but rather an advisory compact, which does not bind its member states. The Comptroller also argued that even if the Compact were binding, the Texas Franchise Tax does not fit squarely under the Compact’s definition of an income tax and, accordingly, it cannot be an “income tax” for purposes of applying the provisions of the Compact.

Court Ruling

On January 15, 2014, the District Court granted the Comptroller’s Motion for Partial Summary Judgment and denied Graphics’ Motion for Summary Judgment, thus precluding Graphic from electing to use the Compact’s three-factor apportionment formula. In its Order, the District Court did not provide any analysis or rationale for

¹ *Graphic Packaging Corporation v. Susan Combs, Comptroller*, Dist. Ct. of Travis County, Texas (353rd Dist.) Cause no. D-1-GN-12-003038, Order on Plaintiff’s Motion for Summary Judgment and Defendants’ Motion for Partial Summary Judgment (Jan. 15, 2014).

² *Id.*

³ With Governor John Connally’s signature of H.B. 365 on June 13, 1967, Texas became the third state to enact the Compact. H.B. 365 provided for the state’s adoption of the Compact in its entirety. See, H.B. 365, 60th Leg., Reg. Sess. (Tex. 1967); Tx. Tax Code ANN. Sec. 141.001.

⁴ Per TTC Sec.141.001.Art.II.4, the term “Income tax” means “a tax imposed on or measured by net income including any tax imposed on or measured by an amount arrived at by deducting expenses from gross income, one or more forms of which expenses are not specifically and directly related to particular transactions.”

its decision. Graphic's additional claims (an as-applied constitutional challenge to the single-sales-factor formula and rate structure and a challenge of the imposition of penalties and interest) are still pending.

Considerations

The District Court's Order in this case is the first judicial decision in Texas on this issue. Graphic has the right to appeal the Order and, as noted above, Graphic's additional claims remain pending. Accordingly, the case is not final. However, taxpayers that have made, or are considering making, an election to use the Compact's three-factor apportionment formula may wish to consider the effect that this case could have if the District Court's Order becomes final.

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