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Multistate Tax
EXTERNAL ALERT

Texas Court Includes Net Loss in Apportionment Factor Denominator

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Overview

The Court of Appeals, 13th District of Texas ("Court of Appeals"), recently upheld an assessment against a taxpayer, holding that gains were required to be offset against losses from the sale of investments and capital assets in determining the Franchise Tax apportionment factor denominator.[1] The case involved the application of Texas Tax Code ("TTC") § 171.105(b), which for purposes of determining the denominator of the Franchise Tax apportionment factor states: "If a taxable entity sells an investment or capital asset, the taxable entity's gross receipts from its entire business for taxable margin *include only the net gain from the sale*" (emphasis added). The taxpayer argued the proper interpretation of this statute was that gains only are included and, thus, losses are disregarded. The Court of Appeals disagreed, siding with the Texas Comptroller ("Comptroller") and concluding that gains are to be offset by losses from the sale of investments and capital assets.

As of the release date of this Tax Alert, the taxpayer has not filed a petition for review with the Texas Supreme Court; however, the period during which such filing may be made remains open.

In this Tax Alert, we summarize the proceedings and arguments in this pending case and offer some taxpayer considerations.

Background

In 2008 the taxpayer had gross receipts in excess of $4B but sustained a loss of more than $600M from the sale of investment and capital assets. In its Franchise Tax Report for 2008, the taxpayer, in calculating its apportionment factor denominator, did not include its losses from the sale of investment and capital assets. As a basis for its position, the taxpayer asserted that:

- under the unambiguous language of TTC § 171.105(b), there is no net gain from the sale of investment and capital assets; and, accordingly,
- zero receipts from the sale of capital and investment assets should be included in the apportionment factor denominator.[2]

The Comptroller audited the taxpayer's 2008 Report and rejected the taxpayer's filing position, concluding that the term "gross receipts is statutorily defined as a net figure for sales of investment or capital assets," and, thus, the taxpayer's denominator should have included the net loss. Accordingly, the Comptroller increased the taxpayer's apportionment factor and assessed a tax liability.[3]

The taxpayer paid the related additional tax assessment and filed a protest in the 126th Travis County District Court ("District Court"). Both parties filed motions for partial summary judgment with the District Court. In its motion, the Comptroller argued the phrase "only the net gain from the sale," as used in TTC § 171.105(b), means that gains are offset against losses in determining the apportionment factor denominator. In contrast, the taxpayer's motion argued that only gains are counted and losses are disregarded.

In its appellate brief, the taxpayer summarized its argument as follows:

> The unambiguous language of Tax Code § 171.105(b) permits the Comptroller to include "only the net gain" from the sale of investment or capital assets in a taxpayer's apportionment factor denominator. The plain, dictionary meaning of "only the net gain" necessarily excludes a net loss. . . .
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> The Comptroller's novel misinterpretation of section 171.105(b) directly contradicts forty years of legislative, administrative, and judicial precedent. In 1974, the court of appeals in *Calvert v. Electro-Science Investors, Inc.*, 509 S.W.2d 700, 702 (Tex. Civ. App.—Austin 1974, no writ) held that an earlier, virtually identical

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[1] *Hallmark Mktg. Co. v. Combs*, No. 13-14-00093-CV (Tex. App.—Corpus Christi, Nov. 13, 2014, no pet. h.), available at: **http://www.search.txcourts.gov/SearchMedia.aspx?MediaVersionID=d1caed5a-43fe-4ab6-9325-c99cd2d05266&coa=coa13&DT=Opinion&MediaID=4bf9b630-a4c4-4905-9255-9be245eed81b**. For the procedural status of the case, see: **http://www.search.txcourts.gov/Case.aspx?cn=13-14-00093-CV&coa=coa13**.

[2] Appellant's Brief, *Hallmark Mktg. Co. v. Combs*, No. 13-14-00093-CV (Tex. App.—Corpus Christi, Mar. 14, 2014), at *4-5.

[3] *Id*. at *9 (citing the District Court's Record).

> version of section 171.105(b) was unambiguous and "there is no doubt as to what its ordinary meaning is." Over the next thirty years, the Texas cases and the Comptroller's own rules reflected this ordinary meaning: If, when gains and losses from the sales of assets were netted together, a net loss resulted, the apportionment factor denominator reflected zero receipts from these sales.[4]

In contrast, in its appellate brief, the Comptroller argued the taxpayer must subtract losses from the sale of investments and capital assets when calculating its everywhere receipts under TTC § 171.105 for three reasons:

> First, losses are defined as "amounts reportable as income" under Section 171.1011. Therefore, [taxpayer] was required to subtract the losses when calculating its total revenue. Because the losses were subtracted from total revenue, so [taxpayer] must also subtract the losses when calculating its everywhere receipts under Section 171.105.
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> Second, the Third Court of Appeals determined that the predecessor statute of Section 171.105 unambiguously "requires that gains and losses be offset against one another in order that a net figure be obtained." *Calvert v. Electro-Sci. Investors*, Inc., 509 S.W.2d 700,702 (Tex. Civ. App. 1974, no writ).
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> Third, the applicable Comptroller Rule [(Rule 3.591(e)(2))] requires [taxpayer] to subtract its losses, and the Rule is a reasonable construction of the tax statutes.[5]

Lower Court Rulings

On December 4, 2013, in a summary decision delivered without explanation or analysis, the District Court granted the Comptroller's motion and denied the motion brought by the taxpayer.[6] On December 10, 2013, the taxpayer appealed the District Court's decision.[7]

Texas Court of Appeals Ruling

On November 13, 2014, the Court of Appeals upheld the additional assessment of Franchise Tax against the taxpayer. Specifically, the Court of Appeals found Comptroller Rule 3.591(e)(2) controlling because it was considered a reasonable construction of the statute.[8] Rule 3.591(e)(2) provides:

> [N]et gains and losses from sales of investments and capital assets must be added to determine the total gross receipts from such transactions. If both Texas and out-of-state sales have occurred, then a separate calculation of net gains and losses on Texas sales must be made. *If the combination of net gains and losses results in a loss, the taxable entity should net the loss against other receipts*, but not below zero. In no instance shall the apportionment factor be greater than 1.[9]

First, the Court of Appeals explained that TTC § 171.105(b) was ambiguous "because it is unclear, by examining only the plain language of the statute, what the term "net gain" means." According to the Court of Appeals, "net gain" could refer to either: (1) the particular gain or loss that results from each individual sale when proceeds are offset by costs; or (2) a taxpayer's cumulative gain or loss on its various investment and capital asset sales made throughout the year. Under the second interpretation, which the Comptroller adopted in Rule 3.591, any losses from individual investment and capital asset sales are used to offset gains from other such sales during the tax year.

The Court of Appeals found the interpretation adopted by Rule 3.591 was reasonable based on the Austin Court of Civil Appeals' 1974 opinion in *Electro-Science*, which held that the term "net gain" (for purposes of the predecessor statute) requires that gains and losses be offset against one another in order to obtain a net figure.[10] Because the Comptroller's interpretation of TTC § 171.105(b) was found reasonable, Rule 3.591(e)(2) controlled.[11]

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[4] Appellant's Brief, *Hallmark Mktg. Co. v. Combs*, No. 13-14-00093-CV (Tex. App.—Corpus Christi, Mar. 14, 2014), at *6-7 (internal citations omitted).
[5] Appellee's Brief, *Hallmark Mktg. Co. v. Combs*, No. 13-14-00093-CV (Tex. App.—Corpus Christi, Apr. 15, 2014), at *4-5.
[6] *Hallmark Mktg. Co. v. Combs*, No. D-1-GN-13-001168 (126th Dist. Ct., Travis Cnty., Tex. Dec. 4, 2013).
[7] Notice of appeal was filed by the District Clerk on December 10, 2013. Notice of appeal was filed by Hallmark in the Texas Third Court of Appeals on December 19, 2013. Although the case was originally appealed to the Texas Third Court of Appeals on February 6, 2014, the Texas Supreme Court ordered transfer of the case to the Texas Thirteenth Court of Appeals in Corpus Christi. *Hallmark Mktg. Co. v. Combs*, No. 13-14-00093-CV (Tex. App.—Corpus Christi). For more information regarding the procedural status of this case, see: **http://www.search.txcourts.gov/Case.aspx?cn=13-14-00093-CV**.
[8] *Hallmark Mktg. Co. v. Combs*, No. 13-14-00093-CV (Tex. App.—Corpus Christi, Nov. 13, 2014, no pet. h.).
[9] Tex. Admin. Code 3.591(e)(2) (emphasis added).
[10] *See Hallmark Mktg. Co.*, No. 13-14-00093-CV, at *6 (citing *Calvert v. Electro-Sci. Investors, Inc.*, 509 S.W.2d 700, 702 (Tex. Civ. App.—Austin 1974, no writ)).
[11] *Id*. at *8-10 (citing *TGS-NOPEC Geophysical Co. v. Combs*, 340 S.W.3d 432, 438 (Tex. 2011) and *Electro-Sci. Investors, Inc.*, 509 S.W.2d at 702).

Consequently, the taxpayer's gains were required to be offset against its losses from the sale of investments and capital assets in determining the apportionment factor denominator.[12]

Under Texas Rule of Appellate Procedure 53.7(a), a taxpayer may file a petition for review with the Texas Supreme Court within 45 days after the Court of Appeals renders judgment. As of the release date of this Tax Alert, the taxpayer has not filed a petition for review; however, the period during which such filing may be made remains open.

Considerations

Taxable entities that have substantial losses reported for federal purposes or that have included net losses when determining the amount of net gain within the apportionment factor denominator may wish to consider whether a claim for refund should be filed while the *Hallmark* case remains pending. In deciding whether to file a refund claim, taxable entities may wish to consider that: 1) the Comptroller is not required to hold the claim in abeyance while the case remains pending; thus, the taxpayer may be required to further pursue its claim before an administrative law judge or in trial court in order to preserve the claim; and 2) the filing of a refund claim may trigger a general audit of open tax years and extend the regular statute of limitations for assessments.[13] Alternatively, taxable entities that have previously taken the position that only gains should be counted and losses should be disregarded may wish to consider voluntarily self-reporting such treatment in order to be considered for penalty abatement.

Contacts

If you have questions regarding the pending litigation in *Hallmark* or other Texas tax matters, please contact any of the following Deloitte Tax LLP professionals.

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[12] *See id*.
[13] Tex. Tax Code § 111.2051.