Texas Supreme Court: Net loss not included in apportionment factor denominator

Overview

On April 15, 2016, in *Hallmark Marketing Company, LLC, v. Hegar*, the Texas Supreme Court reversed a Texas Court of Appeals' decision[1] and held that the Texas Tax Code does not require taxpayers to include a net loss from the sale of investments and capital assets in its apportionment factor denominator for Texas franchise tax purposes.[2] The Texas Supreme Court remanded the case back to the trial court for further proceedings consistent with its decision.

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 Texas Comptroller has 15 days from the date when the Supreme Court renders judgement to submit a motion for rehearing to the Supreme Court clerk.[3]

In this tax alert we summarize the proceedings and arguments in this case and provide some taxpayer considerations.

Background

In 2008 the taxpayer had gross receipts in excess of $4 billion, but sustained a loss of more than $600 million 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 investment and capital assets should be included in the apportionment factor denominator.[4]

The Comptroller audited the taxpayer's 2008 report and rejected the taxpayer's position, concluding that the term "gross receipts is statutorily defined as a net figure for sales of investment or capital assets" based on the Comptroller's interpretation of TTC § 171.105(b) as promulgated in Rule 3.591(e)(2). Thus, the taxpayer's denominator should have included the net loss (i.e., reducing the denominator of the apportionment factor) resulting in an overall increase in the apportionment factor percentage. As a result of the increase in the taxpayer's apportionment factor, the Comptroller assessed a tax liability.[5]

The taxpayer paid the 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.

Lower court ruling

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.

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[1] *Hallmark Mktg. Co. v. Combs*, No. 13-14-0093-CV (Tex. App. – Corpus Christi, Nov. 13, 2014.)
[2] *Hallmark Mktg. Co. v. Hegar*, No. 14-1075 (Tex. Supreme Court, Apr. 15, 2016), *available* here.
[3] TX Rules of Appellate Procedures, Rule 64.1. As of the date of this Alert, it has not yet been confirmed whether any such rehearing motion was filed.
[4] Appellant's Brief, *Hallmark Mktg. Co. v. Combs*, No. 13-14-00093-CV (Tex. App.—Corpus Christi, Mar. 14, 2014), at *4-5.
[5] *Id*., at *9 (citing the District Court's Record).
[6] *Hallmark Mktg. Co. v. Combs*, No. D-1-GN-13-001168 (126th Dist. Ct., Travis Cnty., Tex. Dec. 4, 2013).

Texas Court of Appeals ruling

On November 13, 2014, the Texas Court of Appeals upheld the additional assessment of franchise tax against the taxpayer holding that the Comptroller's rule was a reasonable construction of an ambiguous statute.[7] 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. [Emphasis added.]

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."[8] 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.

Finding the Comptroller's interpretation of TTC § 171.105(b) to be reasonable, Rule 3.591(e)(2) controlled.[9] Consequently, the taxpayer was required to reduce the denominator of its apportionment factor for the losses resulting from the sale of investments and capital assets.

Texas Supreme Court ruling

On April 15, 2016, the Texas Supreme Court reversed the Court of Appeals judgment and held in favor of the taxpayer, remanding the case to the trial court for further proceedings consistent with the opinion.

The Texas Supreme Court concluded that even if the statutory reference to "net gain" is ambiguous, the ambiguity was irrelevant because taxpayer suffered only a net loss during the tax year in question. Accordingly, the Texas Supreme Court could not defer to the Comptroller's rule requiring inclusion of a net loss in taxpayer's apportionment factor denominator because it conflicts with the plain language of TTC §171.105(b). The Texas Supreme Court noted, "[S]imply put, the Comptroller's reading would rewrite the statute to say Hallmark should include 'only the net gain or *net loss*.' Not only would this add to the statute's plain language, it would effectively write the word 'only' out of the statute."[10]

Considerations

Taxpayers subject to the Texas franchise tax that have reduced the denominator of the apportionment factor as a result of having recognized substantial losses from the sale of investments or capital assets may wish to consider whether a claim for refund should be filed. 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.[11]

Contacts

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[7] *Hallmark Mktg. Co. v. Combs*, No. 13-14-0093-CV (Tex. App. – Corpus Christi, Nov. 13, 2014.)
[8] *Id*. at 8.
[9] The Court of Appeals also cited the Austin Court of Civil Appeals' 1974 opinion in *Calvert v. Electro-Science Investors, Inc.*, 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. *Id*.
[10] *Hallmark Mktg. Co. v. Hegar*, No. 14-1075 (Tex. Supreme Court, Apr. 15, 2016) at 7-8. [Emphasis included in text of Supreme Court's decision.]
[11] Tex. Tax Code § 111.2051.

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