

Texas Comptroller ruling - gross proceeds from non-inventory dealer/trader transactions not included in receipts factor

Overview

On March 7, 2018, the Texas Comptroller of Public Accounts (Comptroller) released a ruling addressing whether certain gross proceeds derived from transactions involving securities were properly considered gross receipts that should be included in the calculation of a taxpayer's apportionment factor for purposes of the Texas franchise tax (commonly referred to as the Texas margin tax) under Texas Tax Code (TTC) § 171.106(f).

As described in more detail below, the Comptroller ultimately determined the taxpayer's gross proceeds from the securities were not treated as inventory for Texas franchise tax purposes based on the Comptroller's interpretation of the federal income tax treatment and presentation of the net gain/loss from the sale of securities on the taxpayer's federal income tax return. Because the securities were deemed by the Comptroller not to constitute inventory, the gross proceeds were not considered gross receipts that should be included in the calculation of the taxpayer's apportionment factor. Based on the ruling, only the sale of securities treated as inventory, for which any ordinary income or loss is reported on Line 1 of the federal Form 1120, would allow for inclusion of the gross sale proceeds in the Texas receipts factor.

This tax alert summarizes the Comptroller's decision and offers some taxpayer considerations.

Background

For report years 2008 and 2009 (collectively, Report Years), the taxpayer, through one of its wholly-owned subsidiaries and combined group filing members (Company), used futures contracts to manage fixed price sales contracts with distributors and charged a differential on top of the future price to cover its costs and price risk.¹ The Company's trading activity included securities transactions related to the following: sales of fuel to third-party marketers; the price spread between crude oil and another product (*i.e.*, heating oil or gasoline); and natural gas purchases.²

The taxpayer included the gross proceeds from the Company's securities transactions in the denominator of the taxpayer's Texas franchise tax apportionment factor because the proceeds were reported as ordinary gains and losses for federal income tax purposes.

Based on the taxpayer's federal treatment related to the securities, the auditor determined the taxpayer did not treat the securities as inventory for federal income tax purposes, and, therefore, the gross proceeds from the sales of the securities were not gross receipts included in the calculation of the apportionment factor. As a result, the auditor adjusted the taxpayer's apportionment factor denominator to remove the gross proceeds.³

Comptroller's interpretation of the federal income tax treatment

Under Internal Revenue Code (IRC) § 475(a)(1), any security which is inventory in the hands of a dealer shall be included in inventory at its fair market value. For any securities which are not inventory of the dealer, but held by the dealer at the close of any taxable year, the dealer must recognize gain or loss as if such security were sold for its fair market value on the last business day of the taxable year under IRC § 475(a)(2) (*i.e.*, "mark-to-market" method of accounting). Any gain or loss related to a security that is not inventory under IRC § 475(a)(2) is treated as ordinary income or loss.⁴

IRC § 475 also addresses *traders* in securities. Unlike dealers, traders do not maintain an inventory of securities; thus, a trader's gains and losses on the sales of securities are generally treated as capital gains and losses.⁵ However, IRC §

¹ Texas Comptroller of Public Accounts, Accession No. 201803032H, SOAH Docket Nos. 304-17-3759.13, 304-17-3760.13, CPA Hearing Nos. 113,362, 113,363 (March 7, 2018), available [here](#).

² *Id.*

³ *Id.*

⁴ Although the mark-to-market accounting method is generally applicable only to dealers in securities, IRC § 475(e) allows dealers in commodities to elect the same mark-to-market treatment.

⁵ *Id.* (citing IRS Tax Topic 429.[4], available [here](#)).

475(f) allows traders in securities to elect mark-to-market treatment for securities held in connection with a taxpayer's securities trading business. Because traders do not have inventory, the mark-to-market treatment under IRC § 475(f) is identical to the mark-to-market treatment of securities held by a dealer that are not held as inventory.⁶ For traders that make an election under IRC § 475(f), gains and losses are treated as ordinary gains and losses, rather than capital gains and losses, and reported on IRS Form 4797 (Sales of Business Property) and included on Line 9 of federal Form 1120.

In this matter, the Company operated as both a dealer and a trader in securities as defined under IRC § 475.⁷ As a dealer in securities, the Company made the mark-to-market election under IRC § 475(e) for the Report Years.⁸ As a trader in securities, the Company also made the mark-to-market election under IRC § 475(f), which resulted in the proceeds being recorded as ordinary gains or losses on Form 4797 (Sales of Business Property) and Line 9 of the taxpayer's federal Form 1120 for the Report Years.⁹ As noted previously, the taxpayer included the gross proceeds from the Company's security transactions in its Texas apportionment factor denominator because the proceeds were reported as ordinary gains and losses.

Comptroller's decision

Generally, a taxable entity's franchise tax liability is determined by calculating the entity's taxable margin and then apportioning the taxable margin to Texas by multiplying the taxable entity's margin by a fraction, the numerator of which is the taxable entity's gross receipts from business done in this state and the denominator of which is the taxable entity's gross receipts from its entire business.¹⁰ A taxable entity's "gross receipts from its entire business" is the sum of the taxable entity's receipts from each sale of the taxable entity's tangible personal property; each service, rental, or royalty; and other business.¹¹

Under TTC § 171.106(f), if a loan or security is "treated as inventory of a seller for federal income tax purposes," the gross proceeds of the sale of that loan or security are considered gross receipts for Texas franchise tax purposes.¹² When determining whether securities are held as inventory for federal income tax purposes, Texas guidance instructs auditors to review the taxpayer's internal records and federal Form 1120.¹³ The Comptroller has previously indicated that gains and losses reported on federal Form 1120, Line 1, as ordinary gains and losses, represent securities held for inventory.¹⁴ Alternatively, gains and losses reported on federal Form 1120, Line 8, as capital gains and losses, represent securities held for a taxpayer's own investment.¹⁵ Prior to this hearing, the Comptroller had not specifically addressed the treatment of gains and losses reported on the federal 1120, Line 9, as ordinary gains and losses. However, the Comptroller previously published guidance stating that TTC § 171.106(f) would not apply to securities or loans for which an election is made under IRC § 475(f) (*i.e.*, mark-to-market election for traders).¹⁶

Based on this guidance, the Comptroller determined the Company's securities were not inventory for federal purposes because the Company made an IRC § 475(f) election. As a result of the IRC § 475(f) election, the Company's securities from its trading activities were: (i) treated in the same manner as securities held by a dealer that are not held as inventory (*i.e.*, mark-to-market treatment); and (ii) the gross proceeds from the securities were included on Line 9, as ordinary gains and losses, on the taxpayer's federal Form 1120, instead of Line 1, as ordinary gains and losses.¹⁷ In response, the taxpayer argued that despite being reported on Line 9, the gross proceeds were still reported as ordinary gains and losses, and, thus, TTC § 171.106(f) should apply to the gross proceeds.

⁶ *Id.* (citing IRC §§ 475(a)(2)(A), (B)).

⁷ *Id.*

⁸ *Id.*

⁹ *Id.*

¹⁰ *Id.* (citing Tex. Tax. Code §§ 171.002, 171.103, 171.106; 34 Tex. Admin. Code § 3.591(c)).

¹¹ *Id.* (citing Tex. Tax. Code § 171.105(a)).

¹² *Id.* (citing Tex. Tax. Code § 171.106(f); 34 Tex. Admin. Code § 3.591(e)(16)).

¹³ *Id.* (citing Apportionment of Proceeds from the Sale of Futures Contracts and Securities, Accession No. 201311792L (Nov. 21, 2013), available [here](#)).

¹⁴ *Id.*

¹⁵ *Id.*

¹⁶ *Id.*

¹⁷ *Id.* (citing Tex. Tax Code § 171.106(f): Apportionment of Proceeds from Sales of Loans or Securities, Accession No. 200809240L (Sept. 1, 2008)).

In the ruling, the Administrative Law Judge (ALJ) explained that “the distinction between the ordinary gains and losses included on Line 1 and one Line 9 is a result of the treatment of the securities by the holder.”¹⁸ Here, the inclusion of the gross proceeds on Line 9 of federal Form 1120 was required based on the taxpayer’s IRC § 475(f) election.¹⁹ As mentioned, a trader does not hold inventory, and the requirements for securities held by a dealer that are not held in inventory under IRC § 475(a)(2) also applies to securities held by a trader that makes the mark-to-market election under IRC § 475(f).²⁰ As a result, the ALJ concluded the “Comptroller does not consider securities held by a trader who makes the election under IRC § 475(f) to be treated as inventory for federal income tax purposes under [TTC] Section 171.106(f).”²¹ Consequently, the gross proceeds from such securities were not includible in the calculation of the taxpayer’s apportionment factor.

Considerations

Based on the ruling, only the sale of securities treated as inventory, for which any ordinary income or loss is reported on Line 1 of the federal Form 1120, would allow for inclusion of the gross sale proceeds in the Texas receipts factor. Taxpayers that operate as a dealer or trader of securities or commodities, or that have an entity within its combined group that operate as such, are advised to consult with their tax advisers to determine potential Texas franchise tax implications.

Contacts:

If you have questions regarding the Texas Comptroller’s Decision or other Texas tax matters, please contact any of the following Deloitte Tax professionals:

Robert Topp
Managing Director
Deloitte Tax LLP, Houston
+1 713 982 3185
rtopp@deloitte.com

Russell Brown
Partner
Deloitte Tax LLP, Dallas
+1 214 840 7533
rubrown@deloitte.com

Andrew Robinson
Partner
Deloitte Tax LLP, Houston
+1 713 982 2960
arobinson@deloitte.com

Jacob Aguero
Senior Manager
Deloitte Tax LLP, Houston
+1 713 982 4246
jaguero@deloitte.com

Lauren Rothman
Senior Manager
Deloitte Tax LLP, Houston
+1 713 982 2462
lrothman@deloitte.com

Grace Taylor
Manager
Deloitte Tax LLP, Houston
+1 713 982 3809
grtaylor@deloitte.com

For further information, visit our website at www.deloitte.com

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¹⁸ *Id.*

¹⁹ *Id.*

²⁰ *Id.* (citing IRC §§ 475(f)(1)(A)(i), (ii)).

²¹ *Id.*

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