Texas – Multistate Tax Compact three-factor election denied, Texas Franchise Tax not an income tax

July 31, 2015

In brief

On July 28, 2015, the Texas Court of Appeals, Third District, determined that the Texas Franchise Tax is not a tax imposed on net income for Multistate Tax Compact purposes and therefore the Compact's three-factor apportionment formula provisions were not available to the taxpayer. [*Graphic Packaging Corp. v. Comptroller*, Tx. App. Ct., 3rd Dist. No. 03-14-00197-CV (7/28/15)]

In detail

Facts and procedural history

For report years 2008 and 2009, Graphic Packaging Corp. (Graphic) filed Texas franchise tax reports apportioning its margin using the single-factor gross-receipts formula found in Tex. Tax Code § 171.106(a). On amended 2008 and 2009 reports, and on its originally filed 2010 franchise report, Graphic apportioned its margin to Texas using the three-factor formula found in Tex. Tax Code § 141.001, which incorporates the Multistate Tax Compact's three-factor apportionment election. For all three years, Graphic computed its taxable margin by subtracting cost of goods sold from its total revenue.

The Comptroller denied Graphic's claims. Graphic filed a protest suit in district court against the Comptroller asserting that it properly elected the Compact's three-factor apportionment formula. The district court ruled in favor of the Comptroller and Graphic appealed to the appeals court. Click here for our summary of the district court's decision.

The franchise tax is not an income tax for Compact purposes

The court, in its de novo review, noted the Compact's three-factor apportionment election is available to any taxpayer "subject to an income tax whose income is subject to apportionment and allocation for tax purposes pursuant to the laws of a party state."

An 'income tax' is defined as "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."

The court interpreted 'net income' and 'expenses' by looking to their plain meanings. 'Net income' is the "excess of all revenues and gains for a period over all expenses and losses of the period." An 'expense' is an "item of outlay incurred in the operation of a business enterprise allocable to and chargeable against revenue for a specific period."

The court reviewed whether each alternative base of the franchise tax qualified as a tax on 'net income:'

- **Total revenue, 70% of total revenue, total revenue minus $1 million.** Although 'total revenue' is determined by subtracting certain exclusions such as bad debt, the court declined to interpret it as synonymous with 'net income.' Additionally, subtracting $1 million is not the same as "deducting expenses from gross income."
- **Total revenue minus cost of goods sold or minus compensation.** The court acknowledged that these bases allow subtractions only for select costs. However, the definition of income tax includes a tax imposed on or measured by "an amount arrived at by deducting expenses from gross income." According to the court, to accept either base as qualifying as an income tax, the statute would have to be rewritten to state "an amount arrived at by deducting [any] expense[] from gross income."

The court also noted several other reasons supporting the determination that the franchise tax is not an 'income tax,' including:

- Apportionment provisions under § 141.001 (incorporating the Compact) distinguish between franchise taxes and income taxes.
- The single-factor apportionment formula in § 171.106(a) expressly states that the single-factor formula applies except "as provided by this section." Had the legislature intended the Compact formula to apply, it would have been included in § 171.106.
- § 171.104 incorporates the property and payroll formulas found in § 141.001. Since the legislature knew how to incorporate Compact language, its absence in doing so for the apportionment election signifies that the election was not intended to be available to taxpayers.

Other arguments not addressed

Because the court's resolution that the franchise tax is not an income tax for Compact purposes was dispositive to the appeal, the court did not address Graphic's other arguments that: (1) the single-factor apportionment in Tex. Tax. Code § 171.106 did not impliedly repeal the Compact's election in Tex. Tax Code § 141.001 and (2) if there was such a repeal, the repeal was invalid because the Compact is an interstate agreement that is binding on the party states unless and until they withdraw.

The takeaway

The court noted that the Michigan Supreme Court recently found in the *IBM* case (click here for our summary) that Michigan's modified gross receipts tax (MGRT) fit within the Compact's definition of an income tax. While the Michigan court found the MGRT fit within the Compact's broad definition of an income tax because it was "a variation of net income," the Texas court simply concluded the margin tax was not sufficiently similar and not a variation of net income.

The Court did not address the fact that the franchise tax is treated as an income tax for GAAP purposes. As an income tax, it is subject to addback requirements in many states.

These apparent conflicting views between states as to the definition of an income tax may be taken into consideration should a case make its way to the US Supreme Court.

While the court of appeals decision is another setback for Texas taxpayers seeking the ability to elect three factor apportionment, we expect that Graphic will either file a motion for rehearing with the court of appeals on or before August 12, 2015 or seek review by the Texas Supreme Court without a rehearing, which would be due on or before September 11, 2015.

Let's talk

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