

Texas – Taxpayer files motion for summary judgment in Multistate Tax Compact Case

December 18, 2013

In brief

On December 19, 2013, the Texas Travis County District Court will hear Graphic Packaging Corporation's Motion For Summary Judgment in its action challenging the state's denial of the use of the Multistate Tax Compact three-factor apportionment formula. In its Motion, Graphic argues that Texas permits the use of the Compact's three-factor formula when the underlying tax base is computed by subtracting from gross income one or more indirect expenses. Graphic asserts that each of the five measures of the Revised Texas Franchise Tax (Franchise Tax) satisfies this standard such that the Compact apportionment formula must be available to Texas taxpayers. A contrary ruling would undermine the validity of interstate compacts as a tool for resolving critical multistate issues and would jeopardize the many vital interstate compacts to which Texas is a party.

In detail

The following provides a summary of Graphic Packaging's Motion.

Facts

Graphic and its subsidiaries design, manufacture, and sell packaging for consumer products to customers throughout the US. For report years 2008-2010, Graphic filed either original or amended Texas Franchise Tax returns using the Compact's equally weighted three-factor apportionment formula. The Comptroller denied Graphic's use of the Compact formula. Graphic filed a petition in the Texas district court

challenging the Comptroller's decision.

Compact history

In 1966, Congress introduced a bill implementing recommendations suggested by a Congressional Committee that included a uniform apportionment formula as the sole method for dividing corporate income among the states. To avoid federal regulation and preemption of state taxation, the Multistate Tax Compact was drafted in 1967 by the National Association of Tax Administrators and various state Attorneys General and was presented to the states. By its terms, the Compact became

effective as to all member states upon its enactment into law by seven states. On June 13, 1967, Texas became the third state to enact the Compact.

Compact formula applies to Texas tax

The express terms of the Compact, as adopted by Texas, provide that the Compact applies to:

“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.”

In other words, the Compact formula is available for any Texas tax that is calculated by subtracting indirect expenses or any other non-direct expense – such as a statutory deduction from gross income.

Indirect expenses, as defined in the dictionary, are not directly associated with a particular transaction and include expenses such as electricity, insurance, worker benefits, rent, utilities, fixed or ordinary operating costs, and office expenses.

Each of the five Franchise Tax calculation methods deducts indirect expenses from gross income

The Franchise Tax, also known as the Margin Tax, provides for five calculation methods, each of which begin with a taxpayer's reported federal gross income and deducts various items to arrive at 'total revenue.'

- *EZ method* provides a taxpayer with various deductions that are not specifically and directly related to any particular transaction.
- *Cost of goods sold* allows deductions for indirect costs, including insurance, utilities, rent, administrative salaries, and property taxes.
- *Compensation* allows deductions for indirect costs, including salaries of production workers and administrative staff.
- *Statutory 30% deduction* calculation is based on the taxpayer's total revenue less thirty percent of its revenue.
- *\$1 million statutory deduction* allows for a flat \$1 million deduction from a taxpayer's total revenue.

Each of the above Franchise Tax calculation methods allows for a deduction from gross revenue that is "unrelated to any particular transaction." Accordingly, the Franchise Tax is a tax subject to the Compact and Texas taxpayers are entitled to apportion their taxable margins under the equally weighted three-factor formula.

A tax's nature and effect, not mere labeling, ultimately determines its character

Although the Comptroller may argue that the legislation enacting the Franchise Tax describes it as "not a net income tax," the true nature of the tax is one measured by income. Because the tax allows for deductions, exemptions, and other tax reductions of 'indirect expenses,' it should be subject to the Compact.

Legislative intent supports continued application of the Compact

Other elements of the Franchise reflect a legislative intent to maintain the application of Compact provisions, including:

- Texas has not repealed, disavowed, or otherwise impaired the Compact's three-factor formula.
- The Franchise Tax references the apportionment provisions in its 80/20 entity exclusion test.
- When enacting the current franchise tax, the legislature repealed a provision stating that the Compact "does not apply to this chapter" (the chapter containing the prior Texas Franchise Tax).
- Article XII of the Compact states it 'shall be liberally construed so as to effectuate the purposes thereof.'
- The Compact and Texas law may be read harmoniously. The Texas

apportionment provision does not use language such as "shall," nor does it include any language such as "notwithstanding" the Compact provisions.

In the event of a conflict, the Compact prevails

If the court finds an irreconcilable conflict between the Compact and the Franchise Tax, the Compact should prevail for the following reasons:

- The US Supreme Court in *U.S. Steel Corp. v. Multistate Tax Comm'n* recognized that the Compact is valid and enforceable, and any attempt to challenge the validity of the Compact is without merit.
- The Compact is both a statute and a contract among states.
- The US and Texas Constitutions protect interstate compacts from unilateral impairment by a member state.
- Any ruling that Texas altered its Compact obligations would undermine the validity of interstate compacts as a tool for resolving critical multistate issues and would jeopardize the many vital interstate compacts to which Texas is a party.

The takeaway

The summary judgment motion is the first court proceeding in Texas. Since the state is denying all Compact election claims, many more cases are expected to be filed. These cases will join similar matters in other states, such as Michigan, where the state's Supreme Court will hear the *IBM v. Dep't of Treasury* case in mid-January of 2014.

Let's talk

If you have any questions regarding the *Graphic Packaging* case or are interested in learning about remedies issues associated with the Compact cases, please contact:

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