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Potential Texas Margin Tax Refund Claim

The Texas Supreme Court’s decision in Hallmark Marketing provides a potential Texas margin tax refund claim for taxpayers that recognized net losses on investments and capital assets.

Background

For Texas franchise tax (*i.e.*, margin tax) purposes, taxable margin is determined by multiplying the taxpayer’s total margin by a single gross receipts factor apportionment formula. Tex. Tax Code §§ 171.002, 171.101. The gross receipts apportionment formula consists of the receipts from business conducted in Texas divided by the receipts from all business conducted everywhere. *Id.* § 171.106(a).

For purposes of computing the gross receipts factor, Texas statutes provide that “[i]f a taxable entity sells an investment or capital asset, the taxable entity’s gross receipts from its entire business for taxable margin includes *only the net gain* from the sale.” *Id.* § 171.105(b) (*emphasis added*). The Texas regulations, however, provide that “[i]f the combination of net gains and losses results in a net loss, the taxable entity should net the loss against other receipts, but not below zero.” 34 Tex. Admin. Code § 3.591(e)(2).

Hallmark Marketing Case

For the 2008 tax year, Hallmark Marketing Company, LLC (Hallmark) recognized a net loss of approximately \$628 million from the sale of investments. Based on the plain language of the statute, Hallmark took the position that only net gain, and not net loss, was included in the denominator of its gross receipts factor. Excluding the net loss from the gross receipts factor denominator resulted in a larger denominator, and thus a lower Texas apportionment percentage, than if the net losses were included in the denominator as provided in the regulation.

The Texas Comptroller audited Hallmark and concluded that Hallmark should have included both its net gains and net losses in computing its gross receipts factor denominator. Both the trial court and Texas Court of Appeals agreed with the Comptroller, and upheld the application of the regulation.

On April 15, 2016, the Texas Supreme Court reversed the decisions of the lower courts, and determined that the plain language of the statute clearly provides that only net gains, and not net losses, are included in the gross receipts factor denominator. The Court further determined that the regulation requiring the combination of net gains and net losses in the denominator was not entitled to deference because it directly conflicts with the plain language of the statute.

Potential Refund Claim

Taxpayers with non-Texas investment and capital net losses who netted their gains and losses in the gross receipts factor denominator reported a lower denominator, and thus a Texas higher apportionment percentage, than if they had excluded the net losses from the denominator. As such, taxpayers with such net losses in open tax years should consider consulting with counsel and filing refund claims to exclude net losses in the denominator in order to decrease the Texas apportionment percentage. In addition, it is important for taxpayers to confirm that current and future Texas franchise tax returns take into account the result of *Hallmark Marketing* and to monitor Texas legislative changes that may subsequently change the apportionment computation.

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