

AN ALERT FROM THE BDO STATE AND LOCAL TAX PRACTICE

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## SALT



### SUBJECT

## TEXAS SUPREME COURT DECISION AND ADMINISTRATIVE RULINGS ADDRESS FRANCHISE TAX APPORTIONMENT AND UNITARY COMBINED REPORTING

### SUMMARY

In addition to the Supreme Court of Texas's recent decision in *Hallmark Marketing Co. v. Hegar* that addressed the meaning of "net gain" for franchise tax apportionment purposes, the State Office of Administrative Hearings ("SOAH") recently issued two decisions regarding franchise tax apportionment and unitary combined reporting. One SOAH decision addresses the meaning of "centralized management" for purposes of the franchise tax's definition of a "unitary business" group, and the other addresses the inclusion of captive insurance companies and a reinsurer in a Texas unitary combined group. Also, the Comptroller of Public Accounts ("Comptroller") issued a private letter ruling to address the sourcing of commission receipts received by the operator of an on-line business-to-business exchange.

### DETAILS

***Hallmark Marketing Co. v. Hegar, No. 14-1075 (Tex. Apr. 15, 2016) - "Net gain" does not mean net loss***

**FACTS:** For the taxable year at issue, the taxpayer sold some investment securities for a gain and some for a loss, resulting in an overall net loss. The taxpayer followed the statute, and included no gain or loss in the denominator of its apportionment factor. On audit, the Comptroller followed the language in the administrative rule, which resulted in inclusion of the overall net loss, a lower apportionment factor denominator, a higher overall apportionment factor, and a franchise tax assessment. The taxpayer protested the assessment, and after the trial court and court of appeals decided in favor the Comptroller, the Supreme Court of Texas reversed in favor of the taxpayer.

### CONTACT:

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**ATLANTIC:**

JONATHAN LISS, Tax Senior Director  
215-636-5502 / jliiss@bdo.com

JEREMY MIGLIARA, Tax Senior Director  
703-770-0596 / jmigliara@bdo.com

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**CENTRAL:**

ANGELA ACOSTA, Tax Senior Director  
248-688-3313 / aacosta@bdo.com

NICK BOEGEL, Tax Senior Director  
414-615-6773 / nboegel@bdo.com

JOE CARR, Tax Principal  
312-616-3946 / jcarr@bdo.com

MARIANO SORI, Tax Partner  
312-616-4654 / msori@bdo.com

RICHARD SPENGLER, Tax Senior Director  
616-776-3687 / rspengler@bdo.com

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**NORTHEAST:**

JANET BERNIER, Tax Principal  
212-515-5405 / jbernier@bdo.com

MATTHEW DYMENT, Tax Principal  
617-239-4130 / mdyment@bdo.com

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**SOUTHEAST:**

ASHLEY MORRIS, Tax Senior Director  
919-278-1963 / amorris@bdo.com

SCOTT SMITH, Tax Senior Director  
615-493-5629 / ssmith@bdo.com

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**SOUTHWEST:**

TOM SMITH, Tax Partner  
918-281-4080 / tasmith@bdo.com

GENE HEATLY, Tax Senior Director  
214-665-0716 / gheatly@bdo.com

---

**WEST:**

ROCKY CUMMINGS, Tax Partner  
415-490-3130 / rcummings@bdo.com

PAUL MCGOVERN, Tax Senior Director  
714-913-2592 / pmcgovern@bdo.com

**LAW:** Tex. Tax Code § 171.105(b) provides that only the “net gain” from the sale of investment securities are included in the Texas single sales factor apportionment formula. However, 34 Tex. Admin. Code § 3.591(e)(2) requires a taxpayer with a net loss to net the loss against other receipts, but not below zero.

**HOLDING:** The Supreme Court of Texas decided in favor of the taxpayer because Tex. Tax Code § 171.105(b) does not require the taxpayer to include the net loss from the sale of investments in the apportionment factor. The court declined to give deference to the administrative rule because it conflicts with the statute. That is, since the statute only states that “net gain” is included in the Texas apportionment factor, the Comptroller’s rule added “net loss” to a clear and unambiguous statute.

***SOAH Docket No. 304-15-4111.13 (Oct. 22, 2015) - Common ownership does not always result in strong centralized management***

**FACTS:** A single individual owned all of the shares of Company A and Company B. Company A operated a consulting business that offered conferences, instructional materials, and individualized consulting. Company B operated a carpet, upholstery, and hardwood floor cleaning business.

The sole shareholder took a hands-off approach with respect to Company B, and gave full responsibility to its personnel to run the business. In contrast, the sole shareholder assisted with the operations of Company A, including marketing and sales. Company A and Company B had common payroll and software, and shared a building, one common vendor (a credit card processing company) and an employee that performed certain administrative functions for both entities (i.e., certain accounting functions and generally oversaw purchasing activities). The shared employee did not perform purchasing, personnel, or marketing functions for Company A.

Company A and Company B filed separate franchise tax reports for the taxable years at issue. On audit of Company B, the Comptroller determined that Company A and Company B were engaged in a unitary business, and should have filed combined returns because they “shared centralized management structure arising out of their common ownership.” The Comptroller assessed franchise tax and interest, and Company B protested.

**LAW:** The definition of “unitary business” in Tex. Tax Code § 171.0001(14) considers the following factors in determining whether a unitary business exists:

- ▶ The activities of the affiliated group members are in the same general line of business;
- ▶ The activities of the affiliated group members are steps in a vertically integrated operation; or
- ▶ The affiliated group members are functionally integrated through the exercise of strong centralized management, such as authority over purchasing, financing, product line, personnel, and marketing.

In determining whether a unitary relationship exists, 34 Tex. Admin Code § 3.590(b)(6) provides that consideration should be given to “the entity’s sources of supply, its goods or services produced or sold, its labor force, and market to determine whether the joint, shared, or common activity is directly beneficial to, related to, or reasonably necessary to the income-producing activities of the unitary business.” It also creates a presumption of a unitary business in the case of affiliated entities.

**RULING:** The Administrative Law Judge (“ALJ”) ruled that Company B overcame the presumption that Company A and Company B were engaged in a unitary business, and recommended dismissal of the assessments. The ALJ found that both entities operated independently with respect to their critical functions, and the shared administrative functions did not “amount to centralized management, much less strong centralized management.” In addition, the Comptroller had conceded that Company A and Company B did not satisfy either of the first two factors in the statute.

***SOAH Docket No. 304-15-0925.13 (Sept. 3, 2015) - Reinsurance company not excluded from a Texas unitary combined group; credit card interchange fees sourced to place of performance***

**FACTS:** The taxpayer, a federal savings bank, and a common parent corporation of a Texas unitary combined group owned four captive insurance companies and a Bermuda reinsurance company. The captives and the reinsurer were all non-admitted insurance companies in Texas. The captives paid a gross premiums tax to the states where they were domiciled. The reinsurer paid an annual company fee to Bermuda.

For the taxable years at issue, the taxpayer filed a Texas combined return that did not include the captive insurance companies or the Bermuda reinsurance company, based on the contention that each company was exempt from tax - the captives insurance companies because they reported and paid gross premiums tax to other states, and the Bermuda reinsurance company because the companies it reinsures paid gross premiums tax on the policy premiums paid to it. In addition, the taxpayer excluded interchange fees related to VISA credit cards it issued from Texas gross receipts for apportionment purposes, based on the contention that they were attributable to services performed outside the state. On audit, the Comptroller included the captive insurance companies and the Bermuda reinsurer in the combined group, included the interchange fees in the apportionment factor as Texas receipts, and assessed the corresponding franchise tax. The taxpayer protested the assessment.

**LAW:** Texas law excludes a non-admitted insurance company that pays a gross premiums tax during a taxable year from the unitary combined group of a taxpayer that is required to file a Texas combined franchise tax report. See Tex. Tax Code §§ 171.0002(b)(4) and 171.052(a), and 34 Tex. Admin. Code §§ 3.581(d)(4), 3.583(d)(1), and 3.590(b)(2)(B). In addition, Texas law provides that receipts from the sale of a service are sourced to Texas based on the fair value of the service that has been rendered in the state. See Tex. Tax Code § 171.103(a), and 34 Tex. Admin. Code § 3.591(e)(26).

**RULINGS:** The ALJ ruled that the payment of gross premiums tax to any state or foreign jurisdiction satisfies the statutory requirement for exclusion of an insurance company from a Texas unitary combined group, and found that the auditor erred when it included the captive insurance companies in the taxpayer's combined group. However, the ALJ also ruled that the Bermuda annual company fee was not recognized as a gross premiums tax, and any gross premiums taxes remitted to Texas or other states on insurance and premiums ceded to the reinsurer do not qualify as the payment of a gross premiums tax by the reinsurer. As a result, the ALJ found that the auditor did not err when it adjusted the taxpayer's franchise tax reports to include the Bermuda reinsurer.

On the apportionment issue, the ALJ concluded that none of the interchange fees should be included in Texas receipts because all of the services were performed outside the state. Accordingly, the ALJ recommended that the interchange fees should be removed from the taxpayer's franchise tax assessments.

***Private Letter Ruling No. 201604750L (Apr. 12, 2016) - Commissions received for on-line matching of shipping customers and carriers sourced to the location of the servers***

**FACTS:** The taxpayer is an Arizona headquartered transportation management company that has a sales employee and independent contractors who are primarily engaged in solicitation activities in Texas. These individuals also perform certain customer service activities, none of which are revenue generating. The taxpayer matches shipping customers and transportation companies through proprietary online software stored on a server located in Arizona. The software allows a shipping customer to post a shipping need and view bids from different transportation carriers. Shipping customers make payments to the taxpayer, who remits the payment to the transportation carrier, less a portion retained by the taxpayer as a commission.

**LAW:** Texas law provides that receipts from the sale of a service are sourced to Texas based on the fair value of the service that has been rendered in the state. See 34 Tex. Admin. Code § 3.591(e)(26). The Comptroller advised in Decision No. 104,224 (2013) that the determination of where services are performed is based on the location at which the "specific, end-product acts for which the customer contracts" take place, not the location at which "non-receipt producing, albeit essential, support activities" are performed."

**RULING:** The Comptroller ruled that no portion of the revenues earned by the taxpayer for matching shipping customers and transportation carriers should be apportioned to Texas. The Comptroller reasoned that the taxpayer's customers pay for a matching service - not the customer service activities - which are provided online through the proprietary online software located and maintained outside Texas.

## BDO INSIGHTS

- ▶ The *Hallmark Marketing* decision and the other administrative rulings provide some helpful guidance on the composition and sourcing of the Texas sales factor formula.
- ▶ The SOAH rulings may provide planning guidance or help to identify a potential refund with respect to the composition of a unitary combined group. However, since the unitary business principle can be a “double-edged sword,” they could also be a reminder of potential audit exposure.

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