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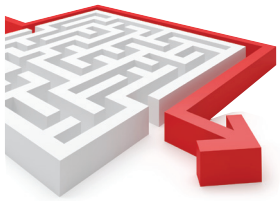

Recent Developments in Texas Multistate Tax Compact Litigation

Is There Hope for Texas Franchise Tax Refunds Based on Retroactive Use of Three-Factor Apportionment?

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The last several years have seen litigation brought in multiple states asserting that taxpayers have a right to compute their state income tax liability using the Multistate Tax Compact's (the Compact) allocation and apportionment provisions in lieu of less favorable methods specified by state tax law. In Texas' lead case on the issue, *Graphic Packaging Inc. v. Combs*, the taxpayer lost at the trial court level, but has recently filed its opening brief with the Third District Court of Appeals in Austin to continue the challenge. Clients whose franchise tax liability would be reduced by applying the Compact's "three-factor" apportionment rather than Texas' default "single factor" apportionment should monitor carefully the progress of this case, and should consider taking prophylactic action to preserve potential refund claims. A taxpayer is most likely to benefit from using the Compact's formula if the percentage of its total property and payroll located in Texas is less than the percentage of its total gross receipts sourced to Texas.

Section 171.106(a) of the Texas Tax Code requires taxpayers to compute Texas franchise tax liability by applying a single-factor apportionment formula. To compute franchise tax, a taxpayer first determines its "margin" of total revenue less certain deductions and subtractions, then computes its "taxable margin" by multiplying its margin by an apportionment factor equal to Texas gross receipts divided by total gross receipts, then computes tax due by applying the applicable tax rate to its taxable margin.

Since 1967, Texas has been a member of the Compact. *See* Texas Tax Code §141.001. The Compact is a multistate agreement that, among other things, obligates member states to offer their multistate taxpayers the option of either using the apportionment formula specified by the state's tax laws or using the Compact's three-factor apportionment formula, which is based on the relative in-state vs. out-of-state proportions of sales, property, and payroll. The heart of the recent state tax litigation is taxpayers' assertion of a right to use the Compact's apportionment formula when it yields lower taxes than the states' normal apportionment formulas.

Graphic Packaging, Inc., the taxpayer in Texas's lead Compact litigation, is currently appealing an adverse trial court outcome in its suit, *Graphic Packaging Inc. v. Combs*, No. 03-14-00197-CV, to recover franchise tax refunds. The trial court granted the Comptroller's motion for summary judgment without explanation or analysis, and the case is now pending in the Third District Court of Appeals in Austin on the following points of appeal:

(1) Whether the enactment of the Texas franchise tax and its single-factor apportionment formula constituted an implied repeal of the Compact's apportionment election provision;
(2) If the Texas Legislature impliedly repealed the Compact's election provision, whether such repeal was valid, or instead was impermissible because the Compact is an interstate agreement that is binding in its entirely on all party states unless and until the state withdraws; and

(3) If the Compact's apportionment election provision was not validly repealed, whether the Texas franchise tax is an "income tax" subject to the election provision.

Similar Compact litigation in other states reflects the potential strength of the arguments, and also illustrates potential legislative responses:

California: The taxpayer in *The Gillette Co. v. Franchise Tax Board*, No. CGC-10-495911 (Oct. 25, 2010), argued that it validly elected to use the Compact's three-factor apportionment formula in lieu of the statutory formula mandated by California. The appellate court found that the Compact was a valid interstate compact that trumped subsequent California state legislation and that taxpayers, in calculating their California income tax, were entitled to elect to use the Compact apportionment formula. *The Gillette Co. v. Franchise Tax Board*, 147 Cal. Rptr. 3d 603 (Cal. Ct. App. 2012); petition for review granted, 291 P.3d 327 (Cal. 2013). California withdrew from the Compact in 2012 as result of the litigation, and the California Supreme Court granted certiorari in *Gillette* in January 2013.

Michigan: Like in *Gillette*, the taxpayer in *International Business Machines Corp. v. Dep't of Treas.*, 2012 WL 6913772 (Mich. App.) claimed that it was entitled to tax refunds because of Michigan's adoption of the Compact in 1969. In 2007 Michigan enacted a new modified gross receipts business tax that included a single-factor apportionment formula, but IBM asserted a right to use the Compact's three-factor formula. The Michigan Supreme Court held that (1) the enactment of the new tax's single-factor formula did not repeal the Compact by implication and (2) the state's modified gross receipts tax fell within the scope of Compact's definition of "income tax," entitling the taxpayer to use the Compact's three-factor formula. *Int'l Bus. Machines Corp. v. Dep't of Treas.*, 496 Mich. 642 (2014). On September 11, 2014, Michigan passed legislation that retroactively repealed the Compact, effective January 1, 2008. The bill's passage ostensibly supersedes the Michigan Supreme Court's recent decision and eliminates any right to refunds.

Oregon: *Health Net, Inc. v. Dep't of Rev.* Oregon Tax Court, No. 120649D (filed July 2, 2012), is a Compact litigation case pending in Oregon. Oregon imposes a single-factor apportionment formula, and taxpayers have asserted the right to a Compact election in Oregon. In response and to avoid the problem in future years, Oregon repealed the statutory election provision of the Compact.

Other states: Like Oregon, Utah and the District of Columbia have withdrawn from the Compact, then reenacted it without the troublesome apportionment formula election provision. Minnesota has withdrawn from the Compact, but still allows for state participation in Multistate Tax Commission audits.

As is usually the case with litigation, it's unclear whether Graphic Packaging, Inc. will ultimately prevail on appeal in Texas. Nevertheless, clients who would benefit from a taxpayer victory should consider taking prophylactic action to preserve their own potential refund claims. The simplest protection is to timely file amended franchise tax returns using the three-factor Compact apportionment formula before the statute of limitation closes for any tax year. However, there's an unresolved procedural issue as to whether an amended return preserves a potential refund claim if a taxpayer's original return is filed using Texas' single-factor apportionment formula. We understand the Comptroller's current position is that if the taxpayer prevails in *Graphic Packaging*, Texas law would allow other taxpayers to claim refunds based on amended returns that change from single-factor to three-factor apportionment. To eliminate uncertainty, taxpayers could consider using the Compact's three-factor apportionment formula when filing original franchise tax returns, or possibly preserving the issue by filing original returns under protest.

For more information on the matters discussed in this *Locke Lord QuickStudy*, please contact one of the authors:

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