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TAX STRATEGIES

Texas Supreme Court Denies Review of Court of Appeals Decision Holding Texas Franchise Tax Earned Surplus Throwback Unconstitutional

In a case in which Strasburger & Price, LLP represented Home Interiors & Gifts, Inc. ("Home Interiors") a Texas Court of Appeals has ruled that the Texas franchise tax earned surplus throwback provision as applied to Home Interiors unconstitutionally burdens interstate commerce in violation of the Commerce Clause of the United States Constitution. *Home Interiors & Gifts, Inc. v. Strayhorn*, 175 SW 3d 856 (Tex. App. – Austin, 2005.) The Texas Comptroller petitioned the Texas Supreme Court to review the Court of Appeals decision. On March 9, 2007, the Supreme Court denied the Comptroller's Petition for Review and on June 1, 2007, it denied the Comptroller's motion for rehearing of that denial. The decision is now final in the Texas courts. The Comptroller is considering whether to seek review by the United States Supreme Court.

HOME INTERIORS

Home Interiors is a Texas corporation which manufactures and purchases home decor products, accessories, and gifts, and then wholesales them to independent contractors throughout the country. During the periods in issue, approximately 90% of Home Interiors' sales were to customers outside of Texas.

THE TEXAS FRANCHISE TAX

The Texas franchise tax is imposed on corporations for the privilege of doing business in Texas. The tax (prior to the recently-enacted "Margin Tax") was in effect the greater of 4.5% of "net taxable earned surplus" or .25% of "net taxable capital." Net taxable earned surplus and net taxable capital are apportioned to Texas on the basis of the ratio of a corporation's gross receipts generated in Texas to its

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world-wide gross receipts.

TEXAS' THROWBACK PROVISIONS

For purposes of determining these apportionment ratios, Texas adopted two different provisions that treat sales of tangible personal property shipped from Texas to customers outside of Texas as though the sales were made to customers in Texas. These are known as the "throwback" provisions. To apportion net taxable capital, sales are thrown back to Texas if the corporation is not "subject to taxation" in the purchaser's state. Tex. Tax Code §171.103 (1). To apportion net taxable earned surplus, sales are thrown back to Texas if the corporation is not "subject to any tax on, or measured by, net income" in the purchaser's state. Tex. Tax Code §171.1032(a)(1).

Public Law 86-272

The court explained that the different standards for throwback were adopted because Texas sought to tax income from sales to customers in states that were prohibited by Public Law 86-272 from imposing an income tax on the seller. Public Law 86-272 [15 U.S.C. §381(a)] was adopted by Congress in 1959 to create minimum standards for business activity in a state before that state may impose a tax "on, or measured by, net income."

COMMERCE CLAUSE REQUIREMENTS

Under the U.S. Constitution, a state tax on interstate commerce must be fairly apportioned. The U.S. Supreme Court has held that a tax is fairly apportioned if it is both "internally consistent" and "externally consistent." To be internally consistent, a tax, if hypothetically adopted by all states in which interstate commerce is conducted, must impose no greater burden on interstate commerce than would be imposed by the same tax on commerce occurring solely within the taxing state. *Oklahoma Tax Comm'n v. Jefferson Lines, Inc.*, 514 U.S. 179 (1995). The court ruled that the earned surplus throwback provision requiring Home Interiors to "throwback" out-of-state sales in computing the earned surplus portion of the Texas franchise tax violated the fair apportionment requirement because it caused the tax to be internally inconsistent.

INTERNAL CONSISTENCY TEST

Applying a hypothetical standard under which all states are assumed to impose a tax similar to the Texas franchise tax,

the court reasoned that an interstate corporation could be subject to tax on its taxable capital in every state where it established substantial nexus, as well as a tax on 100 percent of its earned surplus in Texas, while a corporation operating only in Texas would be subject to tax only on the greater of its taxable capital or earned surplus. The additional tax burden on corporations operating in interstate commerce violated the Commerce Clause.

POTENTIAL REFUND OPPORTUNITY

Although the dual tax base and throwback provisions have been eliminated in the new Margin Tax, businesses that, under the former franchise tax, paid increased tax due to earned surplus throwback should consider filing claims for refund. Likely candidates for refunds include businesses that:

- sold tangible personal property that is shipped from Texas to purchasers in one or more other states;
- were protected by Public Law 86-272 from a tax on net income in those states; and
- had sales to those states thrown back to Texas for apportioning earned surplus.

Refund claims are subject to a four year period of limitations. Tex. Tax Code Sections 111.107(a) and 111.201. Taxpayers that obtained valid extensions of their 2003 Texas franchise tax reports may be able to obtain refunds for their 2003 report year by ***filing refund claims by November 15, 2007.***

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