



MULTISTATE INCOME/FRANCHISE TAX

Texas Court of Appeals affirms net proceeds from hedging transaction included in sales factor Tax Alert

Overview

On October 14, 2021, the Texas Court of Appeals (“Court of Appeals”) affirmed the Travis County District Court ruling that only net proceeds, not gross proceeds, from the sales of commodity futures contracts should be included in the taxpayer’s apportionment factor denominator for Texas franchise tax purposes. [Case No. 03-21-00011-CV](#), Tex. Ct. App. (Oct. 14, 2021).

This Tax Alert summarizes the Court of Appeals’ decision and offers some taxpayer considerations. The key issues surrounding the Court of Appeals’ decision are discussed in more detail within a previous alert involving a related case, available [here](#).

Summary of case

Under Tex. Tax Code § 171.1011(g-2), a taxpayer is required to exclude from its total revenue the tax basis of securities and loans sold. As noted by the Court of Appeals, to the extent the tax basis is excluded from total revenue, the tax basis is similarly excluded from the Texas apportionment factor numerator and denominator. Consequently, only the *net proceeds* from such securities are included within a taxpayer’s Texas apportionment factor. However, if a loan or security is treated as inventory of the seller for federal income tax purposes, the *gross proceeds* from the sale are considered gross receipts pursuant to Tex. Tax Code § 171.106(f).

The taxpayer in this case refines crude oil and sells gasoline and petroleum-based products. As part of its overall operations, the taxpayer bought and sold commodity future contracts and options on such contracts. From a federal income tax perspective, the taxpayer reported the sale of the commodity futures under I.R.C. sec. 475(a)(2) and elected for mark-to-market accounting rules to apply to the securities under I.R.C. sec. 475(e)-(f).

For Texas franchise tax purposes, the taxpayer included the gross proceeds from the sale of the securities in its apportionment factor denominator, but

not the Texas numerator, because the sales generating the proceeds occurred outside of Texas. On audit, the Texas Comptroller (“Comptroller”) determined only the net proceeds were includable in the taxpayer’s apportionment factor denominator, which resulted in additional franchise tax owed to the state.

The taxpayer protested the Comptroller’s decision to state district court. The district court upheld the audit findings and ruled in favor of the Comptroller. The taxpayer appealed the district court ruling.

The Court of Appeals affirmed the district court’s ruling and held only the net proceeds from the sale of the taxpayer’s securities that were reported as “non-inventory” for federal income tax purposes should be included within the Texas apportionment factor denominator.

Observations: It should be noted a taxpayer may file a petition for review with the Texas Supreme Court within 45 days after the Court of Appeals renders judgment. As of the release date of this Tax Alert, the taxpayer has not filed a petition for review; however, the period during which such filing may be made remains open. Taxpayers engaged in multistate tax services with similar fact patterns are advised to consult with their tax advisors to determine potential Texas franchise tax implications.

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