Texas Comptroller decides interest income from operational asset included in Texas receipts

Overview

On September 9, 2019, the Texas Comptroller of Public Accounts (Comptroller) adopted the Administrative Law Judge's (ALJ) recommendation in a redacted decision finding a taxpayer (Taxpayer) may not include interest income claimed to be nonbusiness income from its total revenue. Further, Taxpayer must exclude proceeds from commodity hedges from its gross receipts for apportionment purposes in these circumstances.[1]

As described below, the Comptroller determined the Taxpayer's interest income, which was generated from the sale of a unitary business, should be included in its total revenue. The Comptroller also decided the Taxpayer did not meet its burden of proof to show the commodity hedges were inventory; thus, the net proceeds cannot be included in gross receipts.[2] For purposes of this determination, the ALJ noted the Taxpayer's federal treatment of these items as cost of goods sold (COGS).

This tax alert summarizes the Comptroller's decision as well as offers some taxpayer considerations.

Background facts

Taxpayer was audited by the Comptroller for franchise tax purposes for report years 2011, 2012, 2013, and 2014 (Report Years), which resulted in additional tax due for 2014 and credits for the other periods. Taxpayer requested a redetermination seeking additional adjustments to exclude certain interest payments from its total revenue calculation and include gross proceeds from commodity hedges within gross receipts.

Income from sale of unitary business

Prior to 2008, Taxpayer, a packaged food company, operated in three major segments: consumer foods; international foods; and food and ingredients. In 2008, Taxpayer entered into a sales agreement with an independent entity (Company B) to sell a segment of its food and ingredients business, which among other things, involved agricultural and energy commodities trading services, in exchange for cash, stock, short term receivables, and payment in kind debt (PIK Notes). After the sale, Taxpayer did not retain any stake in the business, did not have any operations in that line of business, and did not share any officers, directors, or personnel with Company B. As a result of the sale, Taxpayer's PIK Notes produced interest income. For each Report Year, Taxpayer classified this interest income as nonbusiness income on its Texas franchise tax reports for the Report Years at issue and deducted the amounts from its taxable margin calculation.

Commodity hedge settlement

Additionally, during the Report Years, Taxpayer entered into commodity hedges designed to protect against an increase in the price of the raw materials needed for manufacturing. The transactions were notional contracts were neither party actually held the underlying asset. Taxpayer bought and sold commodity hedges through commodity exchanges and used various exchanges located outside of Texas. For federal purposes, Taxpayer reported the net gain or loss from the settlement of its hedging transactions as part of its COGS on Line 2. For Texas purposes, the Taxpayer included the gross settlement proceeds in its entire gross receipts.

Comptroller's decision

Income from sale of unitary business

During the examination, the auditor disallowed the deduction for the interest income on the grounds the interest earned was a product of the unitary relationship between Taxpayer and the business that was sold as an operational asset. The Comptroller further asserted during the appeal the interest was an operational asset since it effectively lowered the overall interest obligations of the Taxpayer.

[1] A similar issue involving commodity hedges is currently pending in Travis County District Court. Cause No. D-1-GN-18-004006 (126th Dist. Ct., Travis County, Tex. Aug. 2, 2018).
[2] Texas Comptroller of Public Accounts, Accession No. 20190880H, Hearing Nos. 114,432, 114,433, 114,434, and 114,435 (Aug. 15, 2019), available at https://star.comptroller.texas.gov/view/20190880H.

A taxable entity's Texas franchise tax liability is determined by calculating the entity's taxable margin and then apportioning the taxable margin to Texas by multiplying the taxable entity's margin by a fraction, the numerator of which is the taxable entity's gross receipts from business done in this state and the denominator of which is the taxable entity's gross receipts from its entire business.[3] Under Texas statutory law, business income is all income arising from the regular course of trade of business; all other income is considered nonbusiness income.[4] A taxable entity's "gross receipts from its entire business" is the sum of the taxable entity's receipts from each sale of tangible personal property; each service, rental, or royalty; and other business.[5] Taxpayer determined the interest earned on the PIK Notes was not derived from unitary sources, and therefore, reported the interest income as nonbusiness income.

Under Texas Administrative Code (TAC) § 3.587(c)(9), Texas cannot tax revenue that does not have a sufficient unitary connection with an entity's other activities conducted in Texas.[6] While the Texas Tax Code (TTC) does not define what constitutes a "unitary connection," Texas looks to guidance set forth by the U.S. Supreme Court (Court).[7]

The Court has set forth three factors that generally can be used when determining whether a unitary connection exists between entities: common ownership; centralization of management; and integrated operations. As explained by the ALJ, a unitary connection can be established through an asset with an operational function in the business, not simply based on the relationship between entities themselves. The ALJ provided examples where an asset served an operational function, even if there was not a unitary relationship between parties of a transaction.

In this case, the Taxpayer argued the interest income was not unitary, although the Taxpayer conceded it was unitary with the trading and merchandising segment prior to the sale. However, Taxpayer contended the interest earned on the PIK Notes was non-unitary income now because: (i) Taxpayer did not retain an interest in the business; (ii) Taxpayer did not continue to operate in the same line of business as Company B; (iii) Taxpayer and Company B were independent entities that did not share executives, personnel, or officers before or after the sale; and (iv) the PIK notes were investments.

Ultimately, the ALJ determined the interest accrued from the PIK Notes acted as an operational asset to the Taxpayer's business even if a relationship did not exist between Taxpayer and Company B. The ALJ noted Taxpayer and Company B were separate entities and did not share a unitary connection because Taxpayer did not retain a stake in the business sold, nor did it operate in the same line of business. However, the Taxpayer was unitary with the business it sold at the time of the sale because of its shared ownership and management structure, and the sale of this business ultimately generated the PIK Notes and interest income at issue. Therefore, the interest income from this transaction was part of a unitary connection previously established between the Taxpayer and the trading and merchandising business and should be included in the Taxpayer's gross receipts for apportionment purposes.

Commodity hedge settlement

Due to the Taxpayer's federal reporting of the commodity hedges on Line 2 (COGS) rather than Line 1 (income/loss), the auditor determined the Taxpayer did not treat the commodity hedges as inventory. Therefore, the gross proceeds from the commodity hedge settlements were not includable in Taxpayer's everywhere receipts calculation for Texas franchise tax purposes.

Under TTC § 171.106(f), if a loan or security is "treated as inventory of a seller for federal income tax purposes, the gross proceeds from the sale of that loan or security are considered gross receipts."[8] When determining whether securities are held as inventory, Texas guidance instructs auditors to review a Taxpayer's federal classification, as reflected on a Form 1120, and internal records.[9] The Comptroller has previously indicated that gains and losses reported on federal Form 1120, Line 1, as ordinary gains and losses, represent securities held for inventory.[10] Alternatively, gains and losses reported on federal Form 1120, Line 8, as capital gains and losses, represent securities held for a Taxpayer's own investment.[11]

Here, the ALJ considered the reporting on Taxpayer's Form 1120, which showed the hedging settlement proceeds on Line 2 (COGS) instead of being reported as income on Line 1 determinative.[12] Based on the Taxpayer's federal reporting

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[3] *Id.* (citing Tex. Tax. Code §§ 171.002, 171.103, 171.106; 34 Tex. Admin. Code § 3.591(c)).
[4] Tex. Tax. Code § 141.001.
[5] Texas Comptroller of Public Accounts, Accession No. 20190880H, Hearing Nos. 114,432, 114,433, 114,434, 114,435 (Aug. 15, 2019).
[6] *Id*. (citing 34 Tex. Admin Code § 3.587(c)(9)).
[7] *Id*. (internal citations omitted).
[8] *Id*. (citing Tex. Tax. Code § 171.106(f); 34 Tex. Admin. Code § 3.591(e)(16)).
[9] *Id*. (citing Apportionment of Proceeds from the Sale of Futures Contracts and Securities, Accession No. 201311792L (Nov. 21. 2013), available here).
[10] *See id*.
[11] Texas Comptroller of Public Accounts, Accession No. 20190880H, Hearing Nos. 114,432, 114,433, 114,434, 114,435 (Aug. 15, 2019).
[12] *Id*.

methodology, the ALJ concluded Taxpayer did not meet its burden of proof to show the securities were not held as inventory. Therefore, Taxpayer's proceeds from its commodity hedging activities were properly excluded by the auditor when determining Taxpayer's gross receipts.

Considerations

Based on the ruling, it appears the Comptroller may challenge the state classification of hedges treated as inventory, thus includible in the Texas receipts factor, if these items are not reported on Line 1 of the federal Form 1120. Taxpayers that have recently sold, or intend to sell, significant assets in the near future may want to consult with their tax advisers to determine potential Texas franchise tax implications. Further, taxpayers utilizing commodity hedges may want to consult with their tax advisers to determine the impact of federal reporting methods for Texas franchise tax purposes.

Contacts:

If you have questions regarding the Comptroller's decision or other Texas tax matters, please contact any of the following Deloitte professionals:

Robert Topp
Managing Director
Deloitte Tax LLP, Houston
+1 713 982 3185
rtopp@deloitte.com

Jacob Aguero
Partner
Deloitte Tax LLP, Houston
+1 713 982 4246
jaguero@deloitte.com

Lauren Rothman
Senior Manager
Deloitte Tax LLP, Houston
+1 713 982 2462
lrothman@deloitte.com

Scott Bedunah
Senior Manager
Deloitte Tax LLP, Dallas
+1 214 840 1722
scbedunah@deloitte.com

Grace Taylor
Manager
Deloitte Tax LLP, Houston
+1 713 982 3809
grtaylor@deloitte.com

For further information, visit our website at www.deloitte.com/us/multistatetax

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