

NAME: RE: * * *

NUMBER: HEARING NO. 41,102

COURT: COMPTROLLER OF PUBLIC ACCOUNTS OF THE STATE OF TEXAS

CITE: 2008 *Tex. Tax LEXIS 11*

DATE: April 9, 2008

PANEL: [*1]

ROY G. SCUDDAY, Administrative Law Judge

COUNSEL: ROBERT E. SCOTT, Representing Tax Division

* * *, Representing Petitioner

OPINIONBY: SCUDDAY

TAXPAYER NO.: * * *

AUDIT OFFICE: * * *

AUDIT PERIOD: January 1, 1995 Through December 31, 1998

FRANCHISE TAX/RDT

COMPTROLLER'S DECISION

PRELIMINARY DISCUSSION:

This case was heard at an oral hearing on September 25, 2002. Petitioner, * * *, was represented at the hearing by attorneys * * * and * * * who called as witnesses * * *, Vice President of Petitioner, * * *, Vice President of * * *, and * * *, an attorney. The Tax Division was represented by Assistant General Counsel **Elias V. Lorenzana, Jr.**, who called as a witness Geovan Gedeon, an auditor with the * * * audit office.

Unless otherwise indicated, all Section references are to Title 2, Texas Tax Code Annotated, and all Rule references are to sections of Title 34, Texas Administrative Code. Notice has been taken of all Comptroller's records pertinent to Petitioner and the issues raised in this case.

On October 24, 2006 the Petitioner filed Exceptions to the October 12, 2006, Proposed Comptroller's Decision. The Tax Division filed its Response to these Exceptions on November 8, 2006. The ALJ [*2] and the Comptroller have considered the Petitioner's Exceptions and the Tax Division's Response, and this Comptroller's Decision represents the ruling thereon.

PETITIONER'S CONTENTIONS:

1. Petitioner contends that it had no nexus in Texas prior to January 1997.
2. Petitioner contends that the auditor incorrectly apportioned intercompany fees to Texas.
3. Petitioner contends that the surplus for the report years should be reduced by the short-sales securities liabilities, which qualify for treatment as debts.

FINDINGS OF FACT:

1. * * * (Petitioner) is a registered securities broker-dealer.

2. The Comptroller audited Petitioner for franchise tax compliance for the 1995 through 1998 report years. On September 26, 2000, a Texas Notification of Audit Results was issued that showed an amount due that included tax, penalty on late-filed returns, and interest through the date of the Notification. Petitioner's timely filed request for redetermination resulted in this proceeding.

3. Prior to January 1997, Petitioner had no permanent employees in Texas, did not own or lease real or personal property in Texas, and did not maintain a place of business in Texas. Petitioner's representatives [*3] made 7 visits to Texas from November 1993 to October 1994 for client visits, marketing, and client maintenance. Petitioner made 10 visits to Texas from November 1994 to October 1995 for client visits, customer calls, business entertainment, and training. Petitioner made 16 visits to Texas from November 1995 to October 1996 for client visits, marketing, and business entertainment. Petitioner's representatives met with specific customers either at their offices or at third party establishments in order to promote its products.

4. Petitioner is a subsidiary of * * * (COMPANY A). Petitioner opened a CITY A branch in January 1997. The branch sold bank loan products and other financial products such as bonds on behalf of COMPANY A and its affiliates.

5. Petitioner performed services for COMPANY A and other affiliates, 19 of which are located in CITY A, such as acting as agent in connection with purchases, sales financing, or exchanges of assets; providing advisory services; acting as arranger to invest in credit and loan products; and providing execution and settlement of orders.

6. The auditor scheduled fee income shown on Petitioner's Profit and Loss Statements and Federal Income [*4] Tax Returns as Texas Receipts for the audited report periods, Petitioner having reported no Texas Receipts for those periods. The auditor requested that he be provided with documentation concerning where the services for which the fees were paid were performed, which documentation was not submitted. The auditor subsequently scheduled all amounts listed as Fee Income-CITY A on Petitioner's profit and loss statements as Texas Receipts.

7. During the audited report periods, Petitioner, in its capacity as a broker/dealer and investment banker, regularly entered into short sale positions as part of its ordinary course of business. In these short sales Petitioner filled purchase orders by delivering securities that it had borrowed from other institutions. The obligation to repay the securities was payable on three-days' demand. Petitioner recorded the short sale liability in its books at the current market value of the security, not at the value of the security on the date it was payable. The auditor included the amounts of these short sale security reserves in the calculation of surplus for report years 1997 and 1998.

DISCUSSION AND CONCLUSIONS OF LAW:

PETITIONER'S FIRST CONTENTION:

[*5]

Petitioner's first contention should be denied.

Chapter 171 of the Tax Code provides for the franchise tax to be assessed on corporations doing business in Texas and is based on either taxable capital or taxable earned surplus. Comptroller Rule 3.546(b) provides that a corporation is doing business in Texas for the taxable capital component when it has "sufficient contact with this state to be taxed without violating the United States Constitution." Subsection (c)(4) of that rule provides that activities constituting doing business in Texas include having "independent contractors, agents, or other representatives promote or induce sales of the foreign corporation's goods or services."

It is only reasonable to conclude that the purposes of the client visits and customer calls was to "promote or induce sales" of Petitioner's products. As a result, Petitioner had nexus in Texas from November 1993 for the taxable capital component.

Comptroller Rule 3.554(a) provides that a corporation is doing business in Texas for the earned surplus component when it has "sufficient contact with this state to be taxed without violating the United States Constitution." Subsection (c)(1) provides [*6] that for the Texas activity to be immune under Public Law 86-272, it "must be limited solely to

solicitation," which is defined to include "activities that neither explicitly nor implicitly invite an order, but are entirely ancillary to requests for an order."

The client visits and customer calls exceed the protected activities. As a result, Petitioner had nexus in Texas from November 1993 for the taxable earned surplus component.

PETITIONER'S SECOND CONTENTION:

Petitioner's second contention should be denied.

The Comptroller has held that a taxpayer cannot defeat a tax assessment by failing to provide requested documentation necessary for the Tax Division to meet its burden of proof on assessing tax on services. Comptroller Decision Nos. 30,367 (1994) and 32,800 (1995). Likewise, a taxpayer cannot avoid tax on Texas Receipts by failing to provide documentation requested to determine what constitutes Texas Receipts.

Petitioner had the burden to produce the requested documentation. Inasmuch as the fees were designated as being CITY A fees, on their face they would appear to be Texas Receipts. As a result, Petitioner cannot defeat the assessment without providing the requested [*7] documentation.

Petitioner argues that Mr. ***'s testimony established that only \$ *** of fee income in Report Year 1998 was Texas Receipts rather than the \$ *** shown as Fee Income-CITY A on Petitioner's Profit and Loss Statement. However, Mr. *** acknowledged that wired receipts were the source documents for the reports prepared by Petitioner's managers on which he based his conclusions, and that the point of origination on which he relied for his conclusions was the location where the transaction was handled administratively rather than the place where the transaction originated. In addition, Petitioner did not provide any documentation to show how the wire receipts corresponded to where the services were performed. As a result, Petitioner has not met its burden to show that the auditor's characterization of the CITY A fee income as Texas Receipts was in error.

PETITIONER'S THIRD CONTENTION:

Petitioner's third contention should be denied.

Section 171.101 provides that the taxable capital component is computed by adding the corporation's stated capital and the corporation's surplus. Section 171.109 defines "surplus" as the net assets of a corporation minus its stated capital." [*8] "Net assets" is defined as the "total assets of a corporation minus its total debts." "Debt" is defined as "any legally enforceable obligation measured in a certain amount of money which must be performed or paid within an ascertainable period of time or on demand."

Petitioner argues that short sale liabilities were legally enforceable obligations to repay the securities and the obligations were measured in certain amounts of money. Accordingly, Petitioner argues that these "short sale liabilities" qualify as debt under Sec. 171.109(a)(3). Petitioner cites *Arch Petroleum, Inc. v. Sharp*, 958 S. W. 2d 475, (Tex. App. - Austin 1997) in support, in which the Court stated that the statute "requires only that the obligation be measured in an amount of money; there is no requirement that it be satisfied in that amount of money."

The Tax Division responds that the market price determinations for the borrowed securities were not set at certain amounts at the date of the trade because that amount would not be determined until the date of settlement. Accordingly, these "short sale liabilities" are estimates of what Petitioner would owe if the short sale were immediately [*9] satisfied, citing Comptroller Decision No. 39,347 (2001). As a result, they are not "measured in a certain amount of money" and don't qualify as debt.

In *Arch Petroleum, Inc. v. Sharp*, 984 S.W.2d 475 (Tex. App.-Austin, 1997, no writ) the Court ruled that obligations embodied as convertible redeemable preferred stock may qualify as debt under the Texas Tax Code, and that the amount of such obligations may be deducted from the taxpayer's surplus. In reviewing the statutory definitions of the various components which make up a taxpayer's taxable surplus, the Court concluded that the statutory definitions provided that if an obligation were contingent, it could not be characterized as debt and would, therefore, be includible in the taxpay-

er's taxable surplus. Likewise, if an obligation were not measured in a certain amount of money, it was also not characterized as debt and was not deductible from taxable surplus.

The Court stated further that a contingent liability is "one in which liability has not been incurred with certainty." . . . "[A] contingent obligation that must be included in surplus is one in which the actual incurrence of liability is still [*10] uncertain." The conversion feature of the obligation did not affect "whether the obligation had been incurred, but only how the obligation would be satisfied." p.478. The Court held that Arch's obligation was measured in a certain amount of money. The parties contractually set the amount of the liability at \$ * * *. The Court held that exercising of the conversion option "would only have changed the form as to how Arch's obligation must be satisfied." p.479.

Comptroller Decision No. 36,769 (1998) analyzed the holding in Arch Petroleum as it applied to a "Shadow Stock Plan" obligation of the taxpayer to an employee. The taxpayer argued that the vested portion of its Shadow Stock Plan obligation is measured in a certain amount of money, because on December 31 of each fiscal year the vested portion of the Shadow Stock Plan was a fixed, precise, and exact amount. The Comptroller, in holding that the obligation did not qualify as a "debt," distinguished Arch Petroleum.

Comptroller Decision No. 39,347 (2001) concerned the proper treatment of short sales positions of a broker/dealer for taxable capital purposes. Holding that the decision in 36,769 was directly applicable to the issue, [*11] the Comptroller held that the short sale positions did not qualify as "debt" because the "actual liability is not known until the liability is satisfied with purchase of the stock," and the broker's "daily mark-to-market calculations consequently remain estimates."

Despite the resourceful arguments made by Petitioner, Comptroller Decision No. 39,347 is directly applicable to the facts in this case. The actual value of the securities that were obligated to be repaid could not be known until those securities were repurchased, i.e., upon the settlement dates of the transactions. The values of the liabilities based on the actual market values on the dates of entry were only estimates of what that value would be on the settlement date, and because the purpose of a short sale is to buy the security at a lower price than the sales price, it is intended that the estimated value would be higher than the actual settlement value. As a result, the short sales liabilities were not debts and were properly included in the calculation of surplus.

The Comptroller policy stated in Comptroller Decision No. 39,247 that short sales were not debts resulted in an amendment to the definition of "debt" [*12] in Section 171.109, providing that debt includes "a legally enforceable obligation that requires the return of a like-kind property that was borrowed" if it is a "liability according to generally accepted accounting principles and if the return must be made within an ascertainable period of time or on demand." This amendment became effective January 1, 2004, and clearly caused short sales such as those at issue in this case to be considered debts in the calculation of surplus from that effective date. However, the stated policy in Comptroller Decision No. 39,247 was the law until the substantive change in the statute became effective, well after the report periods at issue.

RECOMMENDATION:

The audit should be upheld in its entirety.

ROY G. SCUDDAY, Administrative Law Judge

HEARING NO. 41,102

ORDER OF THE COMPTROLLER

The above decision resulting in Taxpayer's liability as set out in "Attachment A," which is incorporated by reference, is approved and adopted in all respects. The decision becomes final twenty days after the date Petitioner receives notice of this decision, and the total sum of the tax, penalty, and interest amounts is due and payable within twenty days thereafter. [*13] If such sum is not paid within such time, an additional penalty of ten percent of the taxes due will accrue, and interest will continue to accrue. If either party desires a rehearing, that party must file a Motion for Rehearing,

which must state the grounds for rehearing, no later than twenty days after the date Petitioner receives notice of this decision. Notice of this decision is presumed to occur on the third day after the date of this decision.

Signed on this 9th day of April 2008.

SUSAN COMBS, Texas Comptroller of Public Accounts

by: Martin A. Hubert, Deputy Comptroller

Legal Topics:

For related research and practice materials, see the following legal topics:

Tax LawState & Local TaxesFranchise TaxFailure to Pay TaxTax LawState & Local TaxesIncome TaxCorporations & Unincorporated AssociationsImposition of TaxTax LawState & Local TaxesSales TaxGeneral Overview

06/10/2008