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Taxation

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TAXATION

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I. SALES TAX

A. REPORTED CASES

THE reported cases covered multiple topics but also reflect the following common themes: the importance of focusing precisely on the applicable statutory language, the difficulty of articulating the standards for exemptions in complex fact patterns (such as certain software sales for resale), and the appropriate level of deference accorded to the comptroller’s interpretations. The court cases below reflect a mix of taxpayer and comptroller victories in decisions that show how the courts interpret not only the facts before them but also these repeating issues.

In *7-Eleven, Inc. v. Combs*, the taxpayer sought a refund of sales tax “assessed on 7-Eleven’s purchase of financial software for its retail

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stores.”¹ The case focuses on an issue that the comptroller and taxpayers have been debating for some time—the circumstances in which a transferor of services, software, or both is entitled to a resale exemption for software with respect to which the transferor retains some rights or benefits.² In 1993, 7-Eleven purchased a software license from Canmax Retail Systems, Inc., for custom computer software to be installed on computers in 7-Eleven’s company stores and its franchise stores, both in and outside of Texas.³ The Austin Court of Appeals agreed with 7-Eleven that some of its purchases of software qualified for the sale-for-resale exemption and that software was held in tax-free inventory until shipped out of state.⁴ A main point of discussion was whether the software could qualify for the sale-for-resale exemption as the transfer of tangible personal property integral to the performance of a taxable service (data processing) by 7-Eleven.⁵ The court of appeals concluded that 7-Eleven did indeed perform taxable data processing services for its franchisees,⁶ and even though 7-Eleven benefited from the software, “[s]o long as the purchaser’s intent in acquiring the property was to transfer it as an integral part of a taxable service, the elements of the section 151.006(3) definition would appear to be satisfied.”⁷ The court of appeals thus disagreed with the comptroller’s theory that 7-Eleven’s benefitting from the software

1. No. 03-08-00212-CV, 2009 Tex. App. LEXIS 7067; at *46 (Tex. App.—Austin Aug. 31, 2009, pet. withdrawn). Shortly before the article went to print, the Austin Court of Appeals issued a substituted opinion based on its concern that the evidence did not show whether the software involved a single license or multiple licenses that should be allocated among multiple software users. See *7-Eleven v. Combs*, No. 03-08-00212-CV, 2010 Tex. App. LEXIS 3001 (Tex. App.—Austin Apr. 22, 2010, no pet. h.). The State argued in its motion for rehearing that the comptroller has a “longstanding and consistent policy” of treating the purchase of a single license for a computer program as a single piece of tangible personal property in order to argue that the software development charges were “a single charge for a single license in the form of Golden Masters, not a price per copy.” *Id.* at *58. The case was remanded for further evidentiary determinations. The remand is noteworthy not only for the substantive issue involved, but also because the court of appeals allowed the State to raise this new argument on appeal despite the fact that, in the dissent’s words, “the State was conspicuously silent regarding this ‘longstanding and consistent policy’ until the eleventh hour of this litigation.” *Id.*

2. *Id.* at *46. This suit pertained only to licenses related to store software, and a separate suit was filed regarding host software. *Id.* at 21.

3. *Id.* at *2. The court of appeals disagreed with 7-Eleven that it could prove as a matter of law that the store software was not used in Texas merely because it was eventually installed in out-of-state company stores. *Id.* at *44. Therefore, the court of appeals determined that the record did not conclusively prove either use or absence of use in Texas with respect to software delivered out of state. *Id.* at *45. However, the court of appeals agreed that 7-Eleven’s software purchases qualified for the sale-for-resale exemption even when some portion of the software would ultimately be used by 7-Eleven rather than be resold. *Id.* at *37.

4. *Id.* The court determined that items removed from the tax free inventory were subject to sales tax rather than use tax, but it appropriately concluded that the definition of “use” is material to determining whether the items are used in Texas and therefore subject to tax. *Id.* at *41-42.

5. See *id.* at *16-27.

6. *Id.* at *19.

7. *Id.* at *23. The court of appeals disagreed with the trial court’s view that the statute contains a requirement that the recipient of the service be the “sole” benefiting party. *Id.*

somehow negated the sale-for-resale exemption.⁸

In determining whether the software was integral to the performance of data-processing services, the court of appeals focused on whether the “service could be completed but for the tangible personal property,” in this case, the software.⁹ The court of appeals held that “the store software was essential to the performance of data-processing services that were performed by 7-Eleven, [and] it is not relevant under the statute that the store software may have been put to other uses as well.”¹⁰

The court of appeals also discussed the “essence-of-the-transaction test,” developed to address sales that include both taxable and nontaxable elements, in response to the comptroller’s argument that 7-Eleven had not purchased the software for resale but rather to automate 7-Eleven’s operations and to protect its franchise fee.¹¹ The court of appeals observed that the essence-of-the-transaction test has been used to determine whether a bundled sale of taxable and nontaxable items is entirely taxable or entirely nontaxable or whether the sale can be unbundled and treated as two separate transactions (one taxable and one not), but that there was no authority to apply the test in this situation in order to negate 7-Eleven’s resale exemption.¹²

The court of appeals also correctly confirmed that the sale-for-resale exemption does not require that the reseller actually collect tax on the service, only that the service be a “taxable service.”¹³ Thus, if the tangible personal property (e.g., software) is integral to the performance of a taxable service (e.g., data processing), it should be irrelevant whether the data processing is actually taxed in the particular transaction in question.¹⁴ The court of appeals therefore reversed the trial court’s grant of summary judgment for the State and held that 7-Eleven was entitled to a sales tax refund for the purchase of Canmax store software for resale and delivery to its franchise stores.¹⁵

Combs v. Health Care Services Corp., a district court case consolidated with a Blue Cross and Blue Shield of Texas sales tax refund case, also addressed the sale-for-resale exemption.¹⁶ Health Care Services Corporation (HCSC) asserted that it provided health care management services to the federal government for resale. Specifically, HCSC claimed that: (1) certain purchases of tangible personal property were made for resale to the federal government in connection with health care management services HCSC provided to the government and (2) services consumed by

8. *Id.* at *20.

9. *Id.* at *26.

10. *Id.*

11. *Id.* at *28.

12. *Id.* at *30-32, *33.

13. *Id.* at *36.

14. *See id.*

15. *Id.* at *47.

16. *See generally* *Combs v. Health Care Servs. Corp.*, No. 03-09-00617-CV (53rd Dist. Ct., Travis County, Tex. Oct. 26, 2009). Health Care Services Corporation is the successor to Blue Cross and Blue Shield of Texas.

HCSC in performing a federal contract are subject to the sale-for-resale exemption. The district court not only agreed that the tangible personal property qualified for the resale exemption but also held that the resale tax exemption applied to leases, licenses, products, and taxable services purchased by HCSC as a contractor to implement contracts with the federal government for Medicare and personnel administration. The comptroller, fearing that the court ruling could extend the sale-for-resale exemption to service providers who sell only nontaxable services to the federal government, has appealed.¹⁷

In another software suit, Verizon North Inc. asserted that certain computer software it purchased is not tangible personal property because it is not a computer program within the meaning of the Tax Code¹⁸ and applicable regulations.¹⁹ Verizon had paid over \$1.5 million to SAP America, Inc., for Texas sales and use taxes on the software and then paid GTE Data Services, Inc., to configure, modify, and customize the software to perform the necessary business functions.²⁰ The issue was whether the software fell within the statutory and regulatory definitions of a “computer program”; if so, it was subject to sales and use tax.²¹ The Austin Court of Appeals affirmed the district court’s finding that, in line with the statutory definitions, the software was “coded for acceptance or use by a computer system and designed to permit the computer system to process data and provide results and information.”²² Verizon argued, on the other hand, that the regulatory definition of computer program requires that the series of instructions be “sold as a completed program” and that because Verizon had to pay for configuring, modifying and customization services, the software was not sold as a completed program.²³ Verizon also argued “other necessary elements, components, and capabilities were missing and had to be created before the software was complete.”²⁴ However, the court of appeals determined that the regulatory language focuses on the code and design of the software as sold, not the intended use by the purchasers, so that whether or not software is sold as complete or incomplete does not turn on the subjective intent of the buyer.²⁵ The court of appeals concluded that the software was complete when sold for

17. TEXAS COMPTROLLER OF PUBLIC ACCOUNTS, TREASURY OPERATIONS, FEBRUARY 2010 BOND APPENDIX A-68 (2010), available at <http://www.window.state.tx.us/treasops/1002bond.pdf>.

18. See TEX. TAX CODE ANN. §§ 151.051, 151.009, 151.010, 15.0031 (Vernon 2008).

19. *Verizon N. Inc. v. Combs*, No. 03-08-00151-CV, 2009 Tex. App. LEXIS 3779, at *1 (Tex. App.—Austin May 22, 2009, pet. denied).

20. *Id.*

21. *Id.* at *2.

22. *Id.* at *3-4.

23. *Id.* at *7-8. The district court found that GTE made configurations, modifications, extensions, and customizations to the software in Texas that were necessary before the software performed the business functions for which it was purchased. *Id.* at *8; see 34 TEX. ADMIN. CODE § 3.308(b)(1) (2010) (Comptroller of Pub. Accounts, Computers—Hardware, Software, Services, & Sales).

24. *Verizon N. Inc.*, 2009 Tex. App. LEXIS 3779, at *8.

25. *Id.* at *8-9. Several findings of fact by the district court indicate that the software was complete as sold, and the court of appeals held such findings sufficient to establish that

the use for which it was designed and was therefore a taxable “computer program.”²⁶

Several cases addressed other sales tax exemptions or exclusions. *Jerman Cookie Co. v. Combs*, for example, asserted “that certain bakery products sold by Jerman are exempted from Texas sales tax as ‘food products for human consumption’” pursuant to section 151.314 of the Tax Code.²⁷ The case centered on whether the bakery products sold were considered “ready for immediate consumption” and therefore taxable.²⁸ The Austin Court of Appeals focused on whether Jerman provided eating facilities for the individual-sized portions of cookies and brownies sold in quantities of five or less, not in a heated state, and for which eating utensils were not provided.²⁹ The court of appeals then reversed and remanded the case to determine whether Jerman provided eating facilities for its customers.³⁰

In *Southern Plastics, Inc. v. Combs*, Southern Plastics claimed a refund of sales taxes paid to the City of Kilgore for waste removal services, asserting that the taxes had been paid in error because the waste was “industrial solid waste,” for which removal costs are not subject to sales tax.³¹ The Austin Court of Appeals found at least two possible interpretations of “industrial solid waste” as defined in Chapter 361 of the Health and Safety Code, the standard required by the regulations to qualify for the exclusion from taxable real property services: (1) Southern Plastics’

the software was sold as a completed program in accordance with rule 3.308(b)(1) of the Administrative Code. *Id.* at *11-12.

26. *Id.* at *12.

27. No. 03-08-00562-CV, 2009 Tex. App. LEXIS 5698 (Tex. App.—Austin July 23, 2009, no pet.) (mem. op., not designated for publication). Please note that the authors endeavor to have at least one food case in each year’s Survey. This year’s cookies may be more fun than the foods discussed in prior articles.

28. *Id.* at *5. The statute did not define “ready for immediate consumption,” but rule 3.293(a)(9) of the Administrative Code (as in effect for the period at issue) did. *Id.* The court of appeals noted that its holding did not apply to sales after October 1, 2003, the effective date of changes to section 151.314 of the Tax Code, which expressly includes all “bakery items sold without plates or other eating utensils” within the exemption for food products. *Id.* at *11 n.4; TEX. TAX CODE ANN. § 151.314 (Vernon 2008).

29. *Jerman Cookie Co.*, 2009 Tex. App. LEXIS 5698, at *2. The court’s opinion brings to mind the old administrative “six-donut” presumption that a purchase of less than six donuts was a purchase of food for immediate consumption. See *Cafeteria Operators, L.P. v. Rylander*, 96 S.W.3d 460, 462 (Tex. App.—Austin 2002, pet. denied).

30. *Jerman Cookie Co.*, 2009 Tex. App. LEXIS 5698, at *16. The court of appeals considered certain conflicting facts in attempting to determine whether eating facilities were provided by Jerman in the mall in which its store is located, including: (1) the landlord does not consider Jerman to be a “tenant of the food court”; (2) a map of the mall listed Jerman’s store in the “Food Court” category; (3) a photograph of the store showed tables and chairs adjacent to the side of the store facing the direction of the food court area. *Id.* at *14, *16.

31. No. 03-08-00149-CV, 2009 Tex. App. LEXIS 5107, at *3 (Tex. App.—Austin July 1, 2009, no pet.) (mem. op., not designated for publication). See TEX. TAX CODE ANN. § 151.0048(a)(3)(B) (Vernon 2008); 34 TEX. ADMIN. CODE § 3.356(a)(3)(E) (2010) (Comptroller of Pub. Accounts, Real Property Service). Different types of waste were removed from Southern Plastics’ manufacturing plant, including waste from manufacturing plastic closures and liners, discarded wrapping or packaging materials received with raw materials, and Southern Plastics’ offices. *S. Plastics, Inc.*, 2009 Tex. App. LEXIS 5107, at *2.

interpretation that the definition tracks whatever the term means in the Health and Safety Code, and (2) the comptroller's interpretation that she intended to incorporate the language of the statutory definition, which she would then interpret, as a matter of tax policy and administration.³² The comptroller also contended that Southern Plastics failed to comply with the recordkeeping requirements of the rule.³³ The court of appeals, perhaps giving more weight to the comptroller's arguments than might be expected, determined that it could not conclude that the comptroller's construction was plainly erroneous or inconsistent with the regulations or with the comptroller's interpretation that not all of the solid waste "results from" or is "incidental to" the plant's manufacturing processes.³⁴ Therefore, the court of appeals affirmed the denial of refund.³⁵ The case also illustrates the deference sometimes accorded to the comptroller's interpretation of her own rules.³⁶

In *Reynolds Metals Co. v. Combs*, the Austin Court of Appeals affirmed the refund denial related to the company's purchase of repair and replacement parts for two ship unloaders that operated on rails, holding that the purchases did not qualify for the rolling stock exemption.³⁷ Reynolds claimed that the "unloaders qualify as rolling stock because they operate on and are supported by rails."³⁸ The provision at issue exempts "[r]olling stock, locomotives, and fuel and supplies essential to the operation of locomotives and trains."³⁹ The unloaders, crane-like machines, operated on rails and were used to move bauxite ore from the holds of arriving ships to conveyor belts elsewhere in the shipyard for further processing. The parties agreed that the unloaders were operated on rails. However, the width of the rails on which the unloaders were operated was much greater than the width of the rails for a typical rail car. Also, the unloaders were used only between arriving ships and conveyor belts and not connected to a traditional railroad.⁴⁰ The court of appeals ruled against the taxpayer, finding that the legislative acceptance doctrine was not applicable.⁴¹

In one of the more intriguing cases of the year, the Austin Court of Appeals interpreted the language of section 151.011 of the Tax Code to

32. *Id.* at *32-33. See 34 TEX. ADMIN. CODE § 3.356(a)(3)(E).

33. *S. Plastics, Inc.*, 2009 Tex. App. LEXIS 5107, at *17.

34. *Id.* at *34.

35. *Id.*

36. *Id.*

37. No. 03-07-00709-CV, 2009 Tex. App. LEXIS 2466, at *1 (Tex. App.—Austin Apr. 8, 2009, pet. denied).

38. *Id.* at *2.

39. TEX. TAX CODE ANN. § 151.331(a) (Vernon 2008).

40. *Reynolds Metals Co.*, 2009 Tex. App. LEXIS 2466, at *3-4.

41. *Id.* at *24. The court of appeals determined that for the legislative acceptance doctrine to apply based on an administrative interpretation of a statute, the interpretation must be "longstanding, uniform, and clear"; according to the court, "the Comptroller did not have a long-standing, clear and consistent policy of interpreting the 'rolling stock' exemption to apply literally to any equipment mounted on what could be termed railroad rails" rather than only to traditional railroad equipment. *Id.* at *12, *24.

reach a result that may be different from what legislators intended when they amended this section in 2003. In *Southwestern Bell Yellow Pages v. Combs*, Southwestern Bell sought a refund of use tax paid on printing charges for out-of-state printing of telephone directories that were subsequently distributed in Texas.⁴² Southwestern Bell purchased paper rolls from out-of-state paper mills to print telephone directories out of state before bringing the directories to Texas for distribution. In 2003, the legislature amended Tax Code section 151.011(a), specifically excluding from the definition of use “printed material that has been processed, fabricated, or manufactured into other property . . . transported into this state,” thereby reversing, in this context, the effect of *Sharp v. Morton Buildings, Inc.*⁴³ Southwestern Bell argued that the 2003 amendment excludes charges for printing services from use tax.⁴⁴ Southwestern Bell also relied on the relatively recent case, *May Department Stores Co. v. Strayhorn*, which held that the essence of the transaction for printing services is tangible personal property.⁴⁵ The court of appeals, however, concluded that regardless of how “printed material” is defined, only printed material that serves as a component of some other finished product is excluded from use tax under section 151.011(a) of the Tax Code.⁴⁶ Therefore, because Southwestern Bell had conceded that the telephone directories themselves were a final product and were not incorporated into other property, the refund on the printing charges was denied.⁴⁷ It is not clear how the court would have decided the case had Southwestern Bell requested a refund for only the component parts of the directories (e.g., paper, ink, binding, etc.) and not for the printing services it purchased, but it can be inferred from the way the court of appeals interpreted the statute that only if the raw materials are components of a final product would they be exempt from the use tax.

The concurring opinion, although agreeing that the printed material was taxable, disagreed with the court’s rationale.⁴⁸ The concurring justice (perhaps more accurately) believed that the amendment specifically intended *not* to address printed materials.⁴⁹ The concurring opinion further observed that the court of appeals erred in making a departure from the

42. No. 03-07-00638-CV, 2009 Tex. App. LEXIS 582 (Tex. App.—Austin Jan. 30, 2009, pet. denied) (mem. op., not designated for publication).

43. *Id.* at *5-6. In *Sharp v. Morton Buildings, Inc.*, the Austin Court of Appeals held that raw materials purchased out of state, incorporated into other products out of state, and then subsequently brought into Texas are not subject to the use tax. 953 S.W.2d 300, 303 (Tex. App.—Austin 1997, pet. denied). The 2003 amendment legislatively overturned *Morton* by imposing a use tax on raw materials purchased out-of-state and incorporated into another product before being brought back into Texas. *Sw. Bell Yellow Pages*, 2009 Tex. App. LEXIS 582, at *6.

44. *Sw. Bell Yellow Pages*, 2009 Tex. App. LEXIS 582, at *6-7.

45. *Id.* at *7-8; *May Dep’t Stores Co. v. Strayhorn*, No. 03-03-00729-CV, 2004 Tex. App. LEXIS 7681 at *20-21 (Tex. App.—Austin Aug. 26, 2004, pet. denied) (mem. op., not designated for publication).

46. *Sw. Bell Yellow Pages*, 2009 Tex. App. LEXIS 582, at *8.

47. *Id.* at *10.

48. *Sw. Bell Yellow Pages*, 2009 WL 211633, at *4 (Waldrop, J., concurring).

49. *Id.*

May decision by changing the law “in a significant way” by creating “two categories of printed material: (1) printed material that is a component of some final product, and (2) printed material that is a final product itself.”⁵⁰ It will be interesting to see the ramifications of this decision, but it is almost certain that this holding will result in confusion as taxpayers and the comptroller struggle to determine which printed materials are component parts and which are final products, how to interpret the “other printed material” exclusion, and how this decision and the *May* decision can coexist.

B. NEW LEGISLATION

Although the 2009 legislative session did not make overwhelming changes to the sales and use tax, several amendments are noteworthy. Texas has not adopted the Streamlined Sales and Use Tax Agreement,⁵¹ but the legislature does sometimes look to it for language or concepts. For example, legislators, like followers of the Streamlined Sales and Use Tax Agreement, sought to expand the popular back-to-school exemption. As amended, section 151.327 of the Tax Code adds certain school supplies to the existing exemption for backpacks and now defines backpacks.⁵²

The legislature also amended Tax Code section 151.310 to provide that, for purposes of obtaining a refund or claiming a credit, organizations exempt under section 151.310 are not considered exempt from paying sales tax on taxable items they purchase before the earlier of the date on which the organization applies for exempt status with the comptroller or the date the comptroller assesses tax liability as a result of an audit.⁵³ The legislature also added section 151.4261 to the Tax Code to provide that a “seller is entitled to a credit or reimbursement equal to the amount of sales tax refunded to a purchaser when the purchaser receives a full or partial refund of the sales price of a returned taxable item.”⁵⁴

Consistent with other efforts to bring more media productions to Texas, 2009 legislation amended the Government Code to provide for the creation of up to ten “media production development zones” in the state containing “qualified media production locations.”⁵⁵ New Tax Code sec-

50. *Id.*

51. See generally STREAMLINED SALES AND USE TAX AGREEMENT (2009), available at <http://www.streamlinedsalestax.org/uploads/downloads/Archive/SSUTA/SSUTA%20As%20Amended%2009-30-09.pdf>.

52. TEX. TAX CODE ANN. § 151.327(a)(1)-(2) (Vernon 2009) (“‘Backpack’ means a messenger bag, book bag, or a pack with straps that a person wears on the person’s back, including a backpack with wheels if the backpack can also be worn on the back. The term does not include an item that is commonly considered luggage, a briefcase, an athletic bag, a duffle bag, a gym bag, a computer bag, a purse, or a framed backpack.”).

53. *Id.* § 151.310(f).

54. *Id.* § 151.4261.

55. TEX. GOV’T CODE ANN. § 485A.103 (Vernon 2009). A media production development zone must: (1) be in a metropolitan statistical area, the principal municipality of which has a population of more than 250,000 and adequate workforce, infrastructure, facilities, or resources; (2) be recognized as a media production development zone by ordinance or of municipality or county commissioners court; and (3) contain a qualified media

tion 151.3415 exempts from sales tax for a maximum of two years certain items sold or used to construct, expand, improve, equip, renovate, or maintain a media production facility at a qualified media production location.⁵⁶

In an economy in which tourism dollars are also a critical source of revenue, the legislature added section 151.0565 to the Tax Code to define “destination management services” and to clarify that companies which provide such services under qualified destination management services contracts are consumers of taxable items sold in connection with their services.⁵⁷ Although services in Texas are not taxable unless they are specifically subject to tax, the new code section offers additional certainty by explicitly providing that these destination management services provided under contract are not taxable services.⁵⁸

Faced with continuing challenges to the way in which local sales and use taxes are collected and distributed, the legislature made several significant changes to local tax provisions. First, sections 321.203 and 323.203 of the Tax Code were amended to change the sourcing for local sales tax purposes, requiring sellers to collect local tax based on the place of business where the retailer first receives the customer’s order, provided that the order is placed in person at that place of business, rather than based on the shipped-from location.⁵⁹ To avoid adversely impacting taxpayers and jurisdictions that had entered into economic development agreements in reliance on pre-amendment law, the legislature also enacted a limited grandfather provision.⁶⁰ In addition, section 321.002 was

production location within its geographical boundaries that meets stated criteria. *Id.* § 485A.101. A qualified media production location must be land or other real property in a media production development zone and must: “(1) be used exclusively to build or construct one or more media production facilities; (2) if the real property is a building or other facility, be renovated solely for the purpose of being converted into one or more media production facilities; or (3) if the real property consists solely of one or more media production facilities, be improved or renovated for that purpose or will be expanded into one or more additional media production facilities.” *Id.* § 485A.102.

56. TEX. TAX CODE ANN. § 151.3415(b) (Vernon 2009).

57. *Id.* § 151.0565(a).

58. *Id.* § 151.0565(b). A “qualified destination management company,” among other requirements, must receive at least 80% of annual total revenue from providing or arranging for destination management services, including transportation management, booking and managing entertainers; coordination of tours or recreational activities; meeting, conference, or event registration or staffing; event management; and meal coordination. *Id.* § 151.0565(a)(2).

59. TEX. TAX CODE §§ 321.203, 323.203 (Vernon 2009). The amendments were technically effective June 19, 2009, but not implemented until later.

60. Municipalities (seeking grandfather protection) that entered into economic development agreements were required to provide certain information by September 1, 2009, including information identifying the warehouses covered by each agreement and the retail outlets served by such warehouses. *Id.* § 321.204(c-3). The special local tax sourcing rules relating to economic development agreements expire September 1, 2014. *Id.*; see also Tex. S.B. 636, 81st Leg., R.S. (2009) (focusing on imposition of the franchise tax and local sales and use taxes, including the authority of a county or other local governmental entity to receive local sales tax information). “Other local governmental entities” can request certain information about local sales taxes imposed by such entities, including with respect to amounts paid by certain taxpayers, from the comptroller. See TEX. TAX CODE ANN. § 151.027(c)(6).

amended to provide that a “kiosk” is not a place of business.⁶¹

Amended Tax Code section 321.1055 allows certain special-purpose districts to impose local sales and use tax on the residential use of gas and electricity.⁶² Effective January 1, 2010, a fire control, prevention, and emergency medical services district or a crime control and prevention district located in all or part of a municipality that imposes a tax on the residential use of gas and electricity will be allowed to impose the tax throughout the district.⁶³ However, legislators declined to enact any of the several bills that would have offered local jurisdictions much broader authority to enact new taxes, even if the taxes exceeded the two percent cap mandated by law.

The legislature also enacted multiple changes regarding aircraft and agricultural operations. Tax Code section 151.328 was amended to exempt certain aircraft, including machinery and equipment used in an agricultural aircraft operation, from sales tax.⁶⁴ Aircraft sold in Texas to a person for use exclusively in connection with agricultural use and specifically for certain uses, including predator control, crop dusting, and seeding, and machinery and equipment exclusively used in aircraft operation as defined in FAA regulations,⁶⁵ are exempt from sales tax.⁶⁶ For purposes of the aircraft exemption, the “exclusive” use requirement is met if 95% of the use is for the described purposes.⁶⁷ The exemption for machinery and equipment does not include the explicit reference to 95%, leaving taxpayers and the comptroller to wonder if the legislature intended the word “exclusive” to have the same meaning in these two sections.⁶⁸

Similarly, Tax Code section 151.316 was amended to expand exemptions for property used in agricultural operations and for aircraft used in connection with agriculture.⁶⁹ The exemptions now include, among other things:

tangible personal property, including a tire, sold or used to be installed as a component part of a motor vehicle, machinery or other equipment exclusively used or employed on a farm or ranch in the building or maintaining of roads or water facilities or in the produc-

61. *Id.* § 321.002(a)(3) (providing that a kiosk is a “small, stand-alone area or structure used solely to display merchandise and/or submit orders from taxable items from a data entry device, or both” located entirely within another retailer’s place of business, “at which taxable items are not available for immediate delivery to a customer”).

62. *Id.* § 321.1055.

63. *Id.* § 321.1055(a)-(b).

64. *Id.* § 151.328(h).

65. See 14 C.F.R. § 137.3 (2010) (addressing agricultural aircraft operation).

66. TEX. TAX CODE ANN. § 151.328(a)(5). The 95% standard is conceptually similar to the long-established comptroller position that if more than 5% of a lump-sum charge for services is attributable to taxable services, the total charge is presumed taxable, effectively allowing a 5% de minimis rule. See, e.g., 34 TEX. ADMIN CODE § 3.330(d)(2) (2010) (Comptroller of Pub. Accounts, Data Processing Services) (articulating this standard in the context of data processing services).

67. TEX. TAX CODE ANN. § 151.328(h).

68. See § 151.328(d), (h).

69. *Id.* § 151.316(a) (exempting from sales tax certain tangible personal property components of machinery, equipment, or vehicles used in certain agricultural applications).

tion of: (A) food for human consumption; (B) grass; (C) feed for animal life; (D) or other agricultural products to be sold in the regular course of business.⁷⁰

The legislature also exempted “tangible personal property incorporated into a structure that is used for the disposal of poultry carcasses in accordance with Section 26.303 [of the] Water Code.”⁷¹ Though the agricultural theme continues throughout much of the session and disposing of poultry carcasses seems like a good idea, including sales tax exemption requirements in the Water Code instead of the Tax Code makes them more difficult to locate.

C. COMPTROLLER RULES

Several rules track or implement legislative changes. Amendments to Rule 3.365, pertaining to the three-day tax-free weekend in August, differentiate between the sales tax holiday for clothes, shoes, and school supplies and the sales tax holiday for Energy Star items.⁷² The rule also redefines “school backpack” “to exclude luggage, briefcase, athletic bag, duffle bag, gym bag, computer bag, purse and framed backpack from the definition.”⁷³ Other amendments to the rule address comptroller policy concerns, such as sales of items sold in prepackaged combinations containing both exempt and non-exempt items.⁷⁴

II. FRANCHISE TAX

In 2006, the Texas legislature modified the long standing franchise tax, resulting in an unusual tax that is now computed by reference to “taxable margin” and is therefore sometimes referred to as the “margin tax.” Previous editions of the Texas Survey have focused in detail on this tax, which has thus far produced significantly less revenue than anticipated.⁷⁵ During the current Survey period, more taxpayers filed returns, franchise tax audits of the margin tax began, and taxpayers and the comptroller alike continued to struggle to fill statutory gaps and answer multiple questions.

70. *Id.* § 151.316(a)(10).

71. *Id.* § 151.316(a)(12); TEX. WATER CODE ANN. § 26.303 (Vernon 2008).

72. 34 Tex. Reg. 6440 (2009); *adopted* 34 Tex. Reg. 8338 (2009) (codified at 34 TEX. ADMIN. CODE § 3.365).

73. *Id.*

74. *Id.*

75. *See, e.g.*, Cynthia M. Ohlenforst et al., *Taxation*, 62 SMU L. REV. 1461 (2009) [hereinafter *Taxation* 2009]. Note that one piece of legislation from the 2007 session became effective during the Survey period: Effective April 1, 2009, TEX. TAX CODE ANN. § 171.074 (Vernon 2009) provides that “[a] nonprofit corporation organized under the Development Corporation Act (Subtitle C1, Title 12, Local Government Code) is exempted from the franchise tax”; Cynthia M. Ohlenforst et al., *Taxation*, 61 SMU L. REV. 1131 (2008); Cynthia M. Ohlenforst et al., *Taxation*, 60 SMU L. REV. 1311 (2007).

A. COMPTROLLER HEARINGS

Courts of appeals issued numerous sales and property cases during the Survey period, but they offered little guidance on the franchise tax. Even the State Office of Administrative Hearings (SOAH) issued relatively few franchise tax decisions, and all of them relate to the “old” franchise tax. However, some of the SOAH hearings offer insight to issues that are relevant, not only to contests involving the older version of the tax but also to issues that arise under the revised tax.

Hearing No. 48,507, for example, focused on an apportionment issue important to the franchise tax both before and after the recent revisions to the tax.⁷⁶ This hearing addressed a refund claim filed by a company engaged in rail transportation. The taxpayer had initially treated all its receipts from rail transportation as Texas receipts for the years at issue, based on the fact that all of its tracks are located entirely in Texas. In its refund claim, however, the company asserted that the portion of its receipts from interstate commerce should not be included in Texas receipts. The company explained that some of the freight rail cars that it picked up from customers in Texas were transported to interchange points at which the railcars were transferred from the company’s locomotive to another company’s locomotive and then transported to final destinations outside Texas. Although all the interchange points were in Texas, the company pointed out that the intrastate segments did not fall within the comptroller’s own definition of “intrastate commerce.”⁷⁷ Relying on the comptroller’s administrative rule provisions regarding apportionment by transportation companies, the administrative law judge correctly concluded that Texas receipts for transportation companies included only transportation that both began and ended in the state and did not include “intrastate segments of transportation in interstate commerce.”⁷⁸

B. NEW LEGISLATION

Because the margin tax produced less revenue than it was expected to produce during its first year and because of the economic challenges facing the state and nation, legislators found it difficult—both politically and economically—to modify the tax significantly during the 2009 legislative session. Nor did the comptroller even propose a technical corrections bill. Nonetheless, some franchise bills passed.

The legislature addressed the treatment of proceeds from sales of certain loans and securities for purposes of apportionment under the franchise tax. This change was, in at least some respects, an effort to return to pre-margin tax rules for this specific apportionment issue. As amended, section 171.106 of the Tax Code now provides, “Notwithstanding [s]ection 171.1055, if a lending institution categorizes a loan or secur-

76. See Tex. Comptroller Pub. Accounts, Hearing No. 48,507 (June 15, 2009).

77. *Id.*; cf. 34 TEX. ADMIN. CODE § 3.549(b)(45) (as in effect for 2003 and 2004) (Comptroller of Pub. Accounts, Taxable Capital: Apportionment).

78. Tex. Comptroller Pub. Accounts, *supra* note 76.

ity as ‘Securities Available for Sale’ or ‘Trading Securities’ under Financial Accounting Standard No. 115, the gross proceeds of the sale of that loan or security are considered gross receipts” for apportionment purposes.⁷⁹

Other legislative changes addressed small businesses’ complaints about the tax. The no-tax-due threshold in Tax Code section 171.002 was modified to: (1) change the franchise tax no-tax-due threshold from \$300,000 of total revenue to one million dollars of total revenue from the effective date through December 31, 2011, and (2) change the no-tax-due threshold from one million dollars to \$600,000 beginning January 1, 2012.⁸⁰ Additionally, section 171.0021 was amended to address the discounts for small businesses. The amendments provide that only the following two discounts will be available: (1) forty percent for taxable entities with total revenue greater than \$600,000 but less than \$700,000, and (2) twenty percent for taxable entities with total revenue of greater than \$700,000 but less than \$900,000.⁸¹

House Bill 469 amended the Government Code to establish a franchise tax credit for the first three completed clean energy projects meeting certain compliance requirements (including being implemented in connection with the construction of a new facility), capped for each project at the lesser of \$100 million or ten percent of the capital cost.⁸² This legislation also added section 151.334 to the Tax Code to exempt certain components of clean-energy projects from sales tax and amended section 313.021(4) of the Tax Code to address limitation on appraised value for advanced clean-energy projects. In addition, Tax Code section 171.1011 was amended to allow qualified destination management companies to exclude from total revenue certain amounts paid to others “to provide services, labor, or materials in connection with the provision of destination management services.”⁸³

In an interesting bit of charity-related legislation, the legislature amended Occupations Code section 2001.4335 relating to bingo to address the operation and regulation of charitable bingo and the use of bingo proceeds. Such bingo facilities are now exempt from the franchise

79. TEX. TAX CODE ANN. § 171.106(f-1).

80. *Id.* § 171.002(d)(2).

81. *Id.* § 171.0021(a). Pre-revision discounts were (1) eighty percent if total revenue was greater than \$300,000 but less than \$400,000; (2) sixty percent if total revenue was greater than \$400,000 but less than \$500,000; (3) forty percent if total revenue was greater than \$500,000 but less than \$700,000; and (4) twenty percent if total revenue was greater than \$700,000 but less than \$900,000. *Id.* § 171.0021 (Vernon 2008).

82. TEX. GOV'T CODE ANN. § 490.352(c) (Vernon 2009). No credit is to be issued before September 1, 2013, and the “subsection expires on September 2, 2013.” *Id.* § 490.352(e). This legislation also provides for the Railroad Commission to issue a certificate of compliance, and for the University of Texas–Austin Bureau of Economic Geology to verify that the electricity-generating facility associated with the project is sequestering at least seventy percent of the carbon dioxide from the electricity generation. *Id.* § 490.252(b); TEX. TAX CODE ANN. §§ 151.334, 313.021(4)(c).

83. TEX. TAX CODE ANN. § 171.1011(g-6).

tax.⁸⁴ Part of what makes this provision interesting is that the exemption is in the Occupations Code instead of the Tax Code—another example of straying tax provisions.⁸⁵

C. COMPTROLLER RULES

A new set of franchise tax rules to implement the revised franchise tax was adopted on December 28, 2007, and became effective on January 1, 2008.⁸⁶ Last year's Texas Survey focused on many of the changes to the franchise tax rules.⁸⁷ The comptroller proposed amendments to some franchise tax rules during 2009.⁸⁸ Although a summary of all of the rules is beyond the scope of this Article, it is worthwhile to note some key issues.

Passive Entities. Rule 3.582, which addresses passive entities' exclusion from the franchise tax, has been the subject of debate and scrutiny since it was first proposed. In October 2009, the comptroller proposed new language that was widely criticized by various taxpayer advocates.⁸⁹ Specifi-

84. TEX. OCC. CODE ANN. § 2001.4335 (Vernon 2009).

85. *Id.*

86. *E.g.*, 32 Tex. Reg. 6271 (2007), *adopted* 32 Tex. Reg. 10013 (2007) (codified at 34 TEX. ADMIN. CODE § 3.581 (Comptroller of Pub. Accounts, Margin: Taxable & Nontaxable Entities)); *see generally* 34 TEX. ADMIN. CODE § 3.582 (Comptroller of Pub. Accounts, Margin: Passive Entities), 3.583 (Comptroller of Pub. Accounts, Margin: Exemptions), 3.584 (Comptroller of Pub. Accounts, Margins: Reports and Payments), 3.585 (Comptroller of Pub. Accounts, Margin: Annual Report Extensions), 3.586 (Comptroller of Pub. Accounts, Margin: Nexus), 3.587 (Comptroller of Pub. Accounts, Margin: Total Revenue), 3.588 (Comptroller of Pub. Accounts, Margin: Cost of Goods Sold), 3.589 (Comptroller of Pub. Accounts, Margin: Compensation), 3.590 (Comptroller of Pub. Accounts, Margin: Apportionment), 3.591 (Comptroller of Pub. Accounts, Margin: Combined Reporting), 3.592 (Comptroller of Pub. Accounts, Margin: Additional Tax), 3.593 (Comptroller of Pub. Accounts, Margin: Franchise Tax Credits), 3.594 (Comptroller of Pub. Accounts, Margin: Temporary Credit for Business Loss Carryforwards), 3.595 (Comptroller of Pub. Accounts, Margin: Transition).

87. *See Taxation 2009, supra* note 75.

88. On October 30, 2009, proposed rule amendments appeared in the Texas Register. Six of the proposed amendments received no comments and were published on December 25, 2009, with explanations in the preamble that the amendments were intended to reflect a change in policy, effective December 31, 2009. *See generally* 34 Tex. Reg. 7563 (2009), *adopted* 34 Tex. Reg. 9469 (2009) (codified at 34 TEX. ADMIN. CODE § 3.584); 34 Tex. Reg. 7568 (2009), *adopted* 34 Tex. Reg. 9470 (2009) (codified at 34 TEX. ADMIN. CODE § 3.587); 34 Tex. Reg. 7573 (2009), *adopted* 34 Tex. Reg. 9471 (2009) (codified at 34 TEX. ADMIN. CODE § 3.589); 34 Tex. Reg. 7576 (2009), *adopted* 34 Tex. Reg. 9471 (2009) (codified at 34 TEX. ADMIN. CODE § 3.590); 34 Tex. Reg. 7581 (2009), *adopted* 34 Tex. Reg. 9472 (2009) (codified at 34 TEX. ADMIN. CODE § 3.591); 34 Tex. Reg. 7585 (2009), *adopted* 34 Tex. Reg. 9472 (2009) (codified at 34 TEX. ADMIN. CODE § 33.593). For example, Rule 3.589, regarding compensation, was amended to increase the maximum per-person deduction from \$300,000 to \$320,000, effective for reports due on or after January 1, 2010, and to clarify that amounts paid to anyone, not just independent contractors, that are reportable on Internal Revenue Service Form 1099 may not be included in calculating the compensation deduction. 34 Tex. Reg. 7573 (2009), *adopted* 34 Tex. Reg. 9471 (2009) (codified at 34 TEX. ADMIN. CODE § 3.589). Rule 3.590, regarding combined reporting, was also amended to provide that "a combined group will determine its eligibility for the 0.5% tax rate, discounts and E-Z Computation based on the total revenue of the combined group as a whole after eliminations." 34 Tex. Reg. 7576 (2009), *adopted* 34 Tex. Reg. 9471 (2009) (codified at 34 TEX. ADMIN. CODE § 3.590).

89. 34 Tex. Reg. 9464 (2009) (codified at 34 TEX. ADMIN. CODE § 3.582).

cally, the proposed rule was designed to implement the comptroller's view that certain passive income could be recharacterized as active income in certain instances.⁹⁰ The State Bar of Texas, Tax Section and the Texas Society of Certified Public Accountants commented that the proposed language contradicts the Tax Code because Texas Tax Code section 171.0003(a-1) designates certain sources of income as passive, regardless of how the income was earned.⁹¹

Fortunately, the comptroller ultimately agreed. The Texas Register preamble to the version of Rule 3.582 adopted shortly after the Survey period explains that "the comptroller believes that the legislature did not intend for income from active operations to be included in passive income," but essentially agreed that the current language of the statute does not provide sufficient differentiation to justify recharacterizing passive income.⁹² The comptroller's proposed, but ultimately deleted, language could have called into question the practicality of the passive entity exemption, because the language provided that income identified as passive could nonetheless fail to be passive if it arose out of a taxpayer's "operations." The proposed language also suggested that an entity's otherwise passive income from a subsidiary might not be passive if the subsidiary were controlled by the entity or an affiliate. In addition, the amended rule no longer defines federal gross "[i]ncome by reference to the Internal Revenue Code; new language was added to define federal gross income as the income that is reported on an entity's federal income tax return."⁹³

Initial Reports. Historically, first-time filers of franchise tax returns based their filing dates and computations on whether the report was for an initial period, a second period, or a regular annual period. Applicable statutes and rules provided a complex mechanism for determining the due dates and the periods with respect to which tax is computed.⁹⁴ However, with the elimination of the old taxable capital and earned surplus calculations, the comptroller has determined that these old report mechanisms are no longer necessary. Therefore, the comptroller adopted amendments to Rule 3.584, changing the due date for franchise tax initial reports to make it consistent with the annual report due date.⁹⁵ Thus, the first franchise tax report a taxable entity will file is now an annual report.⁹⁶

90. *Id.*

91. *Id.*

92. *Id.*

93. *Id.*

94. *See, e.g.*, TEX. TAX CODE ANN. §§ 171.151, 171.201, 171.202 (Vernon 2008).

95. Tex. Reg. 7563 (2009), *adopted* 34 Tex. Reg. 9469 (2009) (codified 34 TEX. ADMIN. CODE § 3.584).

96. *Id.* This change is effective for taxable entities becoming subject to the tax on or after October 4, 2009. 34 TEX. ADMIN. CODE § 3.584 (2010). Entities that become subject to the tax between October 4, 2009, and December 31, 2009, will file their first annual report by May 17, 2010. *Id.* Entities that become subject to the tax in 2010 will file their first annual report by May 16, 2011. *See id.* The rule also includes examples. Although some may argue that the comptroller lacks statutory authority to change the report period

Total Revenue. Amendments to Rule 3.587 regarding total revenue were adopted without changes to the proposed text.⁹⁷ Although the rule tracks legislation, discussed previously, regarding exclusions from total revenue for qualified destination management companies, the rule also addresses other items not included in the statutory amendments. New language was added to clarify that uncompensated care charges do not include any portion of a charge that the health care provider has no right to collect under a private health care plan, and language was deleted to allow uncompensated care charges to include charges for services covered by certain programs.⁹⁸ In addition, the rule was amended to provide that amounts reported on line 19 of Internal Revenue Service Form 8825 (the net gain/loss from the disposition of property from rental real estate activities) are now included in the calculation of total revenue for an S corporation.⁹⁹ According to the comptroller's preamble, both amendments "more accurately reflect . . . [the comptroller's] current policy."¹⁰⁰ Finally, and controversially, language was added to Rule 3.589 to clarify the comptroller's position "that net distributive income that is subtracted from total revenue may not be included in the determination of compensation."¹⁰¹ In addition, Rule 3.587 was amended to clarify "that neither the upper tier entity nor the lower tier entity filing under the tiered partnership provision qualifies for no tax due, discounts and the E-Z Computation if . . . the lower tier does not meet the criteria."¹⁰²

III. PROPERTY TAX

A. REPORTED CASES

As in past years, the courts focused on whether property is subject to tax in the first place (or whether it is exempt or nontaxable because it is

provisions, most will applaud the retirement of the Byzantine system that confused many taxpayers. Rule 3.584 was also amended to reflect statutory changes to § 171.002 of the Tax Code, regarding no-tax-due thresholds, and § 171.0021 of the Tax Code, regarding discounts.

97. 34 Tex. Reg. 7568 (2009), *adopted* 34 Tex. Reg. 9470 (2009) (codified at 34 TEX. ADMIN. CODE § 3.587).

98. *Id.* Services performed for a contracted rate from a private health care plan or services performed for an agreed-upon rate from an individual can now be included in uncompensated care charges.

99. *See id.*

100. *See id.* *See also* 32 Tex. Reg. 9466 (2009) (codified at 34 TEX. ADMIN. CODE § 3.583) (adding bingo units to the list of exemptions, but removing Internal Revenue Code § 501(c)(9) entities from the list of exempt entities because, according to the comptroller, this type of entity was added to the list in error).

101. *See* 34 Tex. Reg. 7573 (2009), *adopted* 34 Tex. Reg. 9471 (2009) (codified at amendment to 34 TEX. ADMIN. CODE § 3.589).

102. 34 Tex. Reg. 7568 (2009), *adopted* as 34 Tex. Reg. 9470 (2009) (codified at 34 TEX. ADMIN. CODE § 3.587). The tiered partnership rules permit some flexibility for some taxable entities, such as medical groups or other businesses that include lower-tier partnerships that operate a business and upper-tier partnerships that are comprised of individual doctors or professional associations. However, the tiered partnership mechanism is often confusing. Note too, that tiered partnership reporting is not allowed if the lower-tier entity is included in a combined group.

only temporarily in the jurisdiction) and, if so, how to value the property and whether taxpayers have complied with the strict procedural requirements for challenging taxes.

While tax revenues decreased and uncertainty about legislative changes to the state's property tax regime increased, appraisal districts and property owners continued to fight over the districts' jurisdiction to tax property.

The property owner in *Aviall Services v. Tarrant Appraisal District*, a supplier of aircraft parts, had shipped items to its depot, which was located within a federal enclave that was located within Texas's geographical boundaries.¹⁰³ Aviall protested the appraisal district's assessment of property tax on the items, claiming that, because they had been shipped into the federal enclave, they qualified for the Freeport exemption provided for in article VIII, section 1, of the Texas constitution.¹⁰⁴ Pursuant to that provision, property acquired in or imported into Texas that is forwarded outside the state within 175 days is exempt from property tax.¹⁰⁵ Aviall's position centered on an argument that the federal enclave, despite being located entirely within Texas's geographical boundaries, is "outside" of Texas for purposes of the Freeport exemption.¹⁰⁶

The Fort Worth Court of Appeals rejected Aviall's arguments, electing instead to read into the Freeport exemption a requirement that property be shipped outside the state in terms of location, not in terms of jurisdiction or power.¹⁰⁷ The court of appeals also noted the familiar canons that exemptions are to be strictly construed against taxpayers, and exemptions must have affirmative statutory authority and may not be raised simply by implication.¹⁰⁸

Aviall was not the only case during this Survey period addressing the taxability of aircraft and related items; as is typical, there were a number of such cases before the various courts. In *Starflight 50, LLC v. Harris County Appraisal District*, the taxpayer argued that the aircraft which the taxpayer had unexpectedly relocated to Houston from New Orleans on the eve of Hurricane Katrina was located in Texas only temporarily and therefore should not be subject to Texas property tax.¹⁰⁹ Noting that the return to New Orleans, like the relocation to Houston, was unplanned, the Houston First Court of Appeals upheld the trial court's take-nothing judgment against the taxpayer.¹¹⁰

In *ICAN Enterprise, Inc. v. Williamson County Appraisal District*, the taxpayer cited to Texas Tax Code section 25.07 to argue that its leases of hangars owned by the city of Georgetown and located at the Georgetown

103. 300 S.W.3d 441, 443-44 (Tex. App.—Fort Worth 2009, no pet.).

104. *Id.* at 444.

105. TEX. CONST. art. VIII, § 1-j.

106. *Aviall*, 300 S.W.3d at 446.

107. *Id.*

108. *Id.* at 446-47.

109. 287 S.W.3d 741, 744 (Tex. App.—Houston [1st Dist.] 2009, no pet.).

110. *Id.* at 747.

Airport should be exempt from property tax.¹¹¹ Section 25.07 provides that a leasehold interest in exempt property may not be included in appraisal rolls if the property is part of a public transportation facility owned by a city and is a building used primarily for aircraft equipment storage.¹¹² The Austin Court of Appeals held that the exemption did not apply to ICAN's leasehold in the hangars, because the hangars were used to store whole aircraft, not just aircraft parts.¹¹³

In a case that recalls *Peoples Gas, Light, & Coke Co. v. Harrison Central Appraisal District*, discussed in last year's Survey,¹¹⁴ the Eastland Court of Appeals upheld a trial court holding that oil located in a tank farm in the Midland Pipeline System was not subject to property tax in Midland County.¹¹⁵ In reaching its conclusion, the court of appeals noted that the Pipeline System is an interstate common carrier system that is regulated by the Federal Energy Regulatory Commission. The court of appeals also relied on the fact that oil located in the tank farm is not there for storage, but rather on its way to various in-state and out-of-state destinations, typically exiting a tank within six to seventy-two hours after having first entered it.¹¹⁶ Based on these facts, the court of appeals determined that the oil had been placed in and remained in the stream of interstate commerce, and any stoppage was not related to a business purpose of the owner.¹¹⁷ As a result, the court of appeals held that the Midland County property tax violated the Commerce Clause of the U.S. Constitution.¹¹⁸

The Houston First Court of Appeals tackled the intricacies of heavy equipment valuation in *Briggs Equipment Trust v. Harris County Appraisal District*.¹¹⁹ The taxpayer in that case was a seller of heavy equipment subject to the Texas Tax Code section 23.1241 inventory valuation requirement.¹²⁰ That section provides that heavy equipment inventory includes items of heavy equipment that a dealer holds for sale at retail, including items of heavy equipment that are leased or rented but subject to a purchase option by the lessee or renter.¹²¹ The provision also sets out a formula for calculating the value of a dealer's heavy equipment inventory: from total annual sales, a dealer subtracts sales to dealers, fleet transactions, and "subsequent sales."¹²² The provision defines "subse-

111. No. 03-06-00594-CV, 2009 WL 1025084, at *2 (Tex. App.—Austin Apr. 17, 2009, pet. denied).

112. TEX. TAX CODE ANN. § 25.07(b)(3) (Vernon 2009).

113. ICAN, 2009 WL 1025084, at *3.

114. See *Taxation* 2009, *supra* note 75, at 1471-73.

115. *Midland Cent. Appraisal Dist. v. BP Am. Prod. Co.*, 282 S.W.3d 215 (Tex. App.—Eastland 2009, pet. denied).

116. *Id.* at 219, 221-24.

117. *Id.* at 223-24.

118. *Id.* at 224.

119. 294 S.W.3d 667 (Tex. App.—Houston [1st Dist.] 2009, pet. filed).

120. *Id.* at 669.

121. TEX. TAX CODE ANN. § 23.1241(a)(2) (Vernon 2009).

122. *Id.* at (b).

quent sales” to mean certain dealer-financed sales of heavy equipment.¹²³

In rendering its inventory for property tax valuation, Briggs had subtracted as “subsequent sales” a number of lease transactions that contained a purchase option that the lessee never exercised.¹²⁴ In defense of its calculation method, Briggs argued that once it had included leases with purchase options in its top-line “total annual sales” amount, it should be entitled to count subsequent leases of the same equipment as “subsequent sales” of the equipment.¹²⁵ To buttress its position, Briggs pointed to some of its leases that contained provisions for delay of payment and, in some circumstances, imposition of interest as a result of delayed payment.¹²⁶ The court of appeals nevertheless held that such provisions did not make the leases “dealer-financed sales” in this context and rejected Briggs’s position.¹²⁷

The Houston First Court of Appeals considered the constitutionality of the Texas Tax Code section 23.121 motor vehicle inventory valuation provision in *Expo Motorcars, LLC v. Harris County Appraisal District*.¹²⁸ That provision values motor vehicle dealers’ inventory as of January 1 of a tax year based on the dealer’s actual sales from the previous calendar year.¹²⁹ Expo argued that the section 23.121 valuation method created unconstitutionally unequal, non-uniform taxation among motor vehicle dealers, because dealers whose sales decrease in a tax year after their inventories have been valued as of January 1 will pay more taxes than dealers whose sales increase after valuation.¹³⁰ The court of appeals noted that in other retail contexts, the legislature has adopted a single-date valuation method but opted instead for a sales-based method in the motor vehicle context because the value of a motor vehicle dealer’s inventory fluctuates widely over the course of a year.¹³¹ The court of appeals rejected Expo’s argument that the sales-based method is arbitrary and produces unconstitutionally unequal appraisals.¹³²

The Texas Supreme Court issued an interesting opinion addressing an unusual procedural issue in *Old Farms Owners Association v. Houston Independent School District*.¹³³ In the *Old Farms* case, the taxing jurisdiction had sent a 1997 tax bill to an incorrect address and, after having discovered its error in 1999, sued the record property owner to recover the delinquent taxes.¹³⁴ The taxing units then nonsuited the case in 2000

123. *Id.* at (a)(8).

124. *Briggs*, 294 S.W.3d at 669-70.

125. *Id.* at 672.

126. *Id.*

127. *Id.*

128. No. 01-08-00473-CV, 2009 WL 2232017, at *1 (Tex. App.—Houston [1st Dist.] July 23, 2009, pet. denied).

129. TEX. TAX CODE ANN. § 23.121(b) (Vernon 2009).

130. *Expo*, 2009 WL 2232017, at *4.

131. *Id.*

132. *Id.* at *5.

133. 277 S.W.3d 420 (Tex. 2009).

134. *Id.* at 421.

and refiled the suit in 2002.¹³⁵

The property owner prevailed at trial in 2003, arguing in the alternative that, because the taxing district had sent the bill to the wrong address, the tax had never become delinquent, and that, even if the tax had been delinquent, the taxing unit had never sent the five-year notice of delinquent taxes required by the then-effective Texas Tax Code section 33.04.¹³⁶ That provision, as effective prior to 2001, canceled penalties and interest on delinquent property taxes if the taxing unit did not issue such a notice;¹³⁷ however, the legislature repealed that portion of the provision in 2001.¹³⁸ The 2001 legislation included a savings clause providing that the provision as amended in 2001 did not apply to taxes subject to a delinquent tax suit pending before the 2001 effective date.¹³⁹

The Texas Supreme Court held that the savings clause was broad enough to apply to any collection suit filed prior to the 2001 amendment, even if the suit was eventually nonsuited, and distinguished that circumstance from a dismissal, which the opinion likened to a circumstance in which suit had never been brought in the first place.¹⁴⁰

A couple of perennial procedural issues continued to plague parties challenging appraisal district actions during this Survey period—questions about whether the party bringing a challenge has standing to do so and inadvertent agreements with appraisal districts that barred later suits against the districts (remember last year’s “be-careful-what-you-wish-for” file?).

In three strikingly similar (not only to each other but also to *Mann v. Harris County Appraisal District* and *Verm v. Harris County Appraisal District* from last year’s Survey¹⁴¹) cases, property owners were predictably barred from bringing suit to challenge appraisal district valuations when the owners’ representatives had agreed to values in Appraisal Review Board hearings.¹⁴²

The courts saw a fresh slew of challenges to parties’ standing to protest appraisal district actions during the Survey period as well. In several of the cases, courts determined that the party seeking to challenge the action was not the owner of the property and therefore did not have standing.¹⁴³

135. *Id.*

136. *Id.* at 421-22.

137. TEX. TAX CODE ANN. § 33.04 (Vernon 1999).

138. Act of May 17, 2001, 77th Leg., R.S., ch. 1430, § 40, 2001 Tex. Gen. Laws 5109, 5122-23.

139. *Id.* at 5122.

140. *Old Farms*, 277 S.W.3d at 423-24.

141. See *Taxation* 2009, *supra* note 75, at 1476-77.

142. See, e.g., *Prince v. Harris County Appraisal Dist.*, No. 14-07-00919-CV, 2009 WL 20975 (Tex. App.—Houston [14th Dist.] Jan. 06, 2009, no pet.); *Loposer v. Harris County Appraisal Dist.*, No. 14-07-00956-CV, 2009 WL 2146151 (Tex. App.—Houston [14th Dist.] July 21, 2009, no pet.); *Amidei v. Harris County Appraisal Dist.*, No. 01-08-00833-CV, 2009 WL 2050974 (Tex. App.—Houston [1st Dist.] July 16, 2009, no pet.).

143. See, e.g., *Ray v. Bexar Appraisal Dist.*, Nos. 04-08-00210-CV, 04-08-00212-CV, 2009 WL 700869 (Tex. App.—San Antonio Mar. 18, 2009, no pet.) (an individual owning

B. NEW LEGISLATION

The big property tax news during the Survey period was a package of sweeping property tax legislative changes proposed by Representative John Otto and Senator Tommy Williams. Key to the package was a series of provisions reforming the state's much-maligned property appraisal methods.

House Joint Resolution 36 represents a major policy change and was designed to improve accountability and consistency among appraisal districts across the state.¹⁴⁴ The Resolution contained legislative authorization in three key areas, each of which appeared as a constitutional amendment on the November 3, 2009 constitutional amendment general election ballot: (1) providing for taxation of a homestead solely on the basis of its value as a residence without regard to the property's highest and best use;¹⁴⁵ (2) authorizing a single board of equalization for two or more adjacent appraisal districts that elected consolidated equalizations;¹⁴⁶ and (3) providing for uniform appraisal standards on a statewide basis.¹⁴⁷ Voters approved all three in the November 3, 2009 general election.¹⁴⁸

Also part of the Otto–Williams package, House Bill 3612 allowed appeals to the State Office of Administrative Hearings (SOAH) for certain property tax disputes.¹⁴⁹ The bill created a three-year pilot program in Bexar, Cameron, El Paso, Harris, Tarrant, and Travis Counties in which taxpayers may appeal to SOAH appraisal review board determinations with respect to real or personal property valued over \$1 million.¹⁵⁰ The bill's SOAH appeal is an alternative to a district court challenge, and the party who does not prevail will bear costs, including a \$300 filing fee.¹⁵¹

Senate Bill 771, another key piece of the Williams–Otto appraisal reform package, imposes a number of new and different standards with which appraisal districts must comply when using market data to value property.¹⁵² The bill made changes to the Texas Tax Code's arbitration

both the limited partner interest and the general partner interest of a partnership that held property did not have standing as the property owner for purposes of bringing a property tax dispute); *BACM 2002 PB2 Westpark DR LP v. Harris County Appraisal District*, No. 14-08-00493-CV, 2009 WL 2145922 (Tex. App.—Houston [14th Dist.] June 21, 2009, no pet.) (when a former owner of property no longer had standing to bring a property tax dispute and a subsequent owner did not timely bring the dispute, substitution of the subsequent owner's name as the disputing party was not appropriate where there was no "doing business as" or similar relationship between the parties).

144. Tex. H.J.R. 36, 81st Leg., R.S. (2009).

145. *Id.* at § 1.01.

146. *Id.* at § 2.01.

147. *Id.* at § 3.01.

148. Office of the Secretary of State, 1992–Current Election History, <http://elections.sos.state.tx.us/elchist.exe> (select "2009 Constitutional Amendment Election" and "Statewide Race Summary" and "Submit") (last visited Apr. 1, 2010).

149. Tex. H.B. 3612, 81st Leg., R.S. (2009).

150. See TEX. GOV'T CODE ANN. § 2003.901 *et seq.* (Vernon 2009). Dallas County was included in earlier versions of the bill.

151. *Id.*

152. Tex. S.B. 771, 81st Leg., R.S. (2009).

provisions to provide for expedited binding arbitration as an alternative to property owners who might otherwise file a Texas Tax Code section 42.01 action.¹⁵³ It also amended Texas Tax Code sections 23.01, 23.013, 23.014 and 23.24 to provide that all available evidence specific to the market value of a property shall be taken into account in determining the property's value.¹⁵⁴ It further provided that the chief appraiser may not separately appraise any personal property valued as a portion of the income of the real property when the real property is valued based on rental income.¹⁵⁵ The bill also required the chief appraiser to show that an increase in value for a property whose value decreased in the previous year is reasonably supported by substantial evidence,¹⁵⁶ required that comparable sales must have occurred within twenty-four months of the valuation date and must be adjusted to account for changes in market value over time,¹⁵⁷ and made clear that land may continue to qualify for appraisal as agricultural use during droughts.¹⁵⁸

House Bill 8, another component of the Otto-Williams property tax reform measures, overhauled the comptroller's property value study in a number of important ways.¹⁵⁹ The bill required the comptroller to conduct a study at least every two years in each school district and annually in districts in which the comptroller had determined that the local value was not valid.¹⁶⁰ The bill also changed the comptroller's appraisal district review process in a handful of key ways: the bill created the Comptroller's Property Value Study Advisory Committee and required a school district, appraisal district, or other governmental entity in the state to comply with comptroller requests for information for the study, including information that is statutorily confidential.¹⁶¹ The bill also repealed Texas Tax Code section 5.101, which had provided for the comptroller to establish a Technical Advisory Committee to provide professional and practical expertise regarding the methodology used by the comptroller for annual ratio studies,¹⁶² and it repealed Texas Tax Code section 5.12(g), which did not allow consideration of the results of the comptroller's annual study for tax years before 1989 in determining whether a performance audit of an appraisal district was necessary.¹⁶³

Though not a part of the Otto-Williams reform package, House Bill 3896 made significant changes to the state's tax abatement regime and is worth noting.¹⁶⁴ The bill resolved favorably for taxpayers questions that

153. TEX. TAX CODE ANN. §§ 41A.01, 41A.03, 41A.031 (Vernon 2009).

154. *Id.* §§ 23.01, 23.013, 23.014, 23.24.

155. *Id.* §§ 23.014, 23.24.

156. *Id.* § 23.01.

157. *Id.* § 23.013.

158. *Id.* § 23.522.

159. Tex. H.B. 8, 81st Leg., R.S. (2009).

160. *See id.* § 403.302.

161. *See* TEX. GOV'T CODE ANN. § 403.304 (Vernon 2009).

162. TEX. TAX CODE ANN. § 5.101 (Vernon 2008); Tex. H.B. 8 at § 11.

163. TEX. TAX CODE ANN. § 5.12(g); Tex. H.B. 8 at § 11.

164. Tex. H.B. 3896, 81st Leg., R.S. (2009).

had been raised repeatedly about whether tax abatement agreements may commence after the date on which the parties enter into the agreements, as well as about whether county commissioners may enter into tax abatement agreements with parties other than owners of real property. One key change, styled as a “clarification” of existing law, was to add a new tax code provision that explicitly allows deferral of the commencement of an abatement period until a date subsequent to the date on which the abatement agreement is entered into. The new provision also makes clear that the duration of tax abatement agreements may not exceed ten years.¹⁶⁵ Another noteworthy change in the bill was the amendment of an existing tax code provision to explicitly allow commissioners courts to enter into tax abatement agreements with: owners of tangible personal property located on real property in reinvestment zones with respect to such real property; owners of leasehold interests in tax-exempt real property located in reinvestment zones with respect to such leasehold interests; owners of tangible personal property or improvements located on tax-exempt real property in reinvestment zones with respect to such tangible personal property or improvements; and lessees of taxable real property in reinvestment zones with respect to fixtures, improvements, other real property, and tangible personal property subject to the lease or located on the leased property.¹⁶⁶

IV. PROCEDURE—AND FORM OVER SUBSTANCE ASSERTIONS

The Tax Code provides specific procedures for challenging sales and franchise tax assessments, claiming refunds, and challenging property tax assessments or denials of exemptions. Rarely is a taxpayer successful in challenging a Texas tax via a declaratory judgment, so the *Texas Entertainment* case is particularly interesting.¹⁶⁷ Karpod, a sexually oriented business, and Texas Entertainment Association, Inc., an association representing the interests of sexually oriented businesses in Texas, filed suit for declaratory and injunctive relief against the comptroller asserting that the tax on sexually oriented businesses violated the state and federal constitutions. In *Combs v. Texas Entertainment Association*, the Austin Court of Appeals affirmed the judgment of the trial court that the tax “on a sexually oriented business in an amount equal to \$5 for each entry by each customer admitted to the business” violated the First Amendment to the United States Constitution.¹⁶⁸ The court of appeals subjected the tax to strict scrutiny after a lengthy determination as to whether the restriction was content-based or content-neutral and decided that the restriction was content-based.¹⁶⁹ The comptroller conceded that the tax

165. See TEX. TAX CODE ANN. § 312.007 (Vernon 2009).

166. See *id.* § 312.402.

167. *Combs v. Tex. Entm't Ass'n, Inc. and Karpod, Inc.*, 287 S.W.3d 852 (Tex. App.—Austin 2009, pet. granted).

168. *Id.* at 856.

169. *Id.* at 857-64.

could not withstand strict scrutiny, and she was permanently enjoined from assessing and collecting the tax.¹⁷⁰

Occasionally, over the past many years, someone in the comptroller's office has suggested that the comptroller should be allowed to recharacterize transactions that—in the comptroller's view—did not have a valid business purpose. A 2006 internal memorandum, for example, suggested that certain types of (otherwise sales tax exempt) transfers of aircraft or other tangible personal property could be closely scrutinized if the transfers did not have a business purpose.¹⁷¹ More recently, the comptroller's staff released a letter stating that the comptroller “reserves the right to look through the legal form of a transaction to the realities; to look at the end result and disregard the steps and intermediate entities a taxpayer may have chosen to effect that result.”¹⁷² However, the application of federal tax law concepts like step-transaction and form-over-substance characterizations is not authorized by the Texas Tax Code, and the comptroller's efforts to adopt these theories would surely face multiple challenges. Fortunately, as of the end of the Survey period, the comptroller had agreed that these theories would not be set forth as proposed rule amendments, at least not in the immediate future.

V. CONCLUSION

Tough economic times increased the state's and local jurisdictions' need for revenue and diminished taxpayers' willingness to pay taxes. It is a combination that is likely to produce some interesting developments in 2010.

170. *Id.* at 858, 866.

171. *See* Tex. Comptroller Pub. Accounts, Document No. 200611755L (Nov. 15, 2006).

172. *See* Tex. Comptroller Pub. Accounts, Document No. 200908387L (Aug. 6, 2009). Perhaps as further evidence that this interpretation would be a departure from Texas law, the letter seeks to rely in part on *Gregory v. Helvering* and its discussion of federal income tax and on Texas cases that, as the letter notes, address circumstances in which “the corporate fiction has been used to perpetuate a fraud.” *See generally* *Gregory v. Helvering*, 293 U.S. 465 (1935). Neither these federal income tax cases nor the fraud cases appear applicable to legitimate Texas tax planning. It is no coincidence that both these letters address aircraft sales, an area of tax planning that the comptroller's staff finds particularly vexing. Even vexing situations, however, do not justify disregarding taxpayers' legitimate tax planning.