CORE
Metadata, citation and similar papers at core.ac.uk
Provided by Southern Methodist University

SMU Law Review

Volume 62 | Issue 3 Article 27

2009

Taxation

Cynthia M. Ohlenforst

Sam Megally

Angela Johnson

Follow this and additional works at: https://scholar.smu.edu/smulr

Recommended Citation
Cynthia M. Ohlenforst, et al., *Taxation*, 62 SMU L. Rev. 1461 (2009)
https://scholar.smu.edu/smulr/vol62/iss3/27

This Article is brought to you for free and open access by the Law Journals at SMU Scholar. It has been accepted for inclusion in SMU Law Review by an authorized administrator of SMU Scholar. For more information, please visit http://digitalrepository.smu.edu.

TAXATION

*Cynthia M. Ohlenforst**
*Sam Megally***
*Angela Johnson****

TABLE OF CONTENTS

I. SALES TAX 1462
A. REPORTED CASES 1462
B. COMPTROLLER RULES 1463
II. FRANCHISE TAX 1463
A. REPORTED CASES AND HEARINGS 1463
B. COMPTROLLER RULES 1467
1. *Passive Entities* 1468
2. *Nexus* 1469
3. *Reports* 1470
4. *Cost of Goods Sold—Beginning Inventory* 1470
5. *Compensation Deduction* 1471
III. PROPERTY TAX 1471
IV. PROCEDURE 1477
A. JUDICIAL INTERPRETATIONS 1477
B. ADMINISTRATIVE HEARINGS 1481
V. CONCLUSION 1481

THE economic downturn that began during the closing months of the Survey period obviously places both taxpayers and taxing authorities under intense pressure to protect and increase revenue and will likely result in additional tax contests as both take more aggressive positions, particularly regarding uncertain and new areas of the law. In that context, it is especially noteworthy that the Survey period witnessed the first ever combined-group Texas franchise tax reports, multiple proposed and amended comptroller regulations, administrative decisions, and numerous property tax cases. This Survey highlights some of those cases and developments, illustrating a broad range of interesting 2008 Texas tax issues.

* B.A., Loyola University; M.A., University of Dallas; J.D., Southern Methodist University. Partner, K&L Gates LLP, Dallas, Texas; cindy.ohlenforst@klgates.com
** B.B.A., Southern Methodist University; J.D., The University of Texas School of Law. Associate, K&L Gates LLP, Dallas, Texas; sam.megally@klgates.com.
*** B.B.A., University of Texas at El Paso; J.D., Harvard Law School. Associate, K&L Gates LLP, Dallas, Texas; angela.johnson@klgates.com.

I. SALES TAX

A. Reported Cases

Houston Wire & Cable Co. v. Combs addressed both the manufacturing and resale exemptions. Houston Wire & Cable (HWC) contended that the cable reels used to ship cable to customers qualified for the sale-for-resale exemption, and that HWC qualified for the manufacturing exemption.[1] HWC argued that the reels possessed additional characteristics, distinguishing them as a matter of law from the packaging materials that are excluded from the sale-for-resale exemption in Texas Tax Code section 151.302, and that those additional features distinguished the reels from mere packaging for wire or cable, resulting in a single wire or cable assembly.[2] The court, however, found that the reels were merely packaging materials—that HWC's wire and cable was entirely unusable unless and until it was separated from its reel, unlike the lipstick tube and cigarette lighter examples presented to the court—and that the reels, based on the facts presented, did not qualify for the resale exemption.[3]

The court also denied HWC's manufacturing exemption argument, concluding that none of HWC's operations involved changing the intrinsic characteristics of the cable; therefore, the operations were not processing.[4] Likewise, the court concluded that adding the reels to the cable was merely repackaging and did nothing to make the cable itself work in a new or different manner and that no fabrication was involved.[5] The Austin Court of Appeals affirmed the district court's denial of HWC's refund claim for cable reels, finding that there was legally sufficient evidence to support the district court's finding that HWC was not a manufacturer and that the reels did not qualify for the sale-for-resale exemption.[6]

The transition from having administrative hearings before the comptroller's administrative law judges to before the State Office of Administrative Hearing (SOAH) resulted in a smaller number of sales tax hearing decisions than usual. Several administrative hearings focused on the manufacturing exemption, although most of them offered little additional insight into the comptroller's position on manufacturing issues. Other hearings considered the scope of taxable services, a topic that the district court may address in 2009. The comptroller continued to use *Tax Policy News* and other informal online communication methods to address issues and procedures, so taxpayers may find it helpful—at least in deter-

1. No. 03-07-00006-CV, 2008 Tex. App. LEXIS 1820, at *3 (Tex. App.—Austin Mar. 12, 2008, pet. denied) (mem. op.); *see also* Cynthia M. Ohlenforst et al., *Taxation*, 61 SMU L. Rev. 1131, 1131 (2008).

2. *Houston Wire*, 2008 Tex. App. LEXIS 1820, at *7, *9.

3. *Id.* at *12.

4. *Id.* at *12-20.

5. *Id.* at *14.

6. *Id.* at *19-20.

mining the comptroller's position—to check those sources as well.[7]

B. Comptroller Rules

Although rulemaking focused on the newly amended and adopted franchise tax rules,[8] the comptroller also revised several sales and use tax rules during the Survey period,[9] including Rule 3.291 regarding contractors.[10] As a follow up to the comptroller's earlier focus on concrete-contractor issues, she amended the rule to allow ready-mix concrete contractors to issue a resale certificate in lieu of paying sales tax on taxable items incorporated into the concrete. She further amended the rule to comply with new legislation, which requires contractors who both manufacture concrete for construction purposes and incorporate that concrete into realty, to separately state the price of the concrete from any other charges associated with the contract.[11] The ready-mix concrete contractor is also required to collect and remit the tax due on the higher of the invoice price or fair market value, and the amendments more clearly explain local tax reporting requirements for contractors who improve real property of nonexempt customers.[12]

II. FRANCHISE TAX

A. Reported Cases and Hearings

Meadwestvaco Corp. v. Illinois Department of Revenue, a U.S. Supreme Court case, bears mention because of its possible impact on Texas' interpretation of "unitary" in the context of the state's recent enactment of a combined reporting requirement.[13] The Court decisively and unanimously blocked an attempt by the State of Illinois to expand the concept of unitary taxation beyond the existing boundaries of what constitutes a

---

7. *See, e.g.*, State Tax Automated Research System, http://cpastar2.cpa.state.tx.us/index.html (last visited May 30, 2009); Tax Policy News, http://www.window.state.tx.us/taxinfo/taxpnw/index.html (last visited May 30, 2009).

8. *See* discussion *infra* Part II.B.

9. *See* 32 Tex. Reg. 6756, *adopted* 32 Tex. Reg. 8521 (2007) (to be codified as an amendment to 34 Tex. Admin. Code § 3.286) (requiring wholesalers and distributors of beer, wine, and malt liquor to file electronically with the comptroller a monthly report of sales to retailers in Texas); 32 Tex. Reg. 6760, *adopted* 32 Tex. Reg. 8521 (2007) (to be codified as an amendment to 34 Tex. Admin. Code § 3.337) (clarifying that mandatory gratuity charges when in excess of twenty percent are subject to sales tax in total regardless of how they are disbursed); 33 Tex. Reg. 6060, *adopted* 33 Tex. Reg. 8398 (2008) (to be codified as an amendment to 34 Tex. Admin. Code § 3.365) (regarding the expansion of the exemption from sales tax for a three-day period in August concerning sales of clothing and footwear to include backpacks purchased for use by public elementary or secondary school students and providing that a retailer who sells more than ten school backpacks to a customer at the same time must obtain an exemption certificate from the customer verifying that the backpacks are being purchased for use by elementary or secondary school students).

10. 32 Tex. Reg. 9573 (2007), *adopted* 33 Tex. Reg. 4186 (2008) (to be codified as an amendment to 34 Tex. Admin. Code § 3.291).

11. *Id.*

12. *Id.*

13. *See* MeadWestvaco Corp. v. Ill. Dep't of Revenue, 128 S. Ct. 1498 (2008).

unitary business, notwithstanding the urging of the respondent, Illinois Department of Revenue, and the twenty-four states (plus Puerto Rico) that filed an amicus brief.[14] Given the current movement among various states (including Texas) to enact combined reporting as a basis for state corporate taxation and to tie that taxation to unitary concepts, the *Meadwestvaco* case would appear to have a limiting effect on the reach of those statutes. The unanimity of the decision would also suggest the Court's more general lack of receptivity to creative expansion of the states' taxing jurisdiction over multistate business.

In this case, Mead Corporation (Mead), the parent, was an Ohio corporation headquartered and "commercially domiciled" in Ohio that had been in the paper, packaging, and stationery business for many years.[15] In 1968, Mead acquired a corporation in the printing and information retrieval business, which over the course of time developed the well known electronic research service known as Lexis.[16] In 1994, the tax year in question, Mead sold the Lexis business to a third party, realizing over one billion dollars in capital gain.[17] The Lexis subsidiary corporation had operated in Illinois and paid significant tax to Illinois over the years on its ongoing operations.[18] Mead had also paid substantial Illinois corporate tax on its own separate and distinct paper business. Mead did not, however, pay Illinois tax on its capital gain on the sale of the Lexis business. Illinois assessed Mead additional tax and penalties of approximately four million dollars on the gain.[19] The resulting litigation focused on whether Mead should be obligated to pay the Illinois tax on the sale of the Lexis business on the ground that the Lexis business and Mead's paper business were unitary in nature.[20] The Court held that the state courts erred in considering whether the business division served an "operational pur-

14. *Id.* at 1509. Under a unitary taxation method, if at least one member of the corporate group is directly subject to a state's taxing jurisdiction and the group is deemed unitary, then the entire income of the corporate group becomes part of the tax base in that state, to the extent reasonably apportioned to that state under a proper formula. The key determinant is whether the business entities at issue carry on a "unitary business." *Id.* at 1502. As the court stated, the "hallmarks" of a unitary relationship are functional integration, centralized management, and economies of scale where the related corporations conduct distinct businesses. *Id.* at 1509. See also the Texas definition of unitary: "[A] single economic enterprise that is made up of separate parts of a single entity or of a commonly controlled group of entities that are sufficiently interdependent, integrated, and interrelated through their activities so as to provide a synergy and mutual benefit that produces a sharing or exchange of value among them and a significant flow of value to the separate parts." TEX. TAX CODE ANN. § 171.0001(17) (Vernon 2008).

15. *MeadWestvaco*, 128 S. Ct. at 1502.

16. *Id.*

17. *Id.*

18. *Id.* at 1504.

19. *Id.* at 1503.

20. *Id.* at 1504. The facts revealed that the Mead business and the Lexis business were almost entirely separate and separately conducted. "Neither business was required to purchase goods or services from the other and neither received any discount on the relatively insignificant goods or services purchased from the other and neither was a significant customer of the other." *Id.* Over the period of Mead's ownership of Lexis, Lexis existed as a wholly owned subsidiary corporation for certain periods of time and as an unincorporated division of Mead for other periods of time, including 1994, the year in question.

pose" in Mead's paper business after determining that Mead and Lexis were not unitary, and the case was remanded for further proceedings.[21]

In reaching its decision, the Court did not entertain a suggestion by the State of Illinois and the amicus filers that the Court recognize a new ground for the constitutional apportionment of intangibles based on the taxing state's contact with the in-state capital asset (the Lexis business), rather than its contact with the out-of-state taxpayer (Mead).[22] The Court also observed that the case's issue and outcome may impact the law of other jurisdictions such as Ohio and New York, which have both adopted such a new ground for constitutional apportionment (focusing on an operational function served by an in-state entity).[23]

Although the unitary issue is increasingly important to Texas franchise tax, all the reported Texas cases from the Survey period address the "old," pre-combined-reporting franchise tax. Of course, the holdings of many "old" franchise tax cases will remain important in the context of the "new" revised margin tax.[24] *TGS-NOPEC Geophysical Co. v. Combs*, for example, addressed apportionment.[25] The Austin Court of Appeals affirmed the trial court's decision to find TGS liable for franchise taxes from 1997 to 2003, but waived penalty and interest.[26] TGS licensed geophysical and seismic data used by oil and gas companies to develop oil and gas deposits.[27] TGS charged its customers a flat fee for a non-exclusive license to use this data. The appeal concerned a dispute about the apportionment of TGS's gross receipts from business done in Texas under sections 171.103 and 171.1032 of the Texas Tax Code.[28] The crux of TGS's argument was that TGS is taxed differently than computer software companies. However, the court of appeals upheld liability because TGS provided no proof that it was taxed differently than other geophysical data companies.[29] TGS also argued that by using TGS's customers' shipping or billing addresses to determine the location of use, the comptroller unfairly apportioned a larger share of TGS's gross receipts to Texas and thereby subjected TGS to higher franchise taxes in violation of the Commerce Clause. However, the court of appeals determined that this method was reasonable.[30]

Mead had in fact treated Lexis as a unitary business on its Illinois tax returns for the years 1988 through 1994 at the state's insistence to avoid litigation. *Id.*

21. *Id.* at 1526.
22. *Id.* at 1508.
23. *Id.* at 1509.
24. Because the franchise tax as currently in effect applies to a taxable entity's "taxable margin," as defined for purposes of chapter 171 of the Texas Tax Code, the tax is often referred to as the "margin tax." However, as a technical matter, the tax is still the franchise tax, albeit in a very different form from the franchise tax in effect prior to 2008.
25. 268 S.W.3d 637, 644 (Tex. App.—Austin 2008, pet. filed).
26. *Id.* at 652.
27. *Id.* at 640.
28. *Id.* at 645 (focusing on apportionment of receipts from licenses or licensing activities, as provided for by § 171.103 as amended in 1997).
29. *Id.* at 648.
30. *Id.* at 650.

TGS-NOPEC is also noteworthy for its discussion of penalty criteria. In determining whether the trial court was correct in finding that the comptroller abused her discretion by refusing to waive penalty and interest, the court of appeals found that the comptroller incorrectly asserted that she was required to consider only the six non-audit factors in Comptroller Rule 3.5(b) instead of the nine audit factors in Rule 3.5(c).[31] The record reflected that TGS had relied on letter rulings from the comptroller to apportion licensing receipts during the time the statute was being amended, and the court of appeals determined that the agency must follow its own rules and procedure, and affirmed the trial court's award of a refund of the penalty and interest.[32]

Telecommunications companies' franchise taxes have triggered numerous disputes in recent years, involving issues that are sometimes quite industry specific. *Southwestern Bell Telephone Co. v. Combs* is noteworthy because of the telecommunications issues it addresses and because of its broader implications for, and discussion of, apportionment issues.[33] In this case, the Amarillo Court of Appeals affirmed the trial court's finding that Southwestern Bell Telephone (Bell) was liable for franchise taxes and interest paid under protest, despite Bell's arguments that charges for customer access to its local telephone network to complete long distance calls and pay-per-use services, such as operator assistance, should be excluded from Texas receipts as "receipts from interstate calls" or "revenues from calls in interstate commerce."[34] The court of appeals had to determine whether Bell's access and operator assistance charges were "services performed in this state," in accordance with Texas Tax Code sections 171.103 and 171.1032.[35] Regarding telephone companies, the comptroller interpreted the phrase "business within this state" to include fixed periodic access and equipment charges for equipment located in Texas, whether used for intrastate or interstate communications," and had, according to the court, consistently interpreted access charges for the use of telephone networks and facilities to be charges for rendering a "service."[36] The court of appeals accordingly found that the term "service" included the charges at issue. Because the record established that the services were requested by Bell's customers located in Texas, who were serviced by Bell's networks, facilities, or personnel located in Texas, the court concluded that these transactions began and ended in Texas.[37] As such, the court determined that the comptroller was correct in appor-

31. *Id.* at 652.

32. *Id.*

33. 270 S.W.3d 249, 251 (Tex. App.—Amarillo 2008, pet. filed).

34. *Id.* at 272.

35. *Id.* at 262. The court of appeals initially addressed whether the term "service" includes providing a customer access to a communications network for the purpose of completing long distance calls or operator assistance. *Id.* at 260.

36. *Id.* at 261.

37. *Id.* at 262.

tioning the charges as "gross receipts from business done in Texas."[38]

The Survey period produced surprisingly few franchise tax administrative hearings. As with the court cases, some decisions are so specific to the "old" franchise tax that they may have limited impact on future reporting and cases; others, however, foreshadow the emphasis that future disputes may place on federal tax laws and on other states' interpretations. Hearing No. 49,034, for example, addressed a taxpayer's efforts to justify a child-care credit under section 171.703 of the Tax Code by reliance in part on analogous federal income tax interpretations and on a New Mexico case.[39] The decision, in another foreshadowing of future decisions, considered both legislative intent and the degree to which the cited authority from other jurisdictions should have any impact on the Texas case. The administrative law judge, noting significant differences between the Texas language and the cited provisions, ruled that the taxpayer was not entitled to the requested credit.[40]

B. Comptroller Rules

Revisions to the Texas franchise tax in the last two legislative sessions triggered numerous issues—and multiple new rules—relating not only to old issues (e.g., how to apportion receipts for franchise tax purposes) but also to new issues (e.g., how to file a combined group report). The dialogue between comptroller staff and taxpayers was, in many respects, a dance to music provided by the legislature in which all of the parties (and the band) worked to determine how to move forward under a very different taxing regime.

In addition to helpful webinars, website FAQs, and other public comments that provided taxpayers with informal notice of the comptroller's position on various franchise tax questions, the comptroller also issued a series of new rules. First officially proposed in the September 14, 2007 issue of the *Texas Register*, a new set of franchise tax rules to implement the revised franchise tax was adopted on December 27, 2007, effective January 1, 2008.[41] On November 7, 2008 (one week after the end of the Survey period), proposed rule amendments appeared in the Texas Regis-

---

38. *Id.* at 278. The court of appeals found that the exemption from apportionment for revenues from calls in interstate commerce did not apply. *See* 34 Tex. Admin. Code §§ 3.549(e)(43) (Comptroller of Pub. Accounts, Taxable Capital: Apportionment), 3.557(e)(39) (2009) (Comptroller of Pub. Accounts, Earned Surplus: Apportionment). The court also found that Bell failed to establish that the comptroller made an arbitrary and unreasonable distinction in its treatment of Bell compared to other companies that provide long distance service but whose receipts from intrastate "legs" of interstate telephone service are not apportioned as Texas receipts (i.e. inter-exchange carriers); therefore, Bell's equal protection claim failed. *Bell*, 270 S.W.3d at 273.

39. *See* Tex. Comptroller Pub. Accounts, Hearing No. 4,035 (July 1, 2008).

40. *Id.* (distinguishing *Intel Corp. v. State*, 931 P.2d 775 (N.M. Ct. App. 1995) and I.R.C. § 129 analyses). Taxpayers should hope that the record of taxpayer losses on franchise tax hearings during the Survey period does not foreshadow a continuing trend.

41. 32 Tex. Reg. 6271, *adopted* 32 Tex. Reg. 10013 (2007) (to be codified as amendments to 34 Tex. Admin. Code §§ 3.581-.595 (Comptroller of Pub. Accounts)).

ter.[42] The proposed amendments, regarding rules for passive entities and cost of goods sold, were not adopted because the comptroller is still considering the comments received. Although a summary of all the rules is beyond the scope of this article, it is worthwhile to note some key issues.

1. Passive Entities

Because passive entities are not subject to the franchise tax, the tests for determining whether an entity is passive are critical.[43] Not surprisingly, Rule 3.582, regarding passive entities, has generated much discussion and controversy.[44]

One of the key disputes focuses on whether it is appropriate for the comptroller to refer, as she does in subsection (c) of the rule, to an entity's *net* capital gains and *net* gains in the context of determining whether an entity's income is at least 90 percent passive, and therefore, whether the entity qualifies as a passive entity.[45] Commentators have pointed out that the statutory language never uses the word "net" in this context.[46] In electing to retain the original language from the proposed rule, the comptroller's position is, in part, that the statute bases the passive entity determination on an entity's federal gross income, and that federal gross income includes these net items.[47] However, the comptroller's interpretation may not adequately take into account the federal tax landscape, including the federal taxation of gains on sales of certain depreciable and real property under Internal Revenue Code section 1231, which in some circumstances requires a reclassification of certain gains and losses that could affect this passive entity calculation.[48]

Similarly, the comptroller has added gloss to the passive entity criteria by adopting a definition of "security" for purposes of defining passive sources of income that appears to depart from the statutory language and intent.[49] Specifically, Rule 3.582 provides that income from certain security and ownership interests will be considered passive only if the owner has a non-controlling interest in the investee.[50] Commentators suggested in late 2007 that the comptroller delete the "non-controlling" criterion from the rule, but as with the "net" gain interpretation, the comptroller declined to modify the rule, maintaining that a controlling interest in any entity is, by definition, not passive.[51] The comptroller also rejected sug-

42. Eight of the amendments received no comments and were published on December 26, 2008, effective January 1, 2009. *See* 33 Tex. Reg. 9055, *adopted* 33 Tex. Reg. 10502 (2008) (to be codified as amendments to 34 TEX. ADMIN. CODE § 3.584).

43. *See generally* TEX. TAX CODE ANN. § 171.0003 (Vernon 2008).

44. 34 TEX. ADMIN. CODE § 3.582 (2009).

45. *Id.*; TEX. TAX CODE ANN. § 171.0003(a)(2) (Vernon 2008).

46. 32 Tex. Reg. 10015 (2007) (to be codified at 34 TEX. ADMIN. CODE § 3.582).

47. *Id.*

48. *See generally* 26 U.S.C. § 1231 (2006).

49. 34 TEX. ADMIN. CODE § 3.582 (2009).

50. *Id.*

51. 32 Tex. Reg. 6271, *adopted* 32 Tex. Reg. 10013 (2007) (to be codified as amendments to 34 TEX. ADMIN. CODE § 3.582).

gestions that "security" be defined in this context as it is defined in the Securities Act, maintaining that the Act is merely regulatory in nature and not an apt reference point.[52]

Though amendments proposed in 2008 to the passive entity rule have not yet been adopted, some troublesome proposed changes merit attention. For example, a proposed change to the rule is designed to recharacterize distributive shares of partnership income (which are passive) as rental income to the partner (which is not passive) if the underlying partnership revenue is rental income.[53] In essence, the comptroller is proposing—without statutory language to support her position—to recharacterize passive partnership distributive income as active income if the underlying source of the distribution is rental income.[54] This interpretation stands in stark contrast to the statute, which clearly provides that partnership distributive income is passive.[55] If the comptroller were to adopt this interpretation, taxpayers would surely challenge it as an unwarranted reinterpretation of the statutory language.

2. *Nexus*

The comptroller's laundry list of activities that create nexus with Texas for franchise tax purposes, set forth in Rule 3.586, generally tracks the nexus examples set forth in the old Rule 3.546, relating to nexus for taxable capital purposes.[56] The comptroller has explained that the list is simply a clarification and combination of current rules, and does not represent a change in policy.[57] However, some practitioners have been scratching their heads over certain provisions that they perceive as changes from old policy.

Oil and gas industry representatives, for instance, requested that the comptroller amend subsections (c)(4), (c)(9), and (c)(17) to exclude from the list of activities that give an entity nexus with Texas the newly-formulated descriptions of delivering into Texas materials that remain in interstate commerce even as they rest here—apparently intended to include gas that passes through Texas in interstate pipelines.[58] The comptroller declined to make the requested change, citing the legislature's longstanding requirement that the franchise tax be imposed to the full extent of the U.S. Constitution.[59] Note, however, that at least one Texas court

---

52. *Id.*

53. 33 Tex. Reg. 9053 (2008) (to be codified as an amendment to 34 Tex. Admin. Code § 3.582). See in particular subsection (d)(1), which excludes from passive characterization "rent, including rental income that flows from a partnership to a partner."

54. *Id.*

55. Tex. Tax Code Ann. § 171.0003(a)(2)(B) (Vernon 2008).

56. 34 Tex. Admin. Code § 3.586 (2009). Immediately prior to 2008, the franchise tax required taxpayers to calculate their tax liability by reference to taxable capital and earned surplus.

57. 32 Tex. Reg. 10027 (2007) (to be codified as an amendment to 34 Tex. Admin. Code § 3.586).

58. *Id.*

59. *Id.*

has held that when an entity's sole connection with the state is ownership of property temporarily stored here, but always in interstate commerce, the U.S. Constitution does not give the entity sufficient nexus with Texas to subject it to taxation in Texas.[60]

Practitioners have also noted with curiosity the comptroller's addition of "collecting accounts" and "repossessing property," in connection with loan production activities, to the laundry list of nexus-creating activities, though the comptroller has responded that these new items do not represent changes in policy.[61]

Any student of the comptroller's nexus policy will note without surprise the rule's proclamation that Public Law 86-272 does not apply to the franchise tax.[62] This is due to the fact that Public Law 86-272, which prohibits states from taxing income derived from purely interstate activity, applies only to net income taxes and, as the comptroller is fond of reciting, the franchise tax is not a net income tax.[63] Of course, that assertion—with respect to the franchise tax both as revised and as it existed prior to January 1, 2008—has long been, and will continue to be, the subject of debate.

3. *Reports*

The comptroller amended Rule 3.584, regarding reports and payments, to tie reporting periods more closely to the statutory ceilings and to clarify the reporting requirements of nontaxable entities.[64] In addition, a section was added regarding the calculation of annualized total revenue. Taxable entities that have an accounting period that is more or less than twelve months must annualize total revenue to determine eligibility for the $300,000 no tax due threshold, tax discounts, and the E-Z Computation.[65] The one-half percent rate of taxable margin for entities engaged primarily in retail or wholesale trade is still applicable.

4. *Cost of Goods Sold—Beginning Inventory*

The debates and discussions of how to compute costs of goods sold are extensive enough to justify an entire article—or multiple articles. In some cases, judicial or legislative interpretation will be required. In at least one situation, though, the comptroller and taxpayers ultimately

60. *See* Peoples Gas, Light, & Coke Co. v. Harrison Cent. Appraisal Dist., 270 S.W.3d 208 (Tex. App.—Texarkana 2008, pet. filed).

61. 34 TEX. ADMIN. CODE § 3.586(c)(11) (2009).

62. 34 TEX. ADMIN. CODE § 3.586(e) (referring to 15 U.S.C. §§ 381-84).

63. 15 U.S.C. §§ 381-84 (2006); 32 Tex. Reg. 6282 (2007) (to be codified as an amendment to 34 TEX. ADMIN. CODE § 3.586).

64. 33 Tex. Reg. 9056, *adopted* 33 Tex. Reg. 10502 (2008) (to be codified as 34 TEX. ADMIN. CODE § 3.584). Language was added to require that a nontaxable entity reply to the Comptroller within thirty days when asked in writing if the entity is taxable and language regarding privilege periods was removed because privilege periods no longer affect the calculation of the franchise tax. *Id.*

65. *Id.* The E-Z Computation is described more concisely to emphasize that a deduction for cost of goods sold or compensation is not allowed when using this method. *Id.*

agreed on a revision to the comptroller's original interpretation. Rule 3.588, as originally adopted, provided that no deduction was available for beginning inventory in computing cost of goods sold.[66] However, multiple comments to the comptroller staff ultimately persuaded them that denying a deduction for beginning inventory is inconsistent with statutory intent—and would result in significantly overstating revenue for many taxpayers.[67] Accordingly, proposed amendments to Rule 3.588 include adding language to clarify that an election must be made to capitalize or expense allowable costs for the cost of goods sold and allowing a beginning inventory only to taxable entities that elect to capitalize costs.[68] Another proposed revision would provide that only expenses that are excluded from total revenue may not be included in the determination of cost of goods sold.[69]

5. *Compensation Deduction*

In many respects, the compensation deduction is less complex than the cost of goods sold deduction. The rule regarding compensation deductions was amended to clarify, for example, that the $300,000 per person limit on wages and cash compensation is measured per the twelve-month period on which the tax is based.[70] In addition, subsections regarding staff leasing companies were reworded to clarify that the specified payments cannot be included as compensation, and that a staff leasing company cannot include as compensation payments made to independent contractors.[71]

III. PROPERTY TAX

During the Survey period, a number of cases addressed jurisdictional issues in the property tax context. In addition, several non-procedural cases focused on interesting and developing areas of Texas property tax law, including the taxability of aircraft. One non-procedural case of note during the review period, *Peoples Gas, Light, & Coke Co. v. Harrison Central Appraisal District*, considered whether natural gas temporarily stored in Texas on its way out of the state should be subject to property

66. *See* 32 Tex. Reg. 6288, *adopted* 32 Tex. Reg. 10036 (2007) (to be codified as an amendment to 34 TEX. ADMIN. CODE § 3.588).

67. *Id.*; *see also* TEX. TAX CODE ANN. § 171.1012 (Vernon 2008).

68. *See* 33 Tex. Reg. 9061 (2008) (to be codified as an amendment to 34 TEX. ADMIN. CODE § 3.588). In addition, a new paragraph was added to clarify how a taxable entity elects to deduct the cost of goods sold to determine margin and what restrictions apply when making that election.

69. *See id.* Language was deleted that did not allow costs related to excluded revenue to be included in the determination of the cost of goods sold. In addition, language was proposed to include bars in the list of entities described as "Eating and Drinking Places," and to allow beverages to be included, like food, as part of the cost of goods sold relating to acquisition and production activities for restaurants and bars. *Id.*

70. 33 Tex. Reg. 9063, *adopted* 33 Tex. Reg. 10504 (2008) (to be codified as an amendment to 34 TEX. ADMIN. CODE § 3.589).

71. *Id.*

tax in Texas.[72] Peoples, the taxpayer in this case, purchased gas from suppliers and delivered it outside of the state.[73] The gas at issue was stored underground in large, depleted natural gas fields.[74] For several years, Peoples had prevailed in challenges to the taxability of the gas, and the appraisal district had agreed to remove the gas from its rolls on the advice of its appraisal consultant firm.[75] After several years of removing the gas from its rolls, the district heeded the advice of a new appraisal consultant firm and refused to remove the gas, giving rise to this litigation.[76]

The trial court ruled that the district had the right to assess property tax on the gas and the taxpayer appealed.[77] The Texarkana Court of Appeals opinion laid out an analytical framework in agreeing with the taxpayer and reversing the trial court opinion.[78]

First, the court considered whether Peoples could be considered the owner of the gas.[79] In determining that Peoples did in fact own the gas, the court looked to the extensive regulatory framework governing gas storage and transportation contracts, which barred the pipeline operator from taking ownership of the gas.[80] The court noted that the pipeline operator and Peoples, which had purchased the gas, were the only two entities in the chain of the gas's movement. The court concluded that, because the pipeline operator could not be the owner, Peoples was necessarily the owner.[81]

Having determined that Peoples owned the gas, the court next considered whether the Commerce Clause shields the gas from property tax.[82] The court determined, in relatively short order, that the gas was in interstate commerce, having been "placed with a common carrier," that is, the pipeline operator.[83] The court noted that Peoples had no contractual right to control the direction or time of the gas's movement, so the interstate nature of the pipeline controlled this analysis.[84] The court next considered whether the gas's temporary storage in the depleted underground field removed it from interstate commerce.[85] Citing *Independent Warehouses, Inc. v. Scheele*,[86] the court noted that "[t]he crucial question in determining whether the state may exert its taxing power is whether there

72. Peoples Gas, Light, & Coke Co. v. Harrison Cent. Appraisal Dist., 270 S.W.3d 208 (Tex. App.—Texarkana 2008, pet. filed).
73. *Id.* at 211.
74. *Id.*
75. *Id.*
76. *Id.*
77. *Id.* at 212.
78. *Id.*
79. *Id.* at 212-14.
80. *Id.* at 213-14.
81. *Id.* at 212-14.
82. *Id.* at 214.
83. *Id.* at 215.
84. *Id.* at 216.
85. *Id.* at 215-18.
86. 331 U.S. 70, 73 (1947).

is 'continuity of transit,'" and further noted that "interstate movement . . . may be regarded as continuing . . . despite temporary interruptions due to the necessities of the journey."[87] Looking again to the fact that Peoples did not control the movement of the gas, the court determined that its storage in Texas was incident to its interstate movement, that the interstate movement had been continuous, and that Peoples's interest in the property could not, consistent with the Commerce Clause, be subjected to property tax in Texas.[88]

In one of several aircraft property tax cases during the Survey period, the Dallas Court of Appeals considered a taxpayer's argument that its aircraft was not used "continually" within Texas, and therefore, should not be subject to property tax in Texas.[89] The Alaska Flight Services aircraft was operated and based during the tax year outside of Texas.[90] Of the aircraft's forty-plus departures during the tax year, less than a quarter were from Texas.[91] The taxpayer argued that Texas Tax Code section 11.01(c)(3), which provides that "[the] state has jurisdiction to tax tangible personal property if the property is . . . used continually, whether regularly or irregularly, in [the] state,"[92] did not reach its aircraft because of the relatively low number of departures from within Texas.[93]

The court rejected the taxpayer's proposal that the court construe "continually" to mean "used in Texas without interruption, i.e., not used outside of Texas at all, no matter how much the property is used in Texas."[94] Rather, the court held that "property is 'used continually, whether regularly or irregularly, in this state' if the property is used while it is present in this state, during the tax year," and provided further that such "use can be regular or irregular in pattern or amount, so long as the property is used over the course of the tax year."[95] Therefore, the court held that the taxpayer's aircraft was taxable.[96]

The aircraft owner in *C.I.T. Leasing Corp. v. Dallas Central Appraisal District*[97] fared better than the taxpayer in *Alaska Flight Services.* In that case, C.I.T. Leasing "erroneously rendered" its aircraft for taxation and "the appraisal district assessed property tax on the aircraft."[98] After attempting unsuccessfully to resolve the issue with the appraisal district, the taxpayer paid the taxes under protest, several months late, and filed a

87. *Peoples*, 270 S.W.3d at 215-16.
88. *Id.* at 219.
89. Ala. Flight Servs., LLC v. Dallas Cent. Appraisal Dist., 261 S.W.3d 884, 889 (Tex. App.—Dallas 2008, no pet.).
90. *Id.* at 885.
91. *Id.*
92. TEX. TAX CODE ANN. § 11.01(c)(3) (Vernon 2008).
93. *Ala. Flight*, 261 S.W.3d at 889-90.
94. *Id.* at 888.
95. *Id.* at 889.
96. *Id.* at 890.
97. No. 05-06-01546-CV, 2007 Tex. App. LEXIS 9701 (Tex. App.—Dallas Dec. 13, 2007, no pet.).
98. *Id.* at *1.

motion with the appraisal review board to correct the tax roll.[99] The board dismissed the motion without considering the merits because the taxpayer had failed to pay its property taxes timely.[100]

When the taxpayer sued to have the tax roll corrected pursuant to section 25.25 of the Texas Tax Code,[101] the district court maintained that the taxpayer had failed to comply with Tax Code section 42.08 because it had not timely paid property tax on the aircraft.[102] As the court noted,

> [s]ection 42.08 requires a property owner to pay, before the delinquency date, the *lesser* of (1) the amount of taxes due on the portion of the taxable value of the property *that is not in dispute* or (2) the amount of taxes due on the property under the order from which the appeal is taken.[103]

Because the taxpayer was disputing the entire amount of taxes, and had clearly indicated so at the hearing and in its petition, the court held that the taxpayer had complied with Tax Code section 42.08, and reversed and remanded the case for further proceedings.[104]

The courts issued several interesting opinions addressing procedural and jurisdictional issues in the property tax context during the Survey period as well. In *Appraisal Review Board of Harris County Appraisal District v. O'Connor & Assocs.* and *Appraisal Review Board of Harris County Appraisal District v. Spencer Square Ltd.*, the Fourteenth District Court of Appeals at Houston considered cases in which taxpayers claimed that district courts' writs of mandamus were the only avenue by which the taxpayers could obtain proper appraisal review board hearings.[105]

In *Spencer Square*, the taxpayer had protested the appraisal district's valuation of its property and prevailed, but nevertheless sought a writ of mandamus almost one year later to order the appraisal review board "to conduct a new protest hearing."[106] Similarly, in *O'Connor*, the taxpayer "had either already filed or would likely file protests of the appraised value of their property," but complained that the appraisal review board

> was postponing hearings, refusing to consider property owners' evidence, considering evidence that HCAD had not produced to property owners, determining protests in favor of HCAD even when HCAD presented insufficient or no evidence, and issuing only one order to resolve claims contesting both the appraised value and une-

---

99. *Id.*

100. *Id.* at *1-2.

101. TEX. TAX CODE ANN. § 25.25(c)(1) (Vernon 2008).

102. *C.I.T. Leasing*, 2007 Tex. App. LEXIS 9701, at *2.

103. *Id.* at *4 (citing TEX. TAX CODE ANN. § 42.08 (Vernon 2008) (emphasis added)).

104. *Id.* at *4-5.

105. Appraisal Review Bd. of Harris County Appraisal Dist. v. O'Connor & Assocs., 267 S.W.3d 413, 415 (Tex. App.—Houston [14th Dist.] 2008, no pet.); Appraisal Review Bd. of Harris County Appraisal Dist. v. Spencer Square Ltd., 252 S.W.3d 842, 843 (Tex. App.—Houston [14th Dist.] 2008, no pet.).

106. *Spencer Square*, 252 S.W.3d at 843.

qual appraisal of the property.[107]

In each case, the court held that the taxpayer had not been denied its right to a hearing on the valuation issue and had failed to exhaust its administrative remedies.[108] The *O'Connor* opinion acknowledged that Texas Tax Code section 41.45(f) "states that the district court may compel the Board to hold a hearing when a property owner has been denied a hearing to which he is entitled."[109] The court nevertheless rejected the taxpayers' argument that "the hearing to which a property owner is entitled under section 41.45(f) is one conducted according to the law and ending with a proper order."[110] The court noted in its opinion that adopting the taxpayers' interpretation of Tax Code section 41.45(f) "would allow property owners to circumvent the appeal provisions in chapter 42 [setting forth the procedure for appealing from an adverse appraisal review board hearing] and sue in district court simply by alleging the Board failed to adhere to procedural guidelines," and noted further that "[i]nterpreting section 41.45(f) as creating another avenue of appeal to the district court would essentially render the appeal provisions in chapter 42 meaningless."[111] In both cases, the court concluded that the taxpayers were not entitled to writs of mandamus and were required to exhaust their administrative remedies before again appealing to the district courts.[112]

The court delivering the opinion in *Koll Bren Fund VI, LP v. Harris County Appraisal District*, offered an important reminder to purchasers of taxable property.[113] In that case, the former owner had sold taxable property in August of the tax year.[114] In the following year, the seller filed a notice of protest with the appraisal review board as the owner of the property, claiming that the assessed value "was excessive."[115] The appraisal review board reduced the value of the property, but the former owner nevertheless challenged the board's determination in district court, again asserting that it was the property owner.[116] Over fifteen months later, the seller amended its pleadings to include the purchaser as a plaintiff.[117] The trial court ruled, and the appeals court affirmed, that the seller did not have standing to challenge the valuation because it did not own the property on January 1 of the year following the tax year.[118] The court did note that the purchaser had acquired standing to challenge the

107. *O'Connor*, 267 S.W.3d at 413-14.
108. *Spencer Square*, 252 S.W.3d at 845-46; *O'Connor*, 267 S.W.3d at 419.
109. *O'Connor*, 267 S.W.3d at 417.
110. *Id.*
111. *Id.*
112. *Spencer Square*, 252 S.W.3d at 845-46; *O'Connor*, 267 S.W.3d at 419.
113. Koll Bren Fund VI, LP v. Harris County Appraisal Dist., No. 01-07-00321-CV, 2008 Tex. App. LEXIS 1521 (Tex. App.—Houston [1st Dist.] Feb. 28, 2008, pet. dism'd).
114. *Id.* at *4.
115. *Id.*
116. *Id.* at *4-5.
117. *Id.* at *5.
118. *Id.* at *12.

property valuation when it acquired the property.[119] Nevertheless, because the seller brought the challenge, the purchaser had failed to pursue, on its own behalf, its Tax Code chapter 41 right to protest the value, and therefore, lacked standing to bring a court challenge.[120]

In *Covert v. Williamson Central Appraisal District*, the taxpayers sued to challenge what they claimed were unequal valuations of their property by the appraisal district.[121] The appraisal district opposed their suit on the grounds that the taxpayers had not stated a claim because they had asserted that only the land portion of their property—and not the entire property—was unequally valued.[122] The court looked to Tax Code section 42.26, which provides that "[t]he district court shall grant relief on the ground that a property is appraised unequally if the appraised value of the property exceeds the median appraised value of a reasonable number of comparable properties appropriately adjusted."[123] The taxpayers urged the court to parse the statute, arguing that because the legislature had opted to use the general article "a" before the first appearance of "property" and the more specific article "the" before the second appearance, its clear intent had been to "narrow the median test 'to whichever matter or thing was selected for challenge by the property owner.'"[124] The court rejected this reading, preferring to consider the plain meaning of the statute, and concluded that "a taxpayer challenging the equal and uniform assessment of an improved property under Tax Code section 42.26 must allege that the overall appraised value of the property is unequal."[125] The court did concede, however, that "evidence that only the land or only the improvements were assessed unequally is certainly relevant to [a] taxpayer's challenge."[126]

Finally, in a couple of cases from the be-careful-what-you-wish-for file, taxpayers who were challenging their property valuations in appraisal review board hearings found themselves in surprise agreement with the appraisal districts whose valuations they were challenging. In *Mann v. Harris County Appraisal District* and *Verm v. Harris County Appraisal District*, the taxpayers challenged in appraisal review board hearings what they claimed were excessive valuations of their property and proposed lower values.[127] Not to be outdone, the district representative in *Mann* followed the taxpayer representative by proposing an even lower value, but quickly corrected himself, and agreed with the taxpayer's proposed

---

119. *Id.* at *13.
120. *Id.* at *13-14.
121. Covert v. Williamson Cent. Appraisal Dist., 241 S.W.3d 655, 656 (Tex. App.—Austin 2007, pet. denied).
122. *Id.*
123. *Id.* at 658 (citing TEX. TAX CODE ANN. § 42.26(d) (Vernon 2001)).
124. *Id.*
125. *Id.* at 661.
126. *Id.* at 659.
127. Verm v. Harris County Appraisal Dist., No. 14-06-01046-CV, 2008 Tex. App. LEXIS 4900, at *1 (Tex. App.—Houston [14th Dist.] July 1, 2008, no pet.); Mann v. Harris County Appraisal Dist., No. 01-07-00436-CV, 2008 Tex. App. LEXIS 2790, at *1 (Tex. App.—Houston [1st Dist.] Apr. 17, 2008, no pet.).

value.[128] The district representatives in *Verm* similarly agreed with his taxpayer opponent as to the appropriate value.[129] Neither taxpayer protested further in the hearings, and in both cases, the appraisal review board ordered the district to lower the property values according to the apparently agreed-upon values.[130]

Both taxpayers later brought suit in district court appealing the order to the district to lower their property values to the amounts mentioned in their hearings.[131] In both cases, the taxpayers claimed that there had been no agreement between themselves and the district because they had not "announced" or otherwise formalized an agreement.[132] Both taxpayers also complained that dismissing their suits would deprive them of their due process rights to challenge the valuation of their properties.[133]

In both cases, the courts held that the taxpayers had availed themselves of an opportunity to be heard and, as the courts noted, had obtained precisely the results they sought, therefore suffering no due process deprivation. The courts both further held that the taxpayers could not appropriately appeal from the review board's decisions because "an agreement between a property owner . . . and the chief appraiser is final if the agreement relates to a matter . . . which may be protested to the appraisal review board [or a matter] on which a protest has been filed but not determined by the board."[134] Because the parties had reached an "agreement" prior to issuance of the review board orders, and because the agreements were deemed final when made, the review board orders were not "determinations" of the taxpayers' protests, and the agreements were therefore final and not appealable.[135]

IV. PROCEDURE

A. Judicial Interpretations

In a scenario that may become more common during the current economic downturn, the State pursued individuals for a corporation's unpaid sales taxes. In *State v. Crawford*, the State sued Steve Crawford and Robert Wills as responsible individuals for the sales tax liability of S.L. Crawford Construction, Inc. because the individuals were officers of the

128. *Mann*, 2008 Tex. App. LEXIS 2790, at *4.
129. *Verm*, 2008 Tex. App. LEXIS 4900, at *2.
130. *Verm*, 2008 Tex. App. LEXIS 4900, at *2; *Mann*, 2008 Tex. App. LEXIS 2790, at *4.
131. *Verm*, 2008 Tex. App. LEXIS 4900, at *2; *Mann*, 2008 Tex. App. LEXIS 2790, at *4.
132. *Verm*, 2008 Tex. App. LEXIS 4900, at *7; *Mann*, 2008 Tex. App. LEXIS 2790, at *10-11.
133. *Verm*, 2008 Tex. App. LEXIS 4900, at *7-8; *Mann*, 2008 Tex. App. LEXIS 2790, at *15-16.
134. *Verm*, 2008 Tex. App. LEXIS 4900, at *4-7 (citing Tex. Tax Code Ann. § 1.111(3)(1) (Vernon 2008)); *Mann*, 2008 Tex. App. LEXIS 2790, at *10-15 (citing Tex. Tax Code Ann. § 1.111(e)).
135. *See generally Verm*, 2008 Tex. App. LEXIS 4900; *Mann*, 2008 Tex. App. LEXIS 2790.

company, signed the sales tax returns, and had the authority to sign company checks.[136] The case centered on whether the defendants acted willfully in failing to pay the delinquent sales tax amounts.[137] The company collected but did not remit sales tax on certain construction jobs because the bookkeeper incorrectly marked the job as nontaxable in the company's monthly sales tax worksheets.[138] After an audit, the company requested a redetermination hearing but subsequently withdrew its petition, resulting in the tax becoming due and payable within twenty days.[139] The comptroller sent the final notice of its order to the wrong address, so the company was not aware of the final determination until the comptroller had frozen the company's bank accounts, an action that ultimately contributed to the company's failure.[140]

In addressing the meaning of the term "willfully," the district court ruled that the term "willfully" requires a higher mental state than reckless disregard and that the State had failed to meet the burden of proof.[141] The Austin Court of Appeals found that the term "willfully" in Tax Code section 111.016(b) encompasses both knowledge and reckless disregard and that the evidence established that the defendants did not act with either knowledge or reckless disregard. Thus, the appellate court affirmed the district court holding.[142] The court of appeals agreed with the district court that the legislature intended to adopt the federal court's construction of the term "willfully to include both actual knowledge and reckless disregard."[143] Regarding the burden of proof issue, the court determined that regardless of whether the State introduces a certificate of the comptroller showing the tax delinquency, the State retains the burden of proof on the issue of willfulness under Tax Code section 111.016(b).[144] Finally, the court determined that there must be a "known or obvious risk" that tax "is owed but not paid" in order to satisfy the reckless disregard prong of the "willfully" standard and the evidence did not establish the defendants met this prong.[145]

---

136. State v. Crawford, 262 S.W.3d 532, 536 (Tex. App.—Austin 2008, no pet.).

137. *Id.* at 537.

138. *Id.* at 535.

139. *Id.* at 536.

140. *Id.*

141. *Id.* at 537.

142. *Id.* at 534. Not only was the evidence sufficient to support the district court's finding that the defendants had no knowledge that the tax was actually collected, but there was sufficient evidence that the defendants "did not have knowledge that the tax delinquency" on the job in question had become due. *Id.* at 546. Furthermore, the State presented no evidence that the company paid "unencumbered funds" to other creditors after the point at which the defendants had knowledge of the final determination of the tax due. *Id.* at 546-47.

143. *Id.* at 538. The defendants introduced Texas case law defining the term "willfully" in other contexts to argue that the term lies on a continuum. *Id.* at 541. However, the appellate court determined that such continuum placing "willful" between "knowing" and "intentional" does not apply beyond claims related to the Deceptive Trade Practices Act or the imposition of mental anguish damages. *Id.* at 541.

144. *Id.* at 544.

145. *Id.* at 548.

In *State v. Essentially Yours Industries, Inc.*, the Austin Court of Appeals affirmed a take-nothing judgment in favor of Essentially Yours Industries, Inc. (EYI, Inc.) in a suit by the State of Texas and approximately 170 governmental entities "to recover allegedly delinquent state and local sales taxes."[146] EYI, Inc., "a network marketing business similar in structure to Amway," was a shell corporation with no sales activity in Texas. However, its parent, Essentially Yours Industries, Corp. (EYI, Corp.), made sales to Texas customers through distributors located in Texas.[147] The comptroller's auditor assessed EYI, Inc., but the officer who prepared the responses had provided information regarding EYI, Corp. instead of EYI, Inc.[148]

The State filed suit to recover the audit deficiency, and following a bench trial, the court entered a take-nothing judgment in favor of EYI, Inc.[149] The State appealed, arguing "that the evidence was legally and factually insufficient" to support the finding "that EYI, Inc. was not the same taxpayer that had been audited."[150] The Austin Court of Appeals reviewed only the issue of whether EYI, Inc. was indeed the correct taxpayer.[151] Because, the State had the burden of proof at trial, the court again placed the burden on the State to show that either the evidence conclusively established as a matter of law that EYI, Inc. was the correct taxpayer or, in the alternative, that the finding of the court was so against the great weight and preponderance of the evidence that it was clearly wrong and unjust.[152] The court of appeals determined that there was sufficient evidence to support the district court's finding that EYI, Corp., not EYI, Inc., was the taxpayer audited.[153] Furthermore, in response to the state's estoppel argument that EYI, Inc. knowingly misrepresented itself and intended the comptroller to believe it was the taxpayer, the court determined that the evidence revealed both sides were confused as to which entity was being audited and that neither party noticed the discrepancy while the audit was being conducted.[154]

In *Guardian Life Insurance Co. v. Kinder, Inc.*, the district court denied the plaintiff's motion to dismiss and default judgment filed against Kinder.[155] In this case, the Texas Secretary of State issued a corporate

146. State v. Essentially Yours Indus., Inc., No. 03-07-00506-CV, 2008 Tex. App. LEXIS 6466, at *1 (Tex. App.—Austin Aug. 28, 2008, no pet.) (mem. op.).

147. *Id.* at *2.

148. *Id.* at *3.

149. *Id.* at *3-4.

150. *Id.* at *4.

151. *Id.*

152. *Id.* at *6.

153. *Id.* Evidence included: (1) listing EYI, Corp.'s taxpayer identification number, (2) referring to taxpayer as EYI, Corp. in audit questionnaires, (3) franchise tax returns filed in the name of EYI, Corp., (4) letters and faxes sent to auditor on behalf of EYI, Corp., (5) the auditor designated the taxpayer as EYI, Corp. in the audit plan she prepared, and (6) the electronic funds transfer to the comptroller listed EYI, Corp. *Id.* at *6-7.

154. *Id.* at *11.

155. No. H-06-1745, 2008 U.S. Dist. LEXIS 6506, at *1 (S.D. Tex. Jan. 29, 2008).

charter forfeiture when Kinder failed to pay franchise taxes.[156] The district court determined that when a corporation forfeits its charter for failure to pay franchise taxes, the Texas Business Corporations Act (the Act) controls, and the corporation continues its existence because the Act was amended to include in the definition of "dissolved corporation" as those corporations "whose charter was forfeited pursuant to the Tax code."[157] For three years after a charter is forfeited, the Act provides that the corporation has a right to both sue and defend itself.[158] Therefore, the District Court denied the plaintiff's motion to dismiss because Kinder was included as a defendant within the three-year period and, as such, was entitled to defend itself and bring counterclaims in court.

In *Wilson v. State*, a similar procedural case, the Austin Court of Appeals addressed whether, in the case of delinquent franchise taxes, an individual must be personally assessed by the State.[159] The State failed to personally assess and file suit against Thomas Wilson, the sole officer and director of Wilson Nursery, Inc. (the Nursery), which "twice had its corporate privileges forfeited for failing to timely file its franchise tax reports."[160] The court of appeals determined that "there is no authority requiring the personal assessment of a director or officer before filing suit . . . for taxes that have been assessed against the corporation."[161] Wilson also argued that the suit was not timely because it was filed more than three years after the delinquency became due and payable.[162] However, the court of appeals held that the statute tolled during the time the administrative redetermination process was requested by the Nursery and the "tolling [was] expressly restricted by issues, not by [the] parties."[163] Therefore, tolling applies if an issue contested in the corporation's administration redetermination "[was] also an issue as to the director or officer's personal tax liability."[164] The district court's holding was affirmed, granting summary judgment in favor of the State.[165]

---

156. *Id.* at *2.

157. *Id.* at *4-5. The Texas Business Corporations Act was amended in 1993 to make it consistent with section 171.252 of the Texas Tax Code, which states that once the corporate privileges are forfeited, "the corporation shall be denied the right to sue or defend in a court of this state." *Id.* at *4.

158. *Id.* at *5; TEX. BUS. CORP. ACT ANN., art. 7.12(A) (Vernon 2003).

159. Wilson v. State, 272 S.W.3d 686, 687 (Tex. App.—Austin 2008, no pet.).

160. *Id.* at 689.

161. *Id.*; *see also* TEX. TAX CODE ANN. § 171.255 (Vernon 2008).

162. *Wilson*, 272 S.W.3d at 689.

163. *Id.* at 689-90.

164. *Id.* at 690. The court of appeals determined that the "State's suit against Wilson individually for corporate sales tax liability under tax code section 171.255 violated neither tax code section 111.201's four-year period during which a tax that has become due and payable may be assessed, nor tax code section 111.202's three-year period during which suit may be filed to collect a delinquent tax that has become due and payable." *Id.* at 691.

165. *Id.*

B. Administrative Hearings

The transfer of contested cases to SOAH resulted in fewer cases moving to hearings, at least during the early months of the Survey period. The comptroller also worked to reduce the backlog of older cases, including actively pursuing settlements in some cases. As more cases move forward to SOAH hearings, both taxpayers and the comptroller's hearings attorneys are finding that the SOAH hearings, while very similar in some procedural aspects and held before several of the administrative law judges who were formerly employed by the comptroller, appear to have a more formal emphasis on ensuring that both parties have verified that their evidence is in the record. That difference, together with others regarding the time that pleadings are deemed filed, merits paying careful attention to not only the comptroller's procedural rules but also to the SOAH rules.

V. CONCLUSION

As the Survey period ended, legislators were preparing for the 2009 regular session. In addition to the hundreds of anticipated property tax bills expected to be filed, legislators will undoubtedly be asked to review the franchise tax. Many small businesses, as well as some very large ones, are pushing for relief from a franchise tax that they view as disproportionately high. Other interested parties and legislators are interested in clean-up changes to the way in which the tax is calculated. On the other hand, given the fact that the tax produced less revenue than was expected during its first year, that the comptroller has indicated that she will not propose any franchise tax legislation during the 2009 session, and that the economy has been spiraling downward, it is unlikely that Texas will see major franchise tax legislative changes in 2009. As for any important changes to the franchise tax, the sales tax, or the property tax, those will be a good starting place for next year's Survey article.