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Cynthia M. Ohlenforst

Jeff W. Dorrill

Steven W. Novak

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TAXATION

Cynthia M. Ohlenforst*

Jeff W. Dorrill**

Steven W. Novak***

THE 2001 Survey period¹ resulted in fewer legislative changes and dramatic administrative and judicial interpretations than some had expected. The Legislative Session, in particular, failed to produce the sweeping tax reform, or even semi-sweeping tax relief, for which some had hoped. Most tax bills died an early death and very few tax bills with a positive fiscal note even made it out of the House Ways and Means Committee sessions. Nonetheless, the Comptroller's Technical Corrections and Enforcement Bills, as well as numerous other bills dealing with taxes, including property tax, once again changed Texas law.

I. SALES TAX

A. APPLICATION OF THE TAX

*Macias v. Rylander*² addressed a licensed customs broker (although temporarily unlicensed because the court upheld the 90-day suspension of the custom broker's license) authorized to issue export certificates. On March 11, 1995, a Mexican citizen purchased several items of clothing from a Marshall Fields store in San Antonio. As the court noted, that same afternoon the purchaser sought an export certificate from a Macias employee. The employee issued a stamped export certificate to the purchaser stating the day of export as March 11, 1995. The purchaser used the export certificate to return to Marshall Fields to claim the sales tax exemption and receive her refund. She did not take the merchandise from the United States to Mexico until March 13, 1995. The comptroller subsequently notified Macias of a proposed suspension of his customs broker's license. The court engaged in a relatively detailed summary of the comptroller's argument (focusing on the fact that the export certificate included incorrect information) and Macias's explanation (that the merchandise had entered "the export stream of commerce at the time of purchase").

* B.A., Loyola University; M.A., University of Dallas; J.D., Southern Methodist University. Partner, Hughes & Luce, L.L.P., Dallas, Texas; cindy.ohlenforst@hughesluce.com.

** B.B.A., J.D., Baylor University. Partner, Hughes & Luce, L.L.P., Dallas, Texas; dorrilj@hughesluce.com.

*** B.G.S., University of Kansas; J.D., University of Kansas. Associate, Hughes & Luce, L.L.P., Dallas, Texas; novaks@hughesluce.com.

1. October 1, 2000 through September 30, 2001.

2. 40 S.W.3d 679 (Tex. App.—Austin 2001, pet. denied).

Administrative hearings again covered a waterfront of tax topics, producing far too many decisions to discuss in this context.³ A few administrative decisions, though, deserve discussion. Several focused on the distinction between tangible personal property and real property. Hearing No. 38,388,⁴ for example, addressed the characterization of two eight-thousand gallon storage tanks which were placed on a concrete pad and surrounded by permanent walls. The tanks were not affixed to the ground and were fitted with lifting lugs. Relying on Hearing No. 35,136,⁵ which held that a forty-two foot, forty-thousand pound kettle was machinery or equipment, the Administrative Hearings Section (“AHS”) asserted that the tanks were personal property. The administrative law judge (“ALJ”) disagreed, finding the tanks an improvement to real property, and thus excluded from taxation. Although the most important consideration was the intent of the parties, important factors were that the tanks and related items were affixed to the realty during the same construction operation by one contractor, that the whole facility was constructed by the taxpayer where no previous facility had existed, and that the concrete pad and walls around the tanks would serve no purpose without the tanks (indicating that the tanks were intended to be permanent). The ALJ noted that removability was not a bar to a finding that an item is an improvement to realty.⁶

The distinction between personal property and improvements to realty was also at issue in Hearing No. 38,760.⁷ The comptroller relied on the test in *Hutchison v. Masterson & Street*⁸ to determine whether property (in this case, overhead cranes, leased and installed at the taxpayer’s facility) were improvements to real property. The comptroller concluded that the cranes were improvements to realty, finding that the size, weight, customization, and the fact that the overhead cranes were left in the facility after the petitioner moved to a new location, indicated the parties’ intent that cranes would be permanent. The language in the lease of the cranes indicating that they were personal property did not control, as contract language has not in the past controlled these determinations.⁹

Hearing No. 38,432¹⁰ also focused on the manufacturing exemption. The first issue involved the dredge pipe and pumps used to carry slurry

3. The difficulty of distinguishing non-taxable new construction from taxable repair and remodeling presents itself at the courthouse as well. See *GATX Terminals Corp. v. Rylander*, Nos. 96-10815 & 98-13414 (Tex. Dist. Ct., summary judgment entered for state May 29, 2001).

4. Tex. Comp. Pub. Acc’ts, Hearing No. 38,388 (July 18, 2000).

5. Tex. Comp. Pub. Acc’ts, Hearing No. 35,136 (Jan. 21, 1997).

6. The taxpayer in Hearing No. 38,388 also unsuccessfully argued that an eye wash station at its facility was exempt under the manufacturing exception because it was “necessary and essential” to the manufacturing process.

7. Tex. Comp. Pub. Acc’ts, Hearing No. 38,760 (Jan. 12, 2001).

8. 46 Tex. 551 (1877).

9. See Tex. Comp. Pub. Acc’ts, Hearing Nos. 36,177 (Oct. 30, 1998), 23,572 (Oct. 10, 1988).

10. Tex. Comp. Pub. Acc’ts, Hearing No. 38,432 (July 11, 2001) [hereinafter Hearing No. 38,432].

from a cutter head to the dewatering plant. These dredge pipes and pumps, which are utilized after the beginning of the manufacturing process, were found to fall within section 151.318(c)(2),¹¹ which states that intraplant transportation equipment is not exempted. The petitioner also argued that these pipes and pumps were exempt because they were pollution control equipment. Although it is true that these items prevented pollution, the ALJ reasoned that the exemption for pollution equipment was intended only for those items that were required by law. The taxpayer prevailed, however, with respect to the second issue, the dewatering plant, as the comptroller concluded that "all equipment and machinery that acts upon the product once the actual manufacturing process starts will be considered to be within the exemption whether or not the specific item of equipment 'processes' the tangible personal property."¹² The ALJ also provided the taxpayer an exemption for a production belt system that moved the product from the dewatering plant to another processing plant nearly two miles away. The AHS claimed that this was intraplant transportation equipment. The ALJ noted that this would normally be the case, but that these conveyor belts each had a flat section specifically designed to remove water from the mixture, and that without these special sections, the mixture would be useless when it reached its destination. Thus, the Decision found that the entire conveyor belt system qualified for the manufacturing exemption.

In Hearing No. 39,831,¹³ the claimant contended that because he was a licensed and certified carrier, his purchases of repair, remodeling, and maintenance services on aircraft and purchases of repair and replacement parts were exempted from taxation. However, the claimant was a carrier in the pipeline business, not the airline business, and the comptroller concluded that the exemption under section 151.328¹⁴ and Rule 3.297¹⁵ specifically refers to the transportation of people or equipment for hire.¹⁶ The ALJ determined, however, that the labor was exempt pursuant to section 151.0101,¹⁷ which does not require that the person be involved in carrying people or cargo for hire.

Whether fertilizer and seeds used at a municipal golf course were exempt was at issue in another hearing.¹⁸ The contractor-taxpayer, having contracted with a municipality to operate a golf course, claimed that the seeds and fertilizer were exempt under section 151.311(a)¹⁹ as tangible personal property incorporated into realty of an exempt entity; the taxpayer also claimed that lawn maintenance services and bunker recon-

11. TEX. TAX CODE ANN. § 151.318(c)(2) (Vernon Supp. 2002).

12. Hearing No. 38,432 (July 11, 2001) (citing Hearing No. 36,005 (October 6, 1997)).

13. Tex. Comp. Pub. Acc'ts, Hearing No. 39,831 (July 6, 2001).

14. TEX. TAX CODE ANN. § 151.328 (Vernon Supp. 2002).

15. 34 TEX. ADMIN. CODE § 3.297 (West 2000 and 2001).

16. See also Tex. Comp. Pub. Acc'ts, Hearing Nos. 35,637 (May 23, 2001), 30,845 (May 23, 2001) (dealing with the definition of carrier for exemption purposes).

17. TEX. TAX CODE ANN. § 151.0101 (Vernon Supp. 2002).

18. Tex. Comp. Pub. Acc'ts, Hearing No. 38,369 (July 2, 2001).

19. TEX. TAX CODE ANN. § 151.311(a) (Vernon Supp. 2002).

figuration services were exempt under Rule 3.356(a)(5)²⁰ using a similar analysis. The comptroller disagreed, and reasoned (incorrectly, perhaps) that if the products and services were not sold directly to the exempt entity, they could not be exempted from tax.²¹

In another exempt-entity case, a contractor claimed a sales tax exemption for materials for a house built for the president of a ministry exempt under Section 501(c)(3) of the Internal Revenue Code.²² The contractor received an exemption certificate from the president, but the ALJ, citing Rule 3.287(f),²³ found that the certificate failed to state that the items would be used in a manner that qualifies the sale of the items for an exemption from tax, and that there was no evidence that the home construction related to the ministry's exempt purpose. The project also failed to satisfy section 151.310(a)(2),²⁴ which provides that the item may not be used for the personal benefit of a private stockholder or individual.

Another construction ruling, Hearing No. 39,325,²⁵ could create difficulties for many taxpayers. The construction contract price was determined by a formula that took into account the total cost of labor and materials, but did not distinguish between incorporated and consumed materials. The ALJ found that under Rule 3.291(5)²⁶ the sales tax was the contractor's responsibility because this was a lump-sum, rather than a separated contract. This holding could be somewhat troubling, because many taxpayers, especially in smaller contracts, follow the literal language of Rule 3.291,²⁷ and simply separate out labor and materials. Although taxpayers with sophisticated in-house or outside advisers may break out incorporated materials from consumed materials,²⁸ not all taxpayers do so, and the comptroller has not consistently required such a breakdown.

Several recent cases involve the use of electricity that aids in the refrigeration of food products. In one,²⁹ the petitioner, who was not an actual manufacturer of the food products, claimed that the electricity used to keep its warehouse at a particular temperature were exempt under sec-

20. 34 TEX. ADMIN. CODE § 3.356(a)(5) (West 2001).

21. The result in this case appears correct, given the petitioner's failure to meet its burden of proof, although the analysis may not apply in other cases.

22. 26 U.S.C. § 501(c)(3) (2002).

23. 34 TEX. ADMIN. CODE § 3.287(f) (West 2001).

24. TEX. TAX CODE ANN. § 151.319(a)(2) (Vernon Supp. 2002).

25. Tex. Comp. Pub. Acc'ts, Hearing No. 39,325 (Nov. 15, 2001).

26. 34 TEX. ADMIN. CODE § 3.291(a)(5) (West 2001).

27. *Id.*

28. Moreover, even sophisticated taxpayers often conclude that separating out consumed materials is not cost effective. (Note that this decision also addressed semiconductor clean rooms.)

29. Tex. Comp. Pub. Acc'ts, Hearing No. 39,093 (May 2, 2001). *See also* Tex. Comp. Pub. Acc'ts, Hearing No. 39,371 (Jan. 2, 2001) for a similar analysis.

tions 151.317³⁰ and 151.318.³¹ Based on several previous rulings³² and *Texas Citrus Exchange v. Sharp*,³³ the ALJ denied the petitioner's contention, using the rule that the lowering of the temperature of food is exempt processing, but that maintaining the food at a desired temperature is not considered processing, because no physical change is taking place.³⁴

Hearing No. 39,092³⁵ denied the taxpayer's claim that its services, which involved performing consulting services in the areas of workplace safety, emergency response, hazardous substances, and compliance with OSHA standards, were not taxable insurance services. Factors that led to this decision included that the company focused on developing programs for non-subscribers to the Texas Workers Compensation program and that it provided referrals of agents and adjusters to its clients. Another hearing debated the definition of amusement services.³⁶ A country club claimed that the predetermined fees paid to it by a homeowner's association for the maintenance of tennis and swimming facilities were not taxable because they did not give the association a special privilege, status, or membership classification.³⁷ Even though the association was not an individual, the comptroller determined that because an individual homeowner could not join the club without being a member of the homeowner's association, the club was given a special privilege, status, or membership classification, and the payments were taxable.

Multiple letters continue to develop and refine the comptroller's analysis of taxable services. One letter, for example, addresses a monthly subscription fee paid by car dealers to a company that provides "an Internet-based marketing program and Online services to attract potential purchasers."³⁸ Members of the public can access the website at no charge in order to provide or receive information concerning the nearest car dealer.

30. TEX. TAX CODE ANN. § 151.317 (Vernon Supp. 2002).

31. § 151.318.

32. See, e.g., Tex. Comp. Pub. Acc'ts, Hearing No. 7,378 (Dec. 20, 1976).

33. 955 S.W.2d 164 (Tex. App.—Austin 1997, no writ).

34. Hearing No. 39,370 involves a food distribution company that failed to prevail in its argument that it should be entitled to a refund of sales taxes paid on its electricity purchases pursuant to the court ruling in *Texas Citrus Exchange v. Sharp*. Texas Citrus had prevailed by convincing the court that it used electricity as part of the processing of orange juice, and was therefore entitled to the manufacturing exemption with respect to the electricity charges. In this administrative hearing, however, the judge concluded that the taxpayer's facts were different from those in *Texas Citrus*, and that the taxpayer's lowering the temperature of food products delivered to it did not constitute processing. The comptroller agreed that the taxpayer received processed, packaged food product in bulk quantities, and repackaged it in smaller quantities before shrink wrapping. However, the administrative law judge concluded that most of the products had been processed and packaged by others, precluding the taxpayer's qualifying as a manufacturer. In some respects, the discussion in this case is interesting to review in light of the comptroller's policy of allowing a manufacturer to subcontract out manufacturing steps without losing its status as a manufacturer.

35. Tex. Comp. Pub. Acc'ts, Hearing No. 39,092 (Feb. 2, 2001).

36. Tex. Comp. Pub. Acc'ts, Hearing No. 39,407 (April 13, 2001).

37. If the petitioner's contention were true, this would be exempt. See 34 TEX. ADMIN. CODE § 3.298(a)(8) (West 2001).

38. Tex. Comp. Pub. Acc'ts, Letter No. 200104201L (April 16, 2001).

A car dealer is required to pay the monthly subscription fee even if it is never selected as being the nearest dealer. The ruling concludes (correctly) that the essence of the transaction described is a non-taxable advertising service rather than taxable data processing or taxable information services.³⁹

Key letters also confirm, in a change of comptroller policy, that, when the essence of a transaction is advertising, sales tax does not apply to charges for internet advertising by newspapers or broadcasters.⁴⁰

The claimant in Hearing No. 38,980,⁴¹ the owner and operator of pay telephones, contended that the care, custody, and control of the equipment was transferred to the users of the telephones and that thus it was exempt from tax on its purchases under section 151.302(b)⁴² and Rule 3.344(e).⁴³ In ruling against the taxpayer, the ALJ noted several recent rulings⁴⁴ that rejected the petitioner's argument. A "highly determinative factor" was the "very transitory nature" of the use of the equipment by the customer.

B. LEGISLATIVE DEVELOPMENTS

The Comptroller's Technical Corrections Bill,⁴⁵ like most technical corrections bills, includes both minor, technical changes as well as more substantive changes that are arguably less technical. In many areas, legislation cleaned up troubling provisions of the Tax Code and offered taxpayers guidance in areas in which guidance had been missing.

The legislature amended section 151.007(a)(3)⁴⁶ to provide that no deduction is permitted from the sales price of a taxable item for installation of tangible personal property. Another definitional change, one that is likely to produce litigation, involves the definition of "taxable item." Having concluded in 2000 that a music CD delivered electronically is taxable in the same manner as a CD purchased at the corner store,⁴⁷ the comptroller sought to shore up her position that the music CD is tangible personal property. Therefore, the comptroller suggested and the legislature adopted a change in the definition of taxable item. As amended, the definition of "taxable item" provides that "[e]xcept as otherwise provided by this chapter, the sale or use of a taxable item in electronic form instead

39. Numerous other letters address Internet-related issues. See, e.g., Tex. Comp. Pub. Acc'ts., Letter No. 200107354L (July 10, 2001) (stating that virus protection, if sold with Internet access or data processing, is taxable).

40. Tex. Comp. Pub. Acc'ts, Letter No. 200106290L (June 11, 2001) and unpublished letter dated Oct. 15, 2001 (on file with Survey editor).

41. Tex. Comp. Pub. Acc'ts, Hearing No. 38,980 (Feb. 26, 2001).

42. TEX. TAX CODE ANN. § 151.302(b) (Vernon 1992).

43. 34 TEX. ADMIN. CODE § 3.344(h) (West 2001).

44. Tex. Comp. Pub. Acc'ts., Hearing Nos. 32,054 (Oct. 6, 1995), 33,201 (Oct. 6, 1995), 29,744 (June 24, 1994).

45. Act of June 15, 2001, 77th Leg., R.S., ch. 1263, 2001 Tex. Gen. Laws 3001.

46. TEX. TAX CODE ANN. § 151.007 (Vernon Supp. 2002).

47. See Tex. Comp. Pub. Acc'ts, Letter No. 200005359L (May 30, 2000).

of on physical media does not alter the item's taxable status."⁴⁸ Although the policy of taxing items that are delivered in a "traditional" tangible format the same as those that are delivered electronically or by other less traditional methodology is an admirable one, this legislative "fix" is unlikely to eliminate controversy in this area, particularly because the definition of "taxable item" allows taxpayers to argue that unless an item is a taxable item in the first place, the statute has no bearing on it.⁴⁹

New section 151.3021⁵⁰ provides an exemption for certain wrapping and packaging supplies, including hangers and inventory tags, purchased by a person that is a laundry or dry cleaner for use in packaging items that have been pressed and dry cleaned or laundered. While this particular provision is a new exemption, the Technical Corrections Bill also adopted clarifying changes that confirm the scope of existing exemptions.⁵¹ Section 151.317,⁵² for example, which authorizes an exemption for certain gas and electricity, was revised to make clear that equipment used as described in section 151.318⁵³ (dealing with broadcasters) is also eligible for this electricity exemption.⁵⁴

The manufacturing exemption itself, section 151.318, which has changed repeatedly over the past several sessions, changed again this session.⁵⁵

One of the most significant sales tax changes in the Comptroller's Technical Corrections Bill is a new provision—not a clarification—that addresses divergent use of property used in manufacturing. In the past, the comptroller has taken the position that property previously purchased sales-tax-free pursuant to the manufacturing exemption becomes fully taxable at the moment it ceases to be used for manufacturing and is used for another purpose. Particularly in the context of certain high-tech equipment, such as equipment that is used first to produce software for

48. TEX. TAX CODE ANN. § 151.010 (Vernon Supp. 2002).

49. For other legislative changes to taxable items, *see, e.g.*, TEX. TAX CODE ANN. § 151.0036 (Vernon Supp. 2002) (stating that the charge for selling real property at a foreclosure sale is not taxable debt collection service). Additional water-related exemptions now appear in the Tax Code as a result of exemptions enacted by Act of June 15, 2001, 77th Leg., R.S., ch. 966, 2001 Tex. Gen. Laws 1991, Act of June 15, 2001, 77th Leg., R.S., ch. 1234, 2001 Tex. Gen. Laws 2881. *See* TEX. TAX CODE ANN. § 151.355 (Vernon Supp. 2002); *see also id.* § 151.3021; *id.* § 151.310 (tax-free sales); *id.* § 151.313 (healthcare supplies) (now including a new subsection (c) defining a drug or medicine in this context).

50. TEX. TAX CODE ANN. § 151.3021 (Vernon Supp. 2002).

51. *Id.* § 151.057 (services by employees); *id.* § 151.155 (creating exceptions to divergent used treatment under § 151.155 for property use pursuant to § 151.3181); *id.* § 151.501(d).

52. TEX. TAX CODE ANN. § 151.317 (Vernon 1992 and Vernon Supp. 2002).

53. TEX. TAX CODE ANN. § 151.3185 (Vernon Supp. 2002).

54. Section 151.317(a)(2) is actually intended to refer to "section 151.3185 or section 151.318 by a person . . ." The cross-references to sections 151.318 and 151.3185 are reversed (i.e., the statute as enacted refers to "151.318 or 151.3185" instead of "151.3185 or 151.318"); this erroneous ordering is apparently a drafting error triggered by someone's placing these two sections in numerical order. However, the intent of the statute is clearly to confirm the availability of the exemption for broadcasters.

55. TEX. TAX CODE ANN. § 151.318(a)(8) & (t) (Vernon 2002) (quality control and photographic props, respectively).

sale, but later used to provide services, this interpretation troubled taxpayers, who could be faced with an assessment, several years after purchase, based on the full purchase price of property.⁵⁶ Many taxpayers were also uneasy with the mechanism by which the comptroller calculated use tax on equipment that was used in part for purposes other than manufacturing. New section 151.3181⁵⁷ addresses these concerns. The statute defines divergent use as use other than the manner or purpose that qualified the sale for exemption to begin with,⁵⁸ and provides that divergent use of property that occurs after the fourth anniversary of the date the property is purchased will not result in sales and use tax. The statute also includes a formula for imposing a proportionate amount of tax for divergent use prior to the fourth anniversary.⁵⁹ The statute further provides for a five percent de minimus rule (so that use tax is not imposed as a result of divergent use in a month that does not exceed five percent)⁶⁰ as well as providing for formulas based on hours or output. This new section, which reflects a great deal of work by both comptroller's staff and industry, should reduce significantly the uncertainty concerning divergent use of property originally purchased for manufacturing.

Section 151.3185⁶¹ has its roots in the manufacturing exemption. Prior to the 1999 legislative amendments, the items exempted by this section (which deals with broadcasting and motion pictures) were exempt under the manufacturing exemption. However, in 1999 the legislature enacted new section 151.3185 to move these motion picture and broadcast exemptions to a separate section. The 2001 legislature's technical correction to this section confirms that the sale of a motion picture or video or audio master by the producer is exempt,⁶² and that certain equipment, purchased by broadcasters that are subject to FCC regulations mandating digital broadcasts, is also exempt.⁶³ Both these provisions are intended to be clarifications to the Tax Code.⁶⁴

Despite the relative scarcity of sales tax exemption provisions, there were others. For example, section 151.321 was amended to provide an exemption from sales and use taxes for certain taxable items sold by a qualified student organization affiliated with an institution of higher edu-

56. Although the statute of limitations for sales taxes is generally four years (*See* TEX. TAX CODE ANN. § 111.201 (Vernon 1992)), various exceptions to and tollings of the statute frequently extend the assessment period well beyond four years. *See, e.g.*, TEX. TAX CODE ANN. §§ 111.025, 111.206 (Vernon 1992 and Supp. 2002).

57. TEX. TAX CODE ANN. § 151.3181 (Vernon Supp. 2002).

58. *Id.* § 151.3181(a)(1).

59. *Id.* § 151.3181(c). It provides that the amount of tax due for a month is based on 1/48th of the purchase price multiplied by the percentage of divergent use during that month.

60. *Id.* § 151.3181(d).

61. TEX. TAX CODE ANN. § 151.3185 (Vernon Supp. 2002).

62. *Id.*

63. TEX. TAX CODE ANN. §§ 151.3185(e)-(f) (Vernon Supp. 2002). Subsection (f) is designed to confirm that broadcasters that acquire certain equipment in conjunction with federal mandated digital operations are allowed to purchase the equipment on a tax-free basis.

64. The comptroller has confirmed several times that these are clarifications. *See, e.g.*, Tex. Comp. Pub. Acc'ts, TAX POLICY NEWS 14 (July 2001).

cation,⁶⁵ and the legislature amended section 151.052 to provide a new mechanism concerning sales and use tax of printed materials distributed by mail.⁶⁶

Among the completely new sections added to the sales tax code are two that reach from off-road trucks to mobile telephones. New section 151.0515⁶⁷ imposes a one percent surcharge, to be collected and administered in the same manner as the sales tax, on the retail sale lease or rental of certain equipment, including off-highway trucks, tractors, and paving equipment.⁶⁸

New Section 151.061⁶⁹ covers almost three pages of Vernon's pocket part with complex rules that combine Texas sales and use tax principles with the federal Mobile Telecommunications Sourcing Act.⁷⁰

C. REGULATORY DEVELOPMENTS

Effective July 22, 2001, the comptroller adopted a rewritten Rule 3.291⁷¹ dealing with contractors. This amended rule is designed not only to reflect legislative changes that have occurred since the last amendment to the Rule 3.291,⁷² but also to take into account policy decisions and administrative hearings in several areas, including those with respect to construction for an exempt entity. As revised, the rule includes a new definition of consumable items. Prior Rule 3.291 described consumable items as "[t]angible personal property, other than machinery and equipment, that is not physically incorporated into the property of a customer and that, after being used for its intended purposes, is substantially used up, or is not retained or reusable by the contractor."⁷³ The new definition of consumable items is "[n]ondurable tangible personal property that is used to improve realty and, after being used once for its intended purpose, is completely used up or destroyed."⁷⁴

65. TEX. TAX CODE ANN. § 151.321 (Vernon Supp. 2002) (enacted by House Bill 82 (a/k/a the "Cheerleader Bill")).

66. This section allows the purchaser of certain printed materials that will be delivered by the United States Postal Service to individual recipients in and outside Texas, other than the purchaser, to issue an exemption certificate to the printer instead of paying sales tax. This multistate exemption certificate for services requires that the materials are for multistate use and that the purchaser will pay any state taxes that may become due.

67. TEX. TAX CODE ANN. § 151.0515 (Vernon Supp. 2002) ("Texas Emissions Reduction Plan Surcharge").

68. *Id.* § 151.0515(a). Section 151.0515 expires Sept. 30, 2008. *Id.* § 151.0515(d).

69. TEX. TAX CODE ANN. § 151.061 (Vernon Supp. 2002) ("Sourcing of charges for Mobile Telecommunication Services"). The Survey authors gambled that most readers would not expect or need a detailed summary of these complex provisions. Our apologies to anyone who hoped to see a summary here.

70. 4 U.S.C. §§ 116-26 (2001)

71. 26 Tex. Reg. 5434.

72. Rule 3.291 had not been amended since 1992, and therefore failed to reflect the numerous legislative and/or policy changes that have occurred since then.

73. 34 TEX. ADMIN. CODE § 3.291 (2001).

74. *Id.* Examples of consumable items are "nonreusable concrete forms, nonreusable drop cloths, barricade tape, natural gas and electricity. The term 'consumable item' does not include machinery, equipment, accessories to machinery or equipment, repair or replacement parts for machinery or equipment, or any rented or leased item." *Id.*

Given the examples of drop cloths and barricade tape, it should be a fair inference that the "completely used up or destroyed" portion of this definition is not intended to impose a stricter standard than the "substantially used up, or . . . not retained or reusable by the contractor"; moreover, comptroller representatives have confirmed orally that the new definition will not be interpreted to impose a stricter standard than the former rule.

The new rule also addresses scope of "Exempt Contracts." Section 3.291(a)(5) (which defines an exempt contract as a "contract for the improvement of real property with an entity that is exempted under Tax Code § 151.309 or § 151.310")⁷⁵ provides that an exempt contract "is a contract with a nonexempt entity to improve real property for the primary *use and benefit*" of certain exempt organizations. Although the comptroller has frequently attempted to rely on this "primary use and benefit test," it appears to be without statutory support and should be an example rather than a limitation.

Section 3.291(d), as it appears in the new rule, provides that development work means "a contract with a private party to improve real property by building public *infrastructure, such as* roads or sewer lines, provided the improvements are dedicated to and will be accepted by a governmental entity."⁷⁶ This definition too should be viewed as an example of, rather than a limitation on, the definition of "exempt contract," although the language is not as clear on this point as it could be.

The rule also includes some new (and non-statutory) time lines concerning deduction documentation for private development projects, and exemption certificates.⁷⁷

75. *Id.*

76. *Id.* (emphasis added).

77. For example, Rule 3.291(d) provides that "[t]he private party must *dedicate* the realty and the improvements to the governmental entity *before the work begins*, and the governmental entity must accept or conditionally accept the realty and the improvements." (emphasis added) However, there appears to be no statutory basis for requiring that the dedication documentation be completed before the work begins. Also, the reality of dealing with governmental entities is that they are often required to complete several procedural (and political) steps prior to accepting, even conditionally, the realty and/or improvements. As a result, in many cases construction begins well before the documentation is completed. To impose a timing requirement such as the one suggested by the new version of the rule could effectively either delay construction or allow the comptroller to argue that a taxpayer should not receive an exemption for which it qualifies under the statute.

Section 3.291(c)(2), which deals with contractor liability, provides that if the comptroller subsequently determines that an organization is not an exempt organization, the contractor will be liable for all taxes, penalties and interest unless the contractor had accepted *an exemption certificate "at the execution of the contract."* This requirement also appears to impose a timing requirement that is not supported by the statute; indeed, the Tax Code generally allows taxpayers sixty days after a written request from the comptroller to produce exemption certificates.

II. FRANCHISE TAX

A. APPLICATION OF THE TAX

*Rylander v. Fisher Controls Int'l, Inc.*⁷⁸ focuses on a taxpayer that filed suit to recover franchise taxes paid under protest for the years 1992 and 1993. Fisher manufactured in Texas certain items that it sold to buyers in other states during calendar years 1991 and 1992. In a case that focuses carefully on the throw-back rule, the court reviewed the statutory provisions at issue, including section 171.1032.⁷⁹ As the court pointed out, after the 1993 amendments to section 171.1032, this section provides that Texas receipts result from sales “of tangible personal property shipped from this state to a purchaser in another state in which the seller is not subject to any tax on, or measured by, net income, *without regard to whether tax is imposed.*”⁸⁰ When the legislature added the new language, it provided explicitly that the amendatory act would take effect on January 1, 1994, and would apply to reports originally due on or after that date. In the taxpayer’s—and ultimately the court’s—view, the phrase “subject to taxation” for years prior to the statutory amendment must be interpreted without reliance on the 1993 statutory addition. As the court pointed out, it is altogether possible for a taxpayer to be subject to taxation “in the sense that the tax [does] not offend the Constitution of the United States,” even when the state in which the taxpayer is thus “subject to taxation” does not actually impose an income-based tax.⁸¹

The court concluded that the phrase “not subject to taxation” is ambiguous and therefore open to construction. The court also refused to accept the comptroller’s argument that the 1993 amendment was “merely a clarifying amendment not intended to change the law.”⁸² The court pointed out that the comptroller’s Rule 3.549,⁸³ as then in effect, although technically applicable to taxable capital component only, expressly stated that the term “subject to taxation” referred to constitutional nexus. The court further concluded that if the comptroller’s argument were correct, then the legislative statement that its interpretation would apply to reports filed on or after January 1, 1994, would be surplusage. Finally, the court declined to follow the comptroller’s administrative interpretation, pointing out that the task of statutory construction at issue in this particular case did not involve a matter lying particularly within agency expertise. It instead involved a non-technical question of law—legislative intent—determined from the legislature’s use of the term “not subject to taxation” in context. “Courts are as competent as the comptroller in making that assessment of legislative intent.”⁸⁴ The court ultimately concluded that

78. 45 S.W.3d 291 (Tex. App.—Austin 2001, no pet.).

79. TEX. TAX CODE ANN. § 171.1032 (Vernon Supp. 2002).

80. *Id.* (emphasis added).

81. *Rylander*, 45 S.W.3d at 298.

82. *Id.* at 300.

83. 34 TEX. ADMIN. CODE § 3.549 (2001).

84. 45 S.W.3d at 301.

the fact that Fisher could have been taxed in the other states—even though those other states did not actually impose a tax on Fisher—was sufficient to justify a finding that Fisher was “subject to tax” in those other states; therefore its receipts from sales into those states should not be included in Texas receipts. This case is important not only for its specific holding, but also because it demonstrates the court’s approach to corrective legislative changes, especially those enacted to support a contested comptroller interpretation.

In *Upjohn Co. v. Rylander*,⁸⁵ the appellate court concluded, as had the district court, that the franchise tax statutes at issue must be strictly construed, and that under this strict construction Upjohn was not entitled to the refund of franchise taxes it sought. The analysis in this case focuses on section 171.104⁸⁶ which provides that receipts from certain drug and medicine sales may be deducted from gross receipts for taxable capital purposes. As Upjohn pointed out, the Tax Code sections defining gross receipts for taxable capital purposes contain provisions identical in many respects to the sections defining gross receipts for earned surplus purposes. Upjohn therefore contended that, notwithstanding the fact that Section 171.104⁸⁷ (earned surplus) fails to match the language of 171.103⁸⁸ (taxable capital), the legislative intent had been to exclude drug and medicine receipts from the gross receipts for purposes of computing both earned surplus and taxable capital. Upjohn asserted that because Section 171.104⁸⁹ is partly an apportionment formula, which determines the taxable base, it should be considered an “imposition type item” and construed strictly against the comptroller. The court concluded, on the other hand, that because the calculation at issue involved a deduction, the provision at issue was “tantamount to an exemption and must be strictly construed in favor of the state.” (Once the court makes this determination, it’s reasonably easy to predict the outcome of the case.) After discussing both the policy of the franchise tax and the purpose of the 1991 amendments to the franchise tax,⁹⁰ and giving substantial weight to the comptroller’s interpretation of the statute, as well as dismissing Upjohn’s constitutional challenges, the court ultimately concluded the comptroller’s interpretation was reasonable and that the receipts in question were not deductible. Nor did Upjohn prevail on its request for penalty waiver as the court concluded that the comptroller’s refusal to waive penalty was not “outside her discretionary authority.”

Taxpayers continue to contest the comptroller view that pensions and post-retirement obligations cannot be deducted from taxable capital for

85. 38 S.W.3d 600 (Tex. App.—Austin 2000, pet. denied).

86. TEX. TAX CODE ANN. § 171.104 (Vernon Supp. 2002).

87. *Id.*

88. TEX. TAX CODE ANN. § 171.103 (Vernon Supp. 2002).

89. TEX. TAX CODE ANN. § 171.104 (Vernon Supp. 2002).

90. 38 S.W.3d at 604 (stating that the purpose of the 1991 amendments was “to redistribute the franchise tax burden from capital-intensive industries that have lower earnings and net worth to more profitable industries”).

franchise tax purposes. GMC challenged this interpretation, arguing that ERISA⁹¹ preempted the franchise tax provisions at issue. Observing that the facts and arguments at bar were “virtually indistinguishable” from those advanced in *Sharp v. Caterpillar*⁹², the court declined to revisit the issue or overrule *Caterpillar*.

Decision 36,977⁹³ demonstrates again the difficulty the comptroller’s office has faced in recent years in its efforts to reach a consistent interpretation of the franchise tax as it applies to partnership revenue. The corporate taxpayer in this hearing successfully argued that reimbursements it received from partnerships should not be included in gross receipts for apportioning gross receipts; the administrative hearing section (“AHS”), on the other hand, asserted that in the partnership context, as in the corporate context, “reimbursements” which may be excluded from gross receipts, include only amounts paid for goods or services supplied by third parties. The agreed finding of facts indicated that the reimbursements at issue, which included amounts for marketing, legal fees, auditing fees, office rent, and other expenses, were made at cost. In holding for the taxpayer, the ALJ concluded that “the three key elements that are prerequisites for an agency relationship” had been demonstrated,⁹⁴ and recognized that Rule 3.557(e)(19),⁹⁵ which addresses allocation of intercorporate expenses, had not been previously applied to partnerships. The decision therefore concludes that the at-cost partnership reimbursements receipts of a taxpayer do not constitute revenue for gross receipt purposes. The case also addresses the taxpayer’s contention that in apportioning earned surplus, the partnership net profits should be reported as the taxpayer’s gross receipts. The findings of fact included a finding that generally acceptable accounting principles provide that a controlling partner in a partnership should include its pro rata interest in the partnership as part “of the controlling partner’s consolidated financial statement and, as such, that the controlling partner shall include its share of the partnership’s gross receipts as part of the controlling partner’s gross revenue.” The comptroller ultimately allowed the taxpayer to report its partnership net profits as gross receipts for purposes of apportioning earned surplus. In his legal analysis, the ALJ ultimately determined that a prior decision, Hearing No. 35,123,⁹⁶ was inconsistent with the case at bar and therefore overruled Hearing No. 35,123. The judge also agreed with the taxpayer’s argument that the amount shown on its K-1’s should be used for federal tax reportable revenues rather than “gross receipts” of the partnership.”⁹⁷

91. Employee Retirement Income Security Act, 29 U.S.C. § 1144 (1994).

92. 932 S.W.2d 230 (Tex. App.—Austin 1996, writ denied).

93. Tex. Comp. Pub. Acc’ts, Hearing No. 36,977 (Feb. 16, 2001).

94. *Id.* at 27 ((1) mutual consent that (2) one party will act for the other and (3) subject to the other’s control).

95. TEX. ADMIN. CODE § 3.557(e)(19) (2001).

96. Tex. Comp. Pub. Acc’ts, Hearing No. 35,123 (Dec. 21, 1998) (overruled by Hearing No. 36,977).

97. *Id.*

Several comptroller ruling letters offer additional planning certainty for taxpayers who desire to know, prior to the completion of their transaction, what the tax impact will be, particularly in the context of reorganizations into partnership form.

At least one letter⁹⁸ confirms the comptroller's view that "location of payor" and "legal domicile" are the same for both taxable capital apportionment and earned surplus apportionment, and notes that Rule 3.557⁹⁹ will be amended so that it too contains definitions of location of payor and legal domicile consistent with Rule 3.549.¹⁰⁰

B. REGULATORY DEVELOPMENTS

Several rules were amended, including Rule 3.578 (dealing with *Economic Development Credits*),¹⁰¹ which provides additional guidance concerning credits available against franchise tax, including research and development, jobs creation and investment credits, and Rule 3.549.¹⁰²

C. LEGISLATIVE DEVELOPMENTS

Legislative franchise tax provisions this past session did not enact wholesale changes to the franchise tax, but did make several noteworthy changes. Multiple changes addressed credits,¹⁰³ including those enacted during the 1999 session. As previously noted,¹⁰⁴ the comptroller has encountered difficulty in consistently interpreting provisions of the franchise tax as they apply to partnerships. In an effort to conform the statute to the comptroller's litigating position, the legislature amended section 171.1032,¹⁰⁵ which deals with the apportionment of franchise tax receipts, to add to the laundry list of receipts those receipts from "each partnership or joint venture to the extent provided by subsection (c)."¹⁰⁶ Subsection (c) in turn provides that a corporation is to include in its gross receipts the corporation's "share of the gross receipts of each partnership and joint venture of which the corporation is a part apportioned to this state as though the corporation directly earned the receipts, including receipts from business done with the corporation." To the comptroller's credit, following the enactment of this provision, the comptroller moved quickly to settle several cases dealing with receipts and partnerships. However, this section, which does not focus specifically on issues faced by corporations that hold interest in multi-tiered partnerships, fails to re-

98. Tex. Comp. Pub. Acc'ts, Letter No. 20010737L (July 19, 2001).

99. 34 TEX. ADMIN. CODE § 3.557 (2001).

100. 34 TEX. ADMIN. CODE § 3.549 (2001); *but see* 34 TEX. ADMIN. CODE § 5.4501 (2001) (amending the rule).

101. 34 TEX. ADMIN. CODE § 3.578 (2001).

102. 34 TEX. ADMIN. CODE § 3.549 (2001) (Taxable Capital Apportionment).

103. *See, e.g.*, TAX CODE ANN. §§ 171.076, 171.501, 171.705, 171.721, 171.752; *see generally* subchapters P, Q, R and S of the franchise tax code for other changes.

104. Cynthia M. Ohlenforst et al., *Taxation*, 53 SMU L. REV. 1297, 1317-22 (2000) (summarizing the 1999 changes).

105. TEX. TAX CODE ANN. § 171.1032 (Vernon Supp. 2002).

106. *Id.*

solve adequately the multi-tiered issue.¹⁰⁷ Moreover, the reference to the corporation as “a part” of a partnership is likely to trigger more confusion.¹⁰⁸ Another litigation-based change is the amendment to Section 171.110(e). It explicitly provides that a business loss can be carried forward only by the corporation that incurred the loss, not by any other entity, including the survivor of a merger with the loss entity. Another partnership-related change, not listed as a clarification, is a new subsection 171.109(n), added to require a corporation to use the equity method of accounting when reporting an investment in a partnership or joint venture.¹⁰⁹

Among the other franchise tax changes this session are ones that impact banking. The legislature amended section 171.106¹¹⁰ to provide that a banking corporation shall not include in the numerator of its apportionment factor any interest earned on federal funds or on securities sold under an agreement to repurchase that are held in this state in a correspondent bank domiciled in this state.

The legislature also added a new section 171.851¹¹¹ providing the total credit claimed on a report, including carryover credit, may not exceed the amount of franchise tax due for the report period.¹¹²

III. PROPERTY TAX

As with other Survey periods, there were many cases decided and Attorney General opinions issued during the Survey period that are strong reminders to taxpayers that exemptions are interpreted narrowly¹¹³ and that failure to follow procedural rules can be a taxpayer's death knell.¹¹⁴ There were, however, several cases decided during the Survey period in which courts appeared to interpret exemptions more broadly and gave taxpayers some leniency on procedural issues. Some of these cases are sprinkled among the cases discussed below.

107. *Id.*

108. The legislature also made corresponding changes. *See* TEX. TAX CODE ANN. § 171.1051 (Vernon Supp. 2002) (apportioning gross receipts for earned surplus); *id.* § 171.1121 (gross receipts for taxable earned surplus). A corporation's share of a partnership's gross receipts that is included in the corporation's federal taxable income must be used in computing the corporation's gross receipts.

109. TEX. TAX CODE ANN. § 171.109 (Vernon Supp. 2002).

110. TEX. TAX CODE ANN. § 171.106 (Vernon Supp. 2002).

111. TEX. TAX CODE ANN. § 171.851 (Vernon Supp. 2002); *see also supra* note 103 and accompanying text.

112. *Id.* (providing that the amount of refund due under this provision is the lesser of \$5,000 or 25% of the amount of franchise tax for any one credit period *before any other applicable credits*). The legislature made similar changes to several other franchise tax credit provisions, and changes to §§ 171.754, 171.756.

113. *See, e.g.*, Tex. Att'y Gen. LO JC-0415 (2001) (stating that the portion of a residence that is rented does not qualify for the residence homestead exemption).

114. *See, e.g.*, Bexar Appraisal Dist. v. Wackenhut Corrections Corp., 52 S.W.3d 795 (Tex. App.—San Antonio 2001, no pet.) (holding that the taxpayer could not appeal a denial of an exemption because it failed to challenge timely the denial).

A. APPLICATION OF THE TAX/EXEMPTIONS

In *Fairchild Aircraft v. Bexar Appraisal District*,¹¹⁵ the San Antonio Court of Appeals addressed the taxability of an aircraft that was between commercial aircraft leases on the first day of the tax year. The aircraft at issue was typically leased to certificated air carriers and used as a commercial aircraft.¹¹⁶ However, from January 1, 1997 to October 1997, the aircraft was not being leased and was hangared in Bexar County for repairs and maintenance.¹¹⁷ The appraisal district asserted that property taxes should be imposed on the aircraft for the 1997 year, and the trial court agreed.¹¹⁸ The taxpayer asserted that the aircraft was exempt under section 21.05(c)¹¹⁹ for the 1997 year. Section 21.05(c) provides that a commercial aircraft that is removed from air transportation service for repair, storage or inspection is presumed to be in interstate or foreign commerce and not located in Texas for more than a temporary period; thus, an aircraft meeting section 21.05(c) would not be taxed.¹²⁰

On appeal, the court first addressed the issue of whether the aircraft was a "commercial aircraft" and thus subject to section 21.05. The appraisal district argued that the test is whether the aircraft is a commercial aircraft on January 1 alone (i.e., a snapshot approach); because the aircraft was not being leased on January 1 to a certificated air carrier, it was not a commercial aircraft for the 1997 year.¹²¹ The court rejected this argument, concluding that an aircraft's status as a commercial aircraft for a tax year should be based on its use in the immediately preceding year.¹²² During 1996, the aircraft was used as a commercial aircraft. Indeed, the court noted that the appraisal district's snapshot argument could lead to outrageous results as an aircraft not being treated as a commercial aircraft even if it was leased to a certificated air carrier for every day of the year except January 1.¹²³

The court then considered the appraisal district's assertion that section 21.05(c) is unconstitutional because it exempts property without a constitutional basis. The court held that section 21.05(c) is constitutional because it provides a method for allocating to Texas the portion of the aircraft's value that fairly reflects its Texas use rather than being an exemption statute.¹²⁴

115. 47 S.W.3d 577 (Tex. App.—San Antonio 2001, pet. denied). *Fairchild* is a mirror case to *First Aircraft Leasing, Ltd. v. Bexar Appraisal Dist.*, 48 S.W.3d 218 (Tex. App.—San Antonio 2001, pet. denied).

116. *Fairchild*, 47 S.W.3d at 579.

117. *Id.*

118. *Id.*

119. TEX. TAX CODE ANN. § 21.05(c) (Vernon 1992).

120. TEX. TAX CODE ANN. § 11.01 (Vernon 1992). Only property located in Texas on January 1 of the tax year for longer than a temporary period is generally subject to Texas property tax for that year.

121. *Fairchild*, 47 S.W.3d at 579.

122. *Id.* at 581.

123. *Id.*

124. *Id.* at 583. The court relied on the reasoning in *Appraisal Review Bd. of Galveston County v. Tex-Air Helicopters, Inc.*, 970 S.W.2d 530 (Tex. 1998). In *Tex-Air*, the court ad-

In Letter Opinion JC-0372,¹³⁷ the Attorney General addressed questions relating to the pollution control exemption set forth in section 11.31.¹³⁸ Section 11.31 exempts from property tax property that is being used for the control of air, water and land pollution.¹³⁹ The Attorney General first addressed whether equipment that is of a type new to a location that is used to make a product and by its design limits pollution can qualify for the pollution control exemption. In other words, query whether equipment can be considered to reduce pollution if it controls pollution from a facility that was not there before the pollution control equipment was added. The Attorney General ruled that the pollution control exemption applies equally to property controlling pollution at a new facility as it does to property controlling pollution at an existing facility.¹⁴⁰ Simply, there is no basis for limiting the exemption only to pollution-control property added to an existing facility.¹⁴¹ The Attorney General next addressed whether pollution-reducing production equipment can qualify for the exemption. The argument against such equipment qualifying for the exemption is that production equipment is a source of pollution, and thus should not qualify for the exemption even if it produces less pollution than other equipment producing the same product.¹⁴² The Attorney General rejected this argument, and ruled that this type of equipment can qualify for the exemption (although the exemption would be on only part of the equipment, that which controls pollution).¹⁴³

B. PROCEDURE

In a case of first impression, the Amarillo Court of Appeals in *Western Athletic Clubs, Inc. v. Harris County Appraisal District*¹⁴⁴ held that a taxpayer is not entitled to a review by the appraisal review board of the chief appraiser's determination with respect to a taxpayer motion under section 25.25(b).¹⁴⁵ Section 25.25(b) authorizes the chief appraiser to correct a name, address, property description, clerical error or other inaccuracy as prescribed by board rule that does not increase tax liability.¹⁴⁶ In *Western Athletic Clubs*, the taxpayer requested in 1999 that the appraisal district correct the 1983-87 appraisal rolls to reflect that certain property rendered as personal property was in fact real property fixtures.¹⁴⁷ The appraisal district denied the taxpayer's request, and the tax-

137. Tex. Att'y Gen. LO JC-0372 (2001).

138. TEX. TAX CODE ANN. § 11.31 (Vernon Supp. 2002).

139. *Id.*

140. *Id.*

141. *Id.*

142. *Id.*

143. TEX. TAX CODE ANN. § 11.31. See *supra* note 136 and accompanying text for a discussion of legislation designed to address difficult interpretive issues raised by the pollution control exemption, including issues raised in Letter Opinion JC-0372.

144. 56 S.W.3d 269 (Tex. App.—Amarillo 2001, no pet.).

145. *Id.* at 274; TEX. TAX CODE ANN. § 25.25(b) (Vernon Supp. 2002).

146. TEX. TAX CODE ANN. § 25.25(b) (Vernon Supp. 2002).

147. *Western Athletic Clubs*, 56 S.W.3d at 271.

The Fort Worth Court of Appeals in *Compass Bank v. Bent Creek Investments, Inc.*¹²⁵ addressed the liability as between a purchaser and a seller of the property for rollback taxes under section 23.55.¹²⁶ Section 23.55 imposes rollback taxes on land that previously was specially appraised as open-space property (or agricultural property).¹²⁷ For property tax purposes, open-space property is taxed based on the land's capacity to produce agricultural products instead of its higher market value.¹²⁸ However, when the property's use changes from agricultural property, the owner must pay rollback taxes under section 23.55 for the last five years equal to the tax on the difference each year between its market value and its agricultural value, plus interest.¹²⁹ In *Compass Bank*, the relevant property, which was agricultural property, was sold in December 1995.¹³⁰ The appraisal district later determined that the property's use changed in 1996; thus, rollback taxes were imposed on the buyer.¹³¹ The buyer sued the seller, asserting that the seller breached the warranty in the sales contract guaranteeing that there are no encumbrances on the property as of the date of sale.¹³² In support of its position, the buyer submitted to the court an affidavit of the property lessee that the property was not being used for agricultural purposes in 1995, before the sale.¹³³ The buyer was granted a summary judgment at the lower court.¹³⁴ In reversing the lower court and holding that there was not sufficient evidence to grant the summary judgment, the court reasoned that a change of use does not occur as a matter of law.¹³⁵ Rather, the appraisal district must determine that a change of use occurs, and a tax lien does not exist until such a determination is made.¹³⁶

dressed the constitutionality of the allocation formula used under Section 21.05(b), which allocates use to Texas based on revenue departures, and concluded that the formula used was a reasonable allocation formula and not an unauthorized exemption.

125. 52 S.W.3d 419 (Tex. App.—Fort Worth 2001, no pet.).

126. TEX. TAX CODE ANN. § 23.55 (Vernon Supp. 2002).

127. *Id.* § 23.55(a).

128. *Id.* § 23.52.

129. *Id.* § 23.55(a).

130. *Compass Bank*, 52 S.W.3d at 422.

131. *Id.*

132. *Id.*

133. *Id.* at 422.

134. *Id.* at 423.

135. *Compass Bank*, 52 S.W.3d at 424-25.

136. *Id.* at 424. This case gives practitioners reason to revisit their form real estate sales contracts relating to open space land. For example, consider the following scenario:

It is expected that the buyer will change the use promptly following the sale of the property on July 1, 2002, and the "deal" is that the seller will pay the rollback taxes that relate to years prior to the sale. The sales contract provides that the seller will reimburse the buyer for rollback taxes that are calculated for years prior to the sale date. However, the appraisal district determines that the change of use occurs in January, 2003. Based on *Compass Bank*, it is not clear that the buyer will be indemnified fully for the rollback taxes imposed on it. In this case, the buyer should insist that the sales contract address the possibility that the appraisal district determines that the change of use occurs later than the parties anticipate.

payer protested the denial to the appraisal review board.¹⁴⁸ The appraisal review board notified the taxpayer that it did not have the authority to review or change appraisal rolls under section 25.25(b).¹⁴⁹ The taxpayer sued, claiming that it had a right to have the appraisal review board hear its protest.¹⁵⁰ Specifically, the taxpayer asserted that section 41.41(a)(9),¹⁵¹ which provides that a property owner is entitled to protest before the appraisal review board any action of the appraisal district that applies to and adversely affects the taxpayer,¹⁵² affords the taxpayer a vehicle to protest the denied section 25.25(b) motion.¹⁵³ The court rejected this argument, concluding that section 25.25 does not provide for the review of any action by the appraisal district under section 25.25(b), although it expressly provides for such a review with respect to motions made under section 25.25(c) and (d).¹⁵⁴ The court further reasoned that section 41.41(a) does not apply to section 25.25(b) given that: (i) section 41.41(a)(9) applies only if the taxpayer is adversely affected by the appraisal district's action; and (ii) section 25.25(b) is not a vehicle whereby the taxpayer can be adversely affected by the appraisal district's action because section 25.25(b) cannot be used to increase a taxpayer's tax liability.¹⁵⁵

In *Comerica Acceptance Corp. v. Dallas Central Appraisal District*¹⁵⁶ the Dallas Court of Appeals held that a lienholder as of January 1 of a tax year that is in possession of taxable personal property collateral on January 1 for purposes of selling it in a foreclosure is not the owner of the property for tax purposes for that tax year and is not liable for the property taxes on the item for the year.¹⁵⁷ Under section 32.07(a),¹⁵⁸ property taxes are generally imposed on the owner of the property on January 1 of the tax year.¹⁵⁹ The term "owner" is not, however, defined in the Tax Code. The appraisal district contended that a secured party in possession of the collateral on January 1 is the owner of the collateral for property tax purposes and is liable for the property taxes on the collateral for that year. In addressing this issue, the court relied on two rules of statutory interpretation: (1) tax statutes are construed strictly against the taxing

148. *Id.*

149. *Id.*

150. *Id.*

151. TEX. TAX CODE ANN. § 41.41(a)(9) (Vernon Supp. 2002).

152. *Id.*

153. *Western Athletic Clubs*, 56 S.W.3d at 273.

154. *Id.*

155. *Id.* The court's reading of the term "adversely affected" as used in section 41.41(a) seems to be extremely narrow. Although section 25.25(b) cannot be used as a vehicle to increase a taxpayer's tax, one would think that a taxpayer is still "adversely affected" if the appraisal district rules against the taxpayer on a section 25.25(b) motion.

156. 52 S.W.3d 495 (Tex. App.—Dallas 2001, pet. denied).

157. *Id.* at 499.

158. TEX. TAX CODE ANN. § 32.07(a) (Vernon Supp. 2002).

159. *Id.*; but see *id.* § 25.07(a) (stating that certain leasehold interests in real estate are taxed to the lessee if the lessor is exempt).

authority;¹⁶⁰ and (2) when a term is not defined in the statute, the term is given its ordinary meaning.¹⁶¹ The court concluded that a lienholder does not possess the attributes of a typical owner, such as the benefit of property appreciation, the risk of lost value, and the right to possess the property.¹⁶² In addition, taxing a lienholder on the market value of the property would be unfair because the lienholder can only recover from the property the debt balance, which can be less than the value of the property.¹⁶³ Furthermore, if lienholders were treated as owners for property tax purposes, the curious result of a single property having multiple owners for property tax purposes would occur.¹⁶⁴ The court expressly rejected the conclusion of *General Electric Capital Corp. v. City of Corpus Christi*,¹⁶⁵ which held that a secured party in possession is the same as the title owner for property tax purposes.¹⁶⁶

A Houston Court of Appeals in *Harris County Appraisal District v. United Investors Realty Trust*¹⁶⁷ held that it is not necessary for a taxpayer to obtain an independent appraisal to prove inequality of appraised values under section 42.26(d).¹⁶⁸ There, the taxpayer purchased a shopping center in January 1998 for \$15.2 million, and the appraisal district appraised the shopping center at \$13.9 million for the 1998 tax year.¹⁶⁹ The taxpayer protested the appraisal, which the appraisal review board upheld, and then sued, claiming unequal appraisal under section 42.26(d).¹⁷⁰ Section 42.26(d) provides that a court shall grant a taxpayer relief if the taxpayer's property is appraised unequally such that the property's appraised value exceeds the median appraised value of a reasonable number of comparable properties appropriately adjusted.¹⁷¹ In support of the taxpayer's position that section 42.26(d) applied, the taxpayer called an expert valuation witness, who stated that the taxpayer's property was appraised at \$13 more per square foot than the median appraised value per square foot of a reasonable number of comparable properties (\$85 per square foot versus \$62 per square foot).¹⁷² Based on this inequality of

160. *Dallas Cent. Appraisal Dist. v. Park Stemmons, Ltd.*, 948 S.W.2d 11, 13 (Tex. App.—Dallas 1997, no writ).

161. TEX. GOV'T CODE ANN. § 312.002(a) (Vernon 2000); *City of Dallas v. Cornerstone Bank*, 879 S.W.2d 264, 270 (Tex. App.—Dallas 1994, no writ).

162. *Comerica Acceptance*, 52 S.W.3d at 497-98.

163. *Id.*

164. *Id.* at 498.

165. 850 S.W.2d 596 (Tex. App.—Corpus Christi 1993, writ denied).

166. *Id.* at 599. Justice LaGarde, in a dissenting opinion, stated that the court should have applied the Texas Supreme Court's language in *Childress County v. State*, 127 Tex. 343, 92 S.W.2d 1011 (1936) in which the Court stated that the owner of property for property tax purposes includes one in possession of the property that also possesses such claims and evidences of ownership as will justify that he is the owner. *Comerica Acceptance*, 52 S.W.3d at 500 (LaGarde, J., dissenting).

167. 47 S.W.3d 648 (Tex. App.—Houston [14th Dist.] 2001, pet. denied).

168. *Id.* at 653; TEX. TAX CODE ANN. § 42.26(d) (Vernon Supp. 2002).

169. *United Investors Realty Trust*, 47 S.W.3d at 649.

170. *Id.*

171. TEX. TAX CODE ANN. § 42.26(d) (Vernon Supp. 2002).

172. *United Investors Realty Trust*, 47 S.W.3d at 650.

appraisal, the taxpayer requested that its appraised value be lowered to approximately \$10 million (163,000 square feet times \$62 per foot).¹⁷³ However, the taxpayer did not submit as evidence any appraisals of any properties.¹⁷⁴ The appraisal district asserted that section 42.26(d) should be interpreted to require a determination of the market value of the property at issue in order to establish the variance between appraised values to market values of the subject property and the purported comparable properties.¹⁷⁵ The court rejected the appraisal district's position and expressly ruled that section 42.26(d) does not require that the taxpayer obtain independent appraisals.¹⁷⁶ The court reasoned that section 42.26(d) was added in part to facilitate remedies to taxpayers for unequal appraisals and that requiring independent appraisals would be inconsistent with this purpose.¹⁷⁷

In *Conroe Creosoting Co. v. Montgomery County*¹⁷⁸ the Fifth Circuit Court of Appeals held that the tax assessor was not entitled to summary judgment on the basis that it had qualified immunity from a damages claim for improperly seizing the taxpayer's entire business in collecting on a tax deficiency judgment rather than seizing only those assets needed to satisfy the judgment.¹⁷⁹ In *Conroe* the tax entity obtained a tax judgment for approximately \$74,000.¹⁸⁰ The judgment contained a finding that the taxpayer's personal property had a fair market value of approximately \$800,000.¹⁸¹ The tax entity, however, seized the taxpayer's entire facility and demanded that operations cease and that all employees leave.¹⁸² The entire facility was held for almost two months. The taxpayer asserted that the tax units then sold assets critical to the company's business, instead of less critical assets such as autos, to satisfy the judgment. Total sale proceeds were \$362,000, and \$241,000 of this was used to satisfy taxes, attorneys' fees and expenses.¹⁸³ The taxpayer never reopened for business.

Although the tax assessor admitted that he acted under the mistaken impression that the tax unit obtained a tax warrant rather than a writ of execution, the taxpayer asserted that the assessor was aware of his mis-

173. *Id.*

174. *Id.*

175. *Id.* at 651.

176. *Id.* at 653.

177. *United Investors Realty Trust*, 47 S.W.3d at 653. The court also held that section 42.26(d) is constitutional. *Id.* The appraisal district asserted that to interpret section 42.26(d) as not requiring a determination of market value would result in the provision's being unconstitutional because the Texas Constitution requires all properties to be taxed in proportion to market value. *Id.* at 654; TEX. CONST. art. VIII, § 1(b). Rejecting the appraisal district's argument, the court stated that the Texas Constitution also requires equal and uniform taxation (TEX. CONST. art. VIII, § 1(a)) and that equality and uniformity prevail for the market value requirement. *United Investors Realty Trust*, 47 S.W.3d at 654.

178. 249 F.3d 337 (5th Cir. 2001).

179. *Id.* at 342.

180. *Id.* at 338.

181. *Id.*

182. *Id.* at 339.

183. *Conroe Creosoting*, 249 F.3d at 339.

take before the sale occurred.¹⁸⁴ The taxpayer sued the tax assessor for violation of its substantive due process rights. Absent a statutory waiver, in order to prevail on a substantive due process claim against a government official, his or her activity must be so egregious and outrageous that it shocks our conscience.¹⁸⁵ The court held that there were sufficient issues of fact to avoid a summary judgment on this issue, including that the assessor signed the order authorizing the sale and the closing of the business.¹⁸⁶

C. LEGISLATION

Appraisal districts, assessors and taxpayers have come to expect the Texas Legislature to tinker each session with procedural property tax rules, and the 77th Texas Legislature was no exception. Many of these procedural changes are noteworthy. However, the key property tax changes in 2001 probably relate to exemptions. Not surprisingly, the Texas Legislature adopted or expanded several exemptions in order to encourage economic development.

To encourage large-scale capital investment in Texas, the Texas Economic Development Act¹⁸⁷ permits (but does not require) school districts to limit the appraised value for purposes of the school district's maintenance and operations property tax rate (but not its debt service rate) imposed on new business property meeting detailed requirements set forth in the Act to a specified dollar amount (\$100 million for very large school districts, decreasing on a sliding scale as the size of the school district decreases) for up to eight years beginning in the third year following the approval of the exemption by the school district.¹⁸⁸ In addition, if approved by the school district, the new business is entitled to a credit after the end of the exemption period for school district property taxes that would have been exempted had the exemption also applied for the first two years following the approval of the exemption.¹⁸⁹ The exemption can be granted only to corporations and limited liability companies.¹⁹⁰ One of the key conditions to qualifying for the exemption is that the property must be used for manufacturing, research and development or renewal

184. *Id.*

185. *County of Sacramento v. Lewis*, 523 U.S. 833, 846 (1998).

186. *Conroe Creosoting*, 249 F.3d at 342.

187. TEX. TAX CODE ANN. Ch. 313 (Vernon Supp. 2002). The new tax value limit adopted by the Texas Economic Development Act is not a new exemption that requires constitutional authorization because it fits within the parameters of the exemption authorized by article VIII, section 1-g of the Texas Constitution by virtue of the Act requiring the property to be in a reinvestment zone formed by the relevant municipality. *See* TEX. TAX CODE ANN. § 313.021(2)(a)(i) (Vernon Supp. 2002). Thus, a taxpayer attempting to benefit from Chapter 313 will need the cooperation of the city, the comptroller and the school district.

188. TEX. TAX CODE ANN. § 313.027 (Vernon Supp. 2002).

189. *Id.* §§ 313.102 and 313.104.

190. *Id.* § 313.024(a). Another condition to qualifying for the value limitation is that a specified number of jobs must be created. TEX. TAX CODE ANN. § 313.021(3) (Vernon Supp. 2002).

energy electric generation.¹⁹¹

There were also several important legislative changes to the tax abatement provisions during the session. Most importantly, the sunset provisions to the tax abatement statute were extended to September 1, 2009.¹⁹² However, after September 1, 2001, school districts may not enter into tax abatement agreements.¹⁹³ The abatement statute was amended to clarify that tax abatements for improvements are not effective until January 1 of the tax year immediately following the date the improvements are completed.¹⁹⁴ Tax abatement agreements may now be entered into with the lessee of tax-exempt property.¹⁹⁵ The Texas Legislature also repealed a burdensome provision of the abatement statute that required other taxing units to join in a municipal tax abatement agreement within 90 days after the date the municipality entered into the tax abatement agreement.¹⁹⁶

In November 2001, voters authorized two new property tax exemptions. First, travel trailers that are not held for the production of income are exempt.¹⁹⁷ Second, the voters authorized the Texas Legislature to exempt a new category of goods-in-transit (similar to the Freeport goods exemption).¹⁹⁸ However, the accompanying enabling legislation was not adopted by the Texas Legislature; thus, this exemption will apply only if a later session of the Texas Legislature adopts enabling legislation. The potential new exemption would exempt property, other than oil, natural gas and other petroleum products (but expressly covering aircraft and aircraft parts) that: (a) is detained in Texas at a location that is not owned or under the control of the property owner for assembling, storing, manufacturing, processing or fabricating by the person who acquired the property; and (b) is transported to another location cover that is in the process of being assembled, manufactured, stored, repaired, processed or fabricated, and which is not detained in a location for more than 270 days after the person acquired the property in or imported the property to Texas.¹⁹⁹ If the enabling legislation is passed, each taxing unit would decide whether to grant the exemption.²⁰⁰

Section 25.07 was amended to provide that a convention center, visitor center, sports facility, concert hall, arena or stadium that is owned by a

191. *Id.* § 313.024(b). This legislation effectively responds to school districts' practical inability (due to school financing formulas) to grant property tax abatements in most circumstances, which has been an obstacle attracting some large projects to Texas in recent years. See Cynthia Ohlenforst et al., *Taxation*, 47 SMU L. REV. 1649, 1672 (1994).

192. TEX. TAX CODE ANN. § 312.006 (Vernon Supp. 2002).

193. *Id.* § 312.002(e); but see *Fish Controls*, 45 S.W.3d at 298.

194. *Id.* § 312.204(a).

195. *Id.* §§ 312.204(a), 312.210(b) and 312.402(a). Prior to this amendment, all tax abatement agreements had to be with the owner of the property.

196. *Id.* § 312.206(a). Sections 312.204 and 312.402 also were amended to clarify that a taxpayer does not lose his or her abatement if the owner is elected to a governing body of a taxing unit that granted the exemption. TEX. TAX CODE ANN. §§ 312.204, 312.402.

197. TEX. CONST. art. VIII, §§ 1-j, 1-j-1.

198. *Id.* § 1-n.

199. *Id.* § 1-n(a).

200. *Id.* § 1-n(d).

city or town and that is leased to a taxable entity is exempt to the lessee so long as the facility is open to the public, regardless of whether a fee is charged for admission.²⁰¹ Amended section 21.031 provides that vessels and watercraft under construction, and all tangible personal property intended to be incorporated into such property, are presumed to be in interstate, international or foreign commerce and not located in Texas for more than a temporary time.²⁰² This presumption is tantamount to an exemption for this type of property.

In a piece of legislation that we may all regret only because of the number of irritating car leasing ads it has spurred, new section 11.252 exempts from property tax leased motor vehicles if the lessee does not hold the motor vehicle for the production of income and the motor vehicle is used primarily for activities that do not involve the production of income.²⁰³ A motor vehicle is presumed to be used primarily for non-production of income activities if 50 percent or more of the miles driven in a year are for non-income producing activities.²⁰⁴

House Bill 490²⁰⁵ made numerous changes to the procedural provisions of the Tax Code, including requiring tax collectors to automatically refund duplicate payments,²⁰⁶ raising the maximum collection fees in delinquent tax cases,²⁰⁷ making significant changes to the tax warrant process and foreclosure process,²⁰⁸ and enabling a taxing unit to obtain an injunction preventing personal property subject to delinquent taxes from leaving the county or being transferred to a buyer that is not a buyer in the ordinary course.²⁰⁹ Section 25.195 was amended to increase taxpayers' right to information, including taxpayers' right to copy records at the appraisal office and to inspect all records used by a private appraisal firm hired by the appraisal district in valuing the taxpayer's property.²¹⁰ Amended section 33.011(a) requires tax units to waive interest on property taxes that are delinquent due to the appraisal district or tax unit's error, and gives taxpayers three years to recover erroneously paid interest and penalties.²¹¹ Amended Section 11.251 provides that Freeport exemptions may now be filed before the date the appraisal review board approves the appraisal records.²¹²

201. TEX. TAX CODE ANN. § 25.07(b)(4)(B) (Vernon Supp. 2002).

202. *Id.* § 21.031.

203. *Id.* § 11.252(a)(1)-(2).

204. *Id.* § 11.252(b).

205. H.R. 490, 77th Leg., 1st Spec. Sess. (Tex. 2001).

206. TEX. TAX CODE ANN. §§ 31.111, 31.12 (Vernon Supp. 2002).

207. *Id.* §§ 33.07(a), 33.08(b).

208. *Id.* ch. 33.

209. *Id.* § 33.41.

210. *Id.* § 25.195.

211. TEX. TAX CODE ANN. § 33.011(a) (Vernon Supp. 2002).

212. *Id.* § 11.251. Section 11.31 includes several procedural changes to and administrative guidelines for the application of the pollution control exemption, including requiring the TNRCC to establish specific standards for the exemption to insure equality and uniformity and allowing appraisal districts to appeal TNRCC determinations concerning exemptions. *Id.* § 11.31.

IV. PROCEDURE AND LIABILITY

A. INTERPRETATION

As to personal liability, the court of appeals, in *Parker v. Texas*,²¹³ determined, without deciding whether Parker was individually liable under Section 111.016,²¹⁴ that the state had failed to meet its burden of producing “more than a scintilla of evidence showing how much tax money was actually collected”²¹⁵ and not remitted.

Hearing No. 39,257²¹⁶ addressed successor liability; the petitioner argued that it had no successor liability for tax owed by its predecessor, because the petitioner had acquired the assets of the predecessor company through a foreclosure, rather than through a purchase. While noting that a sale through a foreclosure is not generally considered a sale of a business or stock of goods leading to successor liability, the ALJ examined the loan agreements that were at the heart of the transaction in his analyses, noting that they referred to a sale of the collateral, rather than a “taking back,” and found the petitioner liable.

Hearing 37,967²¹⁷ focused on the fiduciary responsibilities of officers and directors, finding that the president of a computer manufacturing company had check writing authority, had authority to disburse funds to the corporation, and signed the returns of the company, and therefore should be personally responsible for the taxes, based on Section 111.016.²¹⁸

Hearing No. 37,107²¹⁹ offers a warning to participants in oral hearings, including the comptroller’s hearing section, that Texas procedural rules apply to the hearings. The petitioner and the AHS had reached an agreement that certain items were to be considered new construction and announced the agreement in open court at the oral hearing. However, the AHS then sought to withdraw the agreement, believing that the AHS had misread some of the relevant precedents. The ALJ refused to grant the withdrawal, on the grounds that it would prejudice the petitioner, who would be unable to present evidence and cross-examine witnesses on the issue. The ALJ cited Rule 11 of the Texas Rules of Civil Procedure²²⁰ and *Porter v. Holt*²²¹ for the proposition that such withdrawals are “extremely disfavored.”

In another case dealing primarily with procedural matters,²²² the petitioner contended that it was not in existence at the time that the notification for the audit was issued, or at the time of the hearing, and therefore

213. 36 S.W.3d 616 (Tex. App.—Austin 2000) (judgment withdrawn Jan. 11, 2001).

214. TEX. TAX CODE ANN. § 111.016 (Vernon Supp. 2002).

215. *Parker*, 36 S.W.3d at 618.

216. Tex. Comp. Pub. Acc’ts, Hearing No. 39,257 (April 20, 2001).

217. Tex. Comp. Pub. Acc’ts, Hearing No. 37,967 (March 16, 2001).

218. TEX. TAX CODE ANN. § 111.016 (Vernon Supp. 2002).

219. Tex. Comp. Pub. Acc’ts, Hearing No. 37,107 (Nov. 9, 2000).

220. TEX. R. CIV. P. 11.

221. 73 Tex. 447, 11 S.W. 494 (1889).

222. Tex. Comp. Pub. Acc’ts, Hearing No. 39,028 (January 25, 2001).

could not be held liable for the amount owed. The ALJ found these facts irrelevant because the petitioner was in existence for the time period that the audit covered. More interestingly, the ALJ also determined that it was not relevant that the petitioner had received a certification (erroneous, as it turned out) that all taxes had been paid; the judge pointed out that the petitioner knew that the certification was an error. As the ALJ noted, a foreign corporation remains liable for a sales tax deficiency up to three years after the date of dissolution.²²³

On September 28, 2001, the comptroller's office, by internal memorandum,²²⁴ addressed a potential discrepancy in interpretation between the audit division's and tax policy's view of Tax Code Section 111.206.²²⁵ This section provides an exception to the statute of limitations for determinations resulting from administrative proceedings. The audit division interpretation, upheld by the internal memorandum, concludes that the statute is a narrow one which extends the statute of limitations for refunds only to the extent they are related to adjustments made by a regulatory agency, whereas the tax policy division of the comptroller's staff had (correctly) taken the position that section 111.206²²⁶ keeps the limitation period open during the period involved in the proceeding for refund claims even if the claims are unrelated to the regulatory adjustments. It will be interesting to see whether this statutory interpretation is subject to further challenge or litigation.²²⁷

B. LEGISLATIVE DEVELOPMENTS

In addition to several other procedural changes, the legislature also authorized the comptroller to require by rule that certain taxpayers may be required to pay by electronic funds transfer.²²⁸

Senate Bill 1123,²²⁹ the comptroller's first official enforcement bill in some twelve years, provides the comptroller with additional means of ensuring tax compliance. An overview of Senate Bill 1123 makes clear the frustration the comptroller has experienced with taxpayers who sell property out of trucks by the highway, or from boats in the harbor, and then disappear before the comptroller staff is able to secure sufficient information to assess—let alone collect—taxes. Given this background, the additional authority given to the comptroller, such as the right to photograph records and to require taxpayers under pain of criminal penalty to produce certain written records within ten days, could be viewed as reasonable. However, statutory authority that could arguably be interpreted to allow the comptroller's auditor to "examine, copy, and photograph the books, returns, records, and papers of equipment relating to the conduct

223. TEX. BUS. CORP. ACT ANN. art 7.12A.(2) (Vernon Supp. 2000).

224. Tex. Comp. Pub. Acc'ts, Hearing 200109582L (Sept. 28, 2001).

225. TEX. TAX CODE ANN. § 111.206 (Vernon Supp. 2002).

226. *Id.*

227. Tex. Comp. Pub. Acc'ts, Letter No. 200109582L.

228. TEX. TAX CODE ANN. § 111.0625 (Vernon Supp. 2002).

229. S.J. Res. 1123, 77th Leg., 1st Spec. Sess. (2001).

in question”²³⁰ virtually at will clearly poses the risk of abuse. Almost surprisingly, the enforcement provisions in this bill failed to attract much attention from outside the comptroller’s office until near the end of the legislative session. In the waning days of the legislature’s focus on this bill, several practitioners met with comptroller staff to discuss concerns with its enforcement mechanisms. These practitioners sought and received assurance that the comptroller’s staff would put procedures in place to ensure that taxpayers’ rights would not be violated.

The legislature also added additional criminal penalties for several activities, including failure to remit tax collected, selling without a sales tax permit, and failure to furnish a required tax report.²³¹

In addition to the enforcement mechanisms mentioned above, the enforcement bill is significant for its focus on successor liability. Texas, like many states, often seeks to collect certain taxes, including sales and franchise taxes, from the buyer of the assets of a business.²³² Once again, a review of the remedies the comptroller requested makes clear the type of challenges the comptroller has faced. For example, as amended in 2001, section 111.020²³³ now provides that the buyer’s withholding an amount from the purchase price to pay unpaid taxes will no longer be a defense to a tax assessment in circumstances when the price paid to the seller for the asset “is not reasonably equivalent to the value of the business or stock of goods.”²³⁴ The comptroller is also armed with a new section 111.024,²³⁵ which provides for additional liability in fraudulent transfer cases. Pursuant to this new section, a person who acquires the assets of a business “through a fraudulent transfer or a sham transaction” is liable for any tax penalty and interest owed by the taxpayer.²³⁶ This section further sets out a laundry list of factors to be considered in determining fraudulent intent, e.g. whether the transfer was to a current or former business insider or to a taxpayer who retains possession or control of the business and whether the taxpayer was insolvent at the time of the transfer, or soon after.²³⁷

House Bill 1845²³⁸ directs the comptroller to enter into a streamlined sales and use agreement with other states to implement a simplified tax system. This legislation, which adds Chapter 142 to the Tax Code, includes a legislative finding that “a simplified sales and use tax system will reduce and over time eliminate the burden and cost of all vendors to collect the state’s sales and use tax,”²³⁹ and results in ten new sections that, while not generally part of the Sales Use Tax Chapter of the Code,

230. TEX. TAX CODE ANN. § 151.023(b)(1) (Vernon Supp. 2002).

231. TEX. TAX CODE ANN. §§ 151.7032, 151.708, and 709 (Vernon Supp. 2002).

232. *Id.* § 111.020.

233. *Id.* § 111.020(f).

234. *Id.* § 111.020(f)(2).

235. *Id.* § 111.024.

236. TEX. TAX CODE ANN. § 111.024(a).

237. *Id.* at § 111.024(c).

238. H.R. 1845, 77th Leg., 1st Spec. Sess. (Tex. 2001).

239. TEX. TAX CODE ANN. § 142.003 (Vernon Supp. 2002).

have the potential to influence significantly the future of Texas sales and use tax. Although the comptroller is "authorized and directed to participate in Streamlined Sales and Use Tax Agreements with one or more states,"²⁴⁰ and the statute authorizes the comptroller or the comptroller's designee to represent the state, any required legislative changes (e.g., to adopt new definitions) are not self-executing; instead, such changes must be enacted by the Texas Legislature.²⁴¹

New section 142.007²⁴² further provides that the comptroller may not enter into such an agreement unless certain conditions are met. For example, an agreement entered into pursuant to this section must set restrictions to limit over time the number of state rates, must establish uniform standards for sourcing, and must fulfill several other requirements of a simplified sales tax agreement.

Other significant procedural changes enacted by the legislature involve contract auditors. New section 151.0232 authorizes the comptroller to establish by rule a program pursuant to which a taxpayer may hire a certified public accountant, not employed by the comptroller, to audit the taxpayer for sales tax purposes.²⁴³ The comptroller has been working on a proposed new Rule 3.368, dealing with contract auditors. Although still under discussion, the rule would establish certain requirements for both the auditing CPAs and the audited taxpayers.²⁴⁴

The legislature also enacted a new section requiring the comptroller to develop an advanced electronic database system for audits.²⁴⁵

One of the most interesting of the bills that did not become law is House Bill 2809, which attempted to challenge the judiciary's interpretation of a tax statute in *Fleming Foods v. Rylander*.²⁴⁶ The official bill analysis chastises the Texas Supreme Court for concluding that a revision to the Tax Code effected a substantive change rather than following the legislature's "repeated and clear statements" that the statutory changes were intended to be nonsubstantive. Although passed by the legislature, the bill was vetoed by the governor. If enacted, the bill would purportedly have required the judiciary to follow legislative intent as to nonsubstantive recodification, notwithstanding a legislative change that the court

240. TEX. TAX CODE ANN. § 142.005(a) (Vernon Supp. 2002).

241. *Id.* § 142.006.

242. TEX. TAX. CODE ANN. § 142.007 (Vernon Supp. 2002).

243. TEX. TAX. CODE ANN. § 151.0232(a) (Vernon Supp. 2002).

244. Under this proposed rule, in order for a certified public accountant to participate in the CPA audit program, the CPA must not be delinquent for any state tax for which the CPA is liable; the CPA must not be associated with a firm that is delinquent for any state tax; and the CPA must complete the minimum training that the comptroller requires (likely to include passing an examination, signing a confidentiality agreement, and obtaining an authorization card). Taxpayer participation appears likely to be limited to taxpayers that do not fall within a certain classification account set up by the comptroller (e.g., very large taxpayers), that are not routinely audited by the comptroller, and that have received a notice of an upcoming sales and use tax audit.

245. TEX. TAX CODE ANN. § 111.0034 (Vernon Supp. 2002).

246. 6 S.W.3d 278 (Tex. 1999); *see also* Cynthia M. Ohlenforst & Jeff W. Dorrill, *Taxation*, 53 SMU L. REV. 1297, 1299-1301 (2000) (discussing this case).

“would otherwise find to be direct, unambiguous, and irreconcilable with prior law.”²⁴⁷

V. CONCLUSION

Although this was not a landmark year in terms of substantial changes to the Tax Code, the relatively large number of legislative changes, and of tax interpretations, make it impossible to cover all the developments in the scope of a short Survey article, necessitating the omission of not only some regulatory developments, but also of some statutory provisions and interpretations—not to mention some tax cases that fall outside the scope of this year’s Survey.²⁴⁸ However, because the Survey article will be in print by the 4th of July, the authors would hate to omit the fact that, effective October 1, 2001, fireworks are subject to an additional two percent retail sales tax.²⁴⁹

247. H.B. 2809, § 1 (adding § 311.033 to the Government Code).

248. Two of the most interesting recent cases involve insurance. In *Dow Chemical v. Rylander*, 38 S.W.3d 741 (Tex. App.—Austin 2001, pet. denied), the court held that the state may not impose independently provided insurance tax on Dow under the Supreme Court’s decision in *Todd Shipyards Corp.*, 370 U.S. 451 (1962). As the *Dow* court noted, “the Supreme Court’s holding that Texas’ independently procured insurance tax violated [federal law] . . . [c]uriously. . . has not dissuaded the comptroller from levying this tax.” *Id.* at 745. (Ironically, perhaps, the comptroller announced her intent to appeal to the United States Supreme Court.) In *USAA v. Rylander*, No. GN103404, a refund suit pending in Travis County District Court, USAA asserts (not inconsistently with literal statutory language) that insurance companies should not be required to pay any taxes such as sales taxes other than gross premium taxes imposed by Chapter 4 of the Texas Insurance Code.

249. TEX. TAX CODE ANN. § 161.002(b) (Vernon Supp. 2002) (“Fireworks Tax”).

