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## Taxation

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# TAXATION

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**S**HORTLY after the conclusion of this year's Survey period, newly released budget numbers indicated that Texas would be facing a \$9.9 billion shortfall between predicted expenses and predicted revenue through the next biennium. In what some critics complain is a never-ending saga, debate continues about Texas franchise tax, about whether and to what extent Texas should participate in the Streamlined Sales Tax Project, and about how and whether meaningful property tax reform will ever be effected. It is against the background of these and other issues, as well as of the interpretations and policies outlined in this article, that the 2003 Texas Legislature begins its task, and that we begin our review of the Survey period.<sup>1</sup>

## I. SALES TAX

### A. APPLICATION OF THE TAX

Several Survey period cases and rulings addressed definitional issues that delineate the scope of various exemptions. In *Tennessee Gas Pipeline Co. v. Rylander*,<sup>2</sup> Tennessee Gas Pipeline, an entity authorized by the Federal Energy Regulatory Commission ("FERC") to operate as a "common carrier pipeline," filed a refund suit to collect sales and use taxes it paid in connection with the maintenance and repair of its aircraft. Tennessee Gas, which owns and operates two aircraft that it uses to transport employees and their executives and to inspect pipelines and rights-of-way, argued persuasively that it is "a licensed and certificated carrier" and that its expenses for repair and remodeling of the aircraft it operates should therefore be exempt. Both Tennessee Gas and the Comptroller

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1. The Survey period includes October 2001 through November 2002.

2. *Tenn. Gas Pipeline Co. v. Rylander*, 80 S.W.3d 200 (Tex. App.—Austin 2002, pet. denied).

focused not only on Tax Code section 151.328<sup>3</sup> but also on Rule 3.297,<sup>4</sup> which defines “licensed and certificated carrier” to include pipeline operators authorized to operate as common carriers by the appropriate state or federal agency. The Comptroller, however, interpreted the Tax Code section 151.328<sup>5</sup> exemption as “limited to air common carriers certificated by the Federal Aviation Agency (“FAA”).”<sup>6</sup> Tennessee Gas appealed the lower court’s summary judgment in favor of the Comptroller, and argued that Rule 3.297<sup>7</sup> is unambiguous and that the Comptroller’s present interpretation conflicts with her prior interpretation. Tennessee Gas also complained that the Comptroller’s current interpretation constitutes an implicit amendment of the Rule, in violation of rulemaking procedure. Rule 3.297(a)(1) defines a “licensed and certificated carrier” as “a person authorized by the appropriate United States agency or by the appropriate state agency within the United States to operate an aircraft, vessel, train, motor vehicle, or pipeline as a common or contract carrier transporting persons or property for hire in the regular course of business.”<sup>8</sup> The Comptroller asserted that, for purposes of the aircraft exemption, the “appropriate” agency is the FAA, not the FERC. Giving great deference to the Comptroller’s rule and to the fact that the rule addressed not only the aircraft exemption but also other non-aircraft “carrier” issues, the court concluded that it “need not determine whether Tennessee Gas’s interpretation of the Rule is reasonable; we need only determine whether the Rule can reasonably be read in the manner the Comptroller has chosen to interpret it.”<sup>9</sup>

Concluding that the definition of certificated carrier had been drafted for a much broader purpose than the aircraft exemption at issue, the court held that the Comptroller’s interpretation was reasonable. The court also rejected Tennessee Gas’s argument that other Comptroller interpretations appear inconsistent with this case. Instead, the court found that “[i]f anything, the uniformity of these [administrative] decisions with respect to their focus on certification as an air common carrier by the FAA strengthens, rather than weakens, the Comptroller’s position.”<sup>10</sup>

*GATX Terminals Corp. v. Rylander*<sup>11</sup> revisited the frequently debated distinction between remodeling and new construction. GATX is in the business of operating “tank farms where petroleum and petrochemical products are unloaded from transport vehicles” to be stored in tanks until

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3. TEX. TAX CODE ANN. § 151.328 (Vernon 2002).

4. 34 TEX. ADMIN. CODE § 3.297 (West 2002).

5. TEX. TAX CODE ANN. § 151.328 (Vernon 2002).

6. *Tenn. Gas Pipeline Co.*, 80 S.W.3d at 203.

7. 34 TEX. ADMIN. CODE § 3.297 (West 2002).

8. 34 TEX. ADMIN. CODE § 3.297(a)(1) (West 2002).

9. *Tenn. Gas Pipeline Co.*, 80 S.W.3d at 205.

10. *Id.* at 206.

11. *GATX Terminals Corp. v. Rylander*, 78 S.W.3d 630 (Tex. App.—Austin 2002, no pet.). This opinion was substituted for *GATX Terminals Corp. v. Rylander*, No. 03-01-00537-CV (Tex. App.—Austin Apr. 18, 2002) (not designated for publication), 2002 Tex. App. LEXIS 2719, to address issues raised in the Comptroller’s motion for rehearing.

“ready to be loaded again for distribution.”<sup>12</sup> GATX sought a refund of sales tax paid with respect to repainting its tanks and making improvements to bring the facility into compliance with environmental regulations. GATX asserted that the repainting was nontaxable maintenance and the environmental improvements were nontaxable new construction. The Comptroller disagreed and contended that both were taxable real property repair and remodeling. Rule 3.357<sup>13</sup> lay at the heart of the dispute. This Rule defines maintenance as “scheduled, periodic work necessary to sustain or support safe, efficient continuous operations, or to prevent the decline, failure, lapse, or deterioration of the improvement.”<sup>14</sup> Various Comptroller decisions have interpreted “scheduled” to mean that the “work is arranged in advance rather than on an as-needed basis,” and “periodic” to mean performed at regular intervals rather than prompted by a subjective judgment.<sup>15</sup> Because the repainting was in the discretion of GATX managers and done only on an as-needed basis, the judge ruled that the repainting did not qualify under the Rule’s definition of maintenance. Rule 3.357 defines “new construction” as new improvements to real property, whereas “remodeling” is defined as rebuilding, replacing or upgrading existing real property.<sup>16</sup> Because the installation of equipment to bring GATX’s facility into compliance with environmental regulations modified only the way GATX delivered the products into the tank, and not the amount of products loaded, it was held to be taxable remodeling.

*Cafeteria Operators, L.P. v. Rylander*<sup>17</sup> focused on the availability of an exemption for gas and electricity. The taxpayer, which operates Furr’s Cafeterias, used a central kitchen to prepare foods, then shipped the foods to the individual cafeterias for serving. The taxpayer argued on appeal that “the electricity and gas used in the central kitchen during the audit period qualified for exemption from sales tax.”<sup>18</sup> After an examination of the history underlying taxation of gas or electricity used in food preparation, the court determined that food preparation in the central kitchen was part of a continuous stream of activities to produce food ready for consumption at Furr’s Cafeterias. As a result, the court held that the gas and electricity used in the central kitchen during the audit period was taxable.<sup>19</sup>

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12. *GATX Terminals Corp.*, 78 S.W.3d at 632.

13. 34 TEX. ADMIN. CODE § 3.357 (West 2002).

14. *Id.* § 3.357(a)(7).

15. *See, e.g.*, Tex. Comp. Pub. Acc’ts, Hearing No. 28,468, 1992 Tex. Tax. LEXIS 376 (Nov. 2, 1992); Tex. Comp. Pub. Acc’ts, Hearing No. 30,911 (Feb. 10, 1998).

16. 34 TEX. ADMIN. CODE § 3.357(a)(8), (11) (West 2002).

17. *Cafeteria Operators, L.P. v. Rylander*, 96 S.W.3d 460 (Tex. App.—Austin 2002, pet. filed).

18. *Id.* at 460.

19. *Id.* at 463. This opinion was substituted for the July 26, 2002, opinion and judgment, *Cafeteria Operators, L.P. v. Rylander* (Tex. App.—Austin July 26, 2002, no pet.) (not designated for publication), 2002 Tex. App. LEXIS 5398, which included a less thorough discussion of the relevant legislative history.

As during every Survey period, administrative hearings addressed a wide variety of topics, many of which are of limited interest; however, several administrative decisions deserve discussion. In Hearing Number 39,933,<sup>20</sup> the taxpayer paid for certain improvements to a facility pursuant to lump-sum contracts. The facility had been owned previously but had never been finished out for its intended use as a manufacturing facility. A previous lessee had used the facility for storage but, pursuant to its lease, was prohibited from using the HVAC system or fire sprinkler system. The taxpayer argued that the improvements were new construction because the facility, even though actually occupied, had not previously been used for manufacturing. The Administrative Law Judge (“ALJ”) disagreed and held that the improvements were taxable nonresidential repair and remodeling based on the fact that the improvements were not the initial finish out work and did not add additional square footage. The taxpayer also did not succeed in arguing that its purchases of manufacturing equipment, including replacement parts, and cranes qualified for the manufacturing exemption. The ALJ concluded that when this machinery is used to re-manufacture items for customers, those items are not held “for ultimate sale” because title to the remanufactured item always remains with the customer. Consequently, the taxpayer’s use of manufacturing equipment and cranes to remanufacture such items was held to be a divergent use not eligible for the manufacturing exemption.

Several other administrative hearings also addressed the manufacturing exemption.<sup>21</sup> In Hearing Number 40,495,<sup>22</sup> for example, the taxpayer, who manufactured concrete blocks, argued that several pieces of equipment were eligible for the manufacturing exemption. The ALJ sided with the Administrative Hearings Section (“AHS”) interpretation of the exceptions to the manufacturing exemption, rendering all of the equipment in question taxable. First, a conveyor, chain elevator, rotating finger transfer car, lowerator, rail set, and dynamic buffer were found to be taxable as intraplant transportation equipment and not part of the same piece of exempt equipment. The conveyor was not considered part of a larger piece of equipment because the purchase contract listed the conveyor separately from the equipment to which it delivered materials.<sup>23</sup>

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20. Tex. Comp. Pub. Acc’ts, Hearing No. 39,933 (May 30, 2002).

21. See, e.g., Tex. Comp. Pub. Acc’ts, Hearing No. 39,419, 2002 Tex. Tax LEXIS 102 (Nov. 19, 2002); Tex. Comp. Pub. Acc’ts, Hearing No. 38,260 (Nov. 20, 2002); Tex. Comp. Pub. Acc’ts, Hearing No. 40,299 (July 24, 2002); see also Tex. Comp. Pub. Acc’ts, Hearing No. 41343, 2002 Tex. Tax LEXIS 46 (July 18, 2002), and Tex. Comp. Pub. Acc’ts, Letter No. 9907557L (July 8, 1999) (Alas, not only do french fries contribute too many calories and fat grams to the American diet, they apparently also create confusion in the tax world; the taxpayer in this hearing asserted that a letter from the Tax Policy Division of the Comptroller’s office suggested the exact opposite outcome).

22. Tex. Comp. Pub. Acc’ts, Hearing No. 40,495 (Oct. 10, 2002).

23. Fact-sensitive inquiries into the language of contracts affected sales tax decisions in other contexts as well. The decision in Tex. Comp. Pub. Acc’ts, Hearing No. 37,948 (July 3, 2002), hinged on specific language in certain subcontractor contracts that showed sales tax was included in the contracts. In that decision, the judge found that the provision within the sales contract for “all Federal, state, county, municipal and other taxes imposed by law

Other equipment items failed to qualify for exception because the ALJ viewed them as components of a kiln, which is not considered one piece of equipment but a room or building in which equipment resides. Second, the ALJ concluded that a hydronix system that tested raw materials outside the plant was taxable because activity prior to entry into the plant does not qualify as part of the actual manufacturing process. Finally, the ALJ also held taxable a mixer platform that supported several pieces of exempt manufacturing equipment, reasoning that because it holds several pieces of exempt equipment, it cannot be a part or component of any one piece of equipment. The ALJ viewed the platform as more similar to realty than personalty, and thus, non-exempt.

Hearing Number 40,243<sup>24</sup> also addressed the manufacturing exemption, focusing again on a cement manufacturer. In the process of manufacturing cement, the taxpayer operated kilns that were partially fueled by a tire recycling system. The taxpayer argued that the purchase and installation of the tire recycling system qualified for the manufacturing exemption. The ALJ found that equipment purchased before October 1, 1997 was exempt as it either powered the kilns and was part of the manufacturing process or alternatively made powering the kilns possible and was exempt under the “one step removed from manufacturing” test. Equipment purchased after October 1, 1997 was subject to a different standard and was not exempt since it did not make or cause a physical or chemical change to the cement.

In Hearing Number 40,939,<sup>25</sup> the taxpayer, who had retail stores in Texas, contended that the distribution of catalogs at its direction by a third party to residents of Texas was not subject to use tax. The ALJ, relying on Rule 3.346,<sup>26</sup> concluded that “use” includes the purchase of catalogs delivered into Texas at the taxpayer’s direction. The fact that shipment occurred outside of Texas and that the taxpayer did not technically hold title to the catalogs in Texas was not relevant to the Comptroller, who held that a taxable use occurred when the catalogs were delivered at the taxpayer’s request to Texas recipients.<sup>27</sup>

The taxpayer in Hearing Number 38,906,<sup>28</sup> licensed by the United States Postal Service to carry mail in certain areas, asserted that its aircraft qualified for the exemption allowed to certain carriers. The tax-

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or contract, and based upon labor, services, materials, equipment or other items . . . performed, furnished or used in connection with the work, including . . . sales, use, . . . taxes (including interest and penalties), whether stated separately, imposed by reason of performance of the Work, or any materials, equipment, labor, services or other items in connection with the Work,” combined with the fact that sales tax was separately stated in change orders to the contracts, was sufficient to prove that the contracts were sales-tax-included.

24. Tex. Comp. Pub. Acc’ts, Hearing No. 40,243 (May 9, 2002).

25. Tex. Comp. Pub. Acc’ts, Hearing No. 40,939 (May 30, 2002).

26. 34 TEX. ADMIN. CODE § 3.346 (West 2002).

27. The catalog-use-tax issue continues to appear in numerous administrative hearings and in Texas court cases.

28. Tex. Comp. Pub. Acc’ts, Hearing No. 39,806 (Nov. 13, 2001).

payer used an aircraft to transport employees and executives to service centers, contractor meetings, and contract negotiations, as well as to service areas that needed additional drivers because of excess mail volume. The taxpayer claimed that the aircraft was exempt from sales tax under Tax Code section 151.328(a)(1).<sup>29</sup> However, the ALJ concluded that because the claimant was not a licensed or certificated carrier in the business of using aircraft to transport persons or property for hire, the exemption did not apply. The ALJ also denied the claimant's contention that the aircraft was exempt under Tax Code section 151.328(a)(4),<sup>30</sup> because there was no evidence presented that the aircraft was used and registered in one certain state before taxable use in Texas.<sup>31</sup> Finally, with regard to whether the aircraft was subject to use tax under Rule 3.297,<sup>32</sup> the ALJ determined that a substantial presence must be established in another state for the aircraft to be considered hangared outside of Texas.

Several hearings continue to refine and develop issues related to taxability of services.<sup>33</sup> In Hearing Number 38,288,<sup>34</sup> taxpayers continued to test the arguments set forth in the *Raytheon* case.<sup>35</sup> The taxpayer in this hearing was hired by the United States Department of Energy (the "DOE") to manage certain facilities in Texas. The ALJ ruled that telephone services purchased by the taxpayer were exempted because the taxpayer was acting as the agent of the DOE in regard to phone services. The ALJ also found that janitorial services purchased by the taxpayer for the facilities were non-taxable as they were purchased from a third party for resale to the DOE as part of the management services provided, and a resale certificate was provided to the third party supplier.

In Hearing Number 38,961,<sup>36</sup> the taxpayer provided installation and engineering services along with the purchase of store fixtures. The taxpayer based his non-taxability argument on *Rylander v. San Antonio SMSA Ltd. Partnership*,<sup>37</sup> which made clear that multiple items, if distinct and identifiable, should be analyzed separately for sales tax purposes rather than necessarily treated as completely taxable or completely non-

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29. TEX. TAX CODE ANN. § 151.328(a)(1) (Vernon 2002).

30. TEX. TAX CODE ANN. § 151.328(a)(4) (Vernon 2002).

31. Because the ALJ found the taxpayer evidence insufficient, he did not find it necessary to reach the issue of whether the registration and use must occur in the same state; the decision appears based more heavily on desired results than on statutory interpretation.

32. 34 TEX. ADMIN. CODE § 3.297 (West 2002).

33. See, e.g., Tex. Comp. Pub. Acc'ts, Hearing No. 38,440 (Sept. 12, 2002) (surveyor services); Tex. Comp. Pub. Acc'ts, Hearing No. 41,369 (Oct. 9, 2002) (information services).

34. Tex. Comp. Pub. Acc'ts, Hearing No. 38,288 (Aug. 21, 2002).

35. Shortly after the end of the Survey period, this case was reviewed by the Court of Appeals of Texas, Third District. The Court of Appeals agreed with the District Court that the taxpayer was due a refund for purchases of overhead items charged as indirect costs to contracts with the federal government. *Strayhorn v. Raytheon E-Systems*, 2003 Tex. App. LEXIS 2522 (Jan. 30, 2003).

36. Tex. Comp. Pub. Acc'ts, Hearing No. 38,961 (Feb. 1, 2002).

37. *Rylander v. San Antonio SMSA Ltd. P'ship*, 11 S.W.3d 484 (Tex. App.—Austin 2000, no pet.). See Cynthia M. Ohlenforst et al., Taxation, Annual Survey of Texas Law, 54 SMU L. REV. 1595, 1596-98 (2001).

taxable, even if sold in a single transaction. The ALJ ruled that the services provided were not tax-exempt because the taxpayer failed to provide information showing that the services were distinct and identifiable from the purchase of the property. The taxpayer might have prevailed had it been allowed to provide evidence that such services could be purchased separately from the fixtures.<sup>38</sup>

Some of the most interesting sales tax policy interpretations appeared in ruling letters rather than in official rules or administrative cases.<sup>39</sup> Although the statutory language in section 151.346 indicates that an exemption for certain services applies to affiliated entities, “at least one of which is a corporation”<sup>40</sup> that report their income to the Internal Revenue Service (“IRS”) on a consolidated return for the year at issue, the Comptroller had taken the position in a May 2002 ruling letter that only affiliated entities formed as corporations under state law may qualify for the exemption.<sup>41</sup> In the face of substantial taxpayer insistence that the exemption was intended to apply not only to “corporations” but also to the broader category of affiliated “entities,” the Comptroller’s tax policy staff and others within the agency met with taxpayers to review the statutory language, the legislative history, and the history of the rules interpreting this exemption. The agency ultimately reconsidered its position and concluded in a letter issued in early December 2002, that the exemption provided by Tax Code section 151.346 may extend to entities that are not corporations under state law if the transaction occurs between affiliated entities recognized by the IRS as members of an affiliated group within the meaning of Internal Revenue Code §§ 1504(a) or 1504(b),<sup>42</sup> the entities actually report their income to the IRS on a single consolidated federal tax return for the year in which the transaction occurs,<sup>43</sup> and at least one member of the affiliated group is a corporation formed under state law.<sup>44</sup> The Comptroller also explicitly (and correctly) concluded that “a limited partnership that checks the box to report income as a corporation for federal income tax purposes [does] qualify for the sales tax exemption if that limited partnership reports its income on a single consolidated federal income tax return with other affiliated entities.”<sup>45</sup> A limited liability company that is a disregarded entity for federal income tax purposes may also qualify for the exemption. This ruling illustrates not only the Comptroller’s willingness to meet with industry but also her

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38. This hearing is one of the infrequent cases in which a taxpayer prevailed when challenging a sample audit in an administrative hearing.

39. TEX. TAX CODE ANN. § 151.346 (Vernon 2002).

40. The services eligible for exemption under this statute are those which first became taxable in 1987, including data processing and information services as well as certain other services.

41. Tex. Comp. Pub. Acc’ts, Letter No. 200205124L (May 31, 2002).

42. 26 U.S.C. § 1504(a), (b) (2000).

43. This is the case except to the extent the affiliated entities are excluded from filing on a consolidated return under 26 U.S.C. § 1504(b).

44. Tex. Comp. Pub. Acc’ts, Letter No. 200212621L (Dec. 9, 2002).

45. *Id.*



willingness to reverse agency policy in order to reach the correct conclusion. The agency continues to deny the exemption to a partnership that reports its income to the IRS on Form 1065, although technically such an entity would also fall within the statutory language of section 151.346.<sup>46</sup>

Another recent ruling<sup>47</sup> offers guidance to radio and television broadcast stations that intend to take advantage of the statutory exemption for the purchase of certain FCC-required digital equipment, including digital transmission equipment.<sup>48</sup>

A September 24, 2002, ruling<sup>49</sup> confirms the policy expressed in a prior ruling<sup>50</sup> that a direct pay permit holder would owe no Texas use tax if it purchases equipment in Texas, stores it in Texas and then ships it out of the state. The letter explains that a direct pay permit holder agrees to accrue or pay use tax on all of its purchases, may purchase and store a taxable item in Texas, and may subsequently ship the taxable item out of state “prior to any use other than storage.”<sup>51</sup> In that circumstance, the direct pay permit holder does not owe any use tax on the taxable item. The taxability ruling further notes that “[w]hat is relevant in determining whether a direct pay permit holder owes tax is first *use* not first *storage*.”<sup>52</sup>

A May 6, 2002, letter offers a recent example of the Comptroller’s efforts to determine fairly how items should be taxed when taxable and non-taxable items are sold together.<sup>53</sup> This letter involved the sale of non-taxable food products such as coffee and fruit with taxable items such as decorative tents and baskets. The Comptroller points out that the taxability of the complete product “is determined by the ‘essential nature’ of the product.”<sup>54</sup> This particular letter seems to focus on the cost factor; the letter points out that if the “taxable items are not the primary component (predominant cost factor) of the package the entire sales price of the package is exempt.”<sup>55</sup> Note, however, that if the portion that is resold is treated as non-taxable on the resale, then the seller must pay tax on the taxable components of the items at the time the seller purchases them.<sup>56</sup>

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46. *Id.*

47. Tex. Comp. Pub. Acc’ts, Letter No. 200212663L (Dec. 30, 2002). Although this ruling was not published until after the Survey period, the Comptroller had orally confirmed the conclusions set forth in the letter much earlier. In addition to answering several questions about the exemption for digital equipment, the ruling letter includes a non-exhaustive list of examples of equipment that can qualify for the exemption.

48. See TEX. TAX CODE ANN. § 151.3185 (Vernon 2002).

49. Tex. Comp. Pub. Acc’ts, Letter No. 200209450T (Sept. 24, 2002).

50. Tex. Comp. Pub. Acc’ts, Letter No. 9505167L (May 5, 1995). This document comprises a response to a question posed by a Comptroller employee with respect to appropriate treatment of a taxpayer.

51. Tex. Comp. Pub. Acc’ts, Letter No. 200209450T (Sept. 24, 2002) (emphasis added).

52. *Id.*

53. Tex. Comp. Pub. Acc’ts, Letter No. 200205051L (May 6, 2002).

54. *Id.*

55. *Id.*

56. This ruling also notes that admissions to food tasting parties are taxed as sales of food – just in case you were wondering.

Multiple letters address the apparently neverending quest to determine what services are taxable under Texas law. Because many of these rulings are fact-specific and because, unfortunately, they do not always present a consistent analysis, it remains unclear which services are taxable and which are not. Several letters, which address different fact patterns involving security services, point out that the “Board of Private Investigators and Private Security Agencies requires persons that perform investigations in Texas to be licensed,” and then conclude that services provided by licensed providers are generally taxable security services.<sup>57</sup> Unfortunately, the Comptroller’s auditors sometimes make the error of concluding that any service provided by a company with a security license is a taxable service rather than analyzing the taxability of the services provided. A letter dated December 11, 2001,<sup>58</sup> which states that drafting work performed for attorneys in preparation of a patent filing is a taxable service, appears to overlook the “essence of the transaction test,” and is in some respects inconsistent with the ruling noted above regarding food baskets.<sup>59</sup> In addition, the December letter illustrates the difficulty both taxpayers and the Comptroller’s staff face in determining at what point “the use of a computer” makes a service taxable. At the time data processing and information services first became taxable in 1987, many of the services currently provided on a routine basis were simply not available. It is interesting, and encouraging, to note that in her more recent rulings and conversations, the current Comptroller, Carol Keeton Strayhorn, and her staff recognize that the use of a computer in connection with providing a service should not result in automatically characterizing the services as taxable—although that message has not yet traveled to all the Comptroller’s auditors, attorneys and judges.

#### B. REGULATORY DEVELOPMENTS

The Comptroller amended several sales tax rules during the Survey period, although many of the rule revisions reflect recent legislative changes rather than significant policy changes in the Comptroller’s office. Rule 3.300 is one of the most significant of the revised rules.<sup>60</sup> This rule implements the significant changes enacted by the 2001 Legislature with respect to the divergent use of manufacturing equipment that occurs on or after October 1, 2001.<sup>61</sup> The rule includes a formula that determines, based on either output or hours, the appropriate measure of tax. The rule further confirms that no tax is due if the divergent use occurs in any month after the fourth anniversary of the equipment’s purchase. (The

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57. See, e.g., Tex. Comp. Pub. Acc’ts, Letter No. 200203839L (Mar. 4, 2002).

58. Tex. Comp. Pub. Acc’ts, Letter No. 200112685L (Dec. 11, 2001) (another ruling which concluded that drafting work performed for attorneys in preparation of the patent filing is a taxable service and might—“when the computer is utilized”—become taxed as data processing services).

59. See *supra* note 55 (food basket footnote) and accompanying text.

60. 27 Tex. Reg. 6537 (July 23, 2002) (codified at 34 TEX. ADMIN. CODE § 3.300).

61. See TEX. TAX CODE ANN. § 151.3181 (Vernon 2002).

amount of the divergent use is based on a forty-eight month phasing-out period.)

The Comptroller also adopted amendments to Rule 3.286<sup>62</sup> to implement changes made to section 151.052<sup>63</sup> of the Tax Code that allow a printer to accept a multi-state exemption certificate from a purchaser when the printed materials are produced by a website or rotogravure printing processes and materials are delivered by the printer to either a fulfillment house or the United States Postal Service for distribution to third parties located both inside and outside of Texas. Other sales tax rule changes relate to criminal offenses and penalties as well as processing returns and forms electronically.<sup>64</sup> The Comptroller also amended Rule 3.302 regarding accounting methods, credit sales, bad debt deductions, repossessions, interest on sales tax, and trade-ins.<sup>65</sup> Note that subsection (h)(1) of this amended rule provides that tax paid on account that subsequently becomes a bad debt will not be considered tax paid in error and will not accrue interest under section 111.064.<sup>66</sup> The Comptroller also amended rules concerning water-related exemptions,<sup>67</sup> Texas emissions plan reduction surcharge,<sup>68</sup> off-road heavy-duty diesel construction equipment,<sup>69</sup> tax exempt organizations,<sup>70</sup> and taxpayer's bond or other security.<sup>71</sup> Several services rules were also amended, including those with respect to debt collection services,<sup>72</sup> real property services,<sup>73</sup> and non-residential real property repair, remodeling and real property maintenance.<sup>74</sup>

Although the Comptroller issued a draft version of revisions to Rule 3.330<sup>75</sup> to distinguish between taxable data processing and non-taxable internet advertising, the rule had not yet been officially proposed by the end of this Survey period, perhaps because the distinction between taxable and non-taxable is so difficult to define.

The Comptroller is also working on several draft rules, including a new version of the telecommunications rule, as she seeks to adopt by formal regulation her policy with respect to certain telecommunications receipts.<sup>76</sup>

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62. 27 Tex. Reg. 8952 (Sept. 20, 2002) (codified at 34 TEX. ADMIN. CODE § 3.286).

63. TEX. TAX CODE § 151.052 (Vernon 2002)

64. *See, e.g.*, 27 Tex. Reg. 4723 (May 31, 2002) (codified at 34 TEX. ADMIN. CODE § 3.281) (addressing required records and information reflected of changes to TEX. TAX CODE ANN. § 151.025 (Vernon 2002)).

65. 27 Tex. Reg. 10744 (Nov. 15, 2002) (codified at 34 TEX. ADMIN. CODE § 3.302).

66. TEX. TAX CODE ANN. § 111.064 (Vernon 2002).

67. 27 Tex. Reg. 9386 (Oct. 9, 2002) (codified at 34 TEX. ADMIN. CODE § 3.318).

68. 27 Tex. Reg. 2051 (Mar. 19, 2002) (codified at 34 TEX. ADMIN. CODE § 3.320).

69. 27 Tex. Reg. 2051 (Mar. 19, 2002) (codified at 34 TEX. ADMIN. CODE § 3.320).

70. 27 Tex. Reg. 11160 (Dec. 2, 2002) (codified at 34 TEX. ADMIN. CODE § 3.322).

71. 27 Tex. Reg. 6537 (July 23, 2002) (codified at 34 TEX. ADMIN. CODE § 3.327).

72. 27 Tex. Reg. 9386 (Oct. 9, 2002) (codified at 34 TEX. ADMIN. CODE § 3.354).

73. 34 TEX. ADMIN. CODE § 3.356.

74. 27 Tex. Reg. 947 (eff. Feb. 17, 2002) (codified at 34 TEX. ADMIN. CODE § 3.357).

75. 34 TEX. ADMIN. CODE § 3.330 (data processing).

76. 34 TEX. ADMIN. CODE § 3.344 (West 2002).

## II. FRANCHISE TAX

## A. APPLICATION OF THE TAX

*Universal Frozen Foods Co. v. Rylander*<sup>77</sup> affirmed the trial court's holding that the "additional tax" is valid.<sup>78</sup> The court ruled that the issue of validity is controlled by *Rylander v. 3 Beall Brothers 3, Inc.*,<sup>79</sup> in which the same court concluded that the additional tax is constitutional despite the fact that fiscal year taxpayers may pay more tax than calendar year taxpayers. *Universal Frozen Foods Co.* attempted to distinguish itself, relying on *Bullock v. Sage Energy Co.*,<sup>80</sup> because it did not make an election to be a fiscal year taxpayer, but rather was a fiscal year taxpayer by virtue of the fact that its parent corporation used a fiscal year. However, the court concluded that, because the parent corporation was a fiscal year taxpayer as the result of a voluntary election, rather than an involuntary imposition by the Comptroller or other governmental authority, *Beall Brothers* controlled. Universal further argued that the earned surplus used to calculate its additional tax was improper because the gain from the sale of its assets was reported by its parent corporation. Universal joined in the filing of a consolidated return with its parent corporation throughout its existence. Upon the sale of Universal's stock, an Internal Revenue Code § 338 election was made to treat the sale of stock as a deemed asset sale. Universal asserted that because the gain on the deemed asset sale was ultimately reported by the parent corporation on the consolidated return, it should not have been included in Universal's earned surplus. The judge rejected this argument, based on his conclusion that it contradicts the plain meaning of Tax Code section 171.110(h), which prohibits consolidated reporting.<sup>81</sup>

As noted earlier, in *Beall Brothers*<sup>82</sup> the court found application of the "additional tax," enacted in 1991, constitutional. *Rylander v. Palais Royal, Inc.*,<sup>83</sup> relates to Beall's August 2, 1993, cessation of business in Texas for franchise tax purposes due to its merger with Palais Royal. As the court points out, because of its fiscal year, Beall's first tax report following the 1991 franchise tax amendments was due on May 15, 1992, and according to the Comptroller, Beall was required to report its franchise tax based in part on income earned in 1990, whereas a calendar year taxpayer would have been obligated to include only 1991 income in its report year. After paying the disputed tax under protest, Beall filed suit for

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77. *Universal Frozen Foods v. Rylander*, 78 S.W.3d 588 (Tex. App.—Austin 2002, no pet.).

78. TEX. TAX CODE ANN. § 171.0011 (Vernon 2002).

79. *Rylander v. 3 Beall Bros. 3, Inc.*, 2 S.W.3d 562 (Tex. App.—Austin 1999, pet. denied).

80. *Bullock v. Sage Energy Co.*, 728 S.W.2d 465 (Tex. App.—Austin 1987, writ ref'd n.r.e.).

81. TEX. TAX CODE ANN. § 171.110(h); See also, 34 TEX. ADMIN. CODE §3.555(e) (West 2002).

82. *3 Beall Bros. 3, Inc.*, 2 S.W.3d at 562.

83. *Rylander v. Palais Royal, Inc.*, 81 S.W.3d 909 (Tex. App.—Austin 2002, pet. denied).

a refund. The district court concluded, somewhat surprisingly in view of prior cases involving the additional tax, that the earned surplus amendments were unconstitutional as applied to Beall and that Beall was entitled to a business loss carryover.<sup>84</sup> The appeals court reversed the district court's holding on this issue and found that: (1) the additional tax statute was not unconstitutional; (2) the earned surplus amendments do not conflict with state or federal retroactivity laws or due process provisions; and (3) Beall should not be allowed a portion of the business loss carryover for its 1992 report year as if it had been a calendar year taxpayer.<sup>85</sup> In summary, the court held that "the earned-surplus amendments are constitutional. There is nothing in the tax code indicating that a business-loss carryover should be calculated for a period different from that for which the earned surplus is calculated."<sup>86</sup>

Although not a Texas case, *Sherwin-Williams Co. v. Commissioner*<sup>87</sup> merits reference. In reversing the holding of the appellate tax board, the Massachusetts Supreme Judicial Court<sup>88</sup> held that Sherwin-Williams should be entitled to deduct royalties and interest it had paid to its Delaware affiliates. The court concluded that the appellate board had "erred when it found that the transfer and licensing back transactions between Sherwin-Williams and its subsidiaries were without economic substance and therefore a sham."<sup>89</sup> Although Massachusetts law differs from Texas law, a taxpayer victory in the face of state efforts to minimize or eliminate deductions for expenses paid to affiliated companies is worth at least a quick mention.

Hearing Number 41,114<sup>90</sup> involved a multi-media entertainment retail seller of books, music, software videos, DVDs, and periodicals. The taxpayer filed an amended franchise tax report for 1997 seeking to correct accounting errors that understated its cost of goods sold. The taxpayer asserted that the accounting changes were required by the Securities and Exchange Commission ("SEC") and should be taken into account for franchise tax purposes. The taxpayer therefore filed an amended report prior to the expiration of the four-year statute of limitations. The Comptroller rejected the amended return and claim for refund because the pro forma numbers from the accounting period ending January 31, 1996, did not actually appear on an amended 1996 federal income tax return. Since the statute of limitations had expired for filing an amended federal income tax return, the taxpayer was prevented from amending its federal return. The AHS argued that "any amendments to a Texas franchise tax report must be based on a final adjustment to the taxpayer's relevant

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84. However, the district court granted the Comptroller's motion for summary judgment with respect to the officer and director compensation add-back issue.

85. *Palais Royal, Inc.*, 81 S.W.3d at 916-17.

86. *Id.* at 917.

87. *Sherwin-Williams Co. v. Comm'r*, 778 N.E.2d 504 (Mass. 2002).

88. *Id.*

89. *Id.* at 508.

90. Tex. Comp. Pub. Acc'ts, Hearing No. 41,114 (June 28, 2002).

federal income tax return” and that because the franchise tax numbers were not based on an amended federal tax return, they would not be accepted.<sup>91</sup> Because the Tax Code requires that earned surplus calculation begin with a determination of “reportable federal taxable income,”<sup>92</sup> the taxpayer could argue that the correct number was the “reportable” number. The taxpayer unsuccessfully argued that section 171.110(a)(1)<sup>93</sup> allows a change if one is mandated by an audit or other adjustment by “another competent authority,” which, according to the taxpayer, should include the SEC. Interestingly, the AHS, according to the opinion, insisted that the taxpayer’s amended report could not be accepted because the earned surplus figures were based on federal taxable income that had not been reported to the IRS. However, in certain other contexts, taxpayers are not only permitted to base their earned surplus on amounts that have not been reported on a federal income tax return, but are (for example, in the context of an S corporation) *required* to report numbers that are not reported on a federal tax return.

Hearing Number 41,242<sup>94</sup> involved a taxpayer in a software vending business that sought to take advantage of a net operating loss incurred by a Hawaii corporation. As the decision notes, the record is unclear as to whether the Hawaii corporation was merged into the taxpayer, but the ALJ concluded that such a finding was unnecessary to resolve the case. The Comptroller’s interpretation of the applicable law was that the business loss of one corporation cannot be transferred to another even when a merger is involved. The Comptroller, therefore, denied the taxpayer’s claim for a refund based on business losses from the Hawaii corporation, noting that the Hawaii corporation had officially terminated its existence and that the petitioner-taxpayer had separately been incorporated thereafter. More interesting than this conclusion from the administrative law judge is the following comment:

Possibly, the [Hawaii] Corporation could have been converted from a Hawaii corporation to a Texas corporation pursuant to TEX. BUS. CORP. ACT § 5.17 to satisfy Petitioner’s business objectives and preserve the business losses. However, that was not done. The [Hawaii] Corporation’s existence was terminated, and separately Petitioner’s existence was created . . . .<sup>95</sup>

The suggestion that a conversion might have permitted the business losses to be preserved is consistent with another Comptroller letter<sup>96</sup> confirming that a corporation that converts to a Texas limited liability company, and then converts to a Nevada limited liability company, will be able to use the Texas business loss carryover of the pre-conversion

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91. *Id.*

92. *Id.*

93. TEX. TAX CODE ANN. § 171.110(a)(1) (Vernon 2002).

94. Tex. Comp. Pub. Acc’ts, Hearing No. 41,242 (June 24, 2002).

95. *Id.*

96. See Tex. Comp. Pub. Acc’ts, Letter No. 200206204L (June 21, 2002).

corporation.<sup>97</sup>

Comptroller Hearing Number 40,611<sup>98</sup> focused on a taxpayer's contention that its "reportable federal taxable income" should take into account certain adjustments to the basis of its depreciable assets when the taxpayer first becomes subject to the federal income tax. The taxpayer asserted that because Texas "like other states, has adopted federal tax law into its statutes regarding earned surplus computation, the 'federal basis' adjustment under 1.1016-4 should apply to the earned surplus computation."<sup>99</sup> The taxpayer asserted that Texas should follow the California course of allowing a taxpayer to adjust the amount of its gain for depreciable assets sold during a report period. The ALJ determined, however, that Texas statutes, unlike California statutes, do not specifically incorporate § 1016 and that the California decision was therefore inapplicable.<sup>100</sup>

As in past years, ruling letters address multiple key issues. Letters issued during the Survey period confirm that net operating losses will survive sequential conversions,<sup>101</sup> and set forth the Comptroller's determination that transporting electricity is a service, sourced for gross receipts purposes to the location where the services are performed, but that sales of electricity are sales of tangible personal property and therefore sourced to the delivery location.<sup>102</sup> In an interesting pair of letters, the Comptroller concluded that a taxpayer whose business cards have a local address and phone number may not qualify for protection from the earned surplus tax by reason of Public Law 86-272,<sup>103</sup> but that "merely handing out business cards with a salesperson's local telephone number, *without a local address,*" would not cause a taxpayer to lose Public Law

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97. Because of the popularity of conversions in the context of state tax planning, it remains important to confirm the federal income tax treatment of such transactions. The check-the-box regulations (Treas. Reg. § 301.7701-2 (as amended in 1999) and § 301.7701-3 (as amended in 2001), which enable certain business entities to elect how they will be characterized for federal tax purposes) accord significant flexibility on the federal income tax side. Nonetheless, federal tax issues cannot be ignored, and the IRS eased many minds this year by issuing F.S.A. 200237017 in which the National Office confirmed that in certain instances a corporation that (i) converted into a limited partnership and then (ii) elected under check the box regulations to treat the state law partnership as a corporation for federal tax purposes could be treated as if it had effected a tax-free reorganization under 26 U.S.C. § 368(a)(1)(F) (2000). *See also* Op. Tex. Att'y Gen. No. GA-0007 (2003) (concluding that a converted corporation or limited partnership must apply for an amended bingo license to the extent the name or address of the converted entity differs from that of the original entity). Although this ruling focuses on bingo, it is a useful reminder that there are many circumstances in which Texas licensing or other legal considerations will be affected by a conversion.

98. Tex. Comp. Pub. Acc'ts, Letter No. 40,611 (Sept. 27, 2002).

99. *Id.*

100. Taxpayers and the Comptroller continue to struggle with determining when and to what extent federal income tax principles control franchise tax, a task made even more difficult by the fact that the current Texas Tax Code references the Internal Revenue Code as in effect for the tax year beginning on or after Jan. 1, 1996, and before Jan. 1, 1997, and the regulations applicable to that period instead of the current IRC.

101. Tex. Comp. Pub. Acc'ts, Letter No. 200206204L (June 21, 2002).

102. Tex. Comp. Pub. Acc'ts, Letter No. 200202819L (Feb. 25, 2002).

103. Tex. Comp. Pub. Acc'ts, Letter No. 200210497L (Oct. 8, 2002); Pub. L. No. 86-272, 73 Stat. 555 (1959) (codified as amended in 15 U.S.C. §§ 381-84 (2000)).

86-272 protection.<sup>104</sup> The Comptroller also ruled that a limited liability company that is treated as a disregarded entity for federal income tax purposes is entitled to an exemption from the franchise tax on the grounds that it is deemed to be tax exempt because it is considered a part of its tax exempt parent.<sup>105</sup>

## B. REGULATORY DEVELOPMENTS

The Comptroller adopted only a few changes to the franchise tax rules this year. In the franchise tax area as in the sales and administrative areas, the Comptroller sought to clean up and modify rules to take into account legislative changes and to state more clearly Comptroller policy. She proposed changes to Rule 3.557<sup>106</sup> concerning the apportionment of earned surplus. As proposed, the rule amendments add definitions and additional information concerning legal domicile and location of payor; if amended as proposed, the rule would also make explicit that taxable income for federal income tax purposes may differ from reportable federal tax income for franchise tax purposes to the extent that the Internal Revenue Code, upon which the Franchise Tax Code relies, is different from the currently effective Internal Revenue Code. The Comptroller also adopted an amendment to Rule 3.560<sup>107</sup> and amendments concerning franchise tax credits<sup>108</sup> and Rule 3.580.<sup>109</sup>

## III. PROPERTY TAX

### A. APPLICATION OF THE TAX/EXEMPTIONS

In *Dallas Central Appraisal District v. Wang*,<sup>110</sup> the Dallas Court of Appeals added to the reasons that it is “buyer beware” with respect to real property sales. The property at issue, a residence, was owned by a Mr. Vines until his death in August 1998.<sup>111</sup> Mr. Vines rightfully claimed the over-65 and homestead exemptions on the property in 1998, but these exemptions were incorrectly carried over to the 1999 tax year.<sup>112</sup> The Wangs purchased the residence in August 1999; in connection with the closing, the Wangs’ title company obtained a certificate from a private entity showing no property taxes were due on the residence.<sup>113</sup> Several months after the Wangs acquired the residence, the appraisal district noti-

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104. Tex. Comp. Pub. Acc’ts, Letter No. 200210497L (Oct. 8, 2002) (emphasis added).

105. However, the LLC is qualifying as a tax exempt entity on the basis of its sole member and not as an organization that has itself applied for and received its own letter of determination from the IRS and is therefore not eligible for a sales tax exemption.

106. 27 Tex. Reg. 6812 (Aug. 2, 2002) (codified at 34 TEX. ADMIN. CODE § 3.557).

107. 27 Tex. Reg. 10746 (July 12, 2002) (codified at 34 TEX. ADMIN. CODE § 3.560).

108. See 27 Tex. Reg. 6325 (July 12, 2002) (codified at 34 TEX. ADMIN. CODE § 3.579-.580 (credit for hiring the disabled)).

109. 27 Tex. Reg. 6324 (July 17, 2002) (codified at 34 TEX. ADMIN. CODE § 3.569).

110. *Dallas Cent. Appraisal Dist. v. Wang*, 82 S.W.3d 697 (Tex. App.—Dallas 2002, no pet.).

111. *Id.* at 699.

112. *Id.*

113. *Id.*



fied the Wangs of the district's intent to remove the exemptions for the 1999 year and back-appraise the residence to add this taxable value to the 2000 tax year roll.<sup>114</sup> The Wangs asserted that this tax lien was unconstitutional; the essence of their argument was that the Texas Constitution prohibits taxpayers from being burdened by tax liabilities of previous owners.<sup>115</sup>

Although the appellate court repeatedly stated that its ruling produces a harsh, inequitable result to the Wangs, the court reversed the trial court and held that the back-appraisal of taxes on the Wangs' property does not violate the Texas Constitution.<sup>116</sup> The appellate court first concluded that the appraisal district was required to assess the residence for the improperly granted exemption once the district discovered that taxable property had escaped taxation.<sup>117</sup> Given that the appraisal district made this determination in late 1999, the appraisal district's only choice was to add the taxable value to the 2000 tax rolls.<sup>118</sup> Although the 2000 tax year started after the Wangs acquired the residence, the court reasoned that the lien for these taxes existed on January 1, 1999, before the Wangs acquired the residence, and thus the lien for the back-taxes followed the residence into the Wangs' hands.<sup>119</sup> Moreover, the court noted that the Wangs could have averted this liability by obtaining, before purchase, a tax certificate from the relevant taxing units (not from a private company) showing no taxes due; by failing to do so, the Wangs assumed the risk.<sup>120</sup>

Finally, the court examined the Wangs' argument that the lien on the residence violated Article VIII, section 15 of the Texas Constitution,<sup>121</sup> which the Wangs asserted allows only the delinquent taxpayer's property to be sold to pay delinquent taxes. Article VIII, section 15 provides that (1) a tax lien attaches annually to real property for assessed taxes; (2) the taxing unit can sell all of a delinquent taxpayer's property to pay delinquent taxes; and (3) "such property may be sold for the delinquent taxes owed."<sup>122</sup> The Wangs asserted that "such property" refers only to property in category (2) above, and thus implicitly disallows the sale of property not owned by the delinquent taxpayer. The court rejected this argument, holding that "such property" refers to property in categories (1) and (2) above.<sup>123</sup>

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114. *Id.*

115. TEX. CONST. art. VIII, § 15.

116. *Wang*, 82 S.W.3d at 706.

117. *Id.*

118. *Id.*

119. *Id.* at 703. Back-appraised value is added to the current year's tax roll and does not retroactively change the tax rolls for the year or years in which the exemption was improperly granted. See TEX. TAX CODE ANN. § 25.21 (Vernon 2002).

120. *Wang*, 82 S.W.3d at 704.

121. TEX. CONST. art. VIII, § 15.

122. *Wang*, 82 S.W.3d at 704.

123. *Id.* The court acknowledged that its holding puts transferees in a very difficult position in having to defend exemptions granted to their predecessors, and even states that the results can be draconian. *Id.* at 702. Because the Wangs did not raise the type of arguments that would allow the court to consider these issues, the court stated that it could

The Austin Court of Appeals in *Gables Realty Ltd. Partnership v. Travis Central Appraisal District*<sup>124</sup> considered the often perplexing issue of taxation of government-owned property leased to a private entity. In this case, the land at issue was owned by government entities, and was leased to Gables Realty, a non-governmental entity.<sup>125</sup> Gables Realty then constructed apartments on the leased property.<sup>126</sup> The lease provided that Gables Realty would pay all property taxes on the property.<sup>127</sup> The use of the property for apartments was a commercial, non-public purpose; thus, the government entities were not entitled to an exemption under section 11.11<sup>128</sup> for public property used for a public purpose. Gables Realty asserted that the land should be (a) listed in the name as Gables Realty, and (b) appraised under section 25.07<sup>129</sup> at the market value of its leasehold interest in the land, rather than the land's market value.<sup>130</sup>

Section 25.07 provides, *inter alia*, that a leasehold interest in real property that is exempt to the owner shall be listed in the name of the lessee.<sup>131</sup> Section 23.13<sup>132</sup> provides that such leasehold interest is valued at (a) the market value of the leasehold (which would be zero if the rent is at least at market rates), but may not be less than the total rent paid for the leasehold interest for the relevant year.<sup>133</sup> The court rejected Gables Realty's position because the court concluded that section 25.07 applies only if the property is exempt to the owner; thus, because the governmental entities were not eligible for an exemption on the land at issue due to its commercial use, section 25.07 could not apply to the land.<sup>134</sup> The end result under this decision is that the land is taxed at full market value to the governmental entities, but that Gables Realty is required to pay such taxes under the terms of the lease.

*Panola County Appraisal District v. Panola County Fresh Water Supply*

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not consider these issues. *Id.* The court strongly intimated, however, that had these issues been raised, the result would have been different. *Id.*

124. *Gables Realty Ltd. P'ship v. Travis Cent. Appraisal Dist.*, 81 S.W.3d 869 (Tex. App.—Austin 2002, pet. denied).

125. *Id.* at 870.

126. *Id.*

127. *Id.*

128. TEX. TAX CODE ANN. § 11.11 (Vernon 2002).

129. *Id.* § 25.07.

130. *Gables Realty*, 81 S.W.3d at 871.

131. TEX. TAX CODE ANN. § 25.07 (Vernon 2002).

132. *Id.* § 23.13.

133. *Id.*

134. *Gables Realty*, 81 S.W.3d at 875. *Gables Realty* appropriately argued that language in *Univ. Christian Church v. City of Austin*, 789 S.W.2d 361 (Tex. App.—Austin 1990, no writ) supported its position. In this case, the court upheld a jury verdict that a church-owned parking lot leased to a private entity was taxable. *Univ. Christian Church*, 789 S.W.2d at 365. The court noted that the taxing units “could tax [the lessee’s] leasehold estate instead of the church’s property interest.” *Id.* In response to language that is clearly inconsistent with the holding in *Gables Realty*, the court merely notes that such language is *dictum*. *Gables Realty*, 81 S.W.3d at 875.

*District No. One*<sup>135</sup> also addresses the taxation of leasehold interests in real property owned by a tax-exempt entity, and focuses on how to value a taxed leasehold interest. In *Panola County*, the water district owned lakeside lots and leased them to private entities.<sup>136</sup> The lots were exempt in the hands of the water district but the leasehold interests were taxed to the lessees under section 25.07.<sup>137</sup> These lots apparently were highly sought; indeed, many lessees were able to sell their leaseholds for a premium (*i.e.*, the purchaser assumed the lease payments and paid the seller an up-front cash payment to acquire the leasehold interest).<sup>138</sup> The appraisal district assigned taxable values to the leasehold interests that were greater than the yearly rent.<sup>139</sup> The water district challenged such valuations, asserting that the appraisal district had improperly included in the taxable value the water district's reversionary fee simple interest.<sup>140</sup> The trial court held in favor of the water district, concluding that the value of the leasehold interests should be based solely on the rent paid for each lot.<sup>141</sup> The court of appeals reversed the trial court, reasoning that section 23.13<sup>142</sup> does not limit the taxable value of leasehold interests to contract rent.<sup>143</sup> Indeed, section 23.13 expressly states that contract rent is the floor for taxable values, not the ceiling.<sup>144</sup> The court did, however, instruct the trial court not to treat fee simple interests as comparable to a leasehold interest.<sup>145</sup>

In *Tex-Air Helicopters, Inc. v. Galveston County Appraisal Review Board*,<sup>146</sup> the Houston Court of Appeals said in seventeen pages what others might have told the appraisal district in three words: give it up. Yet again, the appraisal district challenged the constitutionality of section 21.05;<sup>147</sup> yet again, the appraisal district lost. Section 21.05(a) provides that if a taxable commercial aircraft is used both in and out-of-state, the

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135. *Panola County Appraisal Dist. v. Panola County Fresh Water Supply Dist. No. One*, 69 S.W.3d 278 (Tex. App.—Texarkana 2002, no pet.).

136. *Id.* at 280.

137. TEX. TAX CODE ANN. § 25.07 (Vernon 2002).

138. *Panola County*, 69 S.W.3d at 280.

139. *Id.* at 281.

140. *Id.*

141. *Id.*

142. TEX. TAX CODE ANN. § 23.13 (Vernon 2002).

143. *Panola County*, 69 S.W.3d at 284-85.

144. TEX. TAX CODE ANN. § 23.13 (Vernon 2002). The court also addressed the jurisdictional issue of whether the water district had standing to challenge the taxable values of its lessees' property, given that it is not the water district that is liable for such tax. The court concluded that the water district had standing because the appraisal district attempted to place tax liens on the water district's property for unpaid taxes on the relevant leasehold interests. *Panola County*, 69 S.W.3d at 283. This logic, however, seems somewhat tortured given that the water district is not liable for the property taxes on the leasehold interests.

145. *Panola County*, 69 S.W.3d at 286. This instruction is probably technically correct; however, query whether the market value of a fee simple interest in property would be materially different than the market value of a 99-year lease of the same property.

146. *Tex-Air Helicopters, Inc. v. Galveston County Appraisal Review Bd.*, 76 S.W.3d 575 (Tex. App.—Houston [14th Dist.] 2002, pet. denied).

147. TEX. TAX CODE ANN. § 21.05 (Vernon 2002).

appraisal district must allocate to Texas the portion of the aircraft's value that fairly reflects its Texas use.<sup>148</sup> Section 21.05(b)<sup>149</sup> provides that the portion of such value allocable to Texas is presumed to be a fraction that takes into account the number of revenue departures from Texas.<sup>150</sup> The *Tex-Air* case concerns helicopters that were situated in Texas but that regularly flew outside Texas boundaries.<sup>151</sup> The appraisal district asserted ostensibly different constitutional challenges to section 21.05 than had been argued in an earlier case in which the Texas Supreme Court held the statute to be constitutional. The appraisal district asserted that section 21.05 is constitutional only if the aircraft have a second situs other than Texas, and that in this case at hand *Tex-Air* never established a second situs for certain of its helicopters.<sup>152</sup> The court rejected this argument, reasoning that evidence was introduced at trial that each of the helicopters flew to the Outer Continental Shelf, which is not a Texas jurisdiction.<sup>153</sup>

The court also rejected the appraisal district's argument that the presumption that the allocation formula in section 21.05(b) is correct should be overridden in the facts at hand.<sup>154</sup> The court agreed that the presumption is rebuttable, but concluded that the presumption stands unless the appraisal district (or taxpayer) presents evidence to rebut the presumption.<sup>155</sup> In *Tex-Air*, the appraisal district did not present such evidence at trial.<sup>156</sup> Finally, the court rejected *Tex-Air*'s assertion that section 42.29<sup>157</sup> is unconstitutional under the Equal Protection Clause of the United States Constitution.<sup>158</sup> Section 42.29 grants taxpayers attorneys' fees in certain cases (*i.e.*, excessive appraisal claims and unequal appraisal claims), but not in cases in which the taxpayer prevails on a taxable allocation argument.<sup>159</sup> *Tex-Air* believed that it should be reimbursed for attorneys' fees in the first *Tex-Air* case because it prevailed.<sup>160</sup> The court, however, concluded that *Tex-Air* did not meet the heavy burden of challenging a statute on an equal protection basis because it did not establish

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148. *Id.* § 21.05(a).

149. *Id.* § 21.05(b).

150. *Id.*

151. *Tex-Air*, 76 S.W.3d at 578.

152. *Id.* at 584.

153. *Id.* at 585.

154. *Id.* at 588.

155. *Id.*

156. *Id.* at 589.

157. TEX. TAX CODE ANN. § 42.29 (Vernon 2002).

158. *Tex-Air*, 76 S.W.3d at 583; U.S. CONST. amend. XIV.

159. *Tex-Air*, 76 S.W.3d at 583.

160. *Id.* The appraisal district also argued again, in spite of the Texas Supreme Court holding in the first *Tex-Air* case (*Tex-Air Helicopters, Inc. v. Appraisal Review Bd. of Galveston County*, 970 S.W.2d 530 (Tex. 1998)), that section 21.05(b) is an improper exemption. *Id.* at 587. Again, the court differed, holding that the allocation formula is not an exemption but is merely a method of allocating value to Texas, citing two Texas Supreme Court cases standing for the proposition that an allocation formula is not an exemption. *Id.*; see *Enron Corp. v. Spring Indep. Sch. Dist.*, 922 S.W.2d 931, 940-41 (Tex. 1996); *Hardin v. Cent. Am. Life Ins. Co.*, 374 S.W.2d 881, 882-84 (Tex. 1964).

that the statute was irrational; rather, the Texas Legislature theoretically might reasonably have wanted to incentivize tax units to avoid unequal or excessive appraisals.<sup>161</sup>

A Houston Court of Appeals in *Stuckey Diamonds, Inc. v. Harris County Appraisal District*<sup>162</sup> addressed the determination of taxable value of inventory. Section 23.01<sup>163</sup> provides that the market value of inventory is the price for which it would sell as a unit to a purchaser who would continue the business.<sup>164</sup> The taxpayer in *Stuckey Diamonds*, a wholesaler and manufacturer of jewelry, rendered its inventory at 10% of cost.<sup>165</sup> Not surprisingly, the appraisal district valued the inventory much higher (close to cost).<sup>166</sup> At trial, the taxpayer's expert appraised the inventory at 57% of cost, but the trial court sided entirely with the appraisal district's experts, who valued the inventory at 98% of cost (cost minus a 2% discount to reflect clearance items and transportation costs).<sup>167</sup> In upholding the trial court, the court of appeals appeared to rely heavily on the appraisal district expert's statement that its research showed that most sales of jewelry inventory by companies not in financial straits were very close to cost.<sup>168</sup> Indeed, the court remarked that the best benchmark for valuing the inventory as a unit is the cost of each item.<sup>169</sup> This statement, by itself, seems inconsistent with section 23.01's requirement that inventory must be valued as if it were sold as a unit. Read in light of the appraiser's conclusion that jewelry inventory typically sells at cost, however, it probably does not mean that the best method of valuing inventory is to add up the total cost of the inventory.

In Letter Opinion JC-0571,<sup>170</sup> the Attorney General addressed whether a building owned by a municipal hospital authority and leased in part to a private entity would be exempt from property tax under Article VIII, section 2 of the Texas Constitution<sup>171</sup> and section 11.11 of the Texas Tax Code.<sup>172</sup> These provisions essentially exempt from property tax public property used for public purposes.<sup>173</sup> The Attorney General concluded that no exemption applies unless the property is used *exclusively* for public purposes, but noted that leasing a portion of the building to a private entity does not necessarily foreclose the property from meeting the public purpose test if the leased premises would continue to be used

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161. *Tex-Air*, 76 S.W.3d at 583.

162. *Stuckey Diamonds, Inc., v. Harris County Appraisal Dist.*, 93 S.W.3d 212 (Tex. App.—Houston [14th Dist.] 2002, no pet.).

163. TEX. TAX CODE ANN. § 23.01 (Vernon 2002).

164. *Id.*

165. *Stuckey Diamonds*, 93 S.W.3d at 213.

166. *Id.*

167. *Id.*

168. *Id.* at 214.

169. *Id.*

170. Op. Tex. Att'y Gen. JC-0571 (2002).

171. TEX. CONST. art. VIII, § 2.

172. TEX. TAX CODE ANN. § 11.11 (Vernon 2002).

173. *Id.*; TEX. CONST. art. VIII, § 2.

wholly for the hospital's public purposes.<sup>174</sup> The Attorney General stated that the determination of whether the particular building at issue meets the public purpose test is a facts and circumstances question that is not addressed in Attorney General opinions.<sup>175</sup> The Attorney General's most powerful conclusion, however, relates to section 262.004 of the Health and Safety Code,<sup>176</sup> which provides that hospital property is exempt from property tax because it is used for public purposes.<sup>177</sup> The Attorney General implies that the Texas Legislature cannot by statute classify property as necessarily used for a public purpose for purposes of the property tax exemption; rather, such determination must be made on a case-by-case basis.<sup>178</sup>

### B. PROCEDURE

In *City of Pharr v. Boarder to Boarder Trucking, SVC, Inc.*,<sup>179</sup> the Corpus Christi Court of Appeals held that a letter sent in 1989 by a taxpayer to the appraisal district complaining about the inclusion of tracts in the appraisal was a valid protest, not only for the 1989 year, but also for the following years.<sup>180</sup> In *Pharr*, the appraisal district taxed the taxpayer on twelve vehicles and certain other property.<sup>181</sup> The taxpayer asserted that it protested the appraisal district's determination based on the letter; the protest was denied.<sup>182</sup> The appraisal district ultimately filed suit to collect delinquent property taxes on this property for the 1989-1995 tax years.<sup>183</sup> The district court ruled that the taxpayer did not own the twelve vehicles and reduced the delinquent tax bill accordingly.<sup>184</sup> The appraisal district appealed, arguing that the district court did not have jurisdiction to address the ownership issue because the taxpayer failed to exhaust administrative remedies by failing to protest taxes due.<sup>185</sup> In rejecting the appraisal district's argument, the court reasoned that the 1989 letter served as a valid protest and that the letter was recognized as a protest by the appraisal review board because it notified the taxpayer that its protest had been denied.<sup>186</sup> Finally, the court stated that the taxpayer was not required to send a protest letter for each year given that it was the same twelve vehicles that were being taxed and challenged as not being owned by the taxpayer.<sup>187</sup>

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174. Op. Tex. Att'y Gen. JC-0571 (2002).

175. *Id.*

176. TEX. HEALTH & SAFETY CODE ANN. § 262.004 (Vernon 2002).

177. *Id.*

178. *Id.*

179. *City of Pharr v. Boarder to Boarder Trucking, SVC, Inc.*, 76 S.W.3d 803 (Tex. App.—Corpus Christi 2002, pet. denied).

180. *Id.* at 806-07.

181. *Id.* at 805.

182. *Id.*

183. *Id.*

184. *Id.*

185. *Id.* at 806.

186. *Id.*

187. *Id.* at 806-07.

A Houston Court of Appeals in *Weingarten Realty Investors v. Harris County Appraisal District*<sup>188</sup> affirmed the lower court's exclusion of the taxpayer's expert concerning unequal valuation.<sup>189</sup> In *Weingarten*, the taxpayer purchased a shopping center for \$36 million; the appraisal district appraised it for \$30 million, and the taxpayer sued based on an unequal appraisal claim.<sup>190</sup> Under section 42.26,<sup>191</sup> a property's taxable value must be reduced (even if it is appraised at market value or below) if the property is appraised unequally as compared to a reasonable and representative sample of similar properties in the appraisal district.<sup>192</sup> The taxpayer's position was based on the written opinion of its expert witness. At trial, the appraisal district prevailed on its assertion that the testimony of the taxpayer's expert should be excluded under the test for admissibility of expert witnesses set forth in *E.I. du Pont de Nemours & Co. v. Robinson*,<sup>193</sup> in which the Texas Supreme Court held that in order for expert testimony to be admissible (a) the expert must be qualified, and (b) the testimony must be relevant and be based on a reliable foundation.<sup>194</sup> The court of appeals held that the trial court did not abuse its discretion in excluding the taxpayer's expert because each of the following facts, which were made known in cross-examination of the expert, formed a satisfactory basis for the trial court to reject the expert's testimony as unreliable: (i) his "comparable properties were significantly smaller" than the subject property; (ii) 90% of the expert's "comparable properties" had per-square-foot appraised values significantly lower than that of the subject property; (iii) he used "only ten comparable properties even though there were" almost 200 shopping centers in the area; (iv) his adjustments to the "comparable properties considered only physical characteristics;" and (v) "the percentage adjustment for each characteristic of the comparable properties that differed from Champion's Village was subjective."<sup>195</sup>

The trial court also rejected the taxpayer's expert based on its conclusion that the expert's report did not comply with section 42.26(d).<sup>196</sup> Section 42.26(d) provides that the court shall grant relief based on an unequal appraisal if the appraised value of the property exceeds the median appraised value of a reasonable number of comparable properties appropriately adjusted.<sup>197</sup> The appraisal district argued that section 42.26(d) requires independent market value appraisals, which the tax-

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188. *Weingarten Realty Investors v. Harris County Appraisal Dist.*, 93 S.W.3d 280 (Tex. App.—Houston [14th Dist.] 2002, no pet.).

189. *Id.* at 282.

190. *Id.*

191. TEX. TAX CODE ANN. § 42.26 (Vernon 2002).

192. *Id.*

193. *E.I. du Pont de Nemours & Co. v. Robinson*, 923 S.W.2d 549, 556 (Tex. 1995).

194. *Id.*

195. *Weingarten Realty Investors*, 92 S.W.3d at 285-86.

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

197. *Id.*

payer's expert did not conduct.<sup>198</sup> The court of appeals rejected this conclusion, stating that the purpose of section 42.26(d) is to avoid the necessity of market-value appraisals in unequal appraisal cases.<sup>199</sup> However, the court did not reverse the trial court on this issue because it did not find that the trial court accepted the appraisal district's approach on this issue.<sup>200</sup>

#### IV. PROCEDURE

Hearing Number 39,205,<sup>201</sup> a sales tax hearing, offers an important evidentiary perspective as the ALJ recognizes that documentary proof is not always available. The taxpayer and the AHS disputed whether the taxpayer had completed a particular sale. The AHS was not satisfied with the taxpayer's internal memorandum indicating that the sale had never been completed, nor with an affidavit that the sale had never been completed because of a dispute between buyer and seller as to the scope of the project. Instead, the AHS insisted upon documentary evidence that no sale had occurred. In a tribute to common sense, the ALJ noted: "Given that Petitioner argues the sale was never completed, the Petitioner is very unlikely to have documentary evidence relating to the aborted transaction other than the defunct contract. Hence, the evidence Petitioner has presented from two individuals within its organization that the transaction was never completed is very compelling."<sup>202</sup> The decision further noted that the AHS could rebut the taxpayer's proof, but that it could not do so simply by arguing that the taxpayer must present documentary evidence.<sup>203</sup>

On September 28, 2001, the Comptroller's office, by internal memo, addressed a potential discrepancy in interpretation between its audit division's and its tax policy division's views of Tax Code section 111.206.<sup>204</sup> 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, concluded that the statute is a narrow one that extends the statute of limitations for refunds only to the extent they are related to adjustments made by regulatory agency, whereas the tax policy division took the position that section 111.206 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 statute is

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198. *Weingarten Realty Investors*, 93 S.W.3d at 283.

199. *Id.* at 286-87.

200. *Id.*

201. Tex. Comp. Pub. Acc'ts, Hearing No. 39,205 (second decision upon rehearing Aug. 20, 2002).

202. *Id.*

203. This decision is particularly noteworthy given the increasingly common insistence by some AHS attorneys that "documentary evidence" must be provided, even to prove a negative – a difficult if not impossible task in many circumstances.

204. TEX. TAX CODE ANN. § 111.206 (Vernon 2002).



subject to further challenge and questioning.<sup>205</sup>

*United Services Automobile Ass'n v. Rylander*<sup>206</sup> focuses on whether an insurance company is required to pay sales tax and certain other non-insurance taxes. Relying on the literal language of the Texas Tax Code, which provides that insurance taxes shall constitute "all taxes collectible under the laws of Texas against any such insurance carrier," and providing that "no other tax shall be levied or collected" from such insurance carriers,<sup>207</sup> USAA argued that these provisions prohibit the state from imposing other taxes, including sales taxes. USAA therefore filed a claim for refund for certain sales and use taxes, motor vehicle taxes, TIF (Telecommunications Infrastructure Fund taxes), and motor fuels taxes it had paid during a multi-year period. The state argued that USAA's interpretation would create an irreconcilable conflict between the Tax Code and the Insurance Code, and that the Tax Code does not authorize exemptions for taxes such as sales taxes by the insurance companies, so that no refund should be due. The court ultimately concluded that USAA's reliance on statutory language was not as compelling as the Comptroller's arguments, and ruled for the Comptroller.

Hearing Number 39,565<sup>208</sup> is proof that being a "large, sophisticated taxpayer" does not automatically preclude penalty waiver. Under the factual circumstances discussed in this letter, the ALJ recommended the penalty waiver be granted for the portion of the assessment related to officer and director compensation adjustment. Comptroller's Rule 1.40<sup>209</sup> provides standards for determining the circumstances in which penalty or interest should be waived. Although the list includes several factors, the Comptroller's auditors and hearings attorneys frequently asserted and prevailed on the assertion that a large sophisticated taxpayer that makes significant errors must not have exercised reasonable diligence and therefore is not entitled to penalty waiver. This case shows that taxpayers are not always on the losing side of that argument.<sup>210</sup>

The Comptroller also amended some of the tax administration rules during the Survey<sup>211</sup> period as part of the Comptroller's effort to update and bring current her rules.

## V. CONCLUSION

Figures released by the Comptroller's office shortly after the Survey period predicted a \$9.9 billion shortfall. Numbers released earlier indicated that the state would see lower than expected sales taxes and could

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205. Tex. Comp. Pub. Acc'ts, Letter No. 200109582L (Sept. 28, 2001).

206. Plaintiff's First Amended Motion for Partial Summary Judgment at 3, *United Servs. Auto Ass'n*, No. GN103414 (345th Dist. Ct. Travis County, Tex. May 13, 2002).

207. TEX. INS. CODE ANN. ART. 4.10 § 14 (Vernon Supp. 2001).

208. Tex. Comp. Pub. Acc'ts, Hearing No. 39,565 (Feb. 6, 2002).

209. 19 TEX. ADMIN. CODE § 1.40 (West 2002).

210. Just most of the time.

211. See, e.g., 34 TEX. ADMIN. CODE § 3.9 (West 2003) (concerning electronic filing of returns and reports and electronic payments).

lose several million dollars during the next budget cycle from Texas companies that have structured around the Texas franchise tax, adding momentum to lawmakers' efforts to overhaul the state's franchise tax system. Those of us who participated in the 1997 legislative session, the last session that focused heavily on proposals to extend the franchise tax to partnerships and/or corporate limited partners, know how ugly this fight can be. In response to past attacks on the structure of the franchise tax, many Texas taxpayers and legislators have correctly noted that the current franchise tax structure encourages companies to keep their headquarters, and their businesses, in Texas. This consideration, combined with the fact that the Texas Constitution prohibits an individual income tax and the "no new taxes" campaigns that so many of the legislators rely on, will make the Legislature's task of balancing the budget challenging. Additionally, the Legislature may have difficulty addressing (yet again) the myriad property tax and school funding issues that appear each session. The Legislature's approach to its budget balancing tasks, including changes made to the Texas Tax Code, will provide interesting fodder for next year's Survey.

