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TAXATION

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POLITICAL infighting—far worse than in most Texas legislative sessions—characterized the 2003 regular session, as well as the three special sessions that followed. The political turmoil impacted both substantive and procedural changes considered by the legislators in their continuing efforts to address Texas’s policy and revenue needs.¹

I. SALES TAX

A. APPLICATION OF THE TAX

A handful of cases during the Survey period dealt with sales tax issues. In *Strayhorn v. Raytheon E-Systems, Inc.*, Raytheon sought a refund for sales taxes on the purchase of tangible overhead items it had charged as indirect costs and allocated among a number of government contracts.² The comptroller argued that Raytheon was not entitled to an exemption under Section 151.302(a) as a “sale for resale of a taxable item” because, according to Section 151.005(1), such a sale required the “transfer of title or possession of tangible personal property.”³ The court agreed with Raytheon that there was sufficient evidence of title transfer because the Federal Acquisition Regulations stated that “the [g]overnment is vested with title to all reimbursable property.”⁴ The court also rejected the comptroller’s assertion that the federal government had abandoned title to the overhead items “because Raytheon controls and uses” them.⁵ The court

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1. The Survey period includes November 2002 through November 2003.

2. *Strayhorn v. Raytheon E-Sys., Inc.*, 101 S.W.3d 558, 561-63 (Tex. App.—Austin 2003, pet. denied).

3. *Id.* at 565 (quoting TEX. TAX CODE ANN. § 151.005(1) (Vernon 2002)).

4. *Id.* at 566.

5. *Id.*

noted that "Raytheon was obligated by contract to consume the overhead items,"⁶ and it did so "in the normal course of its business" of "performing contracts to provide intelligence systems, aircraft navigation systems, and other defense-related products to the federal government."⁷ The court found against Raytheon, however, on a procedural matter: in bringing an action under the Uniform Declaratory Judgments Act, the company "impermissibly sought declaratory relief that was redundant to the relief provided for in the tax code."⁸

One of the more interesting sales tax cases during the past year, *Strayhorn v. Ethical Society of Austin*,⁹ clarifies the meaning of "religious organization" under various sections of the tax code. The Ethical Society of Austin, a group of people who practice a belief system called "Ethical Culture," sought a sales tax exemption as a religious organization under Texas Tax Code Section 151.310(a)(1).¹⁰ It was denied "on the ground that the Ethical Society must demonstrate that it requires belief in a 'God, Gods, or higher power' . . . in order to qualify."¹¹ The trial court found that test to be "unconstitutionally underinclusive," and the Austin Court of Appeals agreed.¹² Basing its analysis on several United States Supreme Court cases¹³ and applying the test set out in *Malnak v. Yogi*,¹⁴ the court asked whether a particular set of beliefs "(1) address[es] fundamental and ultimate questions having to do with deep and imponderable matters such as the meaning of life and death or man's role in the universe; (2) [is] broad in scope and comprehensive in nature; and (3) [is] accompanied by the presence of certain formal and external signs."¹⁵ Under this standard, the Ethical Society was eligible for tax exemption.¹⁶

The taxpayer in *Ghashim v. State* was the owner of a restaurant appealing from a judgment against him personally for delinquent sales taxes incurred by his business.¹⁷ Ghashim raised three issues, and the court found against him on each. First, he argued "the [s]tate [had] failed to prove that he, individually, had collected any sales tax."¹⁸ The court found inapposite the case of *Parker v. State*,¹⁹ on which the taxpayer relied: "In *Parker*, the issue was not how much sales tax was collected by

6. *Id.*

7. *Id.* at 567.

8. *Id.* at 573.

9. *Strayhorn v. Ethical Soc'y of Austin*, 110 S.W.3d 458 (Tex. App.—Austin 2003, no pet. h.).

10. *Id.* at 461.

11. *Id.*

12. *Id.*

13. See e.g., *Wisconsin v. Yoder*, 406 U.S. 205 (1972); *Welsh v. United States*, 398 U.S. 333 (1970); *United States v. Seeger*, 380 U.S. 163 (1965).

14. *Malnak v. Yogi*, 592 F.2d 197 (3d Cir. 1979).

15. *Ethical Society of Austin*, 110 S.W.3d at 469. The court's holding closed an interesting chapter in which the comptroller had originally ruled the Society exempt and then revoked the ruling after adverse publicity.

16. *Id.* at 472-73.

17. *Ghashim v. State*, 104 S.W.3d 184, 185 (Tex. App.—Austin 2003, no pet.).

18. *Id.* at 186.

19. *Parker v. State*, 36 S.W.3d 616 (Tex. App.—Austin 2000, no pet.).

the defendant as an individual, but rather, how much sales tax was collected by the corporation.”²⁰ In the present case, there was no question about the amount collected by the restaurant and, added the court, “there is no statutory requirement that [the responsible individual] must have physically received or collected the sales tax in person.”²¹ Furthermore, to add such a requirement “would be inconsistent with the statutory provision that imposes liability on a responsible individual who is under a duty to account for and pay over the tax.”²² The court also dispensed with the taxpayer’s second argument (“that the district court [had] abused its discretion [by] admitting the comptroller’s certificate of delinquency because it was hearsay evidence”) by finding that such a certificate “constitutes prima facie proof . . . of the tax owed.”²³ Such evidence was presumed correct.²⁴ The comptroller had at one time “notified [Ghashim] that she had released a tax lien filed in error under his individual tax identification number,”²⁵ but then her office assessed him again, individually, for the period at issue. Ghashim argued that the state was, therefore, estopped from the suit, “because the comptroller [had] released a tax lien filed against him in error.”²⁶ The court found that Ghashim had not pled, proven and secured the elements required to establish estoppel, and, moreover, “the released tax lien was different from the delinquent taxes at issue.”²⁷ Finding for the state on all issues, the court affirmed the district court’s judgment that Ghashim was personally liable for the sales taxes.²⁸

In *Littlefield v. Texas*,²⁹ the court examined the intersection of the tax code and the penal code. Defendant Littlefield had been found guilty at trial of misapplication of fiduciary property and of organized criminal activity under the Texas Penal Code in connection with his failure to turn over to the state money that had been collected from his business as sales tax.³⁰ On appeal, Littlefield claimed, inter alia, that his cases were governed solely by the Tax Code and not by the Penal Code.³¹ The court disagreed, finding that penalties under the Penal Code and under Section 151.703 of the Tax Code are not exclusive.³² When two provisions have different purposes in mind, reasoned the court, both may apply: “Under the *in pari materia* principle of statutory construction; two statutes with similarity of purpose must be harmonized if possible,” but this “rule is not

20. *Ghashim*, 104 S.W.3d at 187.

21. *Id.*

22. *Id.*

23. *Id.* at 187-88.

24. *Id.*

25. *Id.* at 186.

26. *Id.* at 188.

27. *Id.*

28. *Id.*

29. *Littlefield v. State*, Nos. 05-00-02102-CR, 05-00-02103-CR, 2003 LEXIS 3845 Tex. App.—Dallas May 6, 2003, no pet.) (not designated for publication).

30. *Id.* at *1.

31. *Id.*

32. TEX. TAX CODE ANN. §151.703 (Vernon 2002).

applicable to enactments that cover different situations and that were apparently not intended to be considered together.”³³ Tax Code Section 151.703 contemplates a “monetary penalty” on those who fail to file or pay the tax; Penal Code Section 32.45 creates the felony of “misapplication of fiduciary property.”³⁴ The two sections “have different elements of proof, provide different penalties, serve different purposes and objectives, and are contained in different legislative acts.”³⁵ In addition, the Tax Code itself provides for criminal penalties when a taxpayer “intentionally or knowingly” fails to remit the tax collected.³⁶

The court upheld the comptroller’s interpretation of her own rule in *Perry Homes v. Strayhorn*.³⁷ The taxpayer/homebuilder claimed a refund of sales taxes on the grounds “that the lump-sum purchase prices it had paid its independent contractors [had] included sales tax.”³⁸ The court found for the comptroller, noting that if the contractors did not “(1) add sales tax to the purchase price and (2) either ‘separately state’ on the bill, contract, or invoice that sales tax was included in the stated price or provide a written statement that the stated price included tax,” then the taxpayer would lose.³⁹ It did not accept Perry Homes’s argument that language in the contracts and in correspondence with the contractors proved that the lump sum included tax. Rather, noted the court, those documents merely constituted indemnities and were “insufficient to overcome the presumption that the purchase price did not include sales tax.”⁴⁰ This case emphasizes again the comptroller’s view that a taxes-paid clause is not sufficient to protect the buyer from a sales tax assessment unless the clause is specific to sales taxes.

The United Services Automobile Association (USAA) sought a sales tax refund under now-repealed Articles 4.10 and 4.11 of the Texas Insurance Code, which levied an occupation tax on insurance companies with the proviso that “[n]o other tax shall be levied or collected from any insurance carrier by the state, county, or city or any town, but this law shall not be construed to prohibit the levy and collection of . . . taxes upon the real and personal property of such carrier.”⁴¹ The court rejected the taxpayer’s statutory construction argument, based on *Fleming Foods of Texas, Inc. v. Rylander*,⁴² and characterized that holding as applicable

33. *Littlefield*, 2003 Tex. App. LEXIS 3845, at *7.

34. *Id.* at *7-8 (citing TEX. TAX CODE ANN. § 151.703 (Vernon 2003) and TEX. PENAL CODE § 32.45 (Vernon 2002)).

35. *Id.* at *8.

36. *Id.*; see also TEX. TAX CODE ANN. § 151.7032(a) (Vernon 2004).

37. *Perry Homes v. Strayhorn*, 108 S.W.3d 444 (Tex. App.—Austin 2003, no pet.).

38. *Id.* at 445.

39. *Id.* at 446.

40. *Id.* at 447.

41. *United Servs. Auto. Ass’n v. Strayhorn*, 124 S.W.3d 722, 724 (Tex. App.—Austin 2003, pet. filed). TEX. INS. CODE ANN. arts. 4.10-11 (Vernon 2004) were repealed by Tex. H.B. 2922, § 26, 78th Leg., R.S., 2003 Tex. Gen. Laws, 1274, effective Apr. 1, 2005.

42. *Fleming Foods of Tex., Inc. v. Rylander*, 6 S.W.3d 278, 284-85 (Tex. 1999).

only to recently codified statutes.⁴³ Instead, the court traced the history of taxation of insurance companies in Texas and concluded that the provisions at issue “created a system of occupation taxes specific to the insurance industry”; accordingly, exemptions in those provisions “acted only to exempt the insurance industry from general occupation and franchise taxes,” not from other non-occupation and non-franchise taxes imposed later, such as sales and use taxes.⁴⁴ The court therefore upheld the tax assessment.⁴⁵

Burgess v. Gallery Model Homes, Inc.,⁴⁶ addresses the issue of whom a consumer may sue for a refund of improperly collected sales taxes. The taxpayer had sued a retailer, but the court found that such an action does not lie: “[T]he comprehensive scheme set out in Sections 111.104, 111.105[,] and 112.151 *et seq.* of the Tax Code and the regulations promulgated thereunder provide the exclusive means of obtaining a refund of an improperly collected sales tax.”⁴⁷ Because the taxpayer had not exhausted her administrative remedies, the trial court lacked jurisdiction over the suit.⁴⁸ This case, with *Fleming Foods*, illustrates the state’s continuing difficulty in determining which parties are responsible for filing—and responding to—refund claims. *Burgess* fairly concludes that consumers should follow statutory refund procedures rather than filing suit against retailers—a conclusion currently being tested in several states by class actions filed against sellers.

Two Attorney General rulings elucidate aspects of the Texas sales tax with respect to economic incentives that municipalities may offer to businesses or developers. In the first ruling, General Abbott found that Article III, Section 55, of the Texas Constitution does not prohibit the rebate by a city of a portion of the municipal sales tax.⁴⁹ The constitutional provision prohibits the legislature or political subdivisions from “releasing or extinguishing, in whole or in part, the indebtedness, liability or obligation of any corporation or individual,” but it does not prohibit a rebate of those taxes once they have been collected.⁵⁰

In the second ruling, General Abbott addressed the scope of authority of an economic development corporation’s board of directors over expen-

43. *United Servs. Auto Ass’n*, 124 S.W.3d at 729. Cynics might well argue that the distinction was results-oriented, although the court was likely correct in concluding that the Texas Legislature did not intend to exempt insurance companies from virtually all taxes. TEX. INS. CODE ANN. arts. 4.10-11 (Vernon 2004) were repealed by Tex. H.B. 2922, § 26, 78th Leg., R.S., 2003 Tex. Gen. Laws, 1274, effective April 1, 2005.

44. *Id.* at 732.

45. *Id.*

46. *Burgess v. Gallery Model Homes, Inc.*, 101 S.W.3d 550 (Tex. App.—Houston [1st Dist.] 2003, pet. denied).

47. *Id.* at 558.

48. *Id.*

49. Op. Tex. Att’y Gen. No. GA-0071 (2003).

50. *Id.* (quoting TEX. CONST. art. III, § 55). This ruling, issued in May of 2003, was in response to a request by Senator Kay Bailey Hutchison, who sponsored the underlying legislation (designed to eliminate certain rebates) to confirm that some rebates are still permitted.

diture of sales tax revenues collected under Section 4A of the Development Corporation Act.⁵¹ The city of Hutto had created such a corporation, and the corporation's board of directors voted to use a portion of their revenue to "help finance a proposed [fiberglass] hippopotamus statue" to serve as the local mascot.⁵² The Hutto city council, however, objected to the expenditure. The Attorney General approached the controversy with the assumption that the authority for this particular development corporation did not itself impose a limitation on how the board could spend its Section 4A proceeds.⁵³ He noted that the statute, Section 4A(b)(1),⁵⁴ allows a development corporation to spend up to ten percent of its revenues for "promotional purposes," which he defined as actions that "advertise or publicize the city for the purpose of developing new and expanded business enterprises."⁵⁵ Whether erecting a hippopotamus statue constitutes such an acceptable purpose, said the opinion, is not for the Attorney General to determine, but for the corporation's board of directors. Actions of that board, however, are subject to review and approval by the city council, and the maximum that could be spent for such a promotional project would be ten percent of the Section 4A revenue collected in a particular year.⁵⁶

Although it is beyond the scope of this Survey to discuss the letter rulings issued last year by the comptroller, at least a few merit discussion. A comptroller letter confirmed that "[d]igital music programming provided via satellite is not taxable," whereas if news or other information were provided by satellite, that would be taxable as an information service.⁵⁷ Another comptroller letter addressed the issue of software modification, when one company provides a number of professional services for another company.⁵⁸ The services at issue consisted of "implementation of software upgrades and modifications of software functionality necessary to meet business and technology requirements" and "did not involve any source code modifications and could have been performed by various [other] vendors."⁵⁹ The comptroller found that those services were taxable.⁶⁰

51. Op. Tex. Att'y Gen. No. GA-0086 (2003).

52. *Id.*

53. *Id.*

54. TEX. LABOR CODE ANN. § 5190.6(4A)(b)(1) (Vernon 2004).

55. Op. Tex. Att'y Gen. No. GA-0086 (2003).

56. *Id.* Author's note: Don't you find it at least a little refreshing to be reading about hippopotamuses in a tax article?

57. Tex. Comptroller of Pub. Accounts, STAR System No. 200301681L (Jan. 10, 2003), at <http://aixtcp.cpa.state.tx.us/star/>. By contrast, the Comptroller asserts that downloading digital music constitutes a taxable sale of tangible personal property. Tex. Comptroller Pub. Accounts, STAR System, No. 200005359L (May 30, 2000), at <http://aixtcp.cpa.state.tx.us/star/>.

58. Tex. Comptroller Pub. Accounts, STAR System No. 200305921L (May 29, 2003), at <http://aixtcp.cpa.state.tx.us/star/>.

59. *Id.*

60. *Id.*

Hearing No. 41,738 concluded that software training charges were taxable when they had not been separately stated on the invoices, under Rule 3.308.⁶¹ In the manufacturing realm, the petitioner in Hearing No. 41,846 sought an exemption from tax on purchase of a conveyor system, on the grounds that it “was an integrated component of an automated manufacturing machine.”⁶² The comptroller disagreed, noting that under a change in the law effective October 1, 1997, conveyors are “expressly excluded from the manufacturing exemption, which itself was confined . . . to necessary and essential manufacturing equipment that caused a physical or chemical change to the product being manufactured or an intermediary or component product.”⁶³ The equipment at issue did not meet that requirement, in the comptroller’s view. Hearing No. 40, 282 addressed another manufacturing issue, holding that sanitizing and cleaning services are taxable when there is a mix of taxable and nontaxable services included and the taxable portion exceeds five percent of the total charge.⁶⁴

In Hearing No. 41,036, the comptroller found that the taxpayer qualified for the occasional sale exemption even though the taxpayer had transferred equipment to another business segment shortly before selling the entire remaining operating assets of a business or a business segment.⁶⁵ Moreover, the retirement of obsolete equipment did not affect the exemption status.⁶⁶ This decision is helpful because it confirms that the one-sale to one-buyer rule⁶⁷ does not preclude a taxpayer from selling off certain assets prior to the occasional sale; unfortunately, comptroller decisions in this area remain too fact-specific to constitute clear planning guidance. In Hearing No. 42,654, petitioner, a soft-drink bottler and distributor, sought an exemption for the purchase of “post-mix machines and repair parts for the post-mix machines” that he provided to his customers as an inducement for them to purchase his products.⁶⁸ Petitioner would sell canisters of the syrup and carbon dioxide to a restaurant, for example, and “place” a post-mix machine on the premises as well, retaining ownership of the machine. The customer could obtain possession of the machine by renting it or by agreeing to purchase all of the ingredients from petitioner.⁶⁹ The comptroller found that petitioner’s purchase of these machines was not a purchase for resale with respect to the machines

61. Tex. Comptroller Pub. Accounts STAR System No. 2003049164 (April 11, 2003), at <http://aixtcp.cpa.state.tx.us/star/>.

62. Tex. Comptroller Pub. Accounts STAR System No. 200305001H (May 30, 2003), at <http://aixtcp.cpa.state.tx.us/star/>.

63. *Id.*

64. Tex. Comptroller Pub. Accounts STAR System No. 200212640H (Dec. 9, 2002), at <http://aixtcp.cpa.state.tx.us/star/>.

65. Tex. Comptroller Pub. Accounts STAR System No. 200212691H (Dec. 6, 2002), at <http://aixtcp.cpa.state.tx.us/star/>.

66. *Id.*

67. TEX. ADMIN. CODE § 3.316(d) (2004).

68. Tex. Comptroller Pub. Accounts STAR System No. 200211718H (Nov. 7, 2002). A post-mix machine mixes the syrup, carbon dioxide, and water to create a “fountain drink.” *Id.*

69. *Id.*

that were not rented by the customers and was, therefore, not exempt from taxation.⁷⁰

B. LEGISLATIVE DEVELOPMENTS

As noted earlier, political turmoil marked the 2003 legislative sessions, slowing (and sometimes derailing) substantive sales tax changes. However, the legislature did make progress in several areas, including in Texas's efforts to move closer to compliance with the principles of the Streamlined Sales Tax Program.

The legislature made a number of changes to the basic definitions that shape the Tax Code. In one such change, the 78th Legislature attempted to clarify the meaning of "data processing service" and "data storage": legislation added a new sentence to the definition of data processing services to provide that data storage (a subset of data processing services) "does not include a classified advertisement, banner advertisement, vertical advertisement, or link . . . displayed on . . . website[s] owned by another person."⁷¹ Legislators also added a new phrase to the definition of "Sale" or "Purchase," to state explicitly that a "charge for an extended warranty or service contract for the performance of a taxable service," when done for consideration, constitutes a "Sale" or "Purchase."⁷² In response to the Austin Court of Appeals ruling in *Sharp v. Morton Buildings, Inc.*,⁷³ the legislature also amended the definition of "use." The new definition of "use" now includes the following language: "the exercise of a right or power incidental to the ownership of tangible personal property over tangible personal property, including tangible personal property other than printed material that has been processed, fabricated, or manufactured into other property or attached to or incorporated into other property transported into this state."⁷⁴ The extent to which the language will overturn *Morton Buildings* remains unclear, particularly because of the printed material exclusions designed to protect numerous items, such as phone directories, that are printed outside Texas.

As part of the ongoing effort to bring Texas into compliance with the Streamlined Sales and Use Tax Agreement, the 78th Legislature added several new sections to the Tax Code and altered a number of preexisting sections. One addition requires rate changes in sales tax to be effective as

70. *Id.* In case you are feeling hungry as you move into the next section of the article, see Tex. Comptroller Pub. Accounts STAR System Nos. 200302747L and 200302744L, at <http://aixtcp.cpa.state.tx.us/star/>, holding respectively that kettle corn and cinnamon roasted nuts are taxable. Kettle corn, although a food product, is taxed if it is sold heated, regardless of quantity, or if non-heated, in individual size servings, if the seller provides tables and chairs; cinnamon roasted nuts are taxable as candy-coated confections.

71. Tex. H.B. 2424, § 16, 78th Leg., R.S., Tex. Gen. Laws 209 (amending TEX. TAX CODE ANN. § 151.0035). This change codified a change in Comptroller policy adopted last year. See also Cynthia M. Ohlenforst et al., *Taxation*, 56 SMU L. REV. 2027, 2035 (2003).

72. *Id.* § 17 (amending TEX. TAX CODE ANN. § 151.005(3)).

73. *Sharp v. Morton Bldgs., Inc.*, 953 S.W.2d 300 (Tex. App.—Austin 1997, writ denied); see also Cynthia M. Ohlenforst et al., *Taxation*, 51 SMU L. REV. 1345, 1346 (1998).

74. TEX. TAX CODE ANN. § 151.011 (Vernon 2004).

of the first day of the calendar quarter.⁷⁵ The same section provides that rate changes that occur after the beginning of the performance of a taxable service, but before its completion, will apply to the first billing period for service performed after the effective date.⁷⁶ The effort to comply with the Streamlined Sales and Use Tax Agreement also resulted in two new subsections being added to the Tax Code in order to help ensure collection of local use taxes from purchasers. Permitted retailers are required to collect local use tax, even if they are not engaged in business in the local jurisdiction where the taxable item is delivered.⁷⁷ In addition, a person who desires to be a seller in Texas must agree to collect local use tax even if the seller is not engaged in business in the local jurisdiction where the taxable item is delivered.⁷⁸ These additions coincide with other modifications made pursuant to the Streamlined Sales and Use Tax Agreement which alter the sourcing rules for local sales taxes. The sourcing rules for municipalities and counties that previously applied to “taxable items” were altered to apply solely to “tangible personal property.”⁷⁹ These same sections also set forth a general rule that “the sale of a taxable service,” other than certain services used both within and outside of Texas, “is consummated at the location at which the service is performed or otherwise delivered.”⁸⁰ These sourcing rules triggered taxpayer concern during the closing days of the regular session that the originally drafted language could be construed to source multistate services (like data processing) to the location from which such services are provided. Taxpayers and comptroller staff worked together to craft the final language, pursuant to which Texas’s sourcing rules for multistate services and for tangible personal property remain in effect. Because Texas law continues to source sales of tangible personal property to the origin of the sale rather than to destination for local sales tax purposes, Texas is not in complete conformity with the Streamlined Sales Tax Agreement, which requires destination-based sourcing for such local taxes.

Special exceptions to these sourcing rules apply to telecommunications services and calling cards. The sale of telecommunications services sold on a call-by-call basis “is consummated at the location where the call originates and terminates or the location where the call either originates or terminates and at which the service address is also located.”⁸¹ The sale of telecommunications services on a basis other than a call-by-call basis, other than post-paid calling services, is consummated at the location of the customer’s place of primary use.⁸² These telecommunication provisions triggered substantial debate, as well as revised rules, and a letter

75. Tex. H.B. 2425, § 98, 78th Leg., R.S., 2003 Tex. Gen. Laws 1310 (adding TEX. TAX CODE ANN. § 151.012(a)).

76. *Id.* (adding TEX. TAX CODE ANN. § 151.012(b)).

77. *Id.* § 100 (adding TEX. TAX CODE ANN. § 151.103(d)).

78. *Id.* § 102 (adding TEX. TAX CODE ANN. § 151.202(c)).

79. *Id.* §§ 115, 118 (amending TEX. TAX CODE ANN. §§ 321.203, 323.203).

80. *Id.* §§ 115, 118 (adding TEX. TAX CODE ANN. §§ 321.203(l), 323.203(l)).

81. *Id.* §§ 115, 118 (adding TEX. TAX CODE ANN. §§ 321.203(g-1), 323.203(g-1)).

82. *Id.* §§ 115, 118 (adding TEX. TAX CODE ANN. §§ 321.203(g-2), 323.203(g-2)).

from the comptroller's staff that attempts to explain and justify the State's current interpretations.⁸³ Finally, a "sale of post-paid calling services is consummated at the location of the origination point of the telecommunications signal as first identified by the seller's telecommunications system or by information received by the seller from the seller's service provider if the system used to transport the signal is not that of the seller."⁸⁴

Another provision adopted to comply with the Streamlined Sales and Use Tax Agreement could simplify and expedite the process of submitting resale certificates. The 2003 Legislature inserted a new phrase that allows resale certificates to be signed by electronic signatures authorized by the comptroller.⁸⁵ Numerous other provisions were adopted in the attempt to comply with the Streamlined Sales and Use Tax Agreement, including the addition of definitions necessary for application of certain streamlined sales tax provisions⁸⁶ and administrative provisions that apply certain streamlined sales tax provisions to municipal and county sales taxes.⁸⁷

Not all of the 2003 legislative changes to municipal sales arose from the Streamlined Sales and Use Tax Agreement; other alterations to the Tax Code sought to clarify the rules regarding a retailer's "place of business" for purposes of municipal sales and use tax collection. Effective on September 1, 2003, "[a]n outlet, office, facility, or location that contracts with a retail or commercial business engaged in activities to which this chapter applies to process for that business invoices or bills of lading onto which sales tax is added is not a 'place of business of the retailer'" if the comptroller finds that the "location functions or exists to avoid" or to rebate to the contracting business a portion of the municipal sales and use tax.⁸⁸ Moreover, if the comptroller makes a finding described in the preceding sentence, the sale is treated as if it were consummated at the place of business of the retailer from whom the location purchased the taxable item.⁸⁹

The 78th Legislature also added a provision concerning records that must be kept by providers of certain telecommunications services. Any nontaxable charges that are combined with taxable telecommunication

83. Letter on file with author.

84. Tex. H.B. 2425, §§ 115, 118, 78th Leg., R.S., Tex. Gen. Laws 1310 (adding TEX. TAX CODE ANN. §§ 321.203(g-3), 323.203(g-3)).

85. *Id.* § 101 (amending TEX. TAX CODE ANN. § 151.152(b)(1)).

86. *Id.* § 93 (amending TEX. TAX CODE ANN. § 142.002).

87. *Id.* §§ 114, 117 (amending TEX. TAX CODE ANN. §§ 321.003, 323.003). Although it is outside the scope of this Survey to review all the changes to the Texas Tax Code that attempt to incorporate the Streamlined Sales and Use Tax Agreement, there are several, including some additional administrative sections of the Tax Code relating to the adoption of the Streamlined Sales and Use Tax Agreement such as amendments to Texas Tax Code sections 142.005(c), 142.0055, and 142.011. See *id.* §§ 94-96.

88. TEX. TAX CODE ANN. § 321.002(a)(3) (Vernon 2004).

89. *Id.* § 321.203(l). The comptroller viewed this legislation as a means of deterring taxpayers from setting up artificial billing offices solely for certain types of tax planning purposes.

service charges and not separately stated (as in “bundled” services) are taxable “unless the provider can identify the portion of the [combined] charges that are nontaxable through . . . books and records kept in the regular course of [the provider’s] business.”⁹⁰ The burden of proving nontaxable charges from combined charges rests with the provider.⁹¹

The provision that imposes a surcharge as part of the plan to reduce emissions from certain diesel equipment was substantially changed to allow for assessment of the surcharge not only in sales or leases of equipment, but also for “storage, use, or other consumption in [the] state of new or used equipment.”⁹² In addition, the rate of the surcharge was raised from one percent to two percent of the sale or lease price,⁹³ and the definition of “equipment” subject to the surcharge was expanded by deleting the limitation that the surcharge applies only to diesel equipment “classified as construction equipment.”⁹⁴

The 2003 Legislature added exemptions for various health care and pharmaceutical facilities; pharmaceutical biotechnological cleanrooms received a good deal of legislative attention. A sales tax exemption was provided for “pharmaceutical biotechnology cleanrooms and equipment that are installed as part of the construction of a new facility with a value of at least \$150 million and on which construction is begun after July 1, 2003, and before August 31, 2004.”⁹⁵ Another section added in 2003 defines “pharmaceutical biotechnology cleanrooms and equipment” to include “all tangible personal property . . . used in connection with the manufacturing, processing, or fabrication in a cleanroom environment of a pharmaceutical biotechnology product,” “without regard to whether such tangible personal property is affixed to or incorporated into realty [and] without regard to whether such tangible personal property is actually contained in the cleanroom environment.”⁹⁶ Moreover, a new provision states that “use of ‘pharmaceutical biotechnology cleanrooms and equipment, . . . to [produce] a pharmaceutical biotechnology product that is not sold is not a divergent use if the use occurs during the certification process by the United States Food and Drug Administration.”⁹⁷ Cleanrooms were not the only subject of legislation in the pharmaceutical field. The drug and medicine exemption was expanded to include “intravenous systems, supplies, and replacement parts used in the treatment of humans.”⁹⁸

90. Tex. H.B. 2425, § 99, 78th Leg., R.S., 2003 Tex. Gen. Laws 1310 (adding TEX. TAX CODE ANN. § 151.025(d)).

91. *Id.*

92. Tex. H.B. 1365, § 21, 78th Leg., R.S., 2003 Tex. Gen. Laws 1331 (adding TEX. TAX CODE ANN. § 151.0515(b-1)).

93. *Id.* (amending TEX. TAX CODE ANN. § 151.0515(b)).

94. *Id.* (amending TEX. TAX CODE ANN. § 151.0515(a)).

95. Tex. H.B. 2425, § 106, 78th Leg., R.S., 2003 Tex. Gen. Laws 1310 (adding TEX. TAX CODE ANN. § 151.318(b)(3)).

96. *Id.* (adding TEX. TAX CODE ANN. § 151.318(q-1)).

97. *Id.* § 107 (adding TEX. TAX CODE ANN. § 151.3181).

98. Tex. H.B. 2424, § 19, 78th Leg., R.S., 2003 Tex. Gen. Laws 209 (adding TEX. TAX CODE ANN. § 151.313(a)(15)).

The legislature also spent a significant portion of 2003 largely rewriting provisions that address the multitude of issues surrounding taxation of customs brokers. It is beyond the scope of this Survey to detail the entirety of the customs brokers provisions, as they are lengthy and technical, but limited in scope.⁹⁹

Food and food-related services were also topics of legislative changes in 2003. The exemption for food products for human consumption was modified by several changes to the definition of "food products," which were generally intended to correspond with definitions contained in the Streamlined Sales and Use Tax Agreement. Drugs and dietary supplements were added to the list of items that are not food products, and certain other items that were previously not food products (i.e., ice and candy) were moved and relisted in new provisions within the statute.¹⁰⁰ Carbonated and noncarbonated packaged soft drinks are now further defined as "nonalcoholic beverages that contain natural or artificial sweeteners."¹⁰¹ In further attempts to reflect the Streamlined Sales and Use Tax Agreement, a number of sections were added to the same statute to define the term "diluted juice drink;"¹⁰² list prepared foods that are not included in the food product exemption;¹⁰³ enumerate additional bakery and grocery items that are included in the food product exemption;¹⁰⁴ eliminate from the food product exemption the sale of any food products from certain vending machines;¹⁰⁵ and eliminate from the food product exemption any "food products, meals, soft drinks, and candy sold to a person confined in a correctional facility operated under the authority . . . of the state."¹⁰⁶ Another legislative modification to the Texas Tax Code regarding food services provides that sales made by volunteers who are volunteering for exempt organizations devoted to the exclusive purpose of either religious training, physical training, or education with an elementary or secondary school are exempt from sales tax.¹⁰⁷ The legislative changes that passed in 2003 were not limited to taxation of the food or food services themselves but also extended to certain inputs used in the preparation of food. The exemption for electricity and gas used in preparation or storage of "food for immediate consumption" was altered to

99. However, we're happy to give you a starting point: See TEX. TAX CODE ANN. §§ 151.157 (Vernon 2004) on the taxation of custom brokers generally; *id.* § 151.1575 on requirements for issuing documentation showing the exportation of property; *id.* § 151.158 on import stamps; *id.* § 151.307 on exemptions required by prevailing law (incorporating new proof required pursuant to other sections mentioned herein); *id.* § 151.406 on contents and forms of certain reports (incorporating the proof required in § 151.307, as amended); and *id.* § 151.712 on civil penalties for persons certifying exports.

100. Tex. H.B. 2425, § 103, 78th Leg., R.S., 2003 Tex. Gen. Laws 1310 (amending TEX. TAX CODE ANN. § 151.314(c)).

101. *Id.*

102. *Id.* (adding TEX. TAX CODE ANN. § 151.314(c-1)).

103. *Id.* (adding TEX. TAX CODE ANN. § 151.314(c-2)).

104. *Id.* (adding TEX. TAX CODE ANN. § 151.314(c-3)).

105. *Id.* (amending TEX. TAX CODE ANN. § 151.314(f)).

106. *Id.* (amending TEX. TAX CODE ANN. § 151.314(g)).

107. *Id.* (amending TEX. TAX CODE ANN. § 151.314(e)(1)).

exempt electricity and gas used in preparation or storage of "prepared food" as described in Section 151.324(c-2) of the Tax Code.¹⁰⁸

The legislature also turned its attention to tax treatment of certain newspaper materials during the Survey period. The exemption for certain newspapers and property used in newspapers was expanded to include newspapers that have an average sales price of \$1.50, instead of the previous limit of \$0.75.¹⁰⁹ The same exemption was clarified to include tangible personal property that becomes an ingredient or component of exempt special order newspaper inserts such as handbills, circulars, flyers, or advertising supplements.¹¹⁰

A number of other miscellaneous exemptions were clarified or added by bills passed in the 78th Legislature. For instance, one addition provides that contractors are not eligible for the exemption for items used in performance of a contract to improve real property.¹¹¹ The legislature also added a provision that mobile telecommunications services are not included in the exemption for long-distance calls that do not originate from and bill to a number in Texas.¹¹² The exemption available for certain water conservation services and equipment was limited to items used "solely" for water conservation purposes.¹¹³ A new section was added to the Tax Code, which provides that separately itemized charges for labor that is used to repair or remodel buildings listed on the National Register of Historic Places are exempt from sale tax.¹¹⁴ Certain bingo equipment is exempted from sales and use tax if it is "(1) purchased by an organization licensed [by the State of Texas] to conduct bingo [and such organization] is exempt from the payment of federal income taxes . . . and (2) used exclusively to conduct bingo authorized under Chapter 2001, Occupations Code."¹¹⁵ One final miscellaneous change during the Survey period was not an exemption at all, but a revocation of power granted to local taxing authorities. Legislation passed in 2003 stripped the governing bodies of local taxing authorities of their power to repeal the application of the popular "sales tax holiday."¹¹⁶

C. REGULATORY DEVELOPMENTS

Although the comptroller amended several sales tax rules during the Survey period, these rule revisions generally reflect recent legislative changes rather than significant policy changes by the comptroller's office.

108. *Id.* § 104 (amending TEX. TAX CODE ANN. § 151.317(a)).

109. Tex. H.B. 2424, § 21, 78th Leg., R.S., 2003 Tex. Gen. Laws 204 (amending TEX. TAX CODE ANN. § 151.319(f)).

110. *Id.* § 94 (amending TEX. TAX CODE ANN. § 151.319(c)).

111. *Id.* § 18 (adding TEX. TAX CODE ANN. § 151.056(f)).

112. *Id.* § 22 (adding TEX. TAX CODE ANN. § 151.323(b)).

113. *Id.* § 24 (adding TEX. TAX CODE ANN. § 151.355).

114. *Id.* § 23 (adding TEX. TAX CODE ANN. § 151.3501).

115. Tex. H.B. 2519, § 32, 78th Leg., R.S., 2003 Tex. Gen. Laws 1144 (adding TEX. TAX CODE ANN. § 151.3105).

116. Tex. H.B. 2425, § 121, 78th Leg., R.S., 2003 Tex. Gen. Laws 1310 (repealing TEX. TAX CODE ANN. § 151.326(c)).

For instance, Rule 3.320 implements changes made by the 78th Legislature to Section 151.0515 of the Tax Code concerning the Texas emissions reduction plan surcharge on off-road, heavy-duty diesel equipment.¹¹⁷ New Rule 3.367 incorporates the changes made in the 77th Legislature to Sections 151.3162 and 151.317 of the Tax Code, which allowed a partial refund or credit of tax paid on certain timber items that are purchased during the period October 1, 2001, through December 31, 2007.¹¹⁸

The comptroller is also working on several draft rules, including a revision of the rule that addresses improvements to realty,¹¹⁹ as well as a revision of the rule that addresses intercorporate services.¹²⁰

II. FRANCHISE TAX

A. APPLICATION OF TAX

The Austin Court of Appeals issued two statutory interpretation cases that merit discussion. *Sergeant Enterprises, Inc. v. Strayhorn*¹²¹ supported the comptroller's position that a corporation may not take advantage of a loss of a predecessor corporation that merged into the taxpayer for purposes of computing its franchise tax liability. While the comptroller agrees that the survivor of a merger may use its own pre-merger losses in determining its franchise tax, the comptroller's interpretation of the Tax Code has been that a pre-merger loss of the target corporation may not be taken into account in computing the survivor's franchise tax analysis. The appellant in this case, the survivor of a two-tiered merger, attempted to use the cumulative business loss of one of the target corporations in computing its franchise tax liability. The court viewed the provision at issue, Tax Code Section 171.110(e),¹²² which authorizes a "deduction" of a business loss, as tantamount to an exemption that must be construed strictly in favor of the comptroller. The taxpayer's arguments, including its argument that the business loss transfers to the successor corporation pursuant to Tax Code Section 171.110(e) as read in tandem with Section 5.06A(2) of the Business Corporation Act, failed to convince the court; the court refused to interpret the statute to allow the survival of the business loss.¹²³

*Westcott Communications, Inc. v. Strayhorn*¹²⁴ focused on whether the taxpayer's receipts from its sales of programming to subscribers throughout the country via satellite broadcast and videotape should be considered Texas receipts (on the ground that the broadcasts were prepared and

117. See 34 TEX. ADMIN. CODE § 3.320 (2004).

118. See *id.* § 3.367.

119. *Id.* § 3.347.

120. *Id.* § 3.331.

121. *Sergeant Enters., Inc. v. Strayhorn*, 112 S.W. 3d 241 (Tex. App.—Austin 2003, no pet.).

122. TEX. TAX CODE ANN. § 171.110(e) (Vernon 2004).

123. *Sergeant Enters., Inc.*, 12 S.W.3d at 247-51.

124. *Westcott Communications, Inc. v. Strayhorn*, 104 S.W.3d 141 (Tex. App.—Austin 2003, pet. denied).

transmitted from Texas) or apportioned among numerous states (on the ground that the customers received the transmissions at their locations, not where the broadcasts were prepared).¹²⁵ Taxpayer's "informational[] and training program" was delivered to subscribers throughout the nation via satellite broadcast and videotape.¹²⁶ While the comptroller conceded that the videotape subscription reviews should be apportioned based on the location of the subscriber, the comptroller argued—and prevailed—on her theory that "service performed in this state" (the statutory buzz words) should be interpreted to mean the place "where the 'act is done.'"¹²⁷ The taxpayer pointed out that subscription television services like cable television are sourced according to the subscriber's locations. However, the court concluded that whereas broadcasters are paid to broadcast television programming, Westcott was being paid to provide training and that its customers had the option of receiving the training via videotapes or via broadcast.¹²⁸ This case also presents an interesting discussion of the taxpayer's several Constitutional arguments, but finds none of them compelling.¹²⁹ Interestingly, this case, like *Sergeant*, gave significant deference to the comptroller's administrative positions; indeed, in *Sergeant*, the court cited letter rulings from the comptroller's website as evidence of the comptroller's consistent interpretation.¹³⁰

It is tempting, and not altogether inaccurate, to describe comptroller franchise tax hearings from the survey in two words: taxpayer loses. In many circumstances, taxpayer losses may be attributed to the taxpayer's pursuing issues that have been resolved in prior hearings. The issue in Hearing 42,310 involves statutes of limitation for filing a claim for refund.¹³¹ The dispute centered on whether the 1997 addition to the Tax Code of Section 111.206(f)(2), which added audits by the Internal Revenue Service as a factor that could toll the statute of limitations,¹³² should be applied prospectively or retrospectively. Unlike many cases, this is a situation in which the taxpayer, rather than the comptroller, argued for retrospective application of the new language, as a retrospective application of the language would have allowed the taxpayer's claim for refund. Noting that this issue had been addressed in prior claims, the comptroller ruled against the taxpayer.¹³³ The case remains interesting for its discus-

125. While it is clear that, in many situations, sales of services are sourced for sales tax purposes where the benefit of the sale is received (*see, e.g.*, 34 TEX. ADMIN. CODE § 3.330 (2004) pertaining to data processing), in the franchise tax context services are treated as creating Texas receipts if the services are performed in Texas.

126. *Westcott Communications, Inc.*, 104 S.W.3d at 144.

127. *Id.* at 145-56.

128. *Id.* at 147.

129. *Id.* at 147-50.

130. *Sergeant Enters., Inc. v. Strayhorn*, 112 S.W.3d 241, 250 (Tex. App.—Austin 2003, no pet.).

131. Tex. Comptroller of Pub. Accounts, STAR System No. 200308116H (Aug. 13, 2003), at <http://aixtcp.cpa.state.tx.us/star/>.

132. TEX. TAX CODE ANN. § 111.206(f)(2) (Vernon 2004).

133. Tex. Comptroller of Pub. Accounts, STAR System No. 200308116H (Aug. 13, 2003), at <http://aixtcp.cpa.state.tx.us/star/>.

sion of statutory interpretation, particularly in the context of prospective versus retrospective application.

B. LEGISLATIVE DEVELOPMENTS

As in the past few sessions, several franchise tax bills were introduced in 2003 that had the potential to make significant changes in the way the Texas franchise tax operates. Some bills would have extended the franchise tax to all business entities, including partnerships and certain trusts; other bills sought to limit the amount of deductions that a franchise tax payor may claim with respect to expenses paid to affiliates. In the end, the Texas Legislature found itself caught between the desire to alter the franchise tax in a way that some described as "closing loopholes" and the reality that such "loophole closing" would in fact constitute a new tax. The tension between "closing the loopholes" and not enacting new taxes was exacerbated by the fact that many of the proposals to expand the tax to partnerships would, in some circumstances, have resulted in taxing income of individuals, thereby violating the Texas Constitutional amendment that precludes an income tax on individual income without voter approval. At the end of the year's multiple sessions, the franchise tax changes actually adopted were far from the sweeping changes the legislature had considered and less significant in many ways than the procedural changes enacted with respect to refund claims and other administrative matters. Some of the changes were intended as conforming changes required by judicial or other interpretations. For example, the Section 171.001 changes deleted the portion of the section that purported to impose franchise tax on any corporation authorized to do business under Texas law,¹³⁴ to make the Tax Code consistent with the holding of *Rylander v. Bandag Licensing Corp.*¹³⁵ Other changes described by the legislature as mere clarifications addressed franchise tax exemptions for certain insurance companies¹³⁶ and the exemption for certain tenants of trade shows.¹³⁷ Also, a reference to "amount[s] excludable under Section 171.110(k)," was added to Sections 171.1032 and 171.1051, which define the amounts deductible by a corporation in determining its gross receipts.¹³⁸ The legislators also revised the definition of "surplus" in Section 171.109 by adding a new subsection (a-1) to provide that "a legally enforceable obligation that requires the return of a like-

134. Tex. H.B. 2424, 78th Leg., R.S., 2003 Tex. Gen. Laws 209 (amending TEX. TAX CODE ANN. § 171.001(a)).

135. *Rylander v. Bandag Licensing Corp.*, 18 S.W.3d 296, 298-301 (Tex. App.—Austin 2000, pet. denied).

136. Tex. H.B. 2424, 78th Leg., R.S., 2003 Tex. Gen. Laws 209 (amending TEX. TAX CODE ANN. § 171.052).

137. *Id.* (amending TEX. TAX CODE ANN. § 171.084(c)).

138. *Id.* (amending TEX. TAX CODE ANN. §§ 171.1032, .1051). Corresponding changes were made to Section 171.110. Specifically, Section 171.110(k) now explicitly provides that "dividends and interest received from federal obligations are not included in earned surplus or gross receipts," and Section 171.100(l) defines federal obligations. *Id.* (amending TEX. TAX CODE ANN. § 171.110).

kind property that was borrowed will be considered debt if it is a liability according to generally accepted accounting principles and if the return must be made within an ascertainable period of time or on demand.”¹³⁹ This section further provides that “[t]he amount . . . considered debt is the fair market value measured on the last day on which the [franchise tax] report” is due.¹⁴⁰ By way of administrative change, Section 171.203(f) now allows a public information report to be filed electronically.¹⁴¹

Additional changes were also made to franchise tax provisions affecting certain refunds for job creation enterprise zones, tax credits for certain job creation activities, and other changes relating to tax credits for the job creation activities.¹⁴² The legislature also added an additional Subchapter U to the franchise tax code to provide a tax credit for title insurance holding companies, available to a title insurance holding company that is subject to Chapter 823 of the Insurance Code and that controls one or more domestic title insurance companies subject to certain insurance premiums imposed under the Insurance Code.¹⁴³

III. PROPERTY TAX

A. JUDICIAL AUTHORITY

In *Harris County Appraisal District v. Texas Eastern Transmission Corp.*, the Houston Court of Appeals held that Section 25.25(c)(3) of the Tax Code does not provide the proper method for a taxpayer to assert a right to interstate allocation of aircraft.¹⁴⁴ The taxpayer in this case owned two business aircraft that had significant non-Texas use and thus would be entitled under Section 21.03 to allocate to Texas only the portion of the fair market value of the aircraft that reflected their use in Texas.¹⁴⁵ However, for the years at issue (1995 through 1998), the taxpayer did not request any such allocation and did not protest the appraisal district’s determination of the aircrafts’ taxable value, which was based on allocating one hundred percent of value to Texas.¹⁴⁶ Finally realizing that it had missed out on an opportunity to reduce substantially its property taxes, the taxpayer in 2000 sought to reduce the taxable value of

139. *Id.* (amending TEX. TAX CODE ANN. § 171.109).

140. *Id.* (amending TEX. TAX CODE ANN. § 171.109).

141. *Id.* (amending TEX. TAX CODE ANN. § 171.203).

142. Tex. S.B. 275, 78th Leg., R.S., 2003 Tex. Gen. Laws 814 (amending TEX. TAX CODE ANN. §§ 171.501, .751).

143. Tex. H.B. 2424, 78th Leg., R.S., 2003 Tex. Gen. Laws 209 (adding Subchapter U to Chapter 171 of the Texas Tax Code and adding § 171.892 to Subchapter U). Confusingly enough, the Texas Legislature enacted two subchapter rules that deal with tax credits for certain insurance companies.

144. *Harris County Appraisal Dist. v. Tex. E. Transmission Corp.*, 99 S.W.3d 849, 852 (Tex. App.—Houston [14th Dist.] 2003, pet. denied). *See also* *A & S Air Serv., Inc. v. Denton Cent. Appraisal Dist.*, 99 S.W.3d 340, 343 (Tex. App.—Fort Worth 2003, no pet.); *Kellair Aviation Co. v. Travis Cent. Appraisal Dist.*, 99 S.W.3d 704, 708 (Tex. App.—Austin 2003, pet. denied).

145. *Tex. E. Transmission Corp.*, 99 S.W.3d at 850.

146. *Id.*

these aircraft for the years 1995 through 1998 by moving to correct the tax rolls pursuant to Section 25.25(c)(3), which provides: "The appraisal review board, on motion of the chief appraiser or of a property owner, may . . . change[] . . . the [tax roll] for any of the five preceding years to correct . . . the inclusion of property that does not exist in the form or at the location described in the [tax] roll."¹⁴⁷

Consistent with most (but not all) of the other Texas courts of appeals that have considered this issue, the Houston court held that a taxpayer may not rely on Section 25.25(c)(3) to obtain an interstate allocation, reasoning that Section 25.25(c)(3) is applicable only when no property exists at the location where property is being taxed, but not when property is at a location for a shorter time than described on the tax roll.¹⁴⁸ The only contrary case is *Himont U.S.A., Inc. v. Harris County Appraisal District*, in which another Houston Court of Appeals, for the First District, reasoned that "location" includes the tax situs of property, not just its physical location, given that an improper interstate allocation can result in a violation of the constitutional nexus test for taxation of property used in interstate commerce.¹⁴⁹ However, in *Harris County Appraisal District v. Texas Gas Transmission Corp.*, that same court changed its opinion on the issue and sided with the majority of Texas courts of appeals.¹⁵⁰

In the fourth (but probably not the last) sequel to the real life drama concerning the constitutionality of the Texas school financing system, the Texas Supreme Court in *West Orange-Cove Consolidated Independent School District v. Alanis* reversed the Texas court of appeals by holding that a lawsuit claiming that the state's school financing system includes an unconstitutional state property tax should not be dismissed.¹⁵¹ Relying on language in *Edgewood IV*, which held that the state's school financing system is constitutional but cautioned that the system would violate the prohibition against a state property tax if the \$1.50 cap on maintenance and operations (M&O) tax rate effectively becomes a floor on the tax rate rather than a ceiling,¹⁵² several school districts alleged that "that day has come" and thus the school financing system now violates the state property tax prohibition.¹⁵³ The district court dismissed the case on the

147. *Id.* at 850-51 (quoting TEX. TAX CODE ANN. § 25.25(c)(3) (Vernon 2001)).

148. *Id.* at 851-52.

149. *Id.* at 851 (citing *Himont U.S.A., Inc. v. Harris County Appraisal Dist.*, 904 S.W.2d 740, 743 (Tex. App.—Houston [1st Dist.] 1995, no writ)).

150. *Harris County Appraisal Dist. v. Tex. Gas Transmission Corp.*, 105 S.W.3d 88, 98-99 (Tex. App.—Houston [1st Dist.] 2003, pet. denied) (en banc); see also *SLW Aviation, Inc. v. Harris County Appraisal Dist.*, 105 S.W.3d 99, 102 (Tex. App.—Houston [1st Dist.] 2003, no pet.). The court also held that a taxpayer asserting that its aircraft's taxable value should be reduced due to interstate use must provide sufficient information on its rendition statement to permit the appraisal district to apply the allocation formula to the aircraft. *Tex. Gas Transmission Corp.*, 105 S.W.3d at 94; see also *SLW Aviation, Inc.*, 105 S.W.3d at 102.

151. *W. Orange-Cove Consol Indep. Sch. Dist. v. Alanis*, 107 S.W.3d 558, 585 (Tex. 2003).

152. *Edgewood Indep. Sch. Dist. v. Meno*, 917 S.W.2d 717, 738 (Tex. 1995).

153. *W. Orange-Cove Consol. Indep. Sch. Dist.*, 107 S.W.3d at 562.

pleadings, reasoning that the state property tax prohibition could not be supported given that fewer than half of Texas's school districts taxed at the maximum rates; the court of appeals affirmed, relying not on the percentage of school districts taxing at maximum rates but on its belief that school districts were not forced to tax at the maximum rate to provide an accredited education.¹⁵⁴

The plaintiff tax districts asserted that, in order to educate their students, they had lost all meaningful discretion in setting their M&O rate, and thus the cap on the M&O rate effectively became a statewide property tax. Indeed, these districts' only option that would allow them to continue to function is to cut programs and employee positions, given that cap on the M&O tax rate. The plaintiffs thus sought a declaratory judgment that the \$1.50 M&O cap rate is unconstitutional.¹⁵⁵

In considering the plaintiffs' position and the grounds for dismissal by the trial court and the court of appeals, the Texas Supreme Court concluded (1) that a single school district can state a claim for a violation of the statewide property tax if that school district is constrained by the state to tax at a particular rate (although left undecided is how a constitutional violation in one or a few school districts impacts the Texas school financing system in general);¹⁵⁶ (2) that by requiring schools to provide adequate education, the legislature effectively offers a school district no meaningful discretion to tax at lower than the cap rate if the imposition of a lower rate would prevent the school district from providing adequate education;¹⁵⁷ (3) that school districts that have opted for an increased homestead exemption are not necessarily precluded from alleging that they have no meaningful discretion but to tax at the cap rate; rather, school districts can assert, and attempt to establish, that even if they did not grant the maximum homestead exemption they would still be unable to provide an accredited education;¹⁵⁸ and (4) that school districts that do not tax at the cap rate can also assert a constitutional violation of prohibition against a statewide property tax—the court's rationale being that a district taxing slightly less than the cap rate that can no longer provide an accredited education at the cap rate need not raise its rate to the cap rate merely to establish its cause of action.¹⁵⁹

In a case of first impression, the San Antonio court of appeals held in *Cypress-Fairbanks Independent School District v. Glenn W. Loggins, Inc.*, that a possibility of reverter interest in real estate is not extinguished in a tax foreclosure sale.¹⁶⁰ In this case, several tax units sued the property owner, Glenn W. Loggins, Inc., for delinquent taxes, seeking a personal

154. *Id.*

155. *Id.* at 573.

156. *Id.* at 579.

157. *Id.* at 579-80.

158. *Id.* at 582-83.

159. *Id.* at 583.

160. *Cypress-Fairbanks Indep. Sch. Dist. v. Glenn W. Loggins, Inc.*, 115 S.W.3d 67, 73 (Tex. App.—San Antonio 2003, pet. denied).

judgment against the property owner and foreclosure of the property. The tax units also brought suit against an entity whose sole interest in the property was a possibility of reverter; specifically, the entity would acquire fee ownership of the property if the property is ever used for a purpose other than flood control. The owner of the possibility of reverter moved for summary judgment, alleging that the purchaser at the foreclosure sale would take title to the property subject to the possibility-of-reverter interest.¹⁶¹

Based on several arguments, the tax units asserted that their tax liens are superior to the possibility of reverter interest. First, the tax units cited to Sections 32.05 and 33.54 of the Tax Code, which essentially provide that a tax lien takes priority over other claims against the property.¹⁶² The court rejected this argument, reasoning that the “possibility of a reverter is not a claim [but is instead] an interest in the property distinct from [the delinquent taxpayer’s] interest.”¹⁶³ The tax units then argued that Section 34.01(n) provides that the tax foreclosure sale vests to the purchaser the “interest owned by the defendant,” which the tax units assert includes the possibility of reverter.¹⁶⁴ The court rejected this argument because the owner of the possibility of reverter interest was not a proper defendant in the lawsuit and thus cannot be delinquent on the tax obligation.¹⁶⁵ Finally, the tax units argued that Texas common law provides “that tax liens . . . are afforded precedence over private rights and interests,” citing *State v. Bank of Mineral Wells*, in which “[t]he court held that a tax lien was superior to [a] bank[] lien despite any express statement [to that effect] by the Texas Legislature.”¹⁶⁶ The court distinguished *Bank of Mineral Wells* because that case “was limited to a lien, not a possibility of reverter.”¹⁶⁷

In *Houston Land & Cattle Co., L.C. v. Harris County Appraisal District*, a Houston court of appeals addressed a property owner’s challenge to delinquent property taxes for twenty years, based on the assertion that the prior property owner had not been notified of property valuation increases, as required by Section 25.19 of the Tax Code.¹⁶⁸ The property owner’s position was that the property taxes were void as to the prior owner because of lack of notice and thus unenforceable against the current property owner and its successors. The court rejected the property owner’s position on two grounds. First, Section 41.11(c) provides that “[f]ailure of the appraisal district to deliver notice [of an increase in value] to ‘the property owner’” nullifies the increase in property valua-

161. *Id.* at 69.

162. *Id.* at 71 (citing TEX. TAX CODE ANN. §§ 32.05, 33.54 (Vernon 2001)).

163. *Id.* (emphasis added).

164. *Id.* (citing TEX. TAX CODE ANN. § 34.01(n) (Vernon 2001)).

165. *Id.* at 72.

166. *Id.* (citing *State v. Bank of Mineral Wells*, 251 S.W.1107 (Tex. Civ. App.—Dallas 1923, writ ref’d)).

167. *Id.*

168. *Houston Land & Cattle Co., L.C. v. Harris County Appraisal Dist.*, 104 S.W.3d 622, 623-24 (Tex. App.—Houston [1st Dist.] 2003, pet. denied).

tion, “but only ‘to the extent the change is applicable to that property owner;’”¹⁶⁹ thus, the court reasoned, the successor owner cannot rely on lack of notice to the prior owner to challenge the delinquent taxes. Second, “a protesting ‘property owner’ [must] comply with the payment requirements of Section 42.08” in order to have a valid suit; in this case, the taxes were not timely paid.¹⁷⁰

In a rare victory for property taxpayers in 2003, a Houston court of appeals in *Spring Branch Independent School District v. Siebert* addressed whether tax bills provided a sufficiently specific description of the property at issue “to sustain a judgment for judicial foreclosure of tax liens and to impose personal liability against the [property owners].”¹⁷¹ In *Siebert*, Spring Branch I.S.D. sued the Sieberts to collect property taxes for years 1996 and 1997 on an approximately two-acre tract. “In 1995, the Sieberts recorded a plot subdividing the tract into three lots, described as ‘Saddlewood Estates Lot 9 and Creekview Lots 1 and 2’ . . . However, [the appraisal district] described the three replatted lots as ‘Lots 1, 2 and 9, Block 1, Saddlewood Estates R/P.’”¹⁷² In 1998, a district court “entered an agreed final judgment against the Sieberts, declaring the 1995 replat to be in violation of deed restrictions” and invalid, although the decision was not retroactive.¹⁷³ Spring Branch I.S.D.’s suit to collect property taxes described the properties as “Lot 9, Saddlewood Estates and Lots 1 and 2, Block 1, Saddlewood Estates.”¹⁷⁴ The Sieberts paid the taxes for Lot 9 but did not pay the taxes for Lots 1 and 2, Block 1, Saddlewood Estates.¹⁷⁵

The district court held that Spring Branch I.S.D. “could not collect taxes for 1996 and 1997 on Lots 1 and 2, Block 1, Saddlewood Estates because the property had not been properly described.”¹⁷⁶ Spring Branch I.S.D. contended that the “1996 and 1997 tax bills provided ‘specific account numbers and . . . legal descriptions’ sufficient to sustain a judgment for . . . foreclosure of tax liens.”¹⁷⁷ However, the court rejected this argument because both the appraisal rolls and the tax bills listed four account numbers, somehow listing Lot 9 twice, but with none of the account numbers describing Lots 1 and 2 as part of Creekview.¹⁷⁸ The court reasoned that although Spring Branch I.S.D. asserts that “this is merely a cosmetic error,” the appraisal district’s maps also did not clearly match the appraisal district records to the properties at issue.¹⁷⁹

169. *Id.* at 624 (quoting TEX. TAX CODE ANN. § 41.11(c) (Vernon 2001)) (emphasis excluded).

170. *Id.* at 625 (quoting TEX. TAX CODE ANN. § 41.411(c) (Vernon 2001)).

171. *Spring Branch Indep. Sch. Dist. v. Siebert*, 100 S.W.3d 520, 523 (Tex. App.—Houston [1st Dist.] 2003, no pet.).

172. *Id.* at 522.

173. *Id.*

174. *Id.*

175. *Id.*

176. *Id.* at 523.

177. *Id.*

178. *Id.* at 524.

179. *Id.* at 525.

C. LEGISLATION

Although prior law required taxpayers to render tangible personal property, there was no penalty for failing to do so (imagine the effectiveness of a speed limit without the risk of a speeding ticket). However, effective for the 2004 tax year, there is a ten percent penalty of taxes due for failure to file a rendition statement or for filing a late rendition statement.¹⁸⁰ Also, there is a penalty of up to fifty percent of taxes due for a fraudulent rendition statement.¹⁸¹ Pursuant to a temporary amnesty provision, taxpayers had the opportunity of avoiding the risk of untaxed assets being discovered and taxed as omitted property for tax years 2001 and 2002 by filing a special amnesty rendition statement from September 1, 2003, through November 30, 2003.¹⁸²

In legislation that is a relief to taxpayers, if (1) property is being appraised by two or more appraisal districts and (2) the appraisal districts are not in agreement by May 1 of a tax year on the property's value, then all such appraisal districts must treat its value as being the lowest value of any of such appraisal districts.¹⁸³ In addition, if the value of property appraised by more than one appraisal district is lowered as a result of a contest (administrative or judicial), and that value becomes the lowest value of all such appraisal districts, then that value must be used by all such appraisal districts.¹⁸⁴ In 1999, the Texas Legislature passed legislation that "encouraged" appraisal districts to appraise properties at the same value but imposed no penalties for failing to do so. As with the prior law's requirement to render that was not backed up by penalties, mere encouragement did not lead to results.

Several bills were passed concerning valuation. For example, the rules for taxpayers challenging valuation based on unequal appraisal were modified to specify what appraisal districts must demonstrate in order to prevail in such a dispute.¹⁸⁵ In addition, the statute governing how the appraisal district must determine value under the income method of valuation was amended to provide that the appraisal district must exclude from the value of real property (1) tangible personal property, (2) intangible personal property, and (3) other property not subject to appraisal as real property.¹⁸⁶ Also, an owner of inventory may waive the right to have its inventory valued under the special inventory valuation provisions.¹⁸⁷

The homestead exemption was amended to provide that the exemption is not lost if the homeowner does not occupy the residence and (1) he or

180. TEX. TAX CODE ANN. § 22.28(a) (Vernon 2004).

181. *Id.* § 22.29(a).

182. *Id.* § 22.23(c).

183. *Id.* § 6.025(d).

184. *Id.*

185. TEX. H.B. 1082, 78th Leg., R.S., 2003 Tex. Gen. Laws 1041 (amending TEX. TAX CODE ANN. § 41.43(a), (b)).

186. TEX. H.B. 1460, 78th Leg., R.S., 2003 Tex. Gen. Laws 548 (adding TEX. TAX CODE ANN. § 23.014).

187. TEX. H.B. 2726, 78th Leg., R.S., 2003 Tex. Gen. Laws 700 (amending TEX. TAX CODE ANN. § 23.20(a)).

she intends to reoccupy the residence and the absence is for less than two years; (2) the absence is due to military service; or (3) the owner was in a facility which provides services related to health, infirmity, or aging.¹⁸⁸ The deadline for filing the homestead exemption was changed from one year after the taxes were paid to one year after the delinquency date for the taxes on the homestead.¹⁸⁹

Texas voters approved an amendment to the Texas Constitution providing an exemption for land owned by a religious organization that is leased for school uses or that will be used to expand or construct a place of religious worship and which produces no revenue for the religious organization.¹⁹⁰ Texas voters also approved the expansion to two years, from six months, of the period during which the former owner of a mineral interest that was sold in a tax foreclosure sale may repurchase the property.¹⁹¹ Texas voters also approved the expansion of the tax freeze provision that applies to elderly to also apply to disabled persons and extended the elderly tax freeze for school taxes to also apply to county, municipality, and junior college district taxes if approved by the relevant tax unit.¹⁹²

The open-space rollback tax provision was amended to expand the circumstances under which rollback taxes do not apply.¹⁹³ They include

a transfer of the property from the state, a political subdivision of the state, or a nonprofit corporation created by a municipality with a population of more than one million under the Development Corporation Act . . . to an individual or a business entity for purposes of economic development if the [Texas C]omptroller determines that the economic development is likely to generate for deposit in the general revenue fund during the next two fiscal bienniums an amount of taxes and other revenues that equals or exceeds [twenty] times the amount of additional taxes and interest that would have been imposed under the [rollback tax provision] . . . had the sanctions provided by that subsection applied to the transfer.¹⁹⁴

IV. PROCEDURE

Political infighting, atypical of most Texas legislative sessions, marked this year's legislative sessions and resulted in enactment of several limits and restrictions on the refund process. Unfortunately, most of these restrictions are unlikely to yield positive results, while they complicate and slow down the administrative refund process.

188. Tex. H.B. 1223, 78th Leg., R.S., 2003 Tex. Gen. Laws 240 (amending TEX. TAX CODE ANN. § 11.13(L)).

189. Tex. H.B. 2147, 78th Leg., R.S., 2003 Tex. Gen. Laws 650 (amending TEX. TAX CODE ANN. § 11.431(a)).

190. TEX. CONST. art. VIII, § 2(a).

191. *Id.* § 13(c).

192. *Id.* § 1-b(h).

193. Tex. S.B. 480, 78th Leg., R.S., 2003 Tex. Gen. Laws 1176 (amending TEX. TAX CODE ANN. § 23.55).

194. TEX. TAX CODE ANN. § 23.55(f)(4) (Vernon 2004).

Among the most unusual maneuverings of the legislature (and there were many this year) was the hasty passage of Rider 11 to the general appropriations bill, House Bill 1. The rider was designed to limit refund amounts paid during the biennium, effectively capping the amount of refunds that a taxpayer could receive without specific legislative appropriations and therefore limits the comptroller's authority to pay refunds in excess of \$250,000 to a particular taxpayer during the biennium.¹⁹⁵ The limit applies to refund claims, final judgments, and settlement agreements. The legislation purports to limit the amount of refunds that can be granted even pursuant to a final court judgment (although there is an exception for court judgments entered prior to the effective date of the law).¹⁹⁶ Rider 11 contemplates that any claim or portion of a claim that is in excess of the \$250,000 limit shall be presented in the next legislature for a specific appropriation in order for the payment to be made.¹⁹⁷

Unlike many tax measures, this provision was not originated in and was not generally supported by the comptroller's staff. The comptroller's staff issued an initial policy statement on July 14, 2003, and a subsequent rule amendment designed to make implementation of Rider 11's limitation provisions somewhat more manageable.¹⁹⁸ One of the important exceptions articulated by the comptroller's staff is that the bill would not apply to refunds of overpayment of taxes that are claimed within 120 days after the due date of the tax;¹⁹⁹ this exception is designed to cover unintended overpayments on current taxes and situations in which the taxpayer pays an amount intended to ensure that the taxpayer has not made an underpayment (e.g., a franchise taxpayer who remits tax prior to having finished its federal income tax and franchise tax filings). The comptroller's initial policy interpretation also made clear that each tax type would stand alone and carry its own \$250,000 aggregate cap; an amount that exceeds \$250,000 will not be refunded, but the taxpayer will be entitled to receive \$250,000.²⁰⁰ Amounts in excess of the cap may be used as credits under certain circumstances.²⁰¹ The cap on refunds was immediately controversial and was almost repealed during the special sessions; unfortunately, budget concerns made it difficult for the legislators to agree to repeal Rider 11, and it remains in the law.²⁰²

As if Rider 11's restrictions on refunds were not onerous enough, the legislature also enacted a provision directing a "state auditor" to review

195. Tex. H.B. 1, art. VI, rider 11, 78th Leg., R.S., 2003 Tex. Gen. Laws 1330.

196. *Id.* Constitutional aficionados will enjoy the prospect of the judiciary's determining whether the legislature may constitutionally restrict courts' ability to authorize refunds that are clearly due to the taxpayer under substantive tax law.

197. *Id.*

198. See 34 TEX. ADMIN. CODE § 3.2(d) (2003).

199. *Id.* § 3.2(d)(2)(C)(ii).

200. See *id.* § 3.2(d)(1)(A).

201. *Id.* § 3.2(d)(3).

202. In fact, the House voted unanimously in August 2003 to repeal Rider 11, indicating a possibility that the provisions may be repealed during a future session.

tax settlements entered into by the comptroller.²⁰³ As originally introduced, the provision not only granted the state auditor the right to review settlements but would also have made public certain information, including refund and settlement amounts, by reference to identified taxpayers.

The state auditor review has its roots more in the disagreement between the comptroller's office and the legislature that characterized the 2003 sessions than in solid tax policy. Although the state auditor may review and criticize settlements (and settlements are described in an extraordinarily broad manner²⁰⁴), the auditor does not have the right to "undo" the comptroller's decisions.²⁰⁵ Nonetheless, the political tension created by the review process serves as an additional barrier to settling cases. Unfortunately, the additional barrier applies to virtually all cases, increasing the difficulty of settling even cases based on assessments that are clearly erroneous (for example, an assessment by an auditor who had inadequate time before the statute of limitations ran to complete his review and who made clearly erroneous assumptions as to the amount of the tax due).

Although the state auditor review as enacted is less onerous than its earlier versions, it remains an additional hurdle for taxpayers wishing to settle or compromise their cases. While the legislation purports to limit judicially-ordered refunds, the courts may well decide that the restrictions are an unacceptable legislative encroachment on the judiciary.

As the Survey period concluded, legislators were continuing to consider yet another Special Session to address (again) funding public education and changing (raising?) taxes. But that's a story for next year's Survey

203. Tex. H.B. 7, § 23.01, 78th Leg., 3d C.S., 2003 Tex. Gen. Laws 3 (adding TEX. GOV'T CODE ANN. § 321.0138).

204. "Settlement" in this provision includes "a settlement of a claim for a tax, refund, or credit of a tax, penalty, or interest"; a "settlement of a taxpayer suit"; or "any circumstance in which a taxpayer received a warrant, offset, check, payment, or credit from the comptroller or comptroller's office arising from the filing of a tax return." *Id.*

205. *See id.*

