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# Taxation

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# TAXATION

Cynthia M. Ohlenforst\*  
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## I. SALES TAX

### A. APPLICATION OF THE TAX<sup>1</sup>

THE United States Supreme Court's decision in *Quill Corp. v. North Dakota*<sup>2</sup> dealt a serious blow to states' use tax collection efforts on out-of-state mail order sales. North Dakota, like many other states (including Texas<sup>3</sup>), enacted legislation compelling businesses that regularly and systematically solicit sales in the state to collect the state's use tax irrespective of whether such businesses had any physical presence in the state.<sup>4</sup> Pursuant to this legislation, North Dakota sought to require Quill to collect North Dakota use tax on Quill's mail order sales in the state. Quill, which did not have any physical presence in North Dakota, generated approximately \$1,000,000 in annual sales of office equipment and supplies to North Dakota customers through mail solicitations, telephone calls and advertisements in national periodicals. Quill shipped these goods from out-of-state to North Dakota customers by common carrier or mail. The Court addressed whether North Dakota's collection efforts were constitutionally permissible under both the Commerce Clause and the Due Process Clause.

A quarter of a century ago, the Court held in *National Bellas Hess, Inc. v. Department of Revenue of Illinois*<sup>5</sup> that a seller whose only connection with customers in the state was by common carrier or mail lacked the requisite minimum contacts with the state to justify imposing use tax collection obligations upon the seller.<sup>6</sup> In spite of *Bellas Hess*, the North Dakota Supreme Court held the state statute to be constitutional, reasoning that comprehensive changes in the economy, technology and the law made *Bellas Hess* obsolete.<sup>7</sup> Whereas the mail order business was a small market niche in 1967, it

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1. Cases, regulations and other developments that fell within this Survey period but were included in last year's Survey article are not included in this article. See Cynthia M. Ohlenforst & Jeff W. Dorrill, *Taxation, Annual Survey of Texas Law*, 45 Sw. L.J. 2093 (1992).

2. 112 S. Ct. 1904 (1992).

3. See TEX. TAX CODE ANN. § 151.008(b)(5) (Vernon 1992).

4. N.D. CENT. CODE § 57-40.2-01(6) (1991 Supp.).

5. 386 U.S. 753 (1967).

6. *Id.* at 758.

7. *Quill Corp. v. North Dakota*, 470 N.W.2d 203 (N.D. 1991), *rev'd*, 112 S. Ct. 1904 (1992).

had grown to a \$180 billion business by 1989.<sup>8</sup> Moreover, the North Dakota Supreme Court concluded that advances in technology greatly eased the burden of use tax collection compliance by mail order businesses.<sup>9</sup> In support of its conclusion that the legal landscape has changed since 1967, the North Dakota Supreme Court emphasized that cases such as *Complete Auto Transit, Inc. v. Brady*<sup>10</sup> are evidence that the U.S. Supreme Court no longer mandates the physical-presence test suggested in *Bellas Hess*.<sup>11</sup>

While admitting that it had always not made a clear distinction between the Due Process Clause and the Commerce Clause, the United States Supreme Court held that a bright-line physical-presence test must be met under the Commerce Clause in order to subject an out-of-state vendor to a state's sales and use tax laws,<sup>12</sup> but that such physical presence is not required to satisfy the Due Process Clause.<sup>13</sup> Thus, the Court distinguished between the "substantial nexus" requirement under the Commerce Clause and the "minimum contacts" requirement for due process purposes. In making this distinction, the Court reasoned that due process centrally concerns the fundamental fairness of a governmental activity,<sup>14</sup> while the Commerce Clause's nexus requirement should focus on a state law's effect on the national economy rather than equity for the individual taxpayer.<sup>15</sup>

The U.S. Bankruptcy Court in *In re Al Copeland Enterprises, Inc.*<sup>16</sup> held that Texas sales taxes collected by a debtor corporation are not part of the debtor's estate but are trust funds for the State of Texas, even if such amounts are commingled with non-trust fund assets.<sup>17</sup> The debtor owed the State of Texas over \$1,000,000 from sales tax collections. As the debtor collected these taxes, he deposited them in a bank account, which account was later swept into a central clearing account that contained funds generated from various other sources. Section 111.016 of the Tax Code provides that any person collecting a state tax holds the collected amounts in trust for

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8. *Id.* at 208-09.

9. *Id.* at 215.

10. 430 U.S. 274 (1977).

11. *Quill*, 470 N.W.2d at 216.

12. *Quill*, 112 S. Ct. at 1914-16. It still remains unclear, however, how much physical presence in a state is necessary in order for an entity to have a substantial nexus with the state.

13. *Id.* at 1910-11. The Court overruled *Bellas Hess* to the extent it interpreted the Due Process Clause to require physical presence in a state for the imposition of tax collection obligations. *Id.* at 1911.

The dissent stated that *Bellas Hess* should be overruled in its entirety. *Id.* at 1918 (White, J., dissenting). The dissent based its conclusion on its belief that (1) the substantial nexus test and the minimum contacts requirement are essentially the same, and (2) the substantive underpinnings of *Bellas Hess* have been dissolved in later decisions. *Id.* at 1918-20.

14. *Id.* at 1913.

15. *Id.* By holding that North Dakota's collection efforts violate the Commerce Clause but not the Due Process Clause, the Court has cleared the way for Congress to pass legislation allowing states to compel out-of-state businesses to collect use tax on sales to customers in the taxing state.

16. 133 B.R. 837 (Bankr. W.D. Tex. 1991).

17. *Id.* at 842. See also *In re Gulf Consol. Servs., Inc.*, 110 B.R. 267 (Bankr. S.D. Tex. 1989) (debtor's obligation to state for sales tax collected was held as a "trust fund," entitling the state to a priority claim).

the state's benefit.<sup>18</sup> In addressing whether the commingling of such amounts affects the status of the collections as trust funds, the court compared the language of Section 111.016 to a similarly worded federal tax statute (Section 7501 of the Internal Revenue Code<sup>19</sup>) providing that federal tax collections are held in trust for the United States. Courts have held that amounts held in trust for the United States under Section 7501 do not lose their trust status merely because such amounts are commingled with non-trust funds if the aggregate commingled funds equals or exceeds the trust fund amounts at all times between collection of taxes and the bankruptcy filing.<sup>20</sup>

As during past Survey periods, the comptroller issued numerous administrative decisions. A brief overview of a few of these noteworthy decisions highlights some recurring issues and changes or clarifications in comptroller policy. Decision No. 27,336<sup>21</sup> rejected the comptroller's long-standing policy of applying sales tax rate increases to operating lease payments received after the effective date of the rate increase.<sup>22</sup> In what appears to be, surprisingly, an issue of first impression, the comptroller considered whether the Texas Legislature intended for the leasing of property to be treated as a single sale or as a series of sales. The comptroller concluded that an operating lease represents only one taxable event, which occurs upon the execution and delivery of possession of the leased property.<sup>23</sup> Thus, each rental payment is taxed at the sales tax rate in effect on the date the lease is consummated.<sup>24</sup>

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18. TEX. TAX CODE ANN. § 111.016 (Vernon 1992).

19. I.R.C. § 7501 (1988).

20. *Begier v. I.R.S.*, 496 U.S. 53 (1990); *In re Mahan & Rowsey, Inc.*, 817 F.2d 682 (10th Cir. 1987).

21. Comptroller Hearing No. 27,336 (Sept. 10, 1991).

22. *Id.* The Tax Division pointed to TEX. TAX CODE ANN. § 151.408 (Vernon 1992) in support of its argument that each lease payment should be subject to the sales tax rate in effect at the time the payment is made. Section 151.408 provides that a taxpayer whose regular books are kept on an accounting basis that accurately reflects the taxpayer's business operations may file sales tax reports on the same basis that is used for the taxpayer's regular books. *Id.* Thus, if a taxpayer books lease income on a monthly basis, the comptroller cannot require the taxpayer to pay the sales tax upfront on all lease payments. See 34 TEX. ADMIN. CODE § 3.294(f)(3)(A) (eff. Dec. 6, 1991, 16 Tex. Reg. 6756). Therefore, based on the fact that § 151.408 allows taxpayers to pay sales tax on leases as lease payments are made, the Tax Division argued that sales tax should be charged on each lease payment at the rate in effect at the time the payment is made. The comptroller found absolutely no relationship between the provisions of § 151.408 and the issue of when a "sale" occurs for sales tax purposes. Comptroller Hearing No. 27,336 (Sept. 10, 1991). This decision appears consistent with the comptroller's policy of requiring outstanding sales tax liability to be accelerated when a lease is factored or assigned (see 34 TEX. ADMIN. CODE § 3.294); the comptroller's justification for acceleration is, in part, that the entire tax was due on the sale date, and that payment over time is permitted merely by grace. In determining that each lease payment is taxed at the rate in effect on the date the payment is made, the comptroller was influenced by decisions in other states addressing similar issues. For example, in *Hansord Agency, Inc. v. Commissioner of Taxation*, 199 N.W.2d 823 (Minn. 1972), the Supreme Court of Minnesota held that, for Minnesota sales tax purposes, a "sale" includes a lease transaction; given that the rights of the lessor and the lessee were irrevocably fixed at the time the lease is entered into, a new "sale" does not occur each time a rental payment is paid. *Id.* at 824.

23. Comptroller Hearing No. 27,336 (Sept. 10, 1991).

24. *Id.*

In Decision No. 28,727,<sup>25</sup> the comptroller addressed Section 151.304(b)(2) of the Tax Code, which exempts from sales tax the sale of the entire operating assets of a separate division, branch or identifiable segment of a company.<sup>26</sup> Rule 3.316(d)(2) provides that this exemption does not apply to a sale unless the income and expenses attributable to the division, branch, or segment could be separately established from the seller's books of account or record.<sup>27</sup> In this decision, a bank sold all of its equipment that was used in its data processing bureau. The data processing bureau had two internal cost centers, one for customer service and the other for actual data processing operations. Although both cost centers had expenses, only the data processing cost center had any income that could be separately established from the bank's books and records. The taxpayers regularly combined the income and expenses from these two cost centers into one "report." The comptroller ruled that the sale constituted an occasional sale because the service bureau, as a whole, had both income and expenses on the taxpayer's books and records.<sup>28</sup>

The comptroller addressed in Decision No. 28,441<sup>29</sup> the difficult question of how the sale for resale exemption applies to taxable services. The comptroller ruled that data processing services used to assist a debt collector in keeping track of payments made by debtors were not purchased for resale.<sup>30</sup> In order for a service to be purchased for resale, the service must be resold as an integral part of a taxable service.<sup>31</sup> The comptroller ruled that these data processing services were not an integral part of the debt collection service because, although the data processing services made the debt collection job easier, the debt collection services could be performed without relying on the data processing services.<sup>32</sup>

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25. Comptroller Hearing No. 28,727 (July 13, 1992).

26. TEX. TAX CODE ANN. § 151.304(b)(2) (Vernon 1992).

27. 34 TEX. ADMIN. CODE § 3.316(d)(2) (eff. Dec. 24, 1984, 9 Tex. Reg. 6188).

28. Comptroller Hearing No. 28,727 (July 13, 1992). The comptroller appeared to be influenced strongly by the fact that the seller *regularly* prepared the report combining income and expenses from both cost centers. *Id.*

29. Comptroller Hearing No. 28,441 (Oct. 14, 1992). In another decision addressing the sale for resale exemption, the comptroller ruled in Decision No. 27,359 that a wholesale grocery business could not accept in good faith a resale certificate from a grocery store on a purchase of a gas pump hose since such an item is not typically sold in a grocery store, but that the wholesale business could accept resale certificates for the purchase of catalogs, card files, fluorescent lamps and light bulbs since such items might be sold in a grocery store. Comptroller Hearing No. 27,359 (June 26, 1991). The comptroller pointed out in this decision that sellers are not expected to police purchasers that give them resale certificates so long as the certificates appear to be valid on their face. *Id.*

30. Comptroller Hearing No. 28,441 (Oct. 14, 1992).

31. TEX. TAX CODE ANN. §§ 151.006, 151.302 (Vernon 1992).

32. Comptroller Hearing No. 28,441 (Oct. 14, 1992). Decision No. 27,715 involves similar facts to those presented in Decision No. 28,441. Comptroller Hearing No. 27,715 (Dec. 9, 1991). In Decision No. 27,715, a debt collection company that contracted with merchants claimed an exemption from taxation on stationery services (used in preparing debt collector's pre-printed notice forms), skip tracing services and data processing services the company used to collect returned checks. The comptroller ruled that, while the skip tracing services qualified for the resale exemption because they were an integral part of the debt collection services, both the stationery services and the data processing services were taxable. *Id.*

Decision No. 27,663<sup>33</sup> also addressed the sales tax on debt collection services. The taxpayer contracted with businesses to collect on returned checks received by the businesses.<sup>34</sup> The taxpayer's contract with the businesses provided that a fifteen dollar service charge would be added to the face amount of each check placed with the taxpayer for collection and that upon collection, the taxpayer would be allowed to retain ten dollars of the additional fifteen dollar charge, with the remaining five dollars remitted to the businesses.<sup>35</sup> In asserting that tax is due on the entire fifteen dollar charge, the Tax Division relied on Rule 3.354(b)(3), which states that the writer of a dishonored check is responsible for paying the cost incurred to process the check, including sales tax due on the debt collection service.<sup>36</sup> Thus, the Tax Division argued that the cost incurred to process the check is the full fifteen dollar charge. The comptroller disagreed, reasoning that only the amount retained by the taxpayer (ten dollars) was subject to the debt collection service tax because that amount represented the price of the taxpayer's service.<sup>37</sup>

Decision No. 26,672<sup>38</sup> addressed what appears to be clever tax planning designed to circumvent Section 151.007(a)(3) of the Tax Code, which provides that charges for transportation of tangible personal property are included in the sales price.<sup>39</sup> The taxpayer and each customer agreed that title to goods would pass to the customer on the invoice date, that the customer would pay a nominal storage fee for the taxpayer's holding the property after sale, and that the taxpayer would deliver the goods by common carrier. The taxpayer argued that it should not be responsible for collecting sales taxes on the transportation charges because it had arranged for transportation of the tangible property in its capacity as bailee rather than as seller of the property. The comptroller ruled that because the taxpayer's customers clearly anticipated that the taxpayer would ultimately deliver the goods, the transportation of the goods was connected with the goods' sale and not their storage.<sup>40</sup>

Decision No. 27,659<sup>41</sup> addressed whether an assignment of an operating lease to a third party was a financing arrangement or a factoring. The distinction is important because if a lease is factored, sales tax is due on all remaining lease payments.<sup>42</sup> This issue is ripe for controversy, given that the comptroller's rules are not particularly lucid in defining a lease factoring and that prior decisions have been inconsistent. In this case, the taxpayer purchased equipment, leased the equipment to third parties, and then assigned the lease agreement to a financing company. The Tax Division as-

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33. Comptroller Hearing No. 27,663 (Oct. 29, 1991).

34. *Id.*

35. *Id.*

36. 34 TEX. ADMIN. CODE § 3.354(b)(3) (eff. Dec. 11, 1992, 17 Tex. Reg. 8332).

37. Comptroller Hearing No. 27,663 (Oct. 29, 1991).

38. Comptroller Hearing No. 26,672 (Feb. 7, 1991).

39. TEX. TAX CODE ANN. § 151.007(a)(3) (Vernon 1992).

40. Comptroller Hearing No. 26,672 (Feb. 7, 1991).

41. Comptroller Hearing No. 27,659 (Apr. 29, 1992).

42. 34 TEX. ADMIN. CODE § 3.294(h) (eff. Dec. 6, 1991, 16 Tex. Reg. 6756).

serted that the leases were factored because (1) the agreement with the financing company described the arrangement as an assignment, (2) the assignments were non-recourse, and (3) the taxpayer never produced any loan agreements or promissory notes. The taxpayer suggested that the assignments with the financing company represented loans because (1) the taxpayer retained title to the equipment, (2) the taxpayer was authorized in the agreement with the financing company to borrow from the financing company certain sums, and (3) UCC-1's were sometimes filed. The comptroller ruled that the transaction more closely resembled an assignment rather than a loan, although it recognized that the distinction was difficult to make.<sup>43</sup>

In Decision No. 28,461,<sup>44</sup> the comptroller ruled that a lump sum sales price for a roofing contract did not include sales tax even though the purchase order provided the price "includes labor, materials and tax."<sup>45</sup> The comptroller based its decision on two factors. First, neither the original price proposal nor any invoices contained any reference to state taxes.<sup>46</sup> Second, the references in the purchase order to the inclusion of tax could relate either to the taxes the roofer paid to its suppliers for materials used on the job or to the tax that was due on the actual roofing job.<sup>47</sup> Given these two possibilities, the language should be interpreted against the taxpayer because the roofer did not hold a sales tax permit.<sup>48</sup>

## B. STATE TAX REGULATIONS

The ongoing process of issuing and amending sales tax regulations continued throughout the Survey period. Rule 3.291, addressing sales tax responsibilities of contractors, was amended to reflect 1991 legislation narrowing the sales tax exemption for property used to improve an exempt organiza-

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43. Comptroller Hearing No. 27,659 (Apr. 29, 1992).

44. Comptroller Hearing No. 28,461 (Aug. 24, 1992).

45. *Id.* Comptroller Hearing No. 28,166 (Apr. 6, 1992) concerns facts similar to those presented in Decision No. 28,461. In Decision No. 28,166, the taxpayer contracted with a roofing company to repair and modify the roof of a hotel the taxpayer owned. The contract with the roofing company provided that the lump sum sales price "includes all labor, materials, taxes and permits." *Id.* The taxpayer asserted that because the contract provided that the sales price included all taxes, the sales price must have included sales tax; therefore, by paying the lump sum price, the taxpayer had paid all sales taxes due. The comptroller ruled that the inclusion of the term "taxes" in the contract was most likely a reference to the taxes the roofer believed it would have to pay to vendors for materials and equipment purchased or rented for use in completing the job. *Id.* As in Decision No. 28,461, the comptroller appeared to be heavily influenced by the fact that the roofer did not have a sales tax permit. *Id.*

46. Comptroller Hearing No. 28,461 (Aug. 24, 1992).

47. *Id.*

48. *Id.* This decision makes clear that if sales tax is to be included in the overall price, invoices, contracts, and purchase orders should clearly document such fact.

Decision No. 28,468 provides guidance with respect to how the comptroller differentiates between real property maintenance (which is not a taxable service) and the repair of non-residential real property (which is a taxable service). In this case, the taxpayer determined that the caulk in its building was allowing moisture penetration and hired a water-proofing company to remove and replace the old caulk. The comptroller ruled that the work performed by the water-proofing company was not maintenance and was a taxable real property restoration service because the work was neither scheduled nor periodic work. Comptroller Hearing No. 28,468 (Nov. 2, 1992).

tion's realty and to provide further guidance with respect to the taxability of materials incorporated into property.<sup>49</sup> In keeping with the changes made to Section 151.311 of the Tax Code,<sup>50</sup> Rule 3.291 now provides that contractors improving realty for school districts or non-profit or public hospitals may obtain an exemption certificate with respect to property purchased by them in connection with such projects.<sup>51</sup> Under the prior rule (and prior law), tangible personal property used to improve the realty of any entity organized by the state, county, city or any other political subdivision was exempt.<sup>52</sup> Amended Rule 3.291, however, expressly allows exempt organizations to purchase materials incorporated into a facility tax-free through the use of separated contracts.<sup>53</sup> Rule 3.291 now defines the term "consumable items," and provides when such items may be purchased tax-free.<sup>54</sup> The rule also provides additional guidance on what constitutes a separated contract.<sup>55</sup> For example, the rule makes clear that the terms of the contract will control over the terms of a bid.<sup>56</sup> The rule also sets forth guidelines taxpayers must meet in order to purchase tax-free tangible personal property that is intended to be incorporated into a facility dedicated to a governmental entity.<sup>57</sup>

The comptroller made substantial revisions to Rule 3.294, which addresses sales tax consequences of rentals and leases of tangible personal property.<sup>58</sup> Amended Rule 3.294 provides more guidance concerning assignments of operating leases. The rule now provides that if a lessor (1) assigns to a third party the lessor's rights to receive all lease payments due under a lease agreement, and (2) transfers title to the leased property, then the third party purchaser must begin collecting tax on the remaining rental

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49. 34 TEX. ADMIN. CODE § 3.291 (eff. July 23, 1992, 17 Tex. Reg. 4955).

50. TEX. TAX CODE ANN. § 151.311 (Vernon 1992).

51. 34 TEX. ADMIN. CODE § 3.291(c).

52. *Id.* § 3.291(c)(1) (11 Tex. Reg. 4930) (amended July 23, 1992, 17 Tex. Reg. 4955).

53. 34 TEX. ADMIN. CODE § 3.291(e)(3).

54. *Id.* § 3.291(a)(2), (b)(2). Consumable items may be purchased tax-free by a contractor if they are transferred to the contractor's customer at or before the time the contractor takes possession of such items where practicable and if the items are immediately marked or physically identified as the customer's property, and the contractor separately states the charges for the consumable items. *Id.* § 3.291(b)(2)(B).

55. *Id.* § 3.291(b)(4).

56. *Id.* § 3.291(b)(5). The rule also provides that the terms of a contract will prevail over the terms of a change order for purposes of determining whether the change order is a lump-sum or separated contract. *Id.* Comptroller representatives have stated, however, that this change-order provision (which constitutes a change in policy) will not affect change-orders to contracts that were executed prior to the effective date of the rule.

57. *Id.* § 3.291(f). A contractor may purchase tax-free tangible personal property used to improve real property that will be ultimately dedicated to a governmental entity if (1) the contract between the contractor and the private party is a separated contract, (2) the contract provides that title to the materials passes to the private party when the materials are delivered to the job site and before they are incorporated into the realty or used by the contractor or the private entity, and (3) the contract provides that the private party intends to donate the property to the governmental entity before it is incorporated into the realty or used by the contractor. *Id.*

58. 34 TEX. ADMIN. CODE § 3.294 (eff. Dec. 6, 1991, 16 Tex. Reg. 6756).



charges.<sup>59</sup> However, the third party may issue a resale certificate to the original lessor so that the third party is not required to pay sales tax on the amount it paid to the original lessor for the leased property.<sup>60</sup> Many of the other changes clarify the application of sales tax to the leasing of tangible personal property with an operator.<sup>61</sup> The revised rule also specifies that damage waiver fees are taxable.<sup>62</sup> Whereas the prior rule did not address transportation charges, the revised rule provides that all transportation charges billed by the lessor to the lessee that are related to the leased property are taxable, but that charges for transportation billed directly to the lessee by third party carriers are not taxable.<sup>63</sup>

New Rule 3.314 addresses sales and use tax consequences of wrapping, packing, and packaging supplies.<sup>64</sup> The rule provides that sales and use tax is not due on containers or packaging supplies purchased by manufacturers for use as part of the manufacturing completion process.<sup>65</sup> The manufacturing process is complete when the property being produced has been packaged by the manufacturer as it will be sold.<sup>66</sup> Sales tax is due on packaging supplies, such as gift wrapping supplies, sold to persons who repack the tangible personal property prior to sale. Additionally, sales tax is due on packaging supplies sold to produce shippers who are not original producers, wholesalers, retailers and service providers for use in delivering or furthering the performance of a service or the rental or sale of tangible personal property.<sup>67</sup> The rule does provide, however, that if a business that primarily manufactures tangible personal property for sale also purchases for resale tangible personal property manufactured by another entity, the business may purchase all of its packaging supplies tax-free even though a portion of such supplies are used in repackaging another product.<sup>68</sup>

Rule 3.298, addressing amusement services, was amended by adding non-profit country clubs to the list of amusement services.<sup>69</sup> The amended rule also provides that amusements are taxable if they are provided jointly by a for-profit organization and by a governmental entity.<sup>70</sup>

During the Survey period, the comptroller continued to enact rules ad-

59. *Id.* § 3.294(i). Amended Rule 3.294 also makes clear that all oral leases will be treated as operating leases rather than as financing leases. *Id.* § 3.294(a)(4).

60. *Id.* § 3.294(i).

61. *Id.* § 3.294(c).

62. *Id.* § 3.294(d)(2).

63. *Id.* § 3.294(d)(3). Rule 3.294 was also amended to provide specific guidance with respect to the obligations of an out-of-state lessor deriving rental receipts from tangible personal property located in Texas. *Id.* § 3.294(f)(3)(C).

64. 34 TEX. ADMIN. CODE § 3.314 (eff. July 23, 1992, 17 Tex. Reg. 4958).

65. *Id.* § 3.314(b)(1).

66. *Id.*

67. *Id.* § 3.314(c).

68. *Id.* § 3.314(e). For example, the rule provides that fast-food restaurants are generally treated as primarily engaged in processing of tangible personal property for sale. Thus, a fast-food restaurant may purchase tax-free not only the containers used for the food it processes, but it may also purchase tax-free the containers used for other items it sells, such as soft drinks or candy. *Id.* § 3.291(e)(1).

69. 34 TEX. ADMIN. CODE § 3.298(a)(1)(G) (eff. Sept. 29, 1992, 17 Tex. Reg. 6372).

70. *Id.* § 3.298(h)(2).

dressings 1989 and 1991 sales tax legislation. For example, Rule 3.300 was amended to reflect 1991 legislation that delayed the phasing in of the sales and use tax exemption for certain manufacturing equipment.<sup>71</sup> Rule 3.345 was added to address 1989 legislation that provides a refund to qualified businesses buying equipment and machinery to be used in an enterprise zone.<sup>72</sup> Amended Rule 3.356 provides a definition of "temporary help services," which cannot be taxed as real property services under 1989 legislation.<sup>73</sup> Amended Rule 3.297 addresses the exemption added in 1989 for certain aircraft items and services.<sup>74</sup> Amended Rule 3.286 now reflects 1989 legislation that expanded the definition of "seller" and "retailer" and eliminated the sales tax permit fee.<sup>75</sup> Rule 3.329 was amended to reflect 1991 legislation that altered the sales tax incentive for enterprise projects creating new jobs.<sup>76</sup>

## II. FRANCHISE TAX

### A. LIABILITY FOR TAX — DOING BUSINESS IN TEXAS AND PUBLIC LAW 86-272

As revised in 1991, the franchise tax is now comprised of two components: a tax on capital<sup>77</sup> and a tax on "earned surplus."<sup>78</sup> Although *Sharp v. House of Lloyd, Inc.*<sup>79</sup> established that a corporation may become subject to the Texas franchise tax by effecting in-state sales through independent contractors, the income from such sales may, in some circumstances, be partially shielded from the franchise tax.<sup>80</sup> Because the tax on earned surplus is, in substance if not in name, an income tax, Public Law 86-272,<sup>81</sup> which limits states' ability to tax companies whose only state contacts are certain solicitations or orders, limits Texas' ability to impose a tax on the earned surplus of an entity whose only ties to Texas are certain limited solicitation activities conducted by independent contractors. Accordingly, the United States Supreme Court's focus on "solicitation of orders" as used in Public Law 86-272 in *Wisconsin Department of Revenue v. William Wrigley, Jr. Co.*<sup>82</sup> will impact the scope and administration of Texas' tax on earned surplus.

The *Wrigley* case noted that the Wrigley company sold gum in Wisconsin, but had no real property, telephone listing or bank accounts in Wisconsin, and did not operate any manufacturing, training or warehouse facilities in

71. 34 TEX. ADMIN. CODE § 3.300(h) (eff. Feb. 5, 1992, 17 Tex. Reg. 473).

72. 34 TEX. ADMIN. CODE § 3.345 (eff. July 9, 1992, 17 Tex. Reg. 4611).

73. 34 TEX. ADMIN. CODE § 3.356(a)(10), (b) (eff. Dec. 6, 1991, 16 Tex. Reg. 6760).

74. 34 TEX. ADMIN. CODE § 3.297(d) (eff. Jan. 28, 1992, 17 Tex. Reg. 324).

75. 34 TEX. ADMIN. CODE § 3.286(a)(1), (a)(3), (c)(1) (eff. Mar. 6, 1992, 17 Tex. Reg. 1744).

76. 34 TEX. ADMIN. CODE § 3.329 (eff. Apr. 17, 1992, 17 Tex. Reg. 2403).

77. See TEX. TAX CODE ANN. §§ 171.002(a)(1); 171.101 (Vernon 1992).

78. *Id.* §§ 171.002(a)(2); 171.110.

79. 815 S.W.2d 245 (Tex. 1991).

80. *Id.* at 249.

81. Pub. L. No. 86-272, 73 Stat. 555 (1959) (codified as amended at 15 U.S.C. §§ 381-84 (1988)).

82. 112 S. Ct. 2447 (1992).

the state. The company, which employed salesmen to solicit sales in Wisconsin, argued that its Wisconsin activities were limited to "solicitation of orders" within the meaning of Public Law 86-272, and that it was therefore immune from Wisconsin franchise taxes. The state asserted that a company forfeits its Public Law 86-272 protection if it engages in "any activity other than requesting the customer to purchase the product."<sup>83</sup> The Court accepted neither the state's narrow construction nor Wrigley's broad interpretation under which solicitation would include any activities that are "ordinary and necessary 'business activities' accompanying the solicitation process" or are "routinely associated with deploying a sales force . . . so long as there is no office, plant, warehouse or inventory in the state."<sup>84</sup> Instead, the Court sought to find the line between activities that are "entirely ancillary" to requests for purchase and those that the company would engage in anyway,<sup>85</sup> while making clear that certain de minimus activities would not result in losing the statutory protection.<sup>86</sup> Finding that, on the facts before the Court, Wrigley's replacement of stale gum, supplying gum through stock checks, and storing gum in state were neither ancillary nor de minimus,<sup>87</sup> the Court upheld Wisconsin's right to tax the company.

The Court's failure to provide a bright-line test ensures additional litigation, and Texas taxpayers may well be among those to look to the courthouse for guidance.

#### B. CALCULATION AND ALLOCATION OF TAXABLE CAPITAL

Taxpayers continue to challenge, but with limited success in administrative hearings, the comptroller's determination of surplus. In Decision 27,758, for example, the comptroller ruled that the taxpayer could not deduct future operating lease obligations from surplus for purposes of calculating its franchise tax liability for years after the 1987 legislative changes to the franchise tax.<sup>88</sup> The taxpayer relied on the Section 171.109(a)(3) definition of debt as "any legally enforceable obligation."<sup>89</sup> The administrative law judge concluded, however, that allowing the taxpayer to deduct (as a debt) its operating lease obligations without taking into surplus (as an asset) the

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83. *Id.* at 2454 (citing Brief For Petitioner at 21). Wisconsin further argued that no post-sale activities could be included within the scope of solicitation. *Id.* at 2457.

84. *Id.* at 2455 (citing Brief For Respondent at 9, 19-20).

85. *Id.* at 2456.

86. *Id.* at 2458.

87. *Id.* at 2459-60. This finding is particularly interesting given the fact that only 0.00007% of Wrigley's annual Wisconsin sales were from stock checks. The Court concluded, by contrast, that Wrigley's in-state recruitment, training and evaluation of sales representatives, using hotels and homes for sales meetings, and certain credit-dispute interventions were ancillary to solicitation. *Id.*

88. Comptroller Hearing No. 27,758 (Mar. 12, 1992).

89. TEX. TAX CODE ANN. § 171.109(a)(3) (Vernon Supp. 1992). This definition, enacted in 1989, is intended to limit taxpayers' ability to reduce taxable surplus; thus, the definition excludes from "debt" obligations that do not constitute fixed, legally enforceable obligations, even if the obligations are characterized as liabilities for generally accepted accounting purposes.

value of the lease would distort the taxpayer's financial condition.<sup>90</sup> This interesting decision fails to reconcile its conclusion with the statutory definition of debt. The comptroller subsequently reached the same conclusion in a hearing that involved refund claims for years prior to the 1987 legislative changes.<sup>91</sup>

In Decision 27,866, the comptroller held that a corporation could not write off, for franchise tax purposes, the value of its shell subsidiaries.<sup>92</sup> The taxpayer argued that it was writing off permanently worthless assets, as allowed by Tax Code Section 171.109(a).<sup>93</sup> The Tax Division argued that the losses in these shells were unrealized, and could not be written off, because the subsidiaries remained in existence, and the comptroller concluded that the shells had some residual value. In addressing the taxpayer's argument that the decline in value occurred as a result of a "specifically identifiable event"<sup>94</sup> (the shells' disposition of all their assets), the comptroller relied on an earlier decision<sup>95</sup> rejecting a similar argument.

These decisions reflect the comptroller's reluctance to allow taxpayers to reduce their surplus by any items other than those specifically listed in Section 171.109.<sup>96</sup> Nonetheless, taxpayers prevailed in some efforts to reduce taxable surplus. In Decision 27,242<sup>97</sup> for example, the comptroller ruled that expected decommissioning costs of a nuclear generating plant should be subtracted from surplus with respect to the taxpayer's 1986 and 1987 report years. The Tax Division argued that the liability should not be subtracted from surplus because the liability had not been booked by the taxpayer. However, observing that the liability was footnoted in the taxpayer's financial statements, the comptroller treated these decommissioning costs similarly to unfunded pension costs, which could be subtracted from surplus for the report years at issue.<sup>98</sup> This decision, although favorable to taxpayers, appears inconsistent with the comptroller's more narrow definition of debt in the other cited cases.

Other significant administrative decisions<sup>99</sup> concluded that a corporation

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90. Comptroller Hearing No. 27,758.

91. Comptroller Hearing No. 27,973 (July 30, 1992). The taxpayers in both this decision and Comptroller Hearing No. 27,758 have filed refund suits in Travis County District Court.

92. Comptroller Hearing No. 27,866 (Apr. 30, 1992).

93. TEX. TAX CODE ANN. § 171.109(a) (Vernon 1992).

94. Comptroller Hearing No. 27,866.

95. Comptroller Hearing No. 20,448 (Dec. 31, 1987).

96. TEX. TAX CODE ANN. § 171.109 (Vernon 1992) provides that surplus includes unrealized, estimated, or contingent losses or obligations or any writedown of assets other than a revenue or allowance for uncollectable accounts and a contra-asset account for depletion, depreciation or amortization. *Id.* § 171.109(a),(i).

97. Comptroller Hearing No. 27,242 (May 15, 1992).

98. *See* Comptroller Hearing Nos. 21,122 and 22,234 (Jan. 5, 1989). *But see* Comptroller Hearing No. 28,399 (June 8, 1992) (retirement and post-retirement employee benefits not subtracted from surplus for 1989 report year because the expected liabilities were based on actuarial estimates and were not certain).

99. The comptroller issued numerous decisions in addition to the ones discussed. Comptroller Hearing No. 28,206 (July 14, 1992), for example, addressed the definition of treasury stock. The taxpayer owned approximately 15 percent of a corporation (X) that owned between 30 and 60 percent of the taxpayer's stock over the relevant period. Taxpayer's account-

may not exclude from surplus the pre-acquisition earnings of second-tier subsidiaries,<sup>100</sup> that tax effecting is required in recomputing taxpayer franchise tax liability,<sup>101</sup> and addressed push-down accounting.<sup>102</sup> As in past Survey periods, significant issues are the subject of litigation, although many cases will be resolved at the district court level without published opinions.

### C. CALCULATION AND ALLOCATION OF TAXABLE EARNED SURPLUS

As Texas adapts to having a tax that functions like an income tax, other states' income tax interpretations become more relevant to Texas taxpayers than in the past. Among the several Supreme Court cases during the Survey period that discuss the parameters of a state's ability to tax are two that focus on dividend income to be included in the tax base.

*Allied-Signal, Inc. v. Director, Division of Taxation*<sup>103</sup> focuses on states' rights to tax certain dividend income earned by a company that is subject to the state's taxation. Bendix Corporation, the predecessor of Allied-Signal, contested New Jersey's attempt to include in apportionable income for state tax purposes the gain recognized on Bendix's sale of a minority interest in ASARCO. Although Bendix and ASARCO were not unitary businesses, New Jersey argued that Bendix's gain on the ASARCO sale should be included in the tax base. Contrary to its normal practice, the Supreme Court ordered the case set for re-argument subsequent to the original oral argument and requested supplemental briefs addressing the possible overruling of *ASARCO, Inc. v. Idaho State Tax Commission*<sup>104</sup> and *F. W. Woolworth Co. v. Taxation and Revenue Department*,<sup>105</sup> both of which support the unitary

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ants required it to report its X stock on financial statements as treasury stock. The Tax Division argued that, for franchise tax purposes, the stock was not treasury stock because it represented an investment in another corporation. However, the comptroller ruled that because surplus is computed in accordance with GAAP, and because GAAP treats such stock as treasury stock, the stock should be treated as treasury stock. *Id.*

100. See Comptroller Hearing No. 27,492 (Jan. 3, 1992). See also Comptroller Hearing Nos. 23,873 and 26,405 (Apr. 29, 1991). In distinguishing *State v. Sun Refining & Mktg., Inc.*, 740 S.W.2d 552 (Tex. App.—Austin 1987, writ denied), which held that the pre-acquisition earnings of subsidiaries should not be included in the acquiring parent corporation's taxable surplus, the comptroller concluded that the holding in *Sun Refining* should be limited to the retained earnings of directly owned (first-tier) subsidiaries. *Id.* Comptroller Hearing Nos. 23,874, 23,874A and 26,474 held that *Sun Refining* applies only if an acquired subsidiary existed at the close of the parent's fiscal year. Comptroller Hearing Nos. 23,874, 23,874A and 26,474 (Dec. 5, 1991). Texas courts may ultimately be required to address the limits of the holding in *Sun Refining*.

101. See Comptroller Hearing Nos. 26,070, 26,346 and 26,347 (Sept. 30, 1991) (holding that taxpayer's downward adjustments to its surplus made to reflect unbooked postretirement benefit liabilities should be modified upwards to reflect federal income tax benefits associated with such liabilities).

102. Comptroller Hearing No. 27,377, still in proposed form at the end of the Survey period, held that the comptroller may not require a corporation to use push-down accounting on the facts in that case (corporation not required by GAAP to use push-down accounting). The rationale in this decision is based in part on a prior comptroller decision that focused on the investment tax credit (Decision No. 25,545 (Dec. 6, 1990)).

103. 112 S. Ct. 2251 (1992).

104. 458 U.S. 307 (1982).

105. 458 U.S. 354 (1982).

principle of taxation. Following reargument, the Court held that New Jersey could not include in apportionable income for state tax purposes the gain Bendix received from the sale of a minority interest in an unrelated, non-unitary business.<sup>106</sup>

*Kraft General Foods, Inc. v. Iowa Department of Revenue and Finance*,<sup>107</sup> another Supreme Court case decided during the Survey period, further illustrates limitations imposed on states in determining which dividend income to include in the tax base. The Court held that Iowa's tax scheme, which included dividends received from non-United States corporations in the tax base, but excluded dividends from domestic corporations, was facially discriminatory against foreign commerce.<sup>108</sup>

#### D. REGULATORY DEVELOPMENTS

Virtually every significant franchise tax rule was revised during 1992 as the comptroller sought to offer further guidance — and some further restrictions — on determining franchise tax liability.<sup>109</sup>

Rule 3.572,<sup>110</sup> which fueled numerous debates as to the comptroller's rule-making authority, had become the subject of at least two court cases when the comptroller decided to abandon the most controversial section of the rule. Rule 3.572, first proposed in November 1991,<sup>111</sup> was designed to deny taxpayers the benefit of merging a target company out of existence prior to the effective date of the franchise tax<sup>112</sup> and thereby allowing the target company to escape the newly enacted tax. The rule required the surviving corporation to pay a supplemental tax based on the target's pre-merger

106. 112 S. Ct. at 2264.

107. 112 S. Ct. 2365 (1992).

108. 112 S. Ct. at 2372.

109. Several rules were adopted during the Survey period without changes from the versions proposed in December 1991: 34 TEX. ADMIN. CODE §§ 3.541 (Exemptions); 3.542 (Trade Show); 3.543 (Deposit); 3.545 (Extensions); 3.546 (Taxable Capital: Nexus); 3.547 (Taxable Capital: Accounting Methods); 3.550 (Taxable Capital: Stated Capital); 3.552 (Taxable Capital: In Process of Liquidation); 3.553 (Taxable Capital: Oil & Gas Reserves); 3.554 (Earned Surplus: Nexus) (A revised version of this rule was circulating in draft form, but had not been adopted at the end of the Survey period.); 3.570 (Liens); 3.574 (\$100 Prepayment) (West Supp. 1992). These rules are effective as of March 16, 1992. See 17 Tex. Reg. 1652 (1992). Other franchise tax rules adopted during the Survey period include 34 TEX. ADMIN. CODE §§ 3.544 (Reports and Payments) (eff. Oct. 21, 1992, 17 Tex. Reg. 7102); 3.548 (Taxable Capital: Close and S Corporations) (eff. Sept. 29, 1992, 17 Tex. Reg. 6373); 3.551 (Taxable Capital: Surplus) (eff. Nov. 11, 1992, 17 Tex. Reg. 7587); 3.555 (Earned Surplus: Computation) (eff. Sept. 23, 1992, 17 Tex. Reg. 6277); 3.556 (Earned Surplus: S Corporations) (eff. Sept. 29, 1992, 17 Tex. Reg. 6373); 3.559 (Earned Surplus: Temporary Credit) (eff. May 26, 1992, 17 Tex. Reg. 3473); 3.561 (Enterprise Zones) (eff. Mar. 12, 1992, 17 Tex. Reg. 1652); 3.565 (Survivor of Mergers) (eff. July 29, 1992, 17 Tex. Reg. 5119); 3.566 (Title Insurance Holding Companies) (eff. May 4, 1992, 17 Tex. Reg. 2874); 3.568 (Changes in Corporate Organization) (eff. Nov. 12, 1992, 17 Tex. Reg. 7671).

110. 34 TEX. ADMIN. CODE § 3.572 (eff. Apr. 27, 1992, 17 Tex. Reg. 2606).

111. See 16 Tex. Reg. 6847 (1991) (prop. to be codified at TEX. ADMIN. CODE § 3.572 (17 Tex. Reg. 2606)) (Nov. 26, 1991 proposed version of the rule).

112. The franchise tax, in its current form, became effective Jan. 1, 1992. Act of Aug. 22, 1991, 72d Leg., 1st C.S., ch. 5, § 8.27, 1991 Tex. Sess. Law Serv. 134, 167 (Vernon).

income.<sup>113</sup> The comptroller's 1992 transition rule was essentially an effort to do what the Legislature did not do — impose an additional tax on corporations that withdrew from Texas in 1991.<sup>114</sup> Although the rule was substantially revised prior to its April 1992 adoption,<sup>115</sup> the revised, better drafted rule nonetheless exceeded the comptroller's authority.<sup>116</sup>

Subsection 3.572(b),<sup>117</sup> which the comptroller has indicated will be deleted from Rule 3.572, attempted to adopt a "principal purpose of evasion or avoidance of tax" test for determining which corporations would be required to pay tax on income earned by a non-surviving corporation.<sup>118</sup> Because the most controversial part of the rule will apparently be repealed, the rule's importance is minimized. However, the rule's history — from proposal to amendment — is an interesting study in rulemaking that may serve as a guide for analyzing other rules. The comptroller's abandonment of this rule apparently reflects a recognition that the rule exceeds his authority. Questions still remain as to whether 1993 will witness the withdrawal or substantial revision of other rules that appear to exceed the comptroller's regulatory authority.<sup>119</sup> Faced with a myriad of taxpayer plans to escape the tax, the

113. § 3.572(a)(1) (proposed version, 16 Tex. Reg. 6847) (requiring surviving corporation to pay a "supplemental tax.").

114. See TEX. TAX CODE ANN. § 171.0011 (Vernon 1992); TEX. TAX CODE ANN. § 171.0011(a) imposes an "additional tax" on each corporation that was subject to the franchise tax which is no longer subject to the "taxing jurisdiction of this state in relation to the tax on net taxable earned surplus." 34 TEX. ADMIN. CODE § 3.567 (effective July 29, 1992, 17 Tex. Reg. 5119), provides that the additional tax applies to corporations that, after December 31, 1991, no longer have "sufficient nexus" with Texas to be subject to a tax based on earned surplus. This new rule further provides that the corporation must file a final report and pay the additional tax within 60 days after the corporation ceases to have sufficient nexus with Texas. *Id.* § 3.567(b). The comptroller requires estimated payments of the additional tax before a corporation can receive clearance to dissolve, merge or withdraw. *Id.*

115. Cf. the proposed rule (16 Tex. Reg. 6847, proposed November 26, 1991) (proposing a "supplemental tax") with the adopted rule at 17 Tex. Reg. 2606 (eff. Apr. 27, 1992) (adopting the "principal purpose" test).

116. Administrative rules may not expand the scope of the state's authority to impose taxes. See *Firestone Tire and Rubber Co. v. Bullock*, 573 S.W.2d 497, 500 n.3 (Tex. 1978).

117. 34 TEX. ADMIN. CODE § 3.572(b) provides:

A corporation . . . which is the surviving corporation in any merger, reorganization or transfer of assets occurring after August 13, 1991, and on or before December 31, 1991, will be subject to tax on the net taxable earned surplus of the nonsurviving corporation which is earned from the day after the date upon which the nonsurviving corporation's previous franchise tax report was based through the date of the merger, reorganization, or transfer of assets from the nonsurviving corporation to the surviving corporation if the principal purpose of the merger, reorganization, or transfer of assets was the evasion or avoidance of franchise tax.

118. The rule also set forth a multi-step procedure allowing taxpayers to file a disclosure statement, get a preliminary determination from the comptroller, and submit additional information to the comptroller. *Id.* § 3.572(b). In fact, prior to announcing that § (b) of the rule would be deleted, the comptroller informed many taxpayers who had complied with this procedure that their 1991 year-end mergers would be respected, so that no additional tax would be due.

119. See, e.g., 34 TEX. ADMIN. CODE § 3.558(g)(2) (eff. Sept. 29, 1992, 17 Tex. Reg. 6373) (addressing exemption for S corporations from compensation add-back). The comptroller is concerned that since the compensation add-back required by TEX. TAX CODE § 171.110(a) (Vernon 1992) for earned surplus purposes does not apply to S corporations (see *id.* § 171.110(b)(1)), S corporations could inflate officer/director compensation figures, thereby

comptroller has sought to stem the tide of tax-planning revenue losses by promulgating regulations that purport to adopt substance-over-form and tax-avoidance concepts that are more characteristic of federal tax law than of Texas tax law.

Accordingly, substantial controversy exists with respect to the extent to which the revised franchise tax statute adopted the Internal Revenue Code. On the one hand, the Texas tax is explicitly based to some extent on federal law.<sup>120</sup> On the other hand, many sections of the revised Texas Tax Code are patently inconsistent with federal principles.<sup>121</sup>

Rule 3.558 illustrates the layering of federal tax principles onto state tax concepts.<sup>122</sup> In arriving at taxable earned surplus from franchise tax purposes, a corporation is required by statute to add to its reportable federal taxable income (subject to some exceptions) "any compensation of officers or directors, or if a bank, any compensation of directors and executive officers, to the extent excluded in determining federal taxable income . . . ."<sup>123</sup> To prevent taxpayers from characterizing creatively, but perhaps inaccurately, compensation too narrowly, a draft version of Rule 3.558 broadly defined compensation as "[a]ll remuneration by whatever name whether in cash or any other medium for services performed by an employee . . . including remuneration on behalf of or for the benefit of the employee."<sup>124</sup>

The rule as adopted defines compensation by reference to the amount reportable to an officer or director for the tax reporting period as includable in the officer's/director's federal taxable income, without regard to any mone-

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excluding that compensation from the earned surplus subject to tax. Rule 3.558 therefore provides for a reallocation of officer/director compensation if such compensation is considered excessive. The rule includes a non-exclusive list of eight factors to be used in evaluating whether compensation is excessive. 34 TEX. ADMIN. CODE § 3.558(g)(2). Section 3.558(h) provides, consistent with statutory authority, that a subsidiary cannot qualify for the 35 or fewer shareholder exclusion if it has a parent which does not qualify for the exclusion. The rule further provides that a parent is defined as any corporation (or limited liability company) that ultimately controls the subsidiary even though control is indirect. *Id.* § 3.558(h).

120. *See, e.g.*, TEX. TAX CODE ANN. § 171.110 (Vernon 1992) (earned surplus computation based on reportable federal taxable income).

121. *See, e.g., id.* § 171.110(d) (determining taxable earned surplus of S corporations).

122. 34 TEX. ADMIN. CODE § 3.558 (eff. Sept. 29, 1992, 17 Tex. Reg. 6373).

123. TEX. TAX CODE ANN. § 171.110(a)(1) (Vernon 1992). 34 TEX. ADMIN. CODE § 3.558(b)(4) provides that officers and directors of non-banking corporations are determined in accordance with the corporation's bylaws and the laws of the corporation's state of incorporation. Identifying executive officers and directors of banks is much more complex. In determining who is an executive officer, the rule generally disregards official titles and looks to who has authority to participate in major policy-making functions of the bank. *Id.* § 3.558(b)(5). The rule, however, appears to create some presumptions. The chairman of the board, the president, every vice president, the cashier, the secretary, and the treasurer of a bank are treated as executive officers unless the officer is excluded from participation by resolution of the board or by the bank's bylaws. Thus, each bank subject to the tax should carefully review its bylaws and relevant resolutions to determine whether an express exclusion of participatory authority of certain officers would be beneficial. The term executive officer does not include a manager or assistant manager of a branch of a bank unless that individual participates in major policy-making functions. The officers and directors of limited liability companies are managers or management persons identified in the company's articles, operating agreement or similar agreements required under the laws of the company's state of organization. *Id.* § 3.558(b)(6).

124. 34 TEX. ADMIN. CODE § 3.558(b)(3) as circulated in draft form, prior to promulgation of the rule in its proposed form.



tary limitations imposed for federal tax purposes.<sup>125</sup> The rule treats all compensation of an officer or director, including compensation as an employee of the corporation, as compensation of an officer or director.<sup>126</sup> Typical of the comptroller's increasing attempts to make substance-over-form arguments, Rule 3.558(f) provides that in certain circumstances payments for *corporate services* will be treated as *compensation* paid to officers or directors.<sup>127</sup>

Many taxpayers have attempted to restructure their businesses to reduce the number of shareholders because corporations with fewer than thirty-six shareholders (and limited liability companies with fewer than thirty-six members) are not subject to the compensation addback.<sup>128</sup> Comptroller representatives confirmed orally in 1991 that a partnership would constitute a single shareholder.<sup>129</sup> However, faced with the possibility of numerous tax-motivated partnerships, the comptroller has taken the position that if a trust, partnership, or other investor-entity "is organized or maintained primarily to avoid the add-back of compensation under the Tax Code," each shareholder or owner of the entity will count as a shareholder.<sup>130</sup> Neither the attempt to look through partnerships nor the plan to disregard excessive officer compensation is rooted in statutory authority, and both are likely to be challenged. Although the legislature enacted a specific look-through provision with respect to corporations,<sup>131</sup> there is no comparable look-through provision for partnerships. The compensation limit is also likely to face challenge, as is the requirement that capitalized compensation be added back.<sup>132</sup>

The comptroller has also adopted new rules on apportionment of taxable capital and earned surplus. These rules illustrate both the similarities and the divergence between taxable capital calculations (which are based on generally accepted accounting principles)<sup>133</sup> and earned surplus calculations (which are based on federal income tax principles).<sup>134</sup> Both the taxable capital rule<sup>135</sup> and the earned surplus rule<sup>136</sup> define revenue in terms of "the value of inflows of economic resources from separate legal entities for delivering or producing goods, rendering services, or carrying out other activities . . ." and have similar rules with respect to several items<sup>137</sup> but provide dif-

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125. See 34 TEX. ADMIN. CODE § 3.558(a)(3) (eff. Sept. 29, 1992).

126. 34 TEX. ADMIN. CODE § 3.558(d).

127. *Id.* § 3.558(f). (The example provided in the rule relates to service fees, paid to related corporations, that may be treated as compensation paid to the corporation's own officers.)

128. *Id.* § 3.558(g)(1). See TEX. TAX CODE ANN. § 171.110(b) (Vernon 1992).

129. In addition, the comptroller issued written letters confirming this result.

130. 34 TEX. ADMIN. CODE § 3.558(b)(7).

131. See TEX. TAX CODE ANN. § 171.110(c), which effectively treats a corporation as having more than 35 shareholders if the corporation's parent corporation has more than 35 shareholders.

132. See 34 TEX. ADMIN. CODE § 3.358(e).

133. See, e.g., TEX. TAX CODE ANN. § 171.112(a) (Vernon 1992).

134. See, e.g., *id.* § 171.1121(a).

135. 34 TEX. ADMIN. CODE § 3.549(b)(6) (eff. Nov. 13, 1992, 17 Tex. Reg. 7663).

136. 34 TEX. ADMIN. CODE § 3.557(b)(7) (eff. Nov. 13, 1992, 17 Tex. Reg. 7667).

137. *Cf. id.* § 3.549(e)(1) with § 3.557(e)(1) (reimbursements to a corporate agent are not gross receipts if the reimbursements do not exceed actual expenses paid to a third party).

ferent rules regarding other items, including partnership income.<sup>138</sup>

These lengthy rules include guidance not only with respect to frequently-occurring items such as dividends and sales receipts,<sup>139</sup> but also regarding items such as debt forgiveness,<sup>140</sup> exchanges of property,<sup>141</sup> and litigation awards<sup>142</sup> that occur far less frequently. The rules also address the "throwback rule," under which receipts for certain non-Texas transactions are treated as Texas receipts if the taxpayer is not "subject to taxation" in the non-Texas state.<sup>143</sup>

In contrast to its proposed form,<sup>144</sup> the earned surplus apportionment rule as adopted provides that having a certificate of authority in another state is not sufficient to cause a corporation to be considered subject to taxation for throwback rule purposes except for reports originally due prior to January 1, 1993.<sup>145</sup> If, as the proposed rule provided, a corporation were treated as subject to tax for earned surplus purposes in any state in which it holds a certificate of authority, taxpayers might have been able to acquire certificates of authority in several other states to avoid having receipts from those states thrown back to Texas under the throwback rule.

Although substantial portions of the new and revised rules represent well-established comptroller policy and straightforward statutory interpretation, the rules also include many questionable provisions that are likely to be challenged in administrative and court proceedings.<sup>146</sup>

### III. PROPERTY TAX

#### A. APPLICATION OF THE TAX

The Fifth Circuit Court of Appeals rendered two important property tax decisions during the Survey period. In *Smith v. Travis County Education District*,<sup>147</sup> the Fifth Circuit addressed whether federal courts have jurisdic-

138. *Cf. id.* § 3.549(e)(29) (receipts reflecting net partnership profits are apportioned to the partnership's principal place of business, as defined in the rule; the corporation's share of gross profits may be used if allowed as revenue under GAAP, and apportioned as if the receipts were earned directly by the corporation) with § 3.557(e)(24) (corporation's share of gross receipts from partnership included in federal taxable income must be included in gross receipts and must be apportioned as though the corporation directly earned such receipts; no alternate method provided).

139. *See id.* §§ 3.549(e)(3) and (41); 3.557(e)(13) and (37).

140. *See id.* §§ 3.549(e)(9); 3.557(e)(8).

141. *See id.* §§ 3.549(e)(15); 3.557(e)(14).

142. *See id.* §§ 3.549(e)(26); 3.557(e)(21).

143. *See id.* §§ 3.549(e)(41)(I); 3.557(e)(37)(I).

144. *See* 17 Tex. Reg. 4332 (proposed version).

145. *See* 34 TEX. ADMIN. CODE § 3.557.

146. *See, e.g.,* 34 TEX. ADMIN. CODE § 3.555(e) which attempts to adopt I.R.C. § 482 by providing:

If the comptroller determines that transactions between members of a controlled group of corporations are not entered into on an arm's-length basis, the comptroller may distribute or allocate income and deductions as necessary to prevent franchise tax avoidance provided such adjustments are authorized by applying principles in Internal Revenue Code § 482, and regulations thereunder.

§ 3.557(d)(9) includes a similar provision with respect to the apportionment of earned surplus.

147. 968 F.2d 453 (5th Cir. 1992).

tion to hear a taxpayer's challenge to *Carrollton-Farmers Branch Independent School District v. Edgewood Independent School District*<sup>148</sup> (commonly referred to as *Edgewood III*). In *Edgewood III*, the Texas Supreme Court held that the Texas public school finance system violated the Texas Constitution, but chose to defer the effect of its ruling for seventeen months to avoid disruption of public school operations and to enable the Texas legislature to consider all options fully.<sup>149</sup> The taxpayer sought a declaratory judgment that the imposition and collection of 1991 and 1992 county education district taxes violated the Due Process Clause of the Fourteenth Amendment to the United States Constitution,<sup>150</sup> and sought an injunction prohibiting collection of the 1992 taxes and requiring the State of Texas to fashion an appropriate remedy to the unconstitutional collection of the 1991 taxes already paid.<sup>151</sup> The Fifth Circuit in *Smith* rejected the taxpayer's plea for a declaratory judgment and injunction, and remanded the case to the district court with instructions to dismiss the suit.<sup>152</sup> In dismissing the lawsuit, the Fifth Circuit relied on the Tax Injunction Act,<sup>153</sup> which prohibits federal courts from interfering with state taxation matters where state law provides a plain, speedy and efficient remedy.<sup>154</sup> The court ruled that because there was no indication that Texas courts had refused to entertain the taxpayer's federal claim, the Tax Injunction Act barred the federal courts from exercising jurisdiction over this matter.<sup>155</sup>

In *Irving Independent School District v. Packard Properties*,<sup>156</sup> the Fifth Circuit held that pre-existing liens for unpaid property taxes were not extinguished when the relevant properties were acquired by the Federal Deposit Insurance Corporation (FDIC), acting as a receiver for a savings and loan association.<sup>157</sup> The FDIC asserted that 12 U.S.C. § 1825(b)(3)<sup>158</sup> requires pre-existing liens, to the extent they support penalties, to be extinguished once the FDIC obtains ownership of the property. In rejecting the FDIC's

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148. 826 S.W.2d 489 (Tex. 1992). See Ohlenforst & Dorrill, 1992 Survey, at 2113-14 for a summary of *Edgewood III*.

149. *Carrollton-Farmers Branch I.S.D.*, 826 S.W.2d at 522, 524.

150. U.S. CONST. amend. XIV, § 1.

151. *Smith*, 968 F.2d at 454-55.

152. *Id.* at 456.

153. 28 U.S.C. § 1341 (1988).

154. *Smith*, 968 F.2d at 456.

155. *Id.* The court's conclusion that the taxpayer has a plain, speedy and efficient remedy in state court is interesting given that *Edgewood III* expressly provides that the "ruling is not to be used as a defense to the payment of any such taxes." *Carrollton-Farmers Branch I.S.D.*, 826 S.W.2d at 522. In fact, Justice Doggett in his dissent (joined by Justice Mauzy) in *Edgewood III* wrote that he expected intrusion by federal courts as a result of the "prospective-plus" application of the holding in *Edgewood III*, and hinted that a taxpayer might be able to secure an injunction against the application of the court's ruling in *Edgewood III* because of the failure of the state to provide a clear and certain remedy when a state tax is collected illegally. *Id.* at 569 (Doggett, J., dissenting); see also *McKesson Corp. v. Division of Alcoholic Beverages & Tobacco*, 496 U.S. 18 (1990).

156. 970 F.2d 58 (5th Cir. 1992).

157. *Id.* at 62. See Ohlenforst & Dorrill, 1992 Survey at 2115, and 1991 Survey at 664, for discussions of the lower court holdings.

158. 12 U.S.C. § 1825(b)(3) (Supp. III 1992).

arguments, the court ruled that while Section 1825(b)(2)<sup>159</sup> prevents liens from attaching to property while the FDIC owns it, a property encumbered by a lien at the time the FDIC acquires the property remains in effect.<sup>160</sup> The court recognized that the FDIC was not liable for penalties under Section 1825(b)(3), but allowed the liens to remain in place because Congress chose to leave property acquired by the FDIC in the condition the FDIC found it.<sup>161</sup>

The court also held that the FDIC was exempt from interest on delinquent taxes (under Section 33.01(c) of the Tax Code<sup>162</sup>) and penalties for non-payment of property tax (under Section 33.07 of the Tax Code<sup>163</sup>) because federal law exempts the FDIC from payment of such amounts.<sup>164</sup> While the court recognized that Section 33.01(c) provides that the interest charges on delinquent taxes are designed to compensate taxing units for lost revenue, the court reasoned that the language in Section 33.01(c) providing that the interest "is to compensate the taxing unit for revenue lost because of the delinquency" did not become law until 1991, long after these interest charges were imposed on the taxpayer.<sup>165</sup> Prior to this amendment, Texas law clearly regarded this interest charge as a penalty.<sup>166</sup> Section 33.07 provides that property taxes delinquent on July 1 incur an additional penalty to defray costs of collection.<sup>167</sup> The court ruled that Section 33.07 functions as a penalty statute because it refers specifically to collection costs as penalties.<sup>168</sup>

In *Tarrant Appraisal District v. American Airlines, Inc.*,<sup>169</sup> the Fort Worth court of appeals held that a taxpayer's leasehold interest in property for ad valorem tax purposes must be valued by using the equity method, which bases the value of a leasehold interest on the lessee's equity or profit in the lease.<sup>170</sup> Under the equity method, a leasehold interest will have no value

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159. 12 U.S.C. § 1825(b)(2) (Supp. III 1992).

160. *Irving I.S.D.*, 970 F.2d at 61.

161. *Id.* at 62. The effect of this holding is that, while the taxing units cannot foreclose their liens (with respect to penalties) while the FDIC owns the property, once the FDIC sells the property, the lien may be foreclosed. *See id.* at 62. Thus, the FDIC is effectively burdened by the lien because it will likely receive less sales proceeds on the property given that the buyer will be burdened by the lien. *Id.*

162. TEX. TAX CODE ANN. § 33.01(c) (Vernon 1992), amended by Act of 1991, 72d Leg., R.S., ch. 836, § 5.3, 1991 Tex. Sess. Law Serv. 2893 (Vernon).

163. *Id.* § 33.07.

164. *Irving I.S.D.*, 970 F.2d at 65-66.

165. *Id.* at 65. Thus, the court implies that because § 33.01(c) interest charges are now expressly designed to compensate for lost revenue due to collection efforts, rather than being in the nature of a penalty, such charges could be imposed on the FDIC.

166. *Id.* at 65. *See Jones v. Williams*, 121 Tex. 94, 45 S.W.2d 130 (1931); *Spindletop Oil and Gas Co. v. Parker County*, 738 S.W.2d 715 (Tex. App.—Fort Worth 1987, writ denied).

167. TEX. TAX CODE ANN. § 33.07(a) (Vernon 1992). The penalty is imposed only if a taxing unit or appraisal district elects to impose the penalty. *Id.* The penalty may not exceed 15 percent of the aggregate taxes, penalties and interest due. *Id.*

168. *Irving I.S.D.*, 970 F.2d at 66. In reaching this conclusion, the court rejects the holding of the Bankruptcy Court in *In re Soraiz*, No. 88-01741 (Bankr. S.D. Tex. 1989), an unpublished opinion, in which the court held that the Section 33.07 penalty was not punitive, but was imposed to recover pecuniary losses. *Irving I.S.D.*, 970 F.2d at 66.

169. 826 S.W.2d 767 (Tex. App.—Fort Worth 1992, writ denied).

170. *Id.* at 771.

(or negative value) under circumstances in which the rent is equal to or in excess of the property's fair market rent for the years in question.<sup>171</sup> While leasehold interests are generally not taxable under the Tax Code, a leasehold interest in real property owned by an exempt owner is taxable, subject to certain exceptions.<sup>172</sup> Section 23.13 of the Texas Tax Code provides that a leasehold or possessory interest in real property that is exempt from taxation to the owner is appraised at the greater of (1) the total rent paid for the interest for the current tax year, or (2) the market value of the leasehold or other possessory interest.<sup>173</sup> The taxing unit asserted that the possessory interest method should be used to value a leasehold interest for purposes of Section 23.13. The possessory interest method values a leasehold by capitalizing the rent due for the remainder of the lease, and generally results in a much higher value than would be determined under the equity method.<sup>174</sup> Based largely on the fact that the statute prevents lessees from escaping taxation if the leasehold has a negative or zero value, the court concluded that it would be illogical to use the possessory interest method because under such method it would be mathematically impossible for the amount to be less than the contract rent for the year.<sup>175</sup>

In a case of first impression, the Texas Supreme Court in *Gifford-Hill & Co. v. Wise County Appraisal District*<sup>176</sup> held that, for property tax purposes, limestone is not a mineral and may not be appraised separately from the surface estate unless the limestone is part of a quarry.<sup>177</sup> In this case, the taxpayer's land qualified for special appraisal as open-space land (which is appraised based on its productive capacity);<sup>178</sup> however, the taxing unit attempted to tax separately the limestone based on its fair market value by categorizing it as "rock in place" rather than part of the surface estate. The court first analyzed the types of real property that are taxable, and examined Section 1.04 of the Tax Code which defines real property as, among other things, land, a mine or quarry, or a mineral in place.<sup>179</sup> Although there is no definition of the term "mineral" in the Tax Code, the court looked to the ordinary and natural meaning of the term and concluded that it does not include a substance such as limestone.<sup>180</sup> In addressing whether the limestone was taxable as a quarry, the court ruled that while limestone may be part of a quarry for tax purposes, the fact that there was a quarry on the

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171. *Id.* at 768, 770.

172. TEX. TAX CODE ANN. § 25.07 (Vernon 1992).

173. *Id.* § 23.13.

174. *American Airlines*, 826 S.W.2d at 768, 771.

175. *Id.* at 770-71. In addition, the court concluded that use of the possessory interest method would effectively result in the lessee's being taxed on the lessor's property value. *Id.* at 771.

176. 827 S.W.2d 811 (Tex. 1991).

177. *Id.* at 815.

178. TEX. TAX CODE ANN. §§ 23.51, 23.52 (Vernon 1992).

179. *Id.* § 1.04.

180. *Gifford-Hill*, 827 S.W.2d at 815. The court recognized that the scientific or technical definition of "minerals" is broad enough to include limestone. However, since the scientific definition would also include the soil itself, the court believed that the ordinary meaning of the term is a more appropriate source for property tax purposes. *Id.*

taxpayer's tract does not automatically subject the entire tract to ad valorem taxation as a quarry.<sup>181</sup> For example, while the term "quarry" includes the open excavation site, the limestone being quarried and surface land upon which any quarrying operation is being conducted, it does not include adjacent land in the path of the quarry and its limestone deposit.<sup>182</sup>

In *Exxon Corp. v. San Patricio County Appraisal District*,<sup>183</sup> the Corpus Christi court of appeals held that oil located in working oil tanks on January 1 was subject to tax in the county in which the tanks were located even though no individual barrel of oil remained in the county for more than seventeen days.<sup>184</sup> Exxon maintained at least 400,000 barrels of oil and seventeen tanks in the county at all times. On January 1, 1988, almost 800,000 barrels of crude oil were located in these tanks, and San Patricio County sought to tax the oil located in such tanks. Exxon asserted that the proper tax situs of the barrels of oil was not in San Patricio County because each barrel transported through the county remained there only temporarily. Rather, Exxon believed that, under Section 21.02(4) of the Tax Code,<sup>185</sup> the oil should be taxed in the county in which it maintains its principal place of business. In rejecting Exxon's position, the court reasoned that the fact that each individual barrel remains in the county for less than seventeen days is inconsequential given that Exxon continually maintained a massive quantity of oil in the county.<sup>186</sup> In essence, the court analyzed the oil as fungible property. The court also stated that the theory of "*mobilia sequuntur personam*" (i.e., that movable property follows the person) has gradually dissipated over time.<sup>187</sup> The court maintained that the doctrine of *mobilia* is being replaced by the acquired situs rule, which provides that property can acquire its own tax situs in an area if it has a "degree of permanency" with such area which will distinguish it from property in the area on a purely temporary or transitory basis.<sup>188</sup> In ruling that the oil had acquired situs in San Patricio County, the court looked to the benefits and protections provided by the county to Exxon's personal property, and found that the oil had significant contact with the county because the county rendered substantial

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181. *Id.* at 816.

182. *Id.* Two other opinions issued during the Survey period that address open-space land are noteworthy. In *Moore v. Tarrant Appraisal Dist.*, 823 S.W.2d 418, 419 (Tex. App.—Fort Worth 1992), *rev'd*, 845 S.W.2d 820 (Tex. 1993) the Fort Worth court of appeals decided whether property used for recreational purposes may qualify as open-space land. The court held in *McCormick v. Attorney Gen. of Texas*, 822 S.W.2d 814, 815 (Tex. App.—Fort Worth 1992, no writ), that the statutory requirement that land cannot qualify as open-space land unless it is principally devoted to agricultural uses for five of the preceding seven years is not an unconstitutional violation of the Equal Protection Clause of the Fourteenth Amendment of the United States Constitution.

183. 822 S.W.2d 269 (Tex. App.—Corpus Christi 1991, writ denied).

184. *Id.* at 271, 276.

185. TEX. TAX CODE ANN. § 21.02(4) (Vernon 1992). The taxing unit argued that because the oil was located in the unit on January 1 for more than a temporary period, it was taxed in the unit under Section 21.02(1) of the Tax Code. *Id.* § 21.02(1).

186. *Exxon Corp.*, 822 S.W.2d at 272-73.

187. *Id.* at 273.

188. *Id.*

services with respect to such property.<sup>189</sup>

The Tyler court of appeals in *Texas Department of Corrections v. Anderson County Appraisal District*<sup>190</sup> applied a "substance-over-form" approach to determine the taxable owner of a prison built by the Texas Department of Corrections (TDC). In order to take advantage of certain tax-exempt financing benefits without violating the Texas Constitution's prohibition against the state's creating certain debt, the TDC transferred legal title to prison land to a trust, and leased back the property. The lease provided that legal title to the property would be transferred back to the TDC upon satisfaction of all lease payments. The TDC argued that, because it was the equitable owner of the property, the property was not subject to tax; thus, the property was exempt because it was used for public purposes. The court ruled that the burden of property taxation is placed on the equitable owner of the property rather than the property's legal owner, and that the evidence clearly indicated that the TDC was the equitable owner of the property.<sup>191</sup>

In *First Baptist Church v. Bexar County Appraisal Review Board*,<sup>192</sup> the Texas Supreme Court upheld a jury's finding that a church parking lot was used primarily for religious purposes, and was therefore exempt from property tax, in spite of the fact that the church leased the lot to a private company five days a week during working hours.<sup>193</sup> The church owned two parking lots which it leased to a private entity. The lease permitted the private entity to use almost all the spaces during weekday working hours, but reserved use of the parking lot for the church at all other times. The church sought an exemption from property tax on the parking lot under Section 11.20 of the Tax Code, which provides that a religious organization is entitled to a property tax exemption on its real property that is used primarily as a place of religious worship and is reasonably necessary for engaging in religious worship.<sup>194</sup> A parking lot can qualify as a place of religious worship

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189. *Id.* at 275. The court also ruled that the taxpayer's prior rendering of the property in the county is admissible with respect to the issue of tax situs because it enlightens the trial court on the taxpayer's state of mind and its interpretation of the property's status. *Id.* at 274.

In another case during the Survey period addressing taxation of items that are moved frequently, the Houston (1st Dist.) court of appeals in *Harris County Appraisal Dist. v. Transamerica Container Leasing Inc.*, 821 S.W.2d 637, 640 (Tex. App.—Houston [1st Dist.] 1991), *cert. granted and judgment vacated*, 61 U.S.L.W. 3446, 3612, 3619 (U.S. Mar. 8, 1993) held that it was not constitutionally permissible for the Harris Appraisal District to tax shipping containers that were frequently present within the district, but which were used exclusively in foreign commerce, because the district did not present any evidence that the tax would not create an enhanced risk that the containers would be subjected to multiple international taxation.

190. 834 S.W.2d 130 (Tex. App.—Tyler 1992, writ denied).

191. *Id.* at 131. See *Texas Turnpike Co. v. Dallas County*, 153 Tex. 474, 271 S.W.2d 400, 402 (1954). A taxing unit may attempt to use the court's rationale in *Texas Dept. of Corrections* to its advantage in a circumstance in which more tax revenue could be generated were the lessee treated as the taxable owner of a property. For example, if an exempt entity leased property to a private entity pursuant to a lease with a bargain purchase option, a taxing unit would likely raise more revenue were it successful in asserting that the private lessee is the equitable owner of the leased property.

192. 833 S.W.2d 108 (Tex. 1992).

193. *Id.* at 111.

194. TEX. TAX CODE ANN. § 11.20(a)(1) (Vernon 1992).

because the definition includes grounds surrounding the sanctuary which are necessary to the use of the church.<sup>195</sup> The court ruled that the jury's finding that the parking lots were used primarily for religious purposes should be upheld in spite of mathematical calculations demonstrating that the private entity physically occupied the parking lots more than the church did.<sup>196</sup> The court reasoned that while the actual use of properties is an important factor in determining primary use, it is not the sole consideration, and that because several witnesses testified that the church's primary use of the parking lot is to provide church members with access to church facilities, there was probative evidence to support the jury's conclusions.<sup>197</sup>

The San Antonio court of appeals in *Atascosa County Appraisal Dist. v. Tymrak*<sup>198</sup> held that the district court did not abuse its discretion in awarding attorney's fees under Section 42.29 of the Tax Code<sup>199</sup> to a taxpayer who settled with the appraisal district a property tax valuation issue for a lower amount than the appraisal district's original valuation.<sup>200</sup> The appraisal district argued that because the case was settled, there was no evidence that the taxpayer had prevailed in the case. The court disagreed, reasoning that while Section 42.29 requires an appeal in order for attorney's fees to be awarded, it does not require a trial.<sup>201</sup> The court also ruled that the lower court had not abused its discretion in granting the taxpayer \$20,000 in attorneys fees (\$5,000 per tax year).<sup>202</sup> Section 42.29, as in effect for the years at issue, limited the award of attorney's fees to the greater of twenty percent of the taxes in controversy or \$5,000 per appeal.<sup>203</sup> The appraisal district argued that because only one lawsuit was involved, only \$5,000 of attorneys fees should have been allowed. The court, however, upheld the lower court's ruling that each tax year constitutes a separate appeal under Section 42.29.<sup>204</sup>

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195. *Austin v. University Christian Church*, 768 S.W.2d 718, 719 (Tex. 1988) (addressing whether church parking lots leased to a private entity were exempt).

196. *First Baptist*, 833 S.W.2d at 111.

197. *Id.*

198. 815 S.W.2d 364 (Tex. App.—San Antonio 1991), *aff'd*, No. D-1804, 1993 WL 30594 (Tex. Feb. 10, 1993).

199. TEX. TAX CODE ANN. § 42.29 (Vernon 1992).

200. *Atascosa County App. Dist.*, 833 S.W.2d at 366.

201. *Id.*

202. *Id.* at 369.

203. TEX. TAX CODE ANN. § 42.29 (Vernon 1992), *amended by* Act of 1991, 72d Leg., R.S., ch. 836, § 4.1, 1991 Tex. Sess. Law Serv. 2893 (1991). Section 42.29 now limits attorney's fees to the greater of \$15,000 or 20 percent of the total amount by which the property owner's tax liability is reduced as a result of the appeal (but not to exceed the aggregate amount the owner's tax liability is reduced). TEX. TAX CODE ANN. § 42.29 (Vernon 1992).

204. *Atascosa County Appraisal Dist.*, 833 S.W.2d at 369. *Gano v. City of Houston*, 834 S.W.2d 585 (Tex. App.—Houston [14th Dist.] 1992, writ denied), another case during the Survey period addressing attorney's fees, stands for the proposition that a taxpayer may avoid being required to pay attorney's fees if it pays all taxes, penalties, interest and court costs prior to trial, because no amounts would be adjudged due. In *Dallas Cent. Appraisal Dist. v. Seven Inv. Co.*, 835 S.W.2d 75, 79 (Tex. 1992), the Texas Supreme Court held that attorney's fees under § 42.29 are not recoverable in an appeal involving the denial of an open-space land designation because such an issue does not involve an excessive appraisal or an unequal appraisal.



## B. PROCEDURE

In *City of Houston v. First City*<sup>205</sup> a Houston court of appeals addressed several procedural issues with respect to collection penalties and attorneys fees. In this case, the taxing unit sued the property owner and the lienholder to recover delinquent taxes, interest and penalties due thereon, and attorneys fees. In response to the lawsuit, the lender, which was proceeding with foreclosure, remitted checks to the taxing authorities in payment of all outstanding taxes, interest and penalties for the years at issue. The letter transmitting these checks, however, provided that payment was to be applied only to tax, interest and penalties pursuant to Section 33.01(a) of the Tax Code<sup>206</sup> (penalty for delinquency) and was not to be applied to any penalties, costs or fees pursuant to Section 33.07<sup>207</sup> (penalty to defray collection costs) and/or Section 33.48<sup>208</sup> (recovery of collection costs, such as attorney's fees). The taxing unit deposited the check and disregarded the notations on the check by applying part of the payment to collection penalties and collection costs.

The court ruled that the taxing unit's acceptance of the check resulted in the acceptance of the conditions associated with the check, namely to apply the payment in full satisfaction of all amounts due except the disputed penalties and fees under Sections 33.07 and 33.48.<sup>209</sup> The court further ruled that the taxing unit was not entitled to penalties under Section 33.07 because it did not take official action to adopt the penalties or to notify the owner of the property of the penalties.<sup>210</sup> In addition, the court held that the taxing unit was not entitled to recover an award of attorney's fees without demonstrating that the fees are reasonable.<sup>211</sup> The court reasoned that the authorization in Section 33.48 of attorney's fees up to fifteen percent of total taxes, penalties and interest imposed on a taxpayer does not mean that a fifteen percent fee is necessarily reasonable in a particular case.<sup>212</sup>

In *Harris County Appraisal Review Board v. General Electric Corp.*<sup>213</sup> a Houston court of appeals addressed whether a taxpayer is required to file a second protest because of the appraisal review board's failure to schedule a hearing on its original protest. General Electric had filed a timely protest with the appraisal review board. Months after the due date of such taxes,

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205. 827 S.W.2d 462 (Tex. App.—Houston [1st Dist.] 1992, writ denied).

206. TEX. TAX CODE ANN. § 33.01(a) (Vernon 1992).

207. *Id.* § 33.07.

208. *Id.* § 33.48.

209. *City of Houston*, 827 S.W.2d at 473.

210. *Id.* at 474. The penalty under § 33.07 cannot be automatically charged by a taxing authority. Rather, it must elect to impose the penalty. TEX. TAX CODE ANN. § 33.07(a) (Vernon 1992). In *Salvaggio v. Houston Indep. School Dist.*, 752 S.W.2d 189, 192 (Tex. App.—Houston [14th Dist.] 1988, writ denied), the Houston (14th Dist.) court of appeals held that three separate actions must be taken before a penalty under § 33.07 can be imposed, including delivering notice of the delinquency and the penalty to the taxpayer.

211. *City of Houston*, 827 S.W.2d at 476.

212. *Id.* The court also held that the trial court's decision not to hold the taxing unit's counsel liable for the taxpayer's attorney's fees was not in error, reasoning that the decision to disregard the taxpayer's instructions on its check was ultimately made by the taxing unit, not its legal counsel. *Id.* at 479.

213. 819 S.W.2d 915 (Tex. App.—Houston [14th Dist.] 1991, writ denied).

General Electric reminded the appraisal district of the protest and of the fact that no hearing had ever been scheduled. The appraisal district advised General Electric that its sole remedy under such a circumstance was to file a protest under Section 41.411 of the Tax Code<sup>214</sup> regarding the appraisal review board's failure to give notice of a hearing. The letter further provided that because no protest was filed prior to the date the taxes became delinquent, the appraisal review board was without jurisdiction to rule on the taxpayer's protest. The court sided with the taxpayer, holding that a taxpayer who timely files a protest and pays the relevant taxes before the delinquency date should not have to file a second protest regarding the appraisal review board's failure to schedule a hearing on the original protest.<sup>215</sup>

During the Survey period, the comptroller adopted numerous property tax rules as part of taking over the responsibilities of the State Property Tax Board.<sup>216</sup> Because the Texas Legislature abolished in 1991 the State Property Tax Board and transferred its duties to the comptroller,<sup>217</sup> the comptroller was required to establish its own set of property tax rules, which are generally similar to the State Property Tax Board's rules. The comptroller also adopted rules concerning its responsibilities for conducting property value studies and protest hearings concerning such studies.<sup>218</sup>

#### IV. OTHER NEW DEVELOPMENTS: SUCCESSOR LIABILITY, PERSONAL LIABILITY AND NEW PROCEDURES

Texas has continued to assert aggressively that individuals may be held liable under Tax Code Section 171.255 for taxes in circumstances in which the corporate charter is forfeited for failure to pay taxes.<sup>219</sup> In *Wilburn v. Texas*,<sup>220</sup> the Austin court of appeals held that liability for unpaid Texas employment taxes is a debt for purposes of Section 171.255.<sup>221</sup> In addition, two recent court cases imposed personal liability upon officers of corporations for actions taken after they failed to pay their franchise taxes but before their corporate charter was actually forfeited.<sup>222</sup> In other cases, individuals

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214. TEX. TAX CODE ANN. § 41.411 (Vernon 1992).

215. *Harris County*, 819 S.W.2d at 918. The court reasoned that to the extent Section 41.411 requires a taxpayer to file another protest, it imposes an undue limitation on the taxpayer's abilities to seek a judicial remedy. *Id.* at 919.

216. See 34 TEX. ADMIN. CODE §§ 9.401-9.405, 9.801, 9.802, 9.1001 (eff. July 17, 1992, 17 Tex. Reg. 4806-08).

217. Act of June 16, 1991, 72d Leg., R.S., ch. 843, 1991 Tex. Sess. Law Serv. 2905 (Vernon); Act of Aug. 29, 1991, 72d Leg., 2d C.S., ch. 6, 1991 Tex. Sess. Law Serv. 26-41 (Vernon).

218. 34 TEX. ADMIN. CODE §§ 9.7-9.14 (eff. May 8, 1992, 17 Tex. Reg. 3002).

219. See TEX. TAX CODE ANN. § 171.255 (Vernon 1992). See also *Dixon v. Texas*, 808 S.W.2d 721, 724 (Tex. App.—Austin 1991, writ dismissed w.o.j.) (corporate officials liable for taxes in circumstances in which the corporation collected but failed to pay taxes over to the state. Corporation officer held liable for taxes of a corporation even though the corporation has not lost its charter).

220. 824 S.W.2d 755 (Tex. App.—Austin 1992, no writ).

221. *Id.* at 762.

222. *Dae Won Choe v. Chancellor, Inc.*, 823 S.W.2d 740, 743 (Tex. App.—Dallas 1992, no writ) (personal liability imposed for debt incurred before forfeiture of corporation's corporate charter but after the date of franchise tax, report or penalty was due but not filed or paid). See

were held liable for federal unemployment taxes,<sup>223</sup> and a Texas corporation that failed to pay its franchise taxes was not permitted to bring a petition in the Tax Court.<sup>224</sup>

Successor liability also continues to pose significant risks to Texas taxpayers. Pursuant to Section 111.020 of the Texas Tax Code,<sup>225</sup> a buyer of a business may be liable for franchise and sales taxes (and any other taxes under Title 2 of the Tax Code)<sup>226</sup> owed by the seller, up to the purchase price of the business or stock of goods. The comptroller has adopted Rule 3.7 which provides that a person who "sells the business or stock of goods of a business or quits the business" for purposes of this successor liability statute may include a person who sells the capital assets of a business, or sells the inventory of the business, or sells the name and goodwill of the business.<sup>227</sup> In addition to setting forth procedures by which a buyer may obtain assurance from the comptroller that the seller has no outstanding tax liability, the rule lists factors that the comptroller must use in determining whether a sale of business or stock of goods occurs. Generally, the sale of a business is broadly defined as the sale of (1) a building, land, furniture, fixtures, inventory, and the right to use the seller's trade name; (2) all a business's capital assets; (3) a business's name and goodwill; (4) all a business's inventory; or (5) fixed assets and realty necessary to operate a similar business as the seller at the same location.<sup>228</sup> The rule also provides that the sale

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also *Schindler v. Austwell Farmers Co-Op*, 829 S.W.2d 283, 287 (Tex. App.—Corpus Christi 1992), *aff'd and modified*, 841 S.W.2d 853 (Tex. 1992) (officer held liable for purchases made during a period during which his wholly-owned corporation had lost its charter).

223. *Mason v. U.S.*, 801 F. Supp. 718, 724 (N.D. Ga. 1992) (holding shareholders and directors of a Texas corporation liable for unpaid federal employment taxes; the Internal Revenue Service prevailed under TEX. TAX CODE ANN. § 171.225, which imposes liability for "debts" rather than under Internal Revenue Code § 6672, which requires that individuals be "responsible persons" to be held liable for unpaid federal employment taxes.)

224. *Valhco Corp. v. Commissioner*, 97 T.C. 428 (1992).

225. TEX. TAX CODE ANN. § 111.020 (Vernon 1992). Several recent administrative hearings focused on successor liability under this section. Comptroller Hearing No. 28,712 (June 8, 1992) includes a good, brief discussion of the predecessors to this statute and notes that the statute apparently tracks a California statute. See also Comptroller Hearing No. 28,813 (May 21, 1992) (stating comptroller view that successor has no standing to challenge the validity of the underlying assessment); Comptroller Hearing No. 24,533 (Jan. 6, 1992) (finding that petitioner may be the successor, but that a lack of consideration flowing to the seller for the acquisition of the business means there is no basis for assessment of successor liability, and further holding that neither Section 111.016, trust fund liability, nor Tax Division's efforts to trace the seller's assets to petitioner allow a creditor to use a trust fund theory to attach such assets, citing *Henry I. Siegal Co., Inc. v. Holliday*, 663 S.W.2d 824 (Tex. 1984), *Hunter v. Fort Worth Capital Corp.*, 620 S.W.2d 547 (Tex. 1981), and Texas Business Corporation Act art.6.04(A)(3) and 7.12(A)(3)).

226. *Id.* Title 2 of the Tax Code contains, among other taxes, the limited sales, excise and use tax, the motor vehicle sales and use tax, various motor fuel taxes, the cigarette tax, the hotel occupancy tax, the interstate motor carrier sales and use tax, a tax on sales and use of boats and boat motors, the franchise tax, various miscellaneous gross receipts taxes, miscellaneous occupation taxes, the gas production tax, the oil production tax and inheritance taxes. TEX. TAX CODE ANN. Title 2 (Vernon 1992).

227. 34 TEX. ADMIN. CODE § 3.7(a) (eff. June 9, 1992) (17 Tex. Reg. 3842). The proposed version of this rule included a statement that successor liability may be incurred by a person purchasing a separate division, branch or identifiable segment of a business. See 34 TEX. ADMIN. CODE § 3.7(e) (proposed Mar. 3, 1992, 17 Tex. Reg. 1597).

228. 34 TEX. ADMIN. CODE § 3.7(d).

of a business or stock of goods by a bankruptcy trustee or by the administrator, executor or guardian in an estate or probate proceedings is not subject to the successor liability provision.<sup>229</sup> Comptroller representatives have indicated, however, that the comptroller is considering the possibility of attempting to impose successor liability on buyers who purchase assets through a bankruptcy trustee.<sup>230</sup>

Over thirty rules of practice and procedure were reissued during 1992 as part of the comptroller's efforts to revise and review his administrative rules,<sup>231</sup> so it remains necessary to review not only statutory provisions that authorize taxpayers to contest their tax liability,<sup>232</sup> but also these regulations.

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229. *Id.* § 3.7(h).

230. This approach, which would be inconsistent with prior comptroller policy, would also be subject to challenge based on bankruptcy laws.

231. 34 TEX. ADMIN. CODE §§ 1.1, 1.2, 1.4-1.9. (Many of these rules were revised, effective as of Feb. 26, 1992, although some of these procedural rules were not revised during the Survey period. See 17 Tex. Reg. 1313).

232. See, e.g., TEX. TAX CODE ANN. §§ 112.052, 112.151 (Vernon 1992).

