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## Taxation

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# TAXATION

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The best way to suppose what may come, is to remember what is past.  
George Savile, Marquis of Halifax

**A**LTHOUGH the 1993 Legislature declined to enact major tax reform, several legislative changes have the potential to effect substantial changes in the administration of Texas taxes. As during last year's Survey period, decisions from other jurisdictions, Texas courts, and administrative hearings, also impact Texas tax law.<sup>1</sup>

## I. SALES TAX

### A. APPLICATION OF THE TAX

A landmark decision handed down during the survey period was *Itel Containers International Corp. v. Huddleston*.<sup>2</sup> In *Itel*, the United States Supreme Court upheld a Tennessee sales tax on the proceeds of leases of containers used exclusively in international commerce. The Court expressly held that the tax in question did not violate either of the international conventions on containers,<sup>3</sup> the foreign commerce clause<sup>4</sup> or the import-export clause.<sup>5</sup>

Itel leased cargo containers for use exclusively in international commerce. The containers were delivered by Itel to the lessees or their agents in many states, including Tennessee. After Tennessee assessed tax on the proceeds Itel earned from the leased containers delivered in Tennessee, Itel's refund suit challenged the constitutionality of the tax. The Tennessee Chancery courts reduced the amount of the assessment on state law grounds, but re-

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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*, 46 SMU L. REV. 1803 (1993).

2. 113 S. Ct. 1095 (1993).

3. Customs Convention on Containers, May 18, 1956, [1969] 20 U.S.T. 301, T.I.A.S. No. 6634 [hereinafter 1956 Container Convention]; Customs Convention on Containers, Dec. 2, 1972, [1975] 988 U.N.T.S. 43 [hereinafter 1972 Container Convention].

4. U.S. CONST. art. I, § 8, cl. 3.

5. U.S. CONST. art. I, § 10, cl. 2.

jected each of Itel's constitutional arguments, and the Tennessee Supreme Court affirmed.<sup>6</sup>

In its appeal to the Supreme Court, Itel's primary argument was that the Tennessee sales tax was precluded by the 1956 Container Convention<sup>7</sup> and the 1972 Container Convention.<sup>8</sup> The Court rejected this argument, stating that the Container Conventions disallowed only those taxes based on the act of importation, not those taxes based on the mere presence of a container within the jurisdiction of the taxing authority.<sup>9</sup> The Court further concluded that indirect value added tax (VAT) placed on container leases by other signatory nations to the Container Conventions was equivalent to Tennessee's direct sales tax on container leases, and that neither type of tax was a tax on importation prohibited by the Container Conventions.<sup>10</sup>

The Court also rejected Itel's contention that the Tennessee sales tax was preempted because it frustrated federal objectives under the Container Conventions, and the laws and regulations granting favored status to international containers.<sup>11</sup> Instead, the Court determined that the federal regulatory scheme for containers used in foreign commerce disclosed no congressional intent to exempt those containers from domestic taxation.<sup>12</sup> Moreover, the Court determined that the Tennessee sales tax did not violate the foreign commerce clause under the test set forth in *Japan Line, Ltd. v. County of Los Angeles*<sup>13</sup> and the import-export clause as interpreted by the Court in *Michelin Tire Corp. v. Wages*.<sup>14</sup> The Court's decision thus reflects a willingness to view favorably certain state efforts to impose tax on items that many taxpayers hoped would not be taxable.

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6. *Itel*, 113 S. Ct. at 1098-99.

7. 1956 Container Convention, *supra* note 3.

8. 1972 Container Convention, *supra* note 3.

9. *Itel*, 113 S. Ct. at 1100.

10. *Id.* at 1100-01.

11. *Id.* at 1103.

12. *Id.* at 1102.

13. 441 U.S. 434 (1979). As set forth in *Japan Line*, the two-part test to determine if a tax violates the foreign commerce clause is "whether the tax, notwithstanding apportionment, creates a substantial risk of international multiple taxation, and, second, whether the tax prevents the Federal Government from 'speaking with one voice when regulating commercial relations with foreign governments.'" 441 U.S. at 451. In applying this test to the sales tax at issue in *Itel*, the Court found that Tennessee decided to tax a discrete transaction occurring within the state and that it credited against its own tax any tax properly paid in another jurisdiction of the same transactions, thereby reducing, if not eliminating, the risk of multiple international taxation. 113 S. Ct. at 1104-05. Likewise, the Court accepted the government's assertion that the Tennessee sales tax did not prevent the government from speaking with one voice when regulating commercial relations with other nations. *Id.* at 1105.

14. 423 U.S. 276 (1976). According to *Michelin*, the following factors must not be compromised in order for a tax not to violate the import-export clause: "the Federal Government must speak with one voice when regulating commercial relations with foreign governments, and tariffs, which might affect foreign relations, could not be implemented by the States consistent with that exclusive power; import revenues were to be the major source of revenue of the Federal Government and should not be diverted to the States; and harmony among the States might be disturbed unless seaboard States, with their crucial ports of entry, were prohibited from levying taxes on citizens of other States by taxing goods merely flowing through their ports to the other States not situated as favorably geographically." 423 U.S. at 285-86 (footnotes omitted).

As is always the case for any given Survey period, several of the comptroller's administrative decisions are worth discussing in some detail. Decision 28,065,<sup>15</sup> for example, considered whether certain expenditures incurred in connection with a government contract were exempt from taxation. In particular, the taxpayer contended that certain software procured either from inventories maintained by the government or from government supply sources were not subject to Texas sales taxes. The taxpayer further claimed that certain security, janitorial, and maintenance services associated with the performance of the contract were also exempt from taxation.

With respect to the taxpayer's first contention, the comptroller agreed on both constitutional and tax law grounds. Because the software was obtained on behalf of the government and because title to the software vested directly in the government at the time of acceptance, the purchase of the software satisfied the requirements of both *United States v. New Mexico*.<sup>16</sup> and *Day & Zimmermann, Inc. v. Calvert*.<sup>17</sup>

With respect to the taxpayer's second contention, however, the comptroller distinguished between services that were inherently necessary to the performance of the contract with the government and services that were incidental to the contract in that they were not essential to the contract's central mission. Under this analysis, the comptroller determined that the security services were tax exempt, but the janitorial and maintenance services were subject to taxation.<sup>18</sup>

Decision 28,273<sup>19</sup> addressed the issue of whether certain work performed on used aircraft piston engines should be considered tax-exempt processing or taxable repairs, remodeling or maintenance. The taxpayer claimed that because the items in question were used in the processing of aircraft piston engine cylinders within six months of their purchase, they were exempt from taxation under Section 151.318<sup>20</sup> and Rule 3.300.<sup>21</sup> The comptroller, however, determined that, under the facts presented, the taxpayer was performing repairs and/or remodeling and that the items purchased for use in performing such services were taxable.<sup>22</sup>

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15. Comptroller Hearing No. 28,065 (Oct. 13, 1993).

16. 455 U.S. 720 (1982). In considering whether certain property that was purchased pursuant to a government contract was exempt from taxation, the United States Supreme Court held that "tax immunity is appropriate in only one circumstance: when the levy falls on the United States itself, or on an agency or instrumentality so closely connected to the Government that the two cannot realistically be viewed as separate entities, at least insofar as the activity being taxed is concerned." *Id.* at 735.

17. 519 S.W.2d 106 (Tex.), *cert. denied*, 423 U.S. 832 (1975) (holding that the purchases by the contractor were exempt from taxation as sales for resale to the government).

18. Comptroller hearing No. 28,065 (Oct. 13, 1993). The comptroller noted that certain maintenance services probably would have met the inherently necessary test, but that the taxpayer had failed to meet its burden of proof with respect to which of the maintenance services qualified for the tax exemption.

19. Comptroller Hearing No. 28,273 (Mar. 10, 1993).

20. TEX. TAX CODE ANN. § 151.318 (Vernon 1992).

21. 34 TEX. ADMIN. CODE § 3.300 (eff. Feb. 5, 1992, West Supp. 1993-94).

22. The services performed by the taxpayer were industrial, hard chrome plating, welding and custom machining on aircraft piston engine cylinders. While the performance of these services brought about chemical and physical changes to the cylinders, the cylinders continued

Decision 28,746<sup>23</sup> was one of several decisions to address the distinction between maintenance services, and remodeling or repairs. In this decision, the taxpayer convinced the comptroller that the periodic repainting of hotel rooms should be considered maintenance rather than remodeling or repairs. The taxpayer repainted its hotel rooms on a scheduled basis, painting the rooms the same color they were painted before, even if the rooms did not appear to require painting. Sandblasting and plastering, on the other hand, were held to be taxable. This decision is noteworthy because it points out that services listed in Rule 3.357<sup>24</sup> as non-taxable are not exempt services, and reiterates the standards for the taxpayer's burden of proof in a non-exemption case.

Decision 29,295<sup>25</sup> involved the issue of whether the installation of an emergency exit in existing building constituted non-taxable new construction. The comptroller determined that when the existing tenant expanded into adjacent office space, and required a fire exit be installed, the addition constituted remodeling or modification of the building, a taxable service, and not new construction. Since the building already existed and all the space had at one point been finished out, the installation could not be considered new construction.

Decision 27,971,<sup>26</sup> a very controversial decision, disallowed a manufacturing exemption for property that was used "in an operation one-or-more-steps removed from the actual operation producing the property to be sold" on the ground that such property was not "used or consumed in or during the actual manufacturing," as required by Section 151.318.<sup>27</sup> Final resolution of this issue appears to require judicial analysis, as the comptroller maintains that his position is correct, notwithstanding a taxpayer victory in a case that dealt with a similar issue.<sup>28</sup>

Whereas Decision 28,461<sup>29</sup> refused to acknowledge that a "taxes paid" clause in a contract meant that sales taxes had been paid, Decision 29,795<sup>30</sup> respected a taxes-paid clause that stated more explicitly that sales tax was

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to perform the same function when the taxpayer's work was finished. As a result, the comptroller determined that this type of work did not meet the definition of processing set forth in Rule 3.300. *Id.* § 3.300(a)(10).

23. Comptroller Hearing No. 28,746 (Feb. 23, 1993).

24. 34 TEX. ADMIN. CODE § 3.357 (eff. Dec. 7, 1992, West Supp. 1993-94).

25. Comptroller Hearing No. 29,295 (Feb. 19, 1993).

26. Comptroller Hearing No. 27,971 (Mar. 8, 1993).

27. TEX. TAX CODE ANN. § 151.318 (Vernon 1992).

28. *Ecolochem v. Bullock*, No. 492,269 (345 Dist. Ct., Travis County, Tex., July 2, 1993) in which the Court permitted the exemption on analogous facts.

29. Comptroller Hearing No. 28,461 (Aug. 24, 1992) (holding that the lump-sum price did not include sales tax even though the purchase order provided that price "includes labor, materials and tax." The comptroller reasoned that neither the original price proposal nor any invoices contained any reference to state taxes, and that references in the purchase order to the inclusion of tax could relate either to the taxes the seller paid to its suppliers for materials used on the job or to the tax that was due on the actual roofing job. Given these two possibilities, the decision held that the language should be interpreted against the taxpayer because the seller did not hold a sales tax permit.

30. Comptroller Hearing No. 29,795 (March 25, 1993).

included.<sup>31</sup> In a decision that reflects a change in comptroller policy, Decision 27,509,<sup>32</sup> the comptroller held that an increase in capacity is taxable remodeling rather than non-taxable new construction. The administrative law judge concluded that prior Taxability Responses and advice given to taxpayers (which had generally held that construction work performed to increase capacity is new construction when performed on refineries and chemical plants) were incorrect. Significantly, the decision recommends that the Tax Division assess and collect taxes from taxpayers who were not required to pay taxes on increased capacity remodeling, regardless of whether the failure to pay tax was due to a Taxability Response, an audit, a refund claim, or any other contact with the agency.

The taxpayer, an electric utility company, argued that the replacement of a 24 kilowatt transmission line with a 69 kilowatt line should be considered new construction because of the line's increased capacity. The administrative law judge acknowledged that several Taxability Responses issued prior to January 1, 1992 concluded that construction to increase capacity of refineries and chemical plants is new construction, but he concluded that "there does not appear to be any rational basis for treating these refineries and chemical plants different than other industries," that the changes should not be considered new construction, and that only a retroactive assessment and collection of taxes due from taxpayers in these industries would remedy the disparate treatment of similarly-situated taxpayers.<sup>33</sup> In struggling to avoid treating similarly-situated taxpayers differently, the judge apparently chose another evil: imposing a tax on taxpayers who may have relied to their detriment on previous written advice from the comptroller.

Finally, Decision 28,391<sup>34</sup> proposed a new two-part test for determining whether improvements made to a facility are for the primary use and benefit of the lessee such that real property repair and remodeling services would be exempt from taxation. First, the lessee must qualify for exempt status under Section 151.309<sup>35</sup> or Section 151.310 of the Texas Tax Code.<sup>36</sup> Second, the lease should be long-term in that it has reasonable relationship to the life of the improvements. If both of these conditions are met, the lessee will be the party receiving the primary use and benefit of the improvements.<sup>37</sup>

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31. The contract provided for labor costs and material costs, each of which was to be increased 8% for overhead and other costs, and then another 7% (the tax rate at the time of the contract) to satisfy state sales tax requirements. Thus, the purchaser had adequate proof that it had paid sales tax on the non-residential realty remodeling. A 1993 draft version of Rule 3.291(b)(3)(A) provided that "[L]ump-sum contracts that contain language about taxes such as 'contract sum includes all labor, material, taxes and permits,' will be regarded as taxes the contractor owes and paid to suppliers and not sales or use taxes collected from the contractor's customer." Draft Rule 3.291(b)(4)(A) (June 1993) (dealing with separated contracts) also addresses tax-paid clauses.

32. Comptroller Hearing No. 27,509 (Jan. 20, 1993).

33. *Id.*

34. Comptroller Hearing No. 28,391 (July 7, 1993).

35. TEX. TAX CODE ANN. § 151.309 (Vernon Supp. 1994).

36. *Id.* § 151.310.

37. Because this test is significantly different from the comptroller's prior interpretations, the comptroller will likely be challenged if he attempts to deny exemptions under this test to taxpayers who qualify for exemption under the prior interpretations.

Other administrative decisions focused on computer services,<sup>38</sup> data processing services,<sup>39</sup> security services,<sup>40</sup> as well as on what constitutes a taxable sale.<sup>41</sup>

## B. LEGISLATIVE CHANGES

Although the 73d Legislature enacted several laws affecting Texas sales tax, these legislative changes are not generally as significant as in some other recent years. The Texas Legislature focused more on refining existing authority rather than on developing new criteria for dealing with sales tax issues.

One of the most important statutory changes involves the sales tax treatment of construction for tax-exempt entities. For the second straight legislative session, Section 151.311 of the Texas Tax Code<sup>42</sup> was substantially revised. Specifically, this section was amended to delete the previous exemption for equipment and machinery used in connection with the improvement of realty for certain school districts and hospitals,<sup>43</sup> and amended also to include two exemptions for the purchase of tangible personal property and an exemption for the purchase of tangible services in connection with a contract to improve realty owned by an organization that is exempt from taxation under Sections 151.309<sup>44</sup> or 151.310.<sup>45</sup> The new exemptions for tangible personal property provide that the purchase of tangible personal property for use in the performance of a contract for improvement to realty

38. See, e.g., Comptroller Hearing No. 28,453 (Apr. 22, 1993) (consulting services provided in conjunction with software sales were not taxable; notes comptroller's difficulty in distinguishing taxable technical support from non-taxable instruction); Comptroller Hearing No. 29,703 (Apr. 20, 1993) (giving instructions with respect to software not taxable as sale of computer programs, commenting on 34 TEX. ADMIN. CODE § 3.308 (eff. Dec. 31, 1987, West 1987)); see also Comptroller Hearing No. 29,408 (Feb. 11, 1993) (no charge made for extensive computer services, therefore no tax) (discussing burden of proof).

39. Comptroller Hearing No. 29,745 (Feb. 16, 1993) (individual's revisions to drafts, including roughly 30% word processing services, were taxable data processing).

40. See, e.g., Comptroller Hearing No. 28,256 (Jan. 12, 1993) (taxpayer relief allowed, based in part on unclear law and detrimental reliance).

41. See Comptroller Hearing No. 29,388 (Feb. 16, 1993) (promotional give-away items not considered sold) (similar comptroller interpretation that mobile phones sold at low prices are not "sold," and that they may therefore not be purchased for resale, has been the subject of considerable discussion; see generally *Tax Policy News* Oct. 1993 at 4 and Dec. 1993 at 5); see also Comptroller Hearing No. 28,901 (May 17, 1993) (analyzing TEX. TAX CODE ANN. § 151.427 (Vernon 1992) and concluding that taxpayer's sale of tax-paid inventory for scrap metal is a qualifying sale, notwithstanding the tax division's argument that it was not a sale in the ordinary course of business); Comptroller Hearing No. 27,580 (June 22, 1993) (granting a refund to a publisher of copyrighted telephone directories under rationale of *Texas Monthly v. Bullock*, 489 U.S. 1 (1989)); Comptroller Hearing No. 27,942 (Feb. 18, 1993) (discussing sales in the context of supplying telephone directories).

42. TEX. TAX CODE ANN. § 151.311 (Vernon Supp. 1994).

43. Texas H.B. 85, 73d Leg., R.S. (1993). This bill amended Section 151.311 to delete the exemption for equipment and machinery used to improve realty for certain school districts and hospitals, and also contained a prior contract exemption for such equipment and machinery purchased "subject to a written contract or bid entered into on or before the effective date of this Act." This prior contract exemption has no effect after three years from October 1, 1993, the effective date of the Act.

44. TEX. TAX CODE ANN. § 151.309 (Vernon Supp. 1994).

45. *Id.* § 151.310 (Vernon Supp. 1994).

of an exempt entity is exempt if it is incorporated into such realty in the performance of the contract<sup>46</sup> and also that tangible personal property, other than machinery or equipment and its replacement parts or accessories, purchased for use in the performance of a contract with an exempt entity is exempt if the property is necessary and essential for the performance of the contract,<sup>47</sup> and the property is completely consumed at the job site.<sup>48</sup> In addition, the purchase of a taxable service for use in the performance of a contract for improvement to realty for an exempt entity is exempt if the service is performed at the job site and if the contract expressly requires the specific service to be purchased by the person performing the contract, or the service is integral to the performance of the contract.<sup>49</sup>

The 73d Legislature also continued its efforts to criminalize various actions taken to avoid or evade taxes.<sup>50</sup> As a result of the amendments to Section 151.707,<sup>51</sup> which formerly provided that a person committed an offense by giving a resale certificate for property the person knew, at the time of purchase, was purchased for use and not for resale,<sup>52</sup> an offense under this section now specifically includes, inter alia, intentionally or knowingly making a false entry in, or fraudulently altering an exemption or resale certificate, using an exemption certificate or resale certificate with knowledge that it is false, and unreasonably impeding the availability of an exemption or resale certificate.<sup>53</sup> More significant, the amendments to Section 151.707 also impose tougher penalties on violations of the statute, and tie the dollar amount of the tax avoided to the characterization of the offense.<sup>54</sup>

The Legislature also modified civil penalties. New Section 151.7031 establishes a civil penalty of \$50.00 for any taxpayer who fails to file a timely tax

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46. *Id.* § 151.311(a).

47. *Id.* Section 151.311 does not define "necessary and essential." However, Section 151.318 (Vernon 1992 & Supp. 1994), which allows a sales tax exemption for certain property used or consumed in a manufacturing process, uses the term "necessary or essential" to determine whether the purchase of tangible personal property used or consumed in the manufacturing process is exempt. Several administrative decisions concerning the manufacturing exemption appear to use "necessary or essential" and "necessary and essential" interchangeably.

48. TEX. TAX CODE ANN. § 151.311(b) (Vernon Supp. 1994).

49. *Id.* § 151.311(c).

50. The emphasis on tougher legislation for tax fraud is not new. In 1991, for example, the Texas Legislature added Section 171.363 to the Tax Code to impose criminal penalties for certain willful and fraudulent acts in the context of franchise tax reporting. Tex. Tax Code Ann. § 171.363 (Vernon 1992). *See also* *Wisembaker v. State*, 860 S.W.2d 681 (Tex. App.—Austin 1993, pet. ref'd) (prosecuting for failure to remit motor fuel taxes).

51. TEX. TAX CODE ANN. § 151.707 (Vernon Supp. 1994).

52. Act effective Jan. 1, 1982, 67th Leg. R.S., ch. 389, § 151.707, Tex. Gen. Laws 1490, 1583, *amended by*, Act of May 24, 1993, 73d Leg., R.S., ch. 486, § 1.09, Tex. Gen. Laws 1900, 1903.

53. TEX. TAX CODE ANN. § 151.707(a) (Vernon Supp. 1994).

54. Under the new statutory framework, the greater the amount of the tax avoided, the tougher the penalty. For example, if the tax avoided by the use of the fraudulent exemption or resale certificate is less than \$20, the offense is a Class C misdemeanor; however, if the tax avoided is \$20,000 or more, the offense is a felony. *See* TEX. TAX CODE ANN. § 151.707(b) (Vernon Supp. 1994). Former law merely provided that an offense under this section was a misdemeanor punishable by a fine of not more than \$500.



report on three separate occasions.<sup>55</sup> This penalty is assessed against the taxpayer even though the reports are subsequently filed and no taxes are due in connection therewith.<sup>56</sup>

The 73d Legislature also had occasion to address the taxability of certain types of services, adding Section 151.350 to the Texas Tax Code expressly providing that separately-stated labor charges for repair of real or tangible personal property damaged within a disaster<sup>57</sup> area by the condition that caused the area to be declared a disaster area<sup>58</sup> is exempt from sales or use tax. The exemption does not apply to tangible personal property transferred as part of the repair.<sup>59</sup>

Section 151.058,<sup>60</sup> which formerly provided that a person performing taxable repair services was the consumer of machinery and equipment used to perform such services,<sup>61</sup> now provides that all taxable services, not just repair services, are included within the coverage of the provision<sup>62</sup> and that the total amount charged for a taxable service is taxable, regardless of whether the charges are separately identified to the purchaser of the service.<sup>63</sup>

The occasional sale exemption, Section 151.304,<sup>64</sup> was narrowed to provide that a person who holds a sales tax permit and who makes a purchase from a person who could qualify for an exemption under Section 151.304(b)(1)<sup>65</sup> is nonetheless required to accrue use tax on the sales transaction, and to remit such tax to the comptroller.<sup>66</sup> Therefore, even if the seller can qualify for exemption, the transaction will not be exempt with respect to the purchaser.

Another noteworthy amendment, to Section 151.310,<sup>67</sup> allows an organization, exempt under Section 151.310(a)(1)<sup>68</sup> or Section 151.310(a)(2),<sup>69</sup> to

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55. TEX. TAX CODE ANN. § 151.7031 (Vernon Supp. 1994).

56. *Id.*

57. Disaster area is defined to mean an area declared a disaster area by the governor of the State of Texas under Chapter 418 of the Texas Government Code or by the President of the United States under Section 5141 of Title 42 of the United States Code. *Id.* § 151.350(c). The authority of the President to declare an area a disaster area is set forth in 42 U.S.C. § 5191 (Supp. 1993).

58. *Id.* § 151.350(a). This legislation raises interesting issues for some taxpayers because the statutory exemption is narrower in some respects than the pre-existing comptroller policy.

59. *Id.* § 151.350(b).

60. TEX. TAX CODE ANN. § 151.058 (Vernon Supp. 1994).

61. Act of July 20, 1987, 70th Leg., 2nd C.S., ch. 5, art. 1, pt. 4, § 18, Tex. Gen. Laws 9, 15, amended by Act of May 26, 1993, 73d Leg., R.S., ch. 1031, § 20, Tex. Gen. Laws 4440, 4444.

62. TEX. TAX CODE ANN. § 151.058(a) (Vernon Supp. 1994).

63. *Id.* § 151.058(b).

64. *Id.* § 151.304.

65. *Id.* § 151.304(b)(1) (Vernon 1992). This subsection provides an exemption from taxation for "one or two sales of taxable items, other than an amusement service, at retail during a 12-month period by a person who does not habitually engage, or hold himself out as engaging, in the business of selling taxable items at retail." *Id.* Regardless of the number of sales, a seller may not qualify for this exemption if the seller holds a sales tax permit. *Id.* § 151.304(f).

66. *Id.* § 151.304(g).

67. TEX. TAX CODE ANN. § 151.310(c) (Vernon Supp. 1994).

68. *Id.* § 151.310(a)(1).

69. *Id.* § 151.310(a)(2).

hold two (rather than one) one-day tax-free sales or auctions during a calendar year.

The Legislature also amended statutes affecting very specific types of activities, including those involved with customs brokers,<sup>70</sup> components of an underground irrigation system exclusively used or employed on a farm or ranch in the production of certain agricultural products to be sold in the regular course of business,<sup>71</sup> and qualified hotel projects.<sup>72</sup> Additionally, Section 151.401<sup>73</sup> was amended to provide for a one-time acceleration of the time for payment of certain taxes.<sup>74</sup> As a final example, the sales tax exemption for a non-resident's aircraft purchase is more restrictive than under prior law.<sup>75</sup>

### C. REGULATORY UPDATE

For several years, the comptroller has agreed that the exemption for prior contracts<sup>76</sup> is available for a two-party transaction. The comptroller, however, has promulgated a proposed revision to Rule 3.319<sup>77</sup> intended to deny prior contract relief to two-party contracts. The comptroller argues, relying on *Calvert v. British-American Oil Producing Co.*,<sup>78</sup> that the prior contract rule is intended to protect a supplier who was obligated to supply goods to a seller who had already contracted with its buyer, and does not apply to two-party contracts. However, this change in policy should be challenged, particularly in view of the comptroller's statement with respect to a prior ver-

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70. Section 151.157 was added to the Texas Tax Code to set forth the procedures pursuant to which a customs broker may issue documentation for the purpose of showing the exemption of tangible personal property exported beyond the territorial limits of the United States. TEX. TAX CODE ANN. § 151.157 (Vernon Supp. 1994). Similarly, Section 151.158 calls for the development by the comptroller of export stamps to be attached to export documentation. *Id.* § 151.158. In addition, under Section 151.159, the comptroller may authorize a customs broker to refund certain taxes collected by the customs broker. *Id.* § 151.159.

71. *Id.* § 151.316(b).

72. *Id.* § 151.429(h) (providing for a rebate of 100% of the sales and use taxes paid or collected by the qualified hotel project, and 100% of the taxes paid by persons using the hotel for the first seven years the hotel is open).

73. *Id.* § 151.401.

74. Specifically, a taxpayer who pays by electronic funds transfer must pay all taxes imposed on the sale, use, storage or other consummation of taxable items between August 1st and August 15th on or before August 20th unless the taxpayer qualifies as a quarterly filer, the taxpayer prepays the tax on a quarterly basis or the comptroller waives the acceleration requirement for all taxpayers. *Id.* § 151.401(a). Likewise, the tax reports due in connection with these taxes will also be due on or before August 20th. *Id.* § 151.402(b). Section 151.401 is effective on September 1, 1994, and expires January 1, 1996. Act of May 24, 1993, 73d Leg., R.S., ch. 486, § 2.04, 1993 Tex. Gen. Laws 1900, 1907. As a result of these dates, the only period of time in which this acceleration provision will be in effect is August 1995.

75. *Id.* § 151.328(f).

76. A prior contract is one that is signed before any change in the tax rate or the tax base. 34 TEX. ADMIN. CODE § 3.319(a)(3) (eff. Nov. 6, 1990, West Supp. 1993-94). In general, taxable items purchased or rented for use in or sold pursuant to the performance of prior contracts are exempted from the amount of the increase in tax or change in the tax base. *Id.* § 3.319(b).

77. 34 TEX. ADMIN. CODE § 3.319 (prop. Aug. 31, 1993, 18 Tex. Reg. 5831).

78. 397 S.W.2d 839, 843 (Tex. 1965) ("It is clear that the exemption statute means that the written contract therein referred to must be one between the purchaser and a third party and not between the seller and the purchaser.").

sion of Rule 3.319 that the rule "applies to two-party contracts as well as to traditional three-party contracts"<sup>79</sup> and the apparent lack of legislative authority for the proposed change.<sup>80</sup> The exclusion of two-party contracts from the prior contract exemption, the most significant change in Proposed Rule 3.319,<sup>81</sup> is particularly noteworthy since the exclusion is to be applied retroactively.

The comptroller revised Rule 3.333 governing security services<sup>82</sup> to delete the distinction between guard services, surveillance, armored car services and courier services. Furthermore, the revision modified a subsection on temporary security services, and discussed a multistate benefit of services.<sup>83</sup>

The comptroller drafted revisions to the rule on information services<sup>84</sup> in an apparent effort to restrict the definition of non-taxable proprietary information services,<sup>85</sup> and revised Rules 3.285<sup>86</sup> and 3.287,<sup>87</sup> governing resale certificates and exemption certificates, respectively. The stated purpose for the revisions was compliance with the recent amendments to Section 151.707<sup>88</sup> that set forth the new penalties for intentionally or knowingly issuing invalid resale or exemption certificates.<sup>89</sup> The revised rules also include revised forms of resale certificate and exemption certificates.

The comptroller also proposed revisions to a number of other rules, including Rule 3.296, which deals with the exemption for tangible personal property installed as a part of an underground irrigation system on farms and ranches.<sup>90</sup> This proposed amendment, like the proposed amendment to Rule 3.297 that provided a new procedure for claiming a sales tax exemption when purchasing an aircraft for registration and use outside Texas, addresses legislative changes made during the Survey period.<sup>91</sup>

Changes were also made, *inter alia*, to rules on imports and exports,<sup>92</sup>

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79. 13 Tex. Reg. 1340 (Mar. 18, 1988) (prop. amend. to 34 TEX. ADMIN. CODE § 3.319).

80. When the comptroller promulgated Rule 3.319 in 1987 (eff. Aug. 5, 1987, 12 Tex. Reg. 2431), the rule pointed to several factors that would disqualify contracts from prior exemptions. In the ensuing years, several disqualifying factors have been held invalid; the new two-party restriction is also likely to be challenged in the administrative hearing process.

81. Other changes to be made by the proposed rule include deleting the requirement that both parties sign the contract, allowing the prior contract exemption to apply to contracts with open price terms, and deleting the statement that notice of prior contracts or bids should not be sent to the comptroller. See 18 Tex. Reg. 5831 (Aug. 31, 1993).

82. 34 TEX. ADMIN. CODE § 3.333 (proposed Aug. 3, 1993, 18 Tex. Reg. 5059).

83. *Id.* § 3.333.

84. 34 TEX. ADMIN. CODE § 3.342 (West Supp. 1993-94).

85. This draft is based in part on Comptroller Hearing No. 27,621 (proposed July 1993), in which the administrative law judge held that mailing lists were not proprietary since they could be resold to others, and because clients for whom the mailing lists were prepared had no contractual control over the lists. The judge then recommended that the agency review and reconsider its rule, particularly the validity of § 3.342(d).

86. 34 TEX. ADMIN. CODE § 3.285 (eff. Dec. 28, 1993, 18 Tex. Reg. 9311).

87. 34 TEX. ADMIN. CODE § 3.287 (eff. Dec. 28, 1993, 18 Tex. Reg. 9312).

88. TEX. TAX CODE ANN. § 151.707 (Vernon Supp. 1994).

89. See Section I.B. *supra* for further discussion of the statutory changes.

90. 34 TEX. ADMIN. CODE § 3.296 (eff. Dec. 28, 1993, 18 Tex. Reg. 9312).

91. 34 TEX. ADMIN. CODE § 3.297 (eff. Dec. 28, 1993, 18 Tex. Reg. 9312).

92. *Id.* § 3.323 (eff. Jan. 1, 1993, West Supp. 1993-94).

transfers of common interests in property and of intercorporate services,<sup>93</sup> and customs brokers.<sup>94</sup> Consistent with the attention focused this year on construction issues, the comptroller also revised the rule on labor relating to residential property and nonresidential real property repair, remodeling, restoration, maintenance, new construction, and residential property.<sup>95</sup>

## II. FRANCHISE TAX

### A. LIABILITY FOR TAX — DOING BUSINESS IN TEXAS

As state governments continually strive to increase revenue, the threshold for nexus for taxation continues to be the subject of frequent litigation. *Geoffrey, Inc. v. South Carolina Tax Commission*<sup>96</sup> illustrates one state's successful effort to tax income received by a corporation that licenses intangible rights within the taxing jurisdiction. In the wake of *Geoffrey*, the comptroller has already indicated his intent to assert taxing jurisdiction over corporations that license certain intangibles in Texas.<sup>97</sup>

Comptroller representatives had announced as early as October 1993 that the comptroller would adopt a new rule, to be effective January 1, 1994, that would state that licensing intangibles in Texas would, under certain circumstances, constitute a nexus within Texas for franchise tax purposes. Although initial oral comments from comptroller representatives indicated that such licensing rights would create nexus only for purposes of the taxable capital component of the tax, subsequent comments indicated that such licensing would give rise to nexus for both the taxable earned surplus and the taxable capital components of the tax. Although significant questions exist concerning the validity of such a rule, its imminent promulgation merits an overview of *Geoffrey*.

*Geoffrey*, a wholly-owned, second-tier subsidiary of Toys R Us, with no employees, offices or tangible property in South Carolina, contracted to provide Toys R Us with the right to use the Toys R Us trade name, as well as certain other rights, including the right to use *Geoffrey's* merchandising skills and "know-how" in connection with the promotion, advertising and sale of products covered by the licensing agreement. The plaintiff in *Geoffrey* asserted that the Due Process Clause and the Commerce Clause precluded South Carolina from taxing the royalty income that *Geoffrey*

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93. *Id.* § 3.331 (eff. Feb. 10, 1993, West Supp. 1993-94).

94. *Id.* § 3.360 (eff. Jan. 1, 1993, West Supp. 1993-94).

95. *Id.* § 3.357 (eff. Dec. 7, 1992, West Supp. 1993-94). See also 18 Tex. Reg. 8339 (Nov. 12, 1993) (proposed amendment to Rule 3.392, concerning exemption for labor to repair tangible personal property damaged within a disaster area).

96. 437 S.E.2d 13 (S.C. 1993), cert. denied, 62 U.S.L.W. 3374 (Nov. 29, 1993).

97. According to the November 1993 issue of the Texas Comptroller's *Tax Policy News*: Effective January 1, 1994, a corporation licensing intangibles (for example, trade names, trademarks, logos, marketing plans, patents copyrights and software) in Texas will have nexus in Texas for franchise tax purposes. In other words, January 1, 1994, will be the earliest date that a corporation will be considered doing business in Texas solely because it is licensing intangibles in Texas.

received for the licenses.<sup>98</sup> The South Carolina Supreme Court concluded, however, that the nexus requirement of the Due Process Clause can be satisfied even when a corporation has no physical presence in the taxing state, that Geoffrey had a franchise as well as an account receivable in South Carolina (because Toys R Us sales gave rise to an account receivable for Geoffrey), and that "the real source of Geoffrey's income is not a paper agreement, but South Carolina's Toys R Us customers."<sup>99</sup> Based in part on these findings, the court concluded that taxing Geoffrey's income from intangibles did not violate Geoffrey's Due Process rights. According to the court: "By electing to license its trademarks and trade names for use by Toys R Us in many states, Geoffrey contemplated and purposefully sought the benefit of economic contact with those states."<sup>100</sup> The court rejected Geoffrey's claim that it has not purposefully directed its activities toward South Carolina's economic forum, and held that Geoffrey's licensing intangibles for use in South Carolina and receiving income in exchange for their use, was sufficient to meet the "minimum connection" with the taxing state required by the Due Process Clause.<sup>101</sup> Similarly, the court held that taxation of Geoffrey's royalty income was not prohibited by the Commerce Clause.<sup>102</sup>

Followed to its logical extreme, the *Geoffrey* rationale would allow states to argue that book authors, clothing manufacturers, and others are subject to tax if their products are sold in the state, notwithstanding the remote, tenuous ties that connect the "sellers" to the taxing state. Recognizing the weakness of such an overly-broad approach, the comptroller has indicated his attempt to draft a rule that would encompass the *Geoffrey* rationale without being so clearly over-broad that it becomes subject to judicial challenge and also impossible to administer.

Several comptroller letters and informal interpretations further exemplify the comptroller's nexus analysis. In one case, for example, the comptroller concluded that a seller of a service that provides access to third-party data bases, by supplying its customers with seller-owned software in Texas that enabled the customers to access the corporation's gateway and thus the third-party data bases, creates nexus in Texas for the seller.<sup>103</sup> The comptroller also continues to assert that, under certain circumstances, a company may establish nexus in Texas when an affiliate of the company performs actions in Texas on behalf of the company.<sup>104</sup> On the other hand, the comp-

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98. The royalty was one percent of net sales of licensed products or services sold under the licensed trademark.

99. *Geoffrey*, 437 S.E.2d at 15.

100. *Id.* at 16.

101. *Id.* at 16.

102. *Id.* at 18.

103. *Tax Policy News*, Feb. 1993 at 5 (summarizing 1217E07).

104. Comptroller representatives have also indicated their position that a holding company that does nothing but hold stock of companies that do business in Texas is likely to be considered as doing business in Texas if it has even minimal connection (e.g., a bank account in Texas) with the state. The comptroller argues that a corporation must be *somewhere*, and that if it is not outside Texas, it must be doing business in Texas. However, Texas law does not appear to support such a broad principle.

troller decided not to contend that a limited partner's interest in a partnership doing business in Texas is sufficient to create a nexus with Texas.<sup>105</sup>

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

The criteria for calculating taxable surplus continue to be the focus of several administrative hearings and court cases, as taxpayers attempt to exclude from surplus, *inter alia*, post-retirement life and medical benefits,<sup>106</sup> operating lease obligations,<sup>107</sup> and pre-acquisition earnings of acquired second-tier subsidiaries.<sup>108</sup> At the core of many of these issues is the comptroller's expansive view of "surplus" coupled with a narrow definition of "debt" under Section 171.109(a)(3).<sup>109</sup>

Other decisions based on the comptroller's analysis hold that prepaid expenses may not be excluded from surplus<sup>110</sup> and that a write-off of goodwill is not permitted.<sup>111</sup> The decision on goodwill is particularly interesting because of the administrative law judge's comment that Rule 3.405(e)(9),<sup>112</sup> which permits a write-off of assets that reflect a permanent decline in asset value, resulting from a specifically identifiable event, appears to be in conflict with the relevant statute.<sup>113</sup>

In summarizing the "throwback" rule, under which receipts from out-of-state sales are treated as Texas receipts if the seller is not subject to tax in the

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105. Although there is no guarantee that the comptroller will maintain this policy, the policy is consistent with promulgated regulations. (See 34 TEX. ADMIN. CODE § 3.546(c)(12)(B) (eff. Mar. 16, 1992, West Supp. 1993-94). In the absence of legislation, it is doubtful that the comptroller has authority to change this long-standing policy. Indeed, comptroller representatives have indicated that the comptroller is likely to seek legislation in 1995 that would treat such a limited partner as having a nexus with Texas.

106. See, e.g., *Arkla v. Sharp*, No. 93-02966 (201st Dist. Ct., Travis County, Tex.); pending (taxpayer excludes benefits as debt within the meaning of TEX. TAX CODE ANN. § 171.109(a)(2) (Vernon Supp. 1994)).

107. See, e.g., Comptroller Hearing No. 25,549, 26,676 (Feb. 23, 1993). Several pending court cases focus on this issue.

108. See *Harken Oil & Gas, Inc. v. Sharp*, No. 91-19926 (345th Dist. Ct., Travis County, Tex., May 27, 1993) (granting state's motion for summary judgment contending that pre-acquisition earnings of second-tier subsidiaries may not be deducted from surplus, notwithstanding *State v. Sun Refining & Marketing, Inc.*, 740 S.W.2d 552 (Tex. App.—Austin 1987, writ denied) (holding that a taxpayer may subtract pre-acquisition earnings of a subsidiary corporation)).

109. TEX. TAX CODE ANN. § 171.109(a)(3) (Vernon 1992).

110. Comptroller Hearing No. 29,834 (Feb. 16, 1993).

111. Comptroller Hearing No. 27,743, 17,916 (Mar. 15, 1993).

112. 34 TEX. ADMIN. CODE § 3.405(e)(9) (West 1987); see 34 TEX. ADMIN. CODE § 3.551(e)(10) (eff. Nov. 11, 1992, West Supp. 1993-94) for the current version of this rule.

113. TEX. TAX CODE ANN. § 171.109. See also Comptroller Hearing No. 25,549; 26,676 (Feb. 23, 1993), that also questions the validity of this rule. This hearing allowed the taxpayer utility company to amend its franchise tax returns to change from straight-line depreciation to another GAAP-permitted method, but denied taxpayer's exclusion from surplus of an AFUDC (Allowance for Funds Used During Construction)-Equity Account and of operating lease payments.

other state,<sup>114</sup> the comptroller has indicated that, for taxable capital purposes, if an officer of a Texas corporation lives in another state *and* manages the Texas corporation that state, the throwback rule does not apply.<sup>115</sup>

As in the past, there were few reported franchise tax decisions, although unreported judicial decisions and administrative decisions continue to offer guidance on some issues.<sup>116</sup>

In a significant taxpayer victory, Decision Nos. 27,377 and 27,378<sup>117</sup> held that the comptroller could not require the corporate taxpayer to use push-down accounting on the facts of that case. The decision points out that the GAAP did not require the particular taxpayer to use push-down accounting and that, since the relevant statute<sup>118</sup> requires only that GAAP principles be employed by the claimant, the comptroller may not by rule<sup>119</sup> limit the taxpayer to only one GAAP principle.<sup>120</sup> The Legislature has since provided that taxpayers may not use push-down accounting.<sup>121</sup>

The primary administrative guidance from the comptroller on the calculation and allocation of taxable earned surplus continues to be regulations and informal guidance, since no administrative hearings published during the survey period address the methodology of the earned surplus calculations.

### C. REGULATORY DEVELOPMENTS

Although the 1993 Survey period saw fewer, and less dramatic, regulatory changes than the preceding year, several proposed new and amended rules merit mention. The comptroller is again working to refine Texas' definition of nexus for franchise tax purposes, and has proposed replacing the current three-paragraph rule<sup>122</sup> with a significantly longer, more detailed rule<sup>123</sup> that attempts to set forth more specific guidance on the circumstances in which Public Law 86-272<sup>124</sup> will shield a taxpayer from the earned surplus component of the Texas franchise tax. The comptroller acknowledges that certain

114. 34 TEX. ADMIN. CODE § 3.549 (Nov. 13, 1992). *See also id.* § 3.557 (Nov. 13, 1992) (Earned Surplus: Apportionment).

115. *Tax Policy News*, May 1993 at 4 (summarizing Taxability Response 1319).

116. *Enron Oil & Gas Co. v. Sharp*, No. 91-7397 (331st Dist. Ct., Travis County, Tex., agreed judgment Sept. 2, 1993), for example, was one of several cases in which taxpayers challenged the irrevocable election requirement of 34 TEX. ADMIN. CODE § 3.391 and reached a pro-taxpayer agreed judgment with the state.

117. Comptroller Hearing Nos. 27,377, 27,378 (Mar. 24, 1993).

118. TEX. TAX CODE ANN. § 171.109 (Vernon 1992).

119. 34 TEX. ADMIN. CODE § 3.547(d)(3) (eff. Mar. 16, 1992, West Supp. 1993-94).

120. Several district court cases on push-down accounting were also resolved by agreed judgments. *See, e.g., Belco Dev. Corp. v. Bullock*, No. 446,650 (250th Dist. Ct., Travis County, Tex., July 7, 1993).

121. *See infra* note 117 and accompanying text. The comptroller continues to assert that, even for taxpayers required under old law to use push-down accounting, negative push-down accounting is not permitted.

122. 34 TEX. ADMIN. CODE § 3.554 (eff. Mar. 16, 1992, West Supp. 1993-94).

123. *See* 18 Tex. Reg. 5652 (1993) (proposing the repeal of current § 3.554 and the adoption of the new version).

124. Pub. L. No. 86-272, 73 Stat. 555 (1959) (codified as amended at 15 U.S.C. §§ 381-84 (1988)). *See* Ohlenforst & Dorrill, 1993 Survey at 1811-12 for a brief overview of Pub. L. 86-272, which prohibits state income taxes on certain, protected solicitations.

de minimis non-solicitation activities will not preclude a taxpayer from relying on the protection offered by Public Law 86-272, but the comptroller predictably attempts to limit the scope of activities that are considered de minimis.<sup>125</sup>

The comptroller has also proposed an amendment to Rule 3.558,<sup>126</sup> concerning officer and director compensation to be included in earned surplus, adding references to newly-created limited banking associations. Proposed new Rule 3.562<sup>127</sup> includes comptroller guidelines for determining the taxable capital and earned surplus of limited liability companies. The rule provides that to the extent a limited liability company allocates income and deductions to its members for federal income tax purposes, those items will be treated as income and deductions in determining the earned surplus of the limited liability company as though it were taxed as a corporation for federal income tax purposes.<sup>128</sup> Additional, specific rules are also provided with respect to dividend income received by a limited liability company.<sup>129</sup> Interestingly, the draft rule provides that some federal income tax requirements and limitations apply in calculating earned surplus,<sup>130</sup> but that other federal income tax requirements and limitations are ignored.<sup>131</sup> The proposed rule contains other provisions that appear to be result-oriented, such as the provision that a one-person limited liability company may not deduct officer and director compensation from earned surplus.<sup>132</sup> The proposed rule further provides that a corporate member's distributive share of a limited liability company's items of income or loss is not included in either the gross receipts or the earned surplus of a corporate member of a limited liability company, to the extent the items would have been reported at the limited liability company level.<sup>133</sup>

The comptroller has also proposed amendments to the rule dealing with Enterprise Zones<sup>134</sup> and new rules dealing with regulated investment companies<sup>135</sup> and with provisional exemption certificates for corporations waiting for an Internal Revenue Service Ruling on exempt status.<sup>136</sup>

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125. See 34 TEX. ADMIN. CODE § 3.554 (c)(3) (prop. Aug. 24, 1993, 18 Tex. Reg. 5652), defining de minimis activities as "those that, when taken together, establish only a trivial connection with Texas," and providing that if activity either qualitatively or quantitatively creates a non-trivial connection, "then the activity exceeds the protection of Pub. L. 86-72." The proposed rule also includes 21 examples of activities that constitute doing business in Texas if they are not of a de minimis level.

126. See 34 TEX. ADMIN. CODE § 3.558 (eff. Sept. 29, 1992, West Supp. 1993-94); *id.* (proposed Nov. 12, 1993, 18 Tex. Reg. 8343).

127. 34 TEX. ADMIN. CODE § 3.562 (prop. Nov. 12, 1993, 18 Tex. Reg. 8346).

128. *Id.* § (d).

129. *Id.* § (d)(4).

130. See, e.g., *id.* § (d)(1).

131. See *id.* § (d)(2).

132. *Id.* § (g).

133. *Id.* § (h)(2)(A).

134. 34 TEX. ADMIN. CODE § 3.561 (prop. Nov. 12, 1993, 18 Tex. Reg. 8345).

135. *Id.* § 3.564 (prop. Nov. 12, 1993, 18 Tex. Reg. 8347).

136. *Id.* § 3.573 (prop. July 20, 1993, 18 Tex. Reg. 4742).



## D. LEGISLATIVE DEVELOPMENTS

Fearful that taxpayers would be awarded substantial refunds based on the rationale of *Allied-Signal, Inc. v. Director, Division of Taxation*,<sup>137</sup> the comptroller successfully sought a legislative change designed to bar such refunds. (In *Allied-Signal*, the Supreme Court held that New Jersey could not include in apportionable income for state tax purposes the gain that the taxpayer had received from the sale of a minority interest in an unrelated, non-unitary business.)<sup>138</sup> The comptroller's shield against *Allied-Signal* refund claims took the form of a new section to the Tax Code<sup>139</sup> that provides that the comptroller may allocate all of certain intangible income, excluding interest and dividends, to Texas if the corporation's commercial domicile is in Texas and the income cannot otherwise be taxed.<sup>140</sup> This legislative change attracted remarkably little attention during the legislative session, given that it purports to abrogate, in limited circumstances, Texas' well-established location of payor rule.<sup>141</sup> The new statutory language is particularly troubling because it relies on concepts (like "insufficient unitary connection") which are ambiguous at best and which find no interpretation under current Texas law.<sup>142</sup>

Faced with significant taxpayer concerns that new Section 171.1061 would be used to allocate stock sale receipts to Texas, the comptroller has provided taxpayers with limited assurances that most income would be "presumed" unitary, and that the comptroller's efforts would focus more on sourcing "nowhere income" to Texas than on sourcing income to Texas in other circumstances.<sup>143</sup>

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137. 112 S. Ct. 2251 (1992). See Ohlenforst & Dorrill, *Taxation, Annual Survey of Texas Law*, 46 SMU L. REV. 1803, 1814 (1993).

138. 112 S. Ct. at 2264.

139. TEX. TAX CODE ANN. § 171.1061 (Vernon Supp. 1994).

140. Specifically, TEX. TAX CODE ANN. § 171.1061 provides:

An item of income included in a corporation's taxable earned surplus, except that portion derived from dividends and interest, that a state, other than this state, or a country, other than the United States, cannot tax because the activities generating that item of income do not have sufficient unitary connection with the corporation's other activities conducted within that state or country under the United States Constitution, is allocated to this state if the corporation's commercial domicile is in this state. Income that can only be allocated to the state of commercial domicile because the income has insufficient unitary connection with any other state or country shall be allocated to this state or another state or country net of expenses related to that income. A portion of a corporation's taxable earned surplus allocated to this state under this section may not be apportioned under Section 171.110(a)(2).

141. See 34 TEX. ADMIN. CODE §§ 3.549(e)(13) and 3.557(e)(13) (eff. Nov. 13, 1992, West Supp. 1993-94) (providing that receipts from dividends, interest and other intangibles are generally allocated to the location [for a corporation, state of incorporation] of the payor). The comptroller has also indicated his intent to treat certain sales of partnership interest as outside the location of payor test, on the ground that such sales should be taxed as asset sales rather than as sales of an intangible partnership interest.

142. The frequently-heard explanation that this provision will be used to tax "nowhere income" fails to answer serious interpretative questions concerning how to determine what is unitary in this context, what is an "item of income," and which expenses are "related to" income.

143. As of the end of the survey period, the comptroller had not yet revised 34 TEX. AD-

The Legislature also modified the definition of "gross receipts" for earned surplus purposes: as revised, Section 171.1121<sup>144</sup> provides that "gross receipts" does not include revenues, like Schedule C special deductions, that are not included in earned surplus.<sup>145</sup> This section therefore makes explicit the comptroller's interpretation that dividends among members of an affiliated group, if excluded from taxable income for federal income tax purposes, may not be included in calculating the percentage of the recipient corporation's receipts that are allocable to Texas.

Among other changes,<sup>146</sup> the Legislature prohibited push-down accounting,<sup>147</sup> provided that Texas chartered savings banks and limited banking associations are subject to franchise tax<sup>148</sup> and modified the throwback rule for earned surplus calculations.<sup>149</sup>

The statutory provision imposing an "additional tax" on a corporation that ceases to be subject to the earned surplus component of the tax was modified to state that the additional tax applies "without regard to whether the corporation remains subject to tax."<sup>150</sup>

### III. PROPERTY TAX

#### A. APPLICATION OF TAX

A host of opinions during the Survey period addressed the agricultural land and qualified open-space land exemptions. (Agricultural and open-space land are entitled to special appraisal according to productive capacity rather than fair market value.)<sup>151</sup> In *Tarrant Appraisal District v. Moore*<sup>152</sup> the Supreme Court of Texas held that the trial court properly instructed the jury that use of land principally for recreational purposes or as a hobby does

MIN. CODE § 3.554 (Earned Surplus: Nexus) to take into account this new statute. The comptroller has previously considered recommending that Texas adopt some form of a unitary or combined reporting system. If he intends to make such a recommendation for the future, he may determine that it would not be in the state's best interests to adopt an overly narrow definition of "unitary."

144. TEX. TAX CODE ANN. § 171.1121 (Vernon Supp. 1994).

145. *Id.*

146. For proof that budget and politics create interesting law, see new TEX. TAX CODE ANN. § 171.651-57 and TEX. GOV'T CODE §§ 497.009-10; 497.022 creating a credit against franchise taxes for certain wages paid to prison inmates.

147. See TEX. TAX CODE ANN. § 171.109(m) (Vernon Supp. 1994). This change brings the state full circle on this issue. See *supra* note 117 and accompanying text.

148. TEX. TAX CODE ANN. § 171.001 (Vernon Supp. 1994).

149. TEX. TAX CODE ANN. § 171.1032 (Vernon Supp. 1994). The section now states explicitly that the criteria is whether the seller is subject to tax in another jurisdiction "without regard to whether the tax is imposed." *Id.*

150. TEX. TAX CODE ANN. § 171.0011(a) (Vernon Supp. 1994). This change is intended to address taxpayer arguments that the additional tax does not apply to a corporation that is no longer subject to either the taxable capital component of the tax or the earned surplus component. Another change in this statute is to provide that the tax is due "on the 60th day" after the corporation is no longer subject to the tax rather than being delinquent after sixty days. *Id.* § 171.0011(c) (emphasis added). The prior wording could allow taxpayers to argue that corporations could liquidate within sixty days of January 1, 1994, but pay tax before the 60th day, to avoid being bound by the law as in effect on January 1, 1994.

151. TEX. TAX CODE ANN. §§ 23.57, 23.52 (Vernon 1992).

152. 845 S.W.2d 820 (Tex. 1993).

not qualify as agricultural use.<sup>153</sup> In order for land to qualify as open-space land, among other requirements, it must be currently and principally devoted to agricultural use to the degree of intensity generally accepted in the area.<sup>154</sup> In reversing the court of appeals, the court reasoned that land cannot be principally devoted to agricultural use if it is also used principally for recreational purposes or as a hobby.<sup>155</sup>

In a landmark decision, the Texas Supreme Court in *HL Farm Corp. v. Self*<sup>156</sup> held that Section 23.56(3) of the Tax Code,<sup>157</sup> which denies open-space land valuation to property owned by a legal entity owned primarily by a nonresident alien or foreign government if such entity is required by federal law to register its ownership of the land,<sup>158</sup> is unconstitutional. In reversing the Dallas Court of Appeals,<sup>159</sup> the court reasoned that the classification created in Section 23.56(3) is not rationally related to the purpose of the open-space land exemption (which is to promote land devoted to farm or ranch purposes), and, therefore, violates the equal protection clause of the Texas Constitution.<sup>160</sup> The court concluded that the preservation of open-space land is based on use, not on ownership, and that there is simply no rational basis for denying an open-space land designation to a foreign entity.<sup>161</sup>

The Attorney General in Opinion No. DM-188<sup>162</sup> addressed the public purpose test, which is another highly litigated issue. Pursuant to Section 11.11 of the Tax Code, property owned by the state or its political subdivision is generally exempt from property tax if the property is used for public purposes.<sup>163</sup> Unfortunately, Texas courts have not developed a completely adequate definition of public purpose. In general, courts have held that the test for public purpose is whether the public property is used primarily for the health, comfort and welfare of the public.<sup>164</sup>

In this ruling, the Attorney General addressed whether a city-owned aircraft hangar leased to a private entity to be used for maintenance and storage of its aircraft meets the public purpose test. The Attorney General recog-

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153. *Id.* at 823.

154. TEX. TAX CODE ANN. § 23.51(1) (Vernon 1992).

155. *Moore*, 845 S.W.2d at 823. In reaching its conclusion, the court relied heavily on guidelines published by the State Property Tax Board (whose duties were taken over by the Comptroller in 1991), which provided that property used primarily for recreational use does not qualify as open-space land. See State Property Tax Board, *Guidelines for the Valuation of Agricultural Land* (1988).

156. 37 Tex. Sup. Ct. J. 321 (1994).

157. TEX. TAX CODE ANN. § 24.56(3) (Vernon 1992).

158. *Id.*

159. See Ohlenforst & Dorrill, *Taxation, Annual Survey of Texas Law*, 45 Sw. L.J. 2093, 2116 (1992) (discussing the Dallas Court of Appeals' decision in *HL Farm*).

160. See TEX. CONST. art. I, § 3.

161. *HL Farm*, 37 Tex. Sup. Ct. at 322. This decision conflicts with *Alexander Ranch v. Central Appraisal Dist.*, 733 S.W.2d 303 (Tex. App.—Eastland 1987, writ ref'd n.r.e.). Furthermore, the court provided that it disapproves of the holding in *Alexander Ranch* to the extent its holding conflicts with *HL Farm*.

162. Op. Tex. Att'y Gen. No. DM-188 (1992).

163. TEX. TAX CODE ANN. § 11.11(a) (Vernon 1992).

164. *A&M Consol. Indep. Sch. Dist. v. City of Bryan*, 184 S.W.2d 914 (Tex. 1945).

nized that the Municipal Airports Act<sup>165</sup> broadly declares that the development and operation of airports are public purposes, and reasoned that the hangar must be used in the direct support of the airport in order to be used for a public purpose.<sup>166</sup> The Attorney General did not reach a conclusion with respect to whether the hangar at issue was used for a public purpose because he viewed the issue one of fact; however, he ruled that if most of the aircraft stored and serviced at the hangar would be brought there solely for maintenance and storage and would not be engaged in the transport of passengers or cargo to or from the airport, then the hangar would not meet the public purpose test.<sup>167</sup>

The San Antonio Court of Appeals in *Nueces County Appraisal District v. Diamond Refining and Marketing Co.*<sup>168</sup> held that crude oil temporarily stored in the county after foreign importation was not exempt from property tax.<sup>169</sup> The oil was shipped from outside the country to the county, where it remained in storage tanks for no more than 25 days until it was delivered to the taxpayer's refinery, which was also located in Texas. The taxpayer asserted that the oil was in transit and immune from property taxes under both the Import-Export Clause and the Commerce Clause of the United State Constitution. The critical issue with respect to the Import-Export Clause was whether the tax violated the third purpose of the Import-Export Clause, as expressed by the United States Supreme Court in *Michelin Tire*,<sup>170</sup> that harmony among the states might be disturbed unless the seaboard states were prohibited from taxing citizens of other states by taxing goods merely flowing through their ports to the inland states.<sup>171</sup> Because the oil's final destination was a Texas refinery, the court reasoned that the tax had no effect on the cost of property moving to inland states.<sup>172</sup> In addressing the Commerce Clause, the court relied on the tests employed in *Complete Auto Transit, Inc. v. Brady*<sup>173</sup> and *Japan Line*.<sup>174</sup> The primary issue examined by the court relative to the Commerce Clause was whether the tax violated the requirement under *Japan Line* that the tax not enhance the risk of multiple taxation on the item taxed. The court reasoned that there was no risk of multiple taxation given that, upon entering the United States, the oil is subject to tax only in Texas, and only in the county in which it has its taxable

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165. In TEX. REV. CIV. STAT. ANN. art. 46d-15 (Vernon 1969 and Supp. 1994). Indeed, the Attorney General ruled in 1986 that, as a matter of law, a city's airport facilities which are leased to a private entity are used for a public purpose. Op. Tex. Att'y Gen. No. JM-464 (1986).

166. Op. Tex. Att'y Gen. No. DM-188 (1992). Apparently, property used to support the city's safe and efficient operation of the airport meets this "direct support" test. *Id.*

167. *Id.* It is not clear from the Attorney General's opinion, however, whether the cargo and passengers need to be public cargo and public passengers in order for the public property exemption to apply.

168. 853 S.W.2d 212 (Tex. App.—Corpus Christi 1993, writ granted).

169. *Id.* at 218.

170. 423 U.S. 276 (1976); see also *supra* note 14 and accompanying text.

171. *Michelin Tire*, 423 U.S. at 285-86.

172. *Nueces County*, 853 S.W.2d at 216.

173. 430 U.S. 274 (1977).

174. 441 U.S. 434 (1979). See also *supra* note 13 and accompanying text.

situs.<sup>175</sup>

The Corpus Christi Court of Appeals in *General Electric Capital Corp. v. City of Corpus Christi*<sup>176</sup> held that a taxpayer which repossessed certain mobile homes was liable for property taxes on such homes, irrespective of whether the taxpayer possessed legal title to such homes.<sup>177</sup> The court concluded that property tax may be imposed not only on those possessing legal title to property, but also on persons possessing property or having a superior right of possession.<sup>178</sup> In this case, the court believed that the taxpayer, after obtaining foreclosure or possession, became the tax owner of the property at issue.<sup>179</sup>

## B. PROCEDURE

The Dallas Court of Appeals' decision in *Collin County Appraisal District v. Northeast Dallas Associates*<sup>180</sup> is yet another example that taxpayers are generally required to follow strictly the property tax statutes in order to be entitled to an exemption. *Northeast Dallas Associates* addressed the scope of Section 25.25(c)(1) of the Tax Code,<sup>181</sup> that allows rolls to be corrected for clerical errors. In this case, the taxpayer applied to the appraisal district requesting that its land be specially appraised as open-space land. In completing the application, however, the taxpayer, a domestic entity, mistakenly checked a box indicating the land was owned by a foreign entity. Land is not eligible for open-space land designation if it is owned by a foreign entity.<sup>182</sup> Because of the foreign ownership designation, the appraisal district denied the open-space application. The taxpayer asserted that it was entitled to relief under Section 25.25(c)(1) because the error in completing the form was a clerical error.<sup>183</sup> The court disagreed, however, reasoning that Section

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175. *Nueces County*, 853 S.W.2d at 218. In another important case addressing the Commerce Clause, the United States Supreme Court vacated the decision of the Houston Court of Appeals in *Harris County Appraisal Dist. v. Transamerica Container Leasing, Inc.*, 821 S.W.2d 637 (Tex. App.—Houston [1st Dist.] 1991), cert. granted and judgment vacated, 113 S. Ct. 1407 (U.S., Mar. 8, 1993), that held that it was not constitutionally permissible for a taxing unit to subject to property tax shipping containers that were frequently present in the district but which were used exclusively in foreign commerce. The court remanded the case to the Texas Court of Appeals for further consideration in light of the holding in *Itel Containers*. See *supra* text accompanying notes 2-14. In *Transamerica*, the Houston Court of Appeals had ruled that the property tax violated the Commerce Clause because there was no evidence that the tax would not create an enhanced risk that the containers would be subjected to multiple international taxation. It is not clear, however, that the court of appeals should reach a different result in *Transamerica* than it did in its first opinion given that Texas' property tax does not expressly allow for a credit of taxes imposed in foreign jurisdictions against the Texas property tax.

176. 850 S.W.2d 596 (Tex. App.—Corpus Christi 1993, writ denied).

177. *Id.* at 599.

178. *Id.*

179. *Id.* The taxpayer argued unsuccessfully that the Uniform Commercial Code provides strong proof that title to repossessed property passes directly from the debtor to the ultimate purchaser in a foreclosure sale, and is not held by the secured party upon repossession. *Id.*

180. 855 S.W.2d 843 (Tex. App.—Dallas 1993, no writ).

181. TEX. TAX CODE ANN. § 25.25(c)(1) (Vernon 1992).

182. *Id.* § 23.56(3) (Vernon 1992).

183. Section 25.25(c)(1) provides that the appraisal roll may be changed only under certain circumstances, including on the motion of the chief appraiser or of a property owner to correct

25.25(c)(1) was intended to allow for the correction of clerical errors by the appraisal district, not the property owner.<sup>184</sup>

In *Brooks County Central Appraisal District v. Tipperary Energy Corp.*<sup>185</sup> however, the court interpreted procedural requirements somewhat loosely in order to allow a taxpayer to receive a refund of taxes it was not required to pay. In this case, the San Antonio Court of Appeals held that the voluntary payment rule and other procedural obstacles did not prevent the taxpayer from being entitled to a tax refund in a circumstance in which another entity had paid taxes for the same property for the same years.<sup>186</sup> The taxing authorities asserted that the taxpayer was not entitled to a refund for the following reasons: (i) the application of the voluntary payment rule which prevents taxpayers from refunds of taxes paid voluntarily;<sup>187</sup> (ii) by failing to file a protest and a correction motion, which is filed to correct a clerical error,<sup>188</sup> the taxpayer failed to exhaust its administrative remedies; (iii) the authorization of refunds under Section 31.11 of the Tax Code,<sup>189</sup> which addresses refunds for erroneous payments,<sup>190</sup> are only allowed where the payment is in excess of the tax bill; and (iv) the taxpayer was barred from receiving a refund because the taxpayer had rendered the property.

The court rejected each of these arguments. Specifically, the court reasoned that the taxpayer's payment was not voluntary because it was not aware of all relevant facts before making the payment (i.e., that another taxpayer had already paid such taxes).<sup>191</sup> With respect to the assertion that the taxpayer did not exhaust its administrative remedies, the court concluded that the filing of a protest is not necessary to correct an appraisal roll under Section 25.25 of the Tax Code,<sup>192</sup> and that a correction motion was not necessary in circumstances in which two tax statements had been generated for the same property, as in the facts at hand.<sup>193</sup> In addressing Section 31.11, the court ruled that the section should not be read to allow taxing units a windfall merely because the taxes paid identically matched the tax bill, and

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clerical errors that affect a property's liability for tax. TEX. TAX CODE ANN. § 25.25(c)(1) (Vernon 1992).

184. *Northeast Dallas Associates*, 855 S.W.2d at 849.

185. 847 S.W.2d 592 (Tex. App.—San Antonio 1992, no writ).

186. *Id.*

187. *Id.* at 595.

188. Generally, in order to challenge a tax, taxpayers have the duty to exhaust administrative remedies, including filing a protest and appearing at an Appraisal Review Board hearing. See TEX. TAX CODE ANN. §§ 41, 42 (Vernon 1992 & Supp. 1994). Under Section 25.25(c) of the Tax Code, a taxpayer is required to submit a written order to correct a clerical error; such written order is referred to as a "correction motion." TEX. TAX CODE ANN. § 25.25(c) (Vernon 1992).

189. TEX. TAX CODE ANN. § 31.11 (Vernon 1992 & Supp. 1994).

190. This section provides that if a taxpayer applies for a refund of an overpayment or a erroneous payment of taxes which is determined by the auditor to be a valid claim, the tax collector is required to refund the amount of such excessive or erroneous payments. If, however, the amount of the refund exceeds \$500, the tax collector is prohibited from making the refund unless the governing body of the taxing unit determines that the payment was erroneous or excessive and agrees to make the refund. *Id.* § 31.11(a).

191. *Tipperary Energy*, 847 S.W.2d at 595.

192. TEX. TAX CODE ANN. § 25.25 (Vernon 1992 & Supp. 1994).

193. *Tipperary Energy*, 847 S.W.2d at 596-98.

that taxpayer's payment was "erroneous," given that it did not know taxes had already been paid on the property.<sup>194</sup> Finally, the court reasoned that *Hunt County Tax Appraisal District v. Rubbermaid*<sup>195</sup> made it clear that the doctrine of estoppel by rendition no longer precludes a refund.<sup>196</sup>

The Texas Supreme Court in *Bailey v. Cherokee County Appraisal District*<sup>197</sup> held that heirs of an estate are not personally liable for property taxes imposed on property owned by the estate during its pendency.<sup>198</sup> In asserting that the heirs possessed personal liability for such taxes, the taxing authority argued that (i) title to the property vests immediately in the heirs upon the decedent's death, and (ii) Section 37 of the Probate Code<sup>199</sup> provides that heirs are liable to the payment of the debts of the intestate. The court disagreed, concluding that for tax purposes heirs are not considered owners of property in an estate still being administered.<sup>200</sup> Indeed, the court used Section 37 of the Probate Code as support for its position, citing that under Section 37, the administrator, as trustee of the estate property, is vested with legal title to property held by the estate.<sup>201</sup> As holder of legal title, the court reasoned that the trustee is the tax owner of the property.<sup>202</sup>

### C. LEGISLATION

In yet another attempt to meet the Texas Supreme Court mandate to equalize public education funding, the Texas Legislature, after rancorous negotiations, enacted Senate Bill 7, that essentially establishes a new public school finance system.<sup>203</sup> A key component of this new system is that each

194. *Id.* at 598-99.

195. 719 S.W.2d 215, 220-21 (Tex. App.—Dallas 1986, writ ref'd n.r.e.).

196. *Tipperary Energy*, 847 S.W.2d at 599.

197. 862 S.W.2d 581 (Tex. 1993).

198. *Id.* at 584.

199. TEX. PROB. CODE ANN. § 37 (Vernon Supp. 1994).

200. *Bailey*, 862 S.W.2d at 584.

201. *Id.* at 584-85.

202. *Id.* In Opinion No. DM-195 the Attorney General addressed an important procedural tax issue. This ruling interpreted Section 34.04 of the Tax Code, which addresses a taxpayer's ability to claim proceeds in excess of those necessary to pay a property tax liability that are generated from a tax sale of the property. TEX. TAX CODE ANN. § 34.04 (Vernon 1992). The section requires a claimant to file a petition in the court that ordered the tax sale in order to recover excess proceeds. *Id.* The Attorney General ruled that in order to claim properly such excess proceeds, the former owner simply needs to file a petition in the foreclosure action whereby the owner makes a claim for the excess proceeds, and is not required to file a separate lawsuit. Op. Tex. Att'y Gen. No. DM-195 (1993).

203. Act of May 31, 1993, 73d Leg., R.S., ch. 347, 1993 Tex. Gen. Laws 1479. Senate Bill 7 was actually the Texas Legislature's second attempt in 1993 to create a new public school finance system to equalize public education funding. On February 15, 1993, the Texas Legislature passed Senate Joint Resolution 7, which proposed to amend the constitution to authorize the legislature to redistribute property tax revenues levied by one school district among other school districts, and to exempt school districts in certain circumstances from complying with certain unfunded state education mandates. See Sen. J. Res. 7, 73d Leg., R.S., 1993 Tex. Sess. Law Serv. vol. 1, A-2 (Vernon). On May 1, 1993, however, voters in a special election rejected the proposed amendment, thereby requiring the Texas Legislature to devise a new school financing scheme in order to meet the Texas Supreme Court's mandate in *Edgewood III*. See *Carrollton-Farmers Branch Indep. School Dist. v. Edgewood Indep. School Dist.*, 826 S.W.2d 489 (Tex. 1992).

school district which has a "wealth per student" (generally defined as the taxable value of its property divided by its number of students)<sup>204</sup> that is in excess of the "equalized wealth level" (initially defined as \$280,000, but that is adjusted each year)<sup>205</sup> is required to exercise one of five options in order to reduce its "wealth per student" to the "equalized wealth level."<sup>206</sup>

The five options a school district can employ to reduce its "wealth per student" are: (i) consolidating with another district (i.e., a district with a low wealth per student);<sup>207</sup> (ii) detaching territory in the school district and having it annexed to another school district, thereby allowing the school district to which the property is annexed to collect the ad valorem tax revenues from such property;<sup>208</sup> (iii) purchasing an average daily attendance credit (i.e., paying funds to the Commissioner of Education in order to be credited with additional students, thereby decreasing the district's "wealth per student");<sup>209</sup> (iv) contracting for the education of nonresident students, thereby reducing a district's "wealth per student" by increasing its number of students;<sup>210</sup> and (v) consolidating its tax base with another district.<sup>211</sup> In order to employ options (iii), (iv) and (v) above, however, a school district must obtain voter approval.<sup>212</sup>

Senate Bill 7 also sets a \$1.50 limit on the total tax rate a school district may impose unless a higher rate has been approved by voters.<sup>213</sup> (Irrespective of whether voter approval of a higher rate is obtained, however, the maintenance and operations portion of the tax rate cannot exceed \$1.50.)<sup>214</sup> By setting these limits, school districts are limited in their ability to use Tier 3 as a funding source. Tier 3 is additional revenue from local property taxes in excess of amounts necessary to provide the basic allotment and the guaranteed yield under Tiers 1 and 2.<sup>215</sup>

The new school finance legislation abolishes, effective September 1, 1993,

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204. TEX. EDUC. CODE ANN. § 36.001(2) (Vernon Supp. 1994).

205. *Id.* § 36.002.

206. *Id.* § 36.003. In order to attempt to address possible constitutional challenges to Senate Bill 7, the Texas Legislature added a provision to the public school finance bill which provides that if any of the five options of achieving an equalized wealth level are ultimately held to be invalid by a court, a school district is entitled to exercise any one of the remaining options. *Id.* § 36.009(a). In addition, the statute provides that if it is ultimately held that each of the five options is invalid, the Commissioner of Education has the authority to adopt a plan to equalize school funding that least disrupts effected school districts. *Id.* § 36.009(b). These provisions may have been added to the statute to deter school districts from suing to challenge the constitutionality of Senate Bill 7, given that other options might be perceived to be worse than those provided in Senate Bill 7. To the extent these provisions were designed to deter lawsuits challenging the legislation, however, they were unsuccessful. See *supra* notes 222-23 and accompanying text.

207. TEX. EDUC. CODE ANN. §§ 36.031-36.034 (Vernon Supp. 1994).

208. *Id.* §§ 36.061-36.065.

209. *Id.* §§ 36.091-36.096.

210. *Id.* §§ 36.121-36.123.

211. *Id.* §§ 36.151-36.160.

212. *Id.* §§ 36.096, 36.122 and 36.154.

213. *Id.* § 20.09(a).

214. *Id.* § 20.04(d).

215. See *Edgewood I.S.D. v. Meno*, No. 362,516 (250th Dist. Ct., Travis County, Tex., Dec. 9, 1993).



county education districts, which were used unsuccessfully as a vehicle under prior law to attempt to equalize school funding.<sup>216</sup> The legislation also appears to provide a deterrent to school districts' entering abatement agreements.<sup>217</sup>

Not surprisingly, the usual suspects (certain property-rich and property-poor districts) quickly challenged Senate Bill 7 on a variety of constitutional and other grounds.<sup>218</sup> In an elaborate opinion, the District Court of Travis County upheld Senate Bill 7, calling the legislation "perhaps our last hope for establishing the system of public education our forbearers believed essential to the preservation of our liberties and rights."<sup>219</sup> There is, of course, little doubt that the Texas Supreme Court will ultimately address the validity of Senate Bill 7.

There were a number of other important procedural and substantive property tax provisions enacted during 1993. For example, the Texas legislature created new exemptions and modified certain existing exemptions. New Section 11.181 of the Tax Code<sup>220</sup> exempts real property owned by certain charitable organizations for the purpose of building or repairing housing on property primarily with volunteer labor to sell without profit to a low-income individual or family.<sup>221</sup> The definition of a "residence homestead," which is entitled to a partial property tax exemption,<sup>222</sup> was expanded to include residential property owned by one or more individuals through a beneficial interest in a qualifying trust if the beneficiary uses the property as his principal residence.<sup>223</sup> Texas voters approved in November, 1993, a con-

216. Act of May 31, 1993, 1993 Tex. Sess. Law Serv. 1481 (Vernon).

217. See, e.g., TEX. EDUC. CODE ANN. § 36.008 (Vernon Supp. 1994).

218. Edgewood I.S.D. v. Meno, No. 362,516 (250th Dist. Ct., Travis County, Tex., Dec. 9, 1993).

219. *Id.*

220. TEX. TAX CODE ANN. § 11.181 (Vernon Supp. 1994).

221. *Id.* Section 11.181, however, provides that the exemption expires after the third anniversary of the date the exempt organization acquires the relevant property. *Id.* § 11.181(b).

222. *Id.* § 11.13.

223. *Id.* The requirements of a "qualifying trust" are quite lengthy, and will certainly be subject to litigation. A "qualifying trust" generally means a trust which provides the trustor the right to use and occupy as his or her principal residence property rent free and without charge (except for taxes and certain other costs) for life, or for the lesser of life or a term of years, or until the date the trust is revoked or terminated. *Id.* § 11.13(j)(3). In addition, the property is not acquired pursuant to a "qualifying trust" unless the trust acquires the relevant property pursuant to an instrument which (i) describes the property with reasonable certainty; (ii) is recorded in the real property records in the county in which the property is located; and (iii) is executed by the trustor or its representative. *Id.* § 11.13(j)(3)(B).

Prior to this case, it was unclear whether property owned by a trust but that was used as the primary residence of the trustor was entitled to the residence homestead exemption. Given that Section 11.13 of the Tax Code (prior to amendment in 1993) expressly required that the property be owned by an individual in order to qualify for the exemption, taxpayers may have had a difficult time establishing a residence homestead exemption for property legally owned by a trust. However, *City of Mesquite v. Malouf*, 553 S.W.2d, 639 (Tex. App.—Texarkana 1977, writ. ref'd n.r.e.), could be used as support for the argument that the exemption should apply even under prior law. In this case, the court addressed whether beneficiaries or the trustee were the owners of property for purposes of determining whether the property qualified for the benefit of agricultural appraisal. The court stated that when a valid trust is created, the beneficiaries become the owners of the equitable or beneficial title to the trust property, and are considered real owners. *Id.* at 644. Therefore, this case could be used for support that the

stitutional amendment allowing the Texas legislature to exempt from ad valorem tax real and personal property that is used, constructed, acquired or installed wholly or partly for certain pollution control purposes.<sup>224</sup>

Section 11.251(k) of the Tax Code,<sup>225</sup> addressing the freeport exemption, was amended to state explicitly that property otherwise meeting the freeport exemption is exempt irrespective of whether the person who owns the property on January 1 is the same person who transports it outside Texas.<sup>226</sup> Pursuant to amended Section 11.18 of the Tax Code,<sup>227</sup> nonprofit hospitals must meet stricter requirements in order to qualify for tax-exempt status.<sup>228</sup>

In addition to amending and creating exemptions, the legislature made other important changes to substantive property tax law provisions. New Section 23.175 of the Tax Code<sup>229</sup> requires that if a real property interest in oil or gas in place is valued for property tax purposes by a method that takes into account expected future income from the sale of oil or gas to be produced from the property, the method must base its values on the average price of the oil or gas from the interest during the preceding year.<sup>230</sup> The Texas legislature repealed the tax on the intangible value of the transportation operation of the following businesses: railroads, toll roads, toll bridges, ferries, oil pipelines and common carrier pipelines engaged in the transportation of oil.<sup>231</sup> New Sections 23.12A and 23.12B of the Tax Code<sup>232</sup> require motor vehicle dealers to pay property taxes on inventory based on the average inventory over the prior twelve month period,<sup>233</sup> and to make monthly deposits based on vehicles sold during the months.<sup>234</sup>

Many important procedural changes were made to the Tax Code. New subsections 26.15(g) and 31.11(b) of the Tax Code<sup>235</sup> allow taxing units to offset property tax refunds against delinquent tax liabilities of the person entitled to the refund.<sup>236</sup> Pursuant to amended Section 32.01 of the Tax Code, tax liens on inventory, furniture, equipment and other personal property attach to after-acquired personal property.<sup>237</sup>

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residence homestead applies under prior law in circumstances in which the property was owned by a trust.

224. House J. Res. 86, 1993 Tex. Sess. Law. Serv. vol. 3, A-1 (Vernon). See TEX. TAX CODE ANN. § 11.31 (Vernon Supp. 1994) (implementing the legislation). One of the issues almost certain to arise in connection with the new exemption for pollution control property is the extent to which particular devices are used to control pollution.

225. TEX. TAX CODE ANN. § 11.251(k) (Vernon Supp. 1994).

226. *Id.*

227. *Id.* § 11.18.

228. *Id.*

229. *Id.* § 23.175.

230. *Id.*

231. Act of June 9, 1993, 1993 Tex. Sess. Law Serv. 1859 (Vernon).

232. TEX. TAX CODE ANN. §§ 23.12A and 23.12B (Vernon Supp. 1994).

233. *Id.* § 23.12A(c).

234. *Id.* § 23.12B. This provision essentially allows motor vehicle dealers to prepay taxes as vehicles are sold, and may enable dealers to facilitate passing along to buyers the cost of such taxes.

235. *Id.* §§ 26.15(g), 31.11(b).

236. *Id.*

237. *Id.* § 32.01(b). In addition, new Section 32.01(c) provides that tax liens are perfected

Section 11.433 of the Tax Code,<sup>238</sup> addressing late applications for the property tax exemption for religious organizations, was amended to provide that the application may be filed as late as December 31 of the 12th year after the year in which the taxes for which the exemption is claimed were imposed, assuming the application is filed before January 1, 1995.<sup>239</sup> Section 42.43(b)<sup>240</sup> was amended to change the interest rate on property tax refunds from 10% per year to an annual rate based on three-month Treasury bills, generally not to exceed 8%.<sup>241</sup> The due date for rendition statements for income-producing personal property was changed to April 15 from April 1.<sup>242</sup>

Section 34.21 of the Tax Code<sup>243</sup> was amended to change the former two-year redemption period for recovering real property sold at a tax sale to a six-month redemption period, although the two-year redemption period still applies to residential homesteads and agricultural land.<sup>244</sup> This amendment implements a constitutional amendment that was ratified by voters in November, 1993.<sup>245</sup>

#### IV. OTHER NEW DEVELOPMENTS: OTHER LEGISLATIVE CHANGES, PERSONAL LIABILITY, AND NEW COMPTROLLER PROGRAMS

Legislative changes authorized the comptroller to require a power of attorney,<sup>246</sup> modified statute of limitation provisions with respect to claims for refund<sup>247</sup> by providing that the statute of limitations does not apply if the tax due, after "correction of [an] error" exceeds the amount of tax reported by at least twenty-five percent,<sup>248</sup> and made other changes to the statutes of

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on attachment and, subject to an exception for manufactured homes purchased by certain bona fide purchasers, perfection requires no further action by the taxing unit imposing the tax.

238. *Id.* § 11.433.

239. *Id.*; Nueces County Appraisal Dist. v. Corpus Christi People's Baptist Church, Inc., 860 S.W.2d 627 (Tex. App.—Corpus Christi 1993, writ pending) held, however, that Section 11.433 is unconstitutional. If this holding stands, the amendment to Section 11.433 would be meaningless.

240. TEX. TAX CODE ANN. § 42.43(b) (Vernon Supp. 1994).

241. *Id.*

242. *Id.* § 22.23(a). In addition, the chief appraiser may extend the deadline to April 30 if the taxpayer demonstrates good cause in writing. *Id.* § 22.23(b).

243. *Id.* § 34.21.

244. *Id.*

245. Sen. J. Res. 19, 1993 Tex. Sess. Law Serv. vol. 4 (Vernon).

246. See TEX. TAX CODE ANN. § 111.023 (Vernon Supp. 1994). According to comptroller representatives, this section was necessary to avoid situations in which unauthorized taxpayer representatives filed claims for refund on behalf of taxpayers who may not have wanted such refund claims filed (e.g., because the filing of such claims may permit the comptroller to assess tax, notwithstanding the statute of limitations). See *id.*, § 111.2051 (Vernon Supp. 1994). Nonetheless, some taxpayer representatives contend that the change was intended to discourage taxpayer representatives from aggressively pursuing claims for refund.

247. See TEX. TAX CODE ANN. § 111.2051, which replaces former TEX. TAX CODE ANN. § 111.205.

248. TEX. TAX CODE ANN. § 111.205(a)(3) (Vernon 1992) provided, prior to the 1993 legislation, that the TEX. TAX CODE ANN. § 111.201 statute of limitation did not apply if information contained in a tax report "contains a gross error and the amount of tax due and

limitations for refunds.<sup>249</sup> The 73d Legislature also enacted several procedural and administrative provisions.<sup>250</sup> In addition, the legislature shortened, from ninety days to forty-five days, the time period following a notice from the state after which a corporation's privileges may be forfeited for failure to pay franchise tax.<sup>251</sup>

A handful of court cases highlight some of the procedural and substantive issues raised by taxpayers.

In *First State Bank of Dumas v. Sharp*<sup>252</sup> the Court held, not surprisingly, that Section 112.108<sup>253</sup> prohibiting declaratory judgments with respect to invalid taxing statutes also prohibits declaratory judgment challenges to regulations.<sup>254</sup> As evidenced by court cases in which the government has brought claims against individuals for the debts of the corporation, the state continues to take action aggressively against individuals, although not always successfully.<sup>255</sup>

Attorney fees are also at issue in several pending Texas cases. Section 1983 of Title 42 of the United States Code<sup>256</sup> allows a party to recover attorneys' fees from the government when the government has, under color of state law, violated the party's constitutional rights.<sup>257</sup> After a 1991 United States Supreme Court decision<sup>258</sup> permitted recovery under Section 1983, both taxpayers and states began focusing more carefully on Section 1983

payable after correction of the error is 25% or more greater than the amount originally reported." As revised, the statute defines "gross error" as one that meets the 25% test.

249. TEX. TAX CODE ANN. § 111.201 (Vernon Supp. 1994) (concerning statutes of limitations). See also *United States Fire Ins. Co. v. Texas*, 843 S.W.2d 283 (Tex. App.—Austin 1992, writ denied) that held, in a motor-fuel bond case, that statutes of limitation for assessment and collection of delinquent taxes apply to a taxpayer's surety, and that taxpayer's bankruptcy did not toll the statute of limitations against the surety. See also TEX. TAX CODE ANN. § 111.201.

250. See, e.g., TEX. TAX CODE ANN. § 111.060 (stating that interest rate on delinquent taxes is now 12% simple interest rather than 12% compounded monthly); § 111.1042 (explicitly permitting informal review of refund claim prior to hearing); § 111.021 (allowing comptroller additional rights to seize and levy bank accounts of delinquent taxpayers).

251. See TEX. TAX CODE ANN. §§ 171.251 and 171.256 (Vernon Supp. 1994).

252. 863 S.W.2d 81 (Tex. App.—Austin 1993, n.w.h.).

253. TEX. TAX CODE ANN. § 112.108.

254. The taxpayers challenged 34 TEX. ADMIN. CODE § 3.411(d) (West 1987) concerning the classification for franchise tax purposes of a bank's receipts from dividend and interest, including interest paid by the federal government. 863 S.W.2d at 82. *Jackson v. Sharp*, 846 S.W.2d 144 (Tex. App.—Austin 1993, n.w.h.) also focused on procedural issues, holding that a taxpayer contesting tax imposed under Controlled Substance Tax Act must comply with TEX. TAX CODE ANN. § 112.108 requirements to contest. See also *R Communications v. Sharp*, 839 S.W.2d 947 (Tex. App.—Austin 1992, writ granted) (holding valid Tax Code Section 112.051 requirement that taxpayer pay deficiency; taxpayer argued unsuccessfully that Texas Administrative Procedure and Texas Register Act (TEX. REV. CIV. STAT. ANN. 7252-13a, § 19 (Pamph. 1992) provided jurisdiction without requiring payment, and that TEX. TAX CODE ANN. § 112.051 is unconstitutional.

255. See, e.g., *Davis v. Texas*, 846 S.W.2d 564 (Tex. App.—Austin 1993, n.w.h.) holding, contrary to earlier decisions, that an individual defendant could be held personally liable for a corporation's unpaid franchise taxes only if they became due and payable after the corporate privileges were forfeited.

256. 42 U.S.C. § 1983 (1981).

257. *Id.*; see also 42 U.S.C. § 1988 (Supp. 1988).

258. *Dennis v. Higgins*, 498 U.S. 439 (1991).

claims. In several Texas cases, the attorney general has filed motions to dismiss Section 1983 claims, on the ground that the relief provided by the Texas Tax Code is exclusive. Other states have taken similar positions, and there is not yet a definitive court ruling on the issue in Texas.<sup>259</sup>

The comptroller focused on several programs during the survey period, including the Renaissance Project,<sup>260</sup> the new Dispute Resolution program<sup>261</sup> and the Revenue Opportunity Program.<sup>262</sup> The changes that these programs will bring and the continuing controversy that courts will face ensure that state taxes will continue to be a rapidly-evolving area of the law.

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259. The Supreme Court's denial of certiorari in two recent cases ensures that the issue will continue to arise. *Quill Corp. v. North Dakota*, 500 N.W.2d 196 (N.D. 1993), *cert. denied*, *Quill Corp. v. North Dakota*, 114 S. Ct. 173 (1993), addressed Quill's claim that it was entitled to prevail on its § 1983 counterclaim and that, as such, it was entitled to attorneys' fees under 42 U.S.C. § 1988 (Supp. 1993). The North Dakota Supreme Court denied Quill's petition, holding that "a § 1983 action seeking to enjoin the collection of state taxes is not cognizable in state court, and accordingly Quill is not entitled to recover its attorney's fees under § 1988." 500 N.W.2d at 202. This is a subsequent proceeding to *Quill Corp. v. North Dakota*, 112 S. Ct. 1904 (1992), discussed at Ohlenforst & Dorrill, *Taxation, Annual Survey of Texas Law*, 46 SMU L. REV. 1803 (1993). See also *Bloomingdale's by Mail Ltd. v. Huddleston*, 848 S.W.2d 52 (Tenn. 1992), *cert. denied*, *Huddleston v. Bloomingdale's by Mail*, 113 S. Ct. 3002 (1993). This case, which allowed award of fees, is particularly interesting because the taxpayer had not originally pleaded for relief under Section 1983.

260. This project is intended to focus on ways to improve various aspects of the comptroller's office, including the administrative hearings process.

261. A Dispute Resolution Officer's task is roughly analogous to an Internal Revenue Service appeals officer's task.

262. This aptly-named program is designed to find areas or industries with respect to which the comptroller may be able to increase tax collections and/or compliance.