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TAXATION

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"What's past is prologue . . ."
Shakespeare, The Tempest, Act 2, Scene 1

TABLE OF CONTENTS

I. INTRODUCTION 559
II. SALES TAX 560
A. REPORTED CASES 560
B. COMPTROLLER RULES 566
III. FRANCHISE TAX 569
A. REPORTED CASES 569
B. COMPTROLLER HEARINGS 570
C. COMPTROLLER RULES 571
IV. PROPERTY TAX 573
A. REPORTED CASES 573
B. COMPTROLLER RULES 576
C. ON THE LEGISLATIVE HORIZON 576
V. PROCEDURE 576
A. LIMITATIONS ON THE COMPTROLLER'S CHANGING HER MIND? 576
B. LIMITATIONS ON A TAXPAYER'S ABILITY TO PROVE WHAT IS "REASONABLE"? 579
C. TAX CLEARANCE CERTIFICATES NOT SO CLEAR . . . ?. 580
VI. CONCLUSION 580

I. INTRODUCTION

IF tax interpretations of the past are a prologue for tax interpretations to come, then this year's Survey foreshadows an additional focus on several key, repeating issues. In the sales tax context, reported cases as well as practical experience with audits indicate that the comptroller and taxpayers continue their struggle to determine the scope of multiple

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exemptions. The sale-for-resale exemption gave rise to significant controversy, especially in the context of software licenses that are granted or used in providing taxable services, such as data processing.

Franchise tax issues also presented multiple controversies, as the Survey period witnessed what was for many of the state's taxpayers, their first audit under the new "margin tax" version of the franchise tax. While those audits have not yet produced reported court cases, they predict a heavy focus on determining the scope of the cost-of-goods sold deduction and on multiple other issues that are new to Texas, including determining which taxpayers qualify for the lower franchise tax rate accorded to wholesalers and retailers.

Despite the original legislative plan that envisioned significant property tax relief resulting from the adoption of the margin tax, property taxes have continued to rise for many taxpayers, and property tax cases reflect continuing issues related not only to property valuation, but also to procedural pitfalls that sometimes lurk in the Texas Tax Code.

What is the most common of the common themes? The search for more funds. At the same time taxpayers are struggling with business challenges (and the temptation to take increasingly aggressive tax positions), taxing authorities are struggling with their own revenue challenges (and their own temptations to take increasingly aggressive positions about the amount of taxes owed). The resulting cases offer some interesting lessons.

II. SALES TAX

A. Reported Cases

In *GTE Southwest Inc. v. Combs*,[1] the Austin Court of Appeals considered whether the manufacturing exemption for tangible personal property in section 151.318 of the Tax Code applies to equipment used by a local exchange carrier in providing taxable telecommunications services to customers. GTE claimed the manufacturing exemption with respect to switches that convert telephone calls back and forth from analog to digital. The court of appeals held that the manufacturing exemption is limited to items taxed as tangible personal property and is not available for items taxed as services, even though the comptroller acknowledges that certain types of taxable services may involve some transfer of tangible personal property.[2] The court of appeals therefore affirmed the district court's denial of the claim for refund.[3] This case illustrates one of many issues that arise from the often unclear line-drawing between tangible personal property and services. In a tax world in which digital products are often subject to sales tax as tangible personal property, it is some-

1. No. 03-08-00561-CV, 2010 Tex. App. LEXIS 4223, at *1 (Tex. App.—Austin 2010, pet. denied).
2. *Id.* at *13–18.
3. *Id.* at *18.

times difficult to determine how the courts will interpret statutes that, like the manufacturing exemption, rely on determining what constitutes a service and what constitutes tangible personal property.

Another case addressing the manufacturing exemption, *Combs v. Home & Garden Party, Ltd.*, involved a refund claim for sales tax paid on purchases of wrapping and packaging supplies.[4] The issue involved whether wrapping and packaging supplies used to rewrap and repackage "pre-finished," prepackaged merchandise qualified for the manufacturing exemption in section 151.318 of the Tax Code.[5] Home & Garden made direct market sales of home decorating products through in-home parties coordinated by independent retailers. Home & Garden fabricated some of the products listed in its catalog, including framed prints and wood products (e.g., shelves, sconces, clocks, and moulding for framed prints). Other products that Home & Garden sold were bulk-packaged items that Home & Garden purchased from other vendors (e.g., silk flowers, wire products, figurines, artwork, and pottery).[6]

Home & Garden claimed a refund for sales tax paid upon its purchases of the bulk-packaged products. The comptroller allowed Home & Garden a proportionate tax credit for supplies used in the wrapping and packaging of the items it actually fabricated, but assessed an additional amount of tax for a later tax period with respect to other packaging materials and supplies. The trial court ordered a sales tax refund under the manufacturing exemption for this later period and the comptroller appealed.[7] The comptroller argued that Home & Garden was not the manufacturer of the bulk-packaged items because the manufacturing process was complete when those items were sold by their manufacturers to Home & Garden.[8] The comptroller also argued that Home & Garden merely repackaged the items and was not entitled to the exemption in Rule 3.314(c).[9] Further, the comptroller argued Home & Garden was not "primarily" engaged in manufacturing; therefore, it did not qualify for the exemption under Rule 3.314(e).[10] The Austin Court of Appeals found the comptroller's interpretation of the exemption, which is construed strictly in favor of taxation, to be reasonable. The court of appeals held that the manufacturing exemption did not apply to the purchases of materials used to package items that Home & Garden "neither fabricated or processed nor altered or assembled the physical characteristics thereof," reversed the summary judgment that the trial court had granted in favor of Home & Garden, and remanded the case for further proceed-

4. No. 03-09-00673-CV, 2010 Tex. App. LEXIS 8875, at *1 (Tex. App.—Austin 2010, no pet.). Note that inclusion of this case is consistent with past Survey attempts to include at least one or two food or party cases.

5. *Id.* at *13–15.

6. *Id.* at *2.

7. *Id.* at *3.

8. *Id.* at *13.

9. *Id.*

10. *Id.*

ings.[11] The facts of this case lie along a spectrum of fact patterns that range from exempt activities that clearly constitute manufacturing of tangible personal property to activities that clearly constitute "mere packaging." Sadly, it is difficult to predict where along the spectrum the line is drawn to distinguish taxable from nontaxable activities, and comptroller auditors (at least some of them) appear inclined to draw the line in a way that denies the exemption to many legitimate manufacturing activities.

In *Laredo Coca-Cola Bottling Co. v. Strayhorn*, yet another example of a battle between the comptroller and taxpayers to determine the scope of an exemption, Laredo claimed a sale-for-resale exemption on the purchase of fountain drink machines and related parts because it transferred possession of the fountain drink machines to customers that purchased syrup and carbon dioxide for use in the machines.[12] According to Laredo, it received consideration for the transfers at issue because certain customers to which Laredo provided fountain equipment were required to enter into "commitment agreements," under which the customers made certain commitments (e.g., minimum purchases, agreeing to remain the "exclusive owners" of the equipment, assuming liability for any damage or loss, etc.) to Laredo even though no payments were required.[13] Laredo required that the customers buy all cups, syrup, and carbon dioxide for soft drinks served from the machines.[14] Laredo also claimed that some of its purchases of fountain equipment were exempt under the manufacturing exemption.[15] The comptroller argued that the resale exemption did not apply because, in her view, the customers did not pay separate consideration for the use of the fountain machines and because the machines were loaned rather than sold.[16] On appeal of the summary judgment for the comptroller, the Austin Court of Appeals held that the manufacturing exemption did not apply because Laredo itself did not use the equipment in "manufacturing, processing, fabricating, or repairing tangible personal property" and because only the entity that uses the equipment for manufacturing is eligible for the exemption.[17] The court of appeals also held that the sale-for-resale exemption did not apply because, in the court's view, the "commitment agreements" did not amount to a "sale," as the transfer of fountain equipment was not performed for consideration.[18] Accordingly, the court of appeals affirmed the lower court's ruling.[19]

Another interesting sale-for-resale case, *Delta Air Lines, Inc. v. Combs*, involved two use agreements between Delta and the DFW Airport Authority, and between Delta and the Houston Intercontinental Airport Au-

11. *Id.* at *16.
12. 317 S.W.3d 735, 735 (Tex. App.—Austin 2010, pet. denied).
13. *Id.* at 737–38.
14. *Id.* at 738.
15. *Id.*
16. *Id.* at 740.
17. *Id.*
18. *Id.* at 737, 742.
19. *Id.* at 742.

thority, which obligated Delta to pay rent and provide janitorial and repair services.[20] Both agreements provided that if Delta failed to provide these services, each respective airport authority would perform the services and charge Delta for the costs of performance. Delta purchased janitorial services and repair services from third parties and sought a refund of the sales tax paid on the services claiming the sale-for-resale exemption under section 151.006 of the Tax Code.[21] Delta contended its performance of the janitorial and repair services was done for consideration and for the purpose of reselling the services to the airports in the normal course of its business.[22] The comptroller argued that Delta performed the services to fulfill its obligations under the agreements with the airports rather than for resale purposes.[23] The Austin Court of Appeals, concluding that Delta did not purchase the janitorial and maintenance services for resale, affirmed the trial court's summary judgment in favor of the comptroller.[24] It is interesting to consider whether Delta might have been more successful had it argued that it had acted as an agent for the airport when purchasing the services or that such services were for the benefit of the public.

Another interesting sales tax case involving a major airline—this one headquartered in Texas—focuses on which parties benefited from certain purchases related to an airport lease agreement. Continental Airlines, Inc. filed suit in district court on May 28, 2010, seeking a refund for sales tax paid on certain property and services (e.g., real estate improvements, janitorial services, cleaning services, security supplies, identification badges, and electricity from third parties), asserting that the airports were the primary beneficiaries of the purchases.[25] Continental had leased real property from Bush Intercontinental Airport, Hobby Airport and Ellington Field to be used for airline operations. The leases provided that improvements constructed on the leased property would be the property of Continental. Continental claimed that section 151.309 of the Tax Code exempted Continental from Texas sales and use tax because improvements and services were purchased for the benefit of exempt entities (i.e., the airports).[26] The comptroller contended that Continental's services were neither necessary to the operation of the aircraft nor related to actual repair or maintenance of aircraft.[27] This case is pending in Travis County District Court, and it will be interesting to see whether the court will focus more on the types of services at issue or on the scope of the exemption for items used by governmental entities.[28] It may be that the

20. 318 S.W.3d 523, 524 (Tex. App.—Austin 2010, no pet.).
21. *Id.* at 524–25.
22. *Id.* at 525.
23. *Id.*
24. *Id.* at 526.
25. Cont'l Airlines, Inc. v. Combs, No. D-1-GN-10-00175 (126th Dist. Ct., Travis County, Tex. May 28, 2010).
26. *Id.*
27. *Id.*
28. *Id.*

case will hinge on Continental's ability to show that its services benefited the exempt entities, or that such services were donated or resold to the airports (or perhaps both), or that Continental acted as a de facto agent in purchasing the items. Stay tuned for further developments in the context of airlines' obligations under airport lease agreements.

In *Combs v. Chevron USA, Inc.*, a sales tax case focusing on both substantive sales tax and procedural issues in connection with Chevron's refund claim with respect to sales tax assessed on the provision of scaffolding services, the Austin Court of Appeals denied Chevron's refund claim both because it found Chevron's contracts were for taxable services and also because the court of appeals concluded that Chevron incorrectly added new claims to its motion for rehearing.[29] As to the taxability of the scaffolding, the court of appeals considered whether Chevron's scaffolding contracts related to the taxable rental of tangible personal property or nontaxable services.[30] Chevron's contractors provided design, erection, inspection, operation, maintenance, and dismantling of the scaffolding, as well as all of the materials for the scaffolding. The contractors' employees inspected the scaffolding at least once per shift and made adjustments as necessary. The contractors monitored and regulated access to the scaffolding at all times by "tag[ging]" the scaffolding as either safe to use or unsafe to use.[31] Chevron was not involved in design, assembly, inspection, operation, or disassembly of the scaffolding. The trial court determined that the contractors retained "operational control" over the scaffolding because they controlled access to it, so that the contractors provided nontaxable services.[32] The court of appeals reversed, reasoning that Chevron's contracts were taxable because of the comptroller's repeated rulings determining that scaffolding contracts were "essentially rentals even though they necessarily involved nontaxable services."[33] The court of appeals held that controlling access to scaffolding is not the same as controlling use of the scaffolding, and that the comptroller's decisions "make clear [that] *use* of scaffolding determines operational control."[34] Therefore, the court of appeals viewed itself as applying comptroller precedent to decide that possession of the scaffolding was transferred to Chevron resulting in rental of the scaffolding.[35] The court of appeals held that the comptroller was entitled to summary judgment on Chevron's scaffolding refund claim because Chevron was essentially renting property, not obtaining services, when it contracted for the use of temporary scaffolding.[36] In addition to its ultimate conclusion, the case is noteworthy because it shows deference to comptroller rulings

29. 319 S.W.3d 836, 845 (Tex. App.—Austin, 2010, pet. denied).
30. *Id.* at 842–43.
31. *Id.* at 842 n.1.
32. *Id.* at 842.
33. *Id.* at 844.
34. *Id.* at 842.
35. *Id.*
36. *Id.* at 842–43.

and appears to give somewhat limited credence to the fact findings of the trial court.

The procedural aspect of the Chevron case also merits discussion. The comptroller had also filed a plea to the jurisdiction, claiming that Chevron had not timely amended its administrative pleadings to add new issues.[37] The trial court denied the comptroller's plea to the jurisdiction, accepting instead Chevron's argument that section 112.152(a) of the Tax Code permitted Chevron to sue on issues first raised in a motion for rehearing.[38] The Austin Court of Appeals held on these facts that a motion for rehearing can include only claims on which the comptroller has already decided.[39] In many respects, this conclusion seems counter to the Tax Code provision that requires taxpayers to include claims in their motions for rehearing—supported by the policy that the comptroller should not be dragged to the courthouse on claims that have not previously been presented to her. Raising claims in a motion for rehearing satisfies that policy and prior interpretations of the Tax Code requirements. Nonetheless, the court of appeals held that the trial court lacked jurisdiction over Chevron's other claims because Chevron had not followed the required administrative procedures.[40] Accordingly, the court of appeals reversed the judgment and rendered in favor of the comptroller.[41]

A local sales tax case that merits mention is *Combs v. City of Webster*,[42] in which the Austin Court of Appeals addressed the definition of "place of business" for purposes of allocating local sales tax.[43] Following the filing of amended tax returns filed by Houston-area furniture stores, local sales taxes were reallocated from the furniture stores' showroom locations to the furniture stores' warehouses, located in Grand Prairie, from which the furniture items had shipped. The City of Webster sued the comptroller, making claims under the Texas constitution, Uniform Declaratory Judgments Act (UDJA) and Administrative Procedure Act

37. *See id.* at 844. TEX. TAX CODE ANN. § 112.152(a) (West 2011) provides that "[t]he grounds of error contained in the motion for rehearing are the only issues that may be raised in a suit under this subchapter," and Comptroller Rule 1.7(e) provides that "[t]he Statement of Grounds may be amended up to the time that a reply to the Position Letter is required." 34 TEX. ADMIN. CODE ANN. § 1.7(e) (2011).

38. *Id.* at 840. Almost two years after Chevron filed suit, Chevron amended its petition to add refund contentions unrelated to its scaffolding claim.

39. *Id.* at 845.

40. *Id.*

41. *Id.*

42. 311 S.W.3d 85, 90 (Tex. App.—Austin 2009, pet. denied).

43. TEX. TAX CODE ANN. § 321.002(a)(3) defines "place of business" as:

> An established outlet, office, or location operated by the retailer or the retailer's agent or employee for the purpose of receiving orders for taxable items and includes any location at which three or more orders are received by the retailer during a calendar year. A warehouse, storage yard, or manufacturing plant is not a 'place of business of the retailer' unless at least three orders are received by the retailer during the calendar year at the warehouse, storage yard, or manufacturing plant.

TEX. TAX CODE ANN. § 321.002(a)(3) (West Supp. 2010).

(APA).[44] The court of appeals determined that the comptroller has discretion to reallocate local sales taxes within limitations under her statutory authorization to "administer, collect, and enforce local sales tax."[45]

B. COMPTROLLER RULES

Although the legislature did not meet this year, the comptroller adopted several rules affecting sales and use taxes. Amendments to Rule 3.286, pertaining to sellers' and purchasers' responsibilities, made changes to reorganize, to reflect (in the comptroller's words) "longstanding agency policy," and to improve clarity by adding and expanding definitions, explaining who is required to be permitted for sales and use tax collections and remittances, and explaining general rules for collection of tax due.[46] Perhaps most notably, the amendments state that a person is engaged in business if he or she "derives receipts from a rental or lease of tangible personal property that is located in this state or *owns or uses* tangible personal property that is located in this state, including a computer server or software."[47] On the other hand, the preamble to the rule (consistent with past comptroller policy) states that the amendments revised the term "engaged in business" to state that "*ownership* of tangible personal property in this state, including a computer server, means a person is engaged in business and has nexus in the state."[48] This revision drew much scrutiny, largely because the preamble seemed to conflict with the rule, resulting in confusion rather than clarification, and ultimately, the comptroller agreed to repeal the rule to clarify its intent and more

44. *Webster*, 311 S.W.3d at 89. The city asserted Texas constitutional claims regarding takings, UDJA ultra vires claims, and APA claims regarding the comptroller's rule allowing retrospective reallocation of taxes. Regarding the constitutional claim, the court of appeals held that the city had no vested right in local tax allocations because those are subject to change within limitations. *Id.* at 94. Regarding the APA claim, the court of appeals held that the city had failed to allege the existence of a rule, or other "statement of general applicability" concerning retroactive reallocation of local sales tax, and therefore, failed to plead a cause of action over which the district court had subject-matter jurisdiction. *Id.* at 94, 101. However, the court of appeals held that the district court had jurisdiction to consider the UDJA claim to consider whether the comptroller had misapplied the "place of business" statute, but went on to reverse the district court's denial of the plea to the jurisdiction and held that the comptroller's interpretation of the "place of business" statute was reasonable, and that the city, therefore, did not have a valid ultra vires claim under the UDJA. *Id.* at 94–96.

45. *Id.* at 99. The *City of Webster* case prompted the legislature to make several significant changes to local tax provisions during the last legislative session, including amending sections 321.203 and 323.203 of the Tax Code to change local sales tax sourcing rules, requiring sellers to collect local tax based on the place of business where the retailer first receives the customer's order, provided that the order is placed in person at that place of business, rather than based on the shipped-from location. See a more thorough discussion at Cynthia M. Ohlenforst et al., *Taxation*, 63 SMU L. REV. 821, 829–30 (2010).

46. *See* 35 TEX. REG. 611 (2010), *adopted* 35 TEX. REG. 6085 (2010) (codified at amendment to 34 TEX. ADMIN. CODE § 3.286 (2011)).

47. *Id.* (emphasis added).

48. *Id.* (emphasis added).

clearly state agency policy.[49] There was significant concern that expansion of the "engaged in business" definition to include "use" might evidence comptroller intent to create nexus in Texas for entities that simply contract with companies that have a server in Texas.[50] The comptroller's office has acknowledged that the purpose of the proposed rule was indeed broader than stated in the preamble, but not so broad as to extend nexus to anyone using a server in Texas.[51] However, the comptroller has indicated that the new rule would clearly provide that the sale of data housed on a Texas server creates nexus for the owner of the data, because taxable items are subject to taxation in both electronic and physical form (e.g., downloadable music).[52]

The comptroller's staff seems to be in the process of reconsidering policy regarding software, servers, and data processing, though no legislative changes have been enacted to merit an expansion of taxes on any of these items. A 1997 letter ruling was superseded on October 26, 2010 after the comptroller decided that the software services at issue should be treated as purchased to provide taxable data processing services rather than for resale.[53] Other rulings relating to the taxability of software were also issued, modified, or superseded, creating further questions about the comptroller's interpretation of software-related tax obligations.[54] Stay tuned for further comptroller developments in the software arena.

Amendments to Rule 3.344, regarding telecommunications services, implemented legislation from 2001 through 2007 (including the federal Mobile Telecommunications Sourcing Act) to source state and local sales taxes on mobile telecommunications services to the customer's place of primary use, changed billing and records requirements for telecommunications service providers, excluded from telecommunications services phone calls made using coins, and expanded the sale-for-resale exemp-

49. Email from Texas Taxpayers and Research Association, *TTARA Update from the Tax Front: Computer Servers and Sales Tax Nexus* (Oct. 4, 2010, 03:26 PM CST) (on file with author).

50. *See id.*

51. *Id.*

52. *Id.* For a discussion of other recent software-related developments at the comptroller's office, see *Tax Policy News*, Nov. 2010, regarding maintenance by the seller of software, stating that "any person who sold the software within the stream of commerce . . . is responsible for collecting tax when performing maintenance on that software." The Comptroller's Office, *Maintenance by one Seller of Softwave*, TAX POLICY NEWS (Texas Comptroller of Public Accounts), Nov. 2010, *available at* http://www.window.state.tx.us/taxinfo/taxpnw/tpn2010/tpn1011.html. It is unclear whether the comptroller is attempting to change the long-established legal principle that software maintenance by a party other than the seller is generally not taxable. *See* 34 TEX. ADMIN. CODE ANN. § 3.308(b)(3) (2011).

53. *See* Tex. Comptroller Pub. Accounts, Doc. No. 9703063L (Mar. 17, 1997, superseded Oct. 26, 2010) (initially providing that a taxpayer may purchase software for resale when reselling computer software, documentation and related services as either taxable computer software or data processing services).

54. *See, e.g.*, Tex Comptroller Pub. Accounts, Doc. No. 2004098691 (Sept. 10, 2004, superseded Mar. 23, 2011) (initially providing that if software is used on a server outside of Texas such that the company uses computers in Texas to access and work on the server outside of Texas, there is no taxable use of the software in Texas).

tion to apply to cell phones and other wireless voice communication devices.[55]

Amendments to Rule 3.333, regarding security services, also implemented legislation from 1999 through 2007.[56] Licensing authority was changed to reflect new licenses required by certain companies under the Occupations Code, including adding electronic access control device companies, locksmith companies, and private security consultant companies.[57] Locksmiths were removed from the list of persons excepted from the licensing requirements, while persons providing telematics services, certain persons who provide personal emergency response systems, accountants, and persons selling alarm systems through e-commerce were added to the list of excepted persons.[58] Interestingly, subsection (j) was added to exclude from sales tax the use of a slim-jim or similar device to unlock a vehicle.[59]

Amendments to Rule 3.369 regarding sales tax holidays implemented 2007 legislation regarding an exemption for certain Energy Star qualified products sold during a three-day period in May.[60] Amendments to Rule 3.326 regarding carbon dioxide capture and sequestration implemented 2009 legislation regarding a sales tax exemption for certain components installed in connection with an advanced clean energy project.[61]

The comptroller also proposed, but has not yet adopted, amendments to Rule 3.346 regarding use tax, which includes changing the definitions of "storage" and "use" to reflect the statutory definitions, linking "contractor" to the Rule 3.291 definition, addressing use tax responsibility of a permitted purchaser who makes a purchase under the occasional sale exemption, providing that the user of taxable items from out-of-state or under a direct pay permit is liable for accrual and remittance of use tax, providing guidance on the accrual of use tax for items stored in Texas, and adding subsection (g) to address the accrual of local use taxes.[62]

The comptroller is also considering proposing amendments to Rule 3.296 relating to agriculture, animal life, feed, seed, plants, and fertilizer to incorporate 2009 legislative changes regarding tangible personal property incorporated into structures used for the disposal of poultry carcasses. Finally, the comptroller is considering proposing new Rule 3.325 concerning refunds and payments under protest and new Rule 3.339 regarding statute of limitations to reflect 2009 legislative changes and policy

55. *See* 35 TEX. REG. 2729 (2010), *adopted* 35 TEX. REG. 9329 (2010) (codified at amendment to 34 TEX. ADMIN. CODE § 3.344).

56. *See* 34 TEX. REG. 9099 (2009), *adopted* 35 TEX. REG. 1468 (2010) (codified at amendment to 34 TEX. ADMIN. CODE § 3.333 (2011)).

57. *Id.*

58. *Id.*

59. *Id.*

60. *See* 35 TEX. REG. 5786 (2010), *adopted* 35 TEX. REG. 8138 (2010) (codified at amendment to 34 TEX. ADMIN. CODE § 3.369 (2011)).

61. *See* 35 TEX. REG. 442 (2010), *adopted* 35 TEX. REG. 6694 (2010) (codified at amendment to 34 TEX. ADMIN. CODE § 3.326 (2011)).

62. *See* 35 TEX. REG. 9639 (proposed Oct. 29, 2010).

clarifications. The continuing revisions to these and other rules make it important for taxpayers to check current versions of the rules to determine how the comptroller views the law.

III. FRANCHISE TAX

A. Reported Cases

Five years after the Texas legislature enacted the "margin tax" version of the Texas franchise tax, there are no reported court cases dealing with the margin tax. However, franchise tax cases relating to the "old" franchise tax remain relevant, particularly when they address continuing issues like nexus.

In *Galland Henning Nopak v. Combs*, both the comptroller and the taxpayer filed motions for summary judgment based on the evidence that had been admitted during the prior administrative hearing.[63] The case focused solely on whether Nopak had substantial nexus with the state of Texas. After reviewing both state cases and federal law, including the *Quill* decision, the Amarillo Court of Appeals reiterated that "the Constitutionality of the imposition of the Texas franchise tax on Nopak depends on the determination of whether Nopak had a physical presence in Texas."[64] Other than the activities of a regional manager, Nopak's only connection to Texas was by common carrier and U.S. Mail. Testimony indicated that the regional manager's job was to support the sales efforts of the distribution companies and that the regional managers were "more or less [a] liaison with the distributors of Nopak's products."[65] The court of appeals fully acknowledged that the regional manager was not authorized to directly solicit or take orders for Nopak's products, but nonetheless concluded that its Texas activities were intended "to promote or induce sales" of the company's products and were therefore sufficient to establish a physical presence in the state.[66] The court of appeals conceded that it was difficult to identify any services the manager provided "beyond extolling the virtues of Nopak's products to distributors and attempting to resolve customer complaints," but the court of appeals viewed those actions as consistent with company policy and as occurring on a continuous basis, and affirmed the trial court's implied finding that the activities were more than de minimis.[67] While confirming that the physical presence standard in *Quill* is determinative for Texas franchise tax purposes (and not just sales and use tax purposes, as some states have asserted), the court of appeals viewed the regional manager's activities as significant enough to bring the company into Texas taxing jurisdiction.[68]

63. 317 S.W.3d 841, 842 (Tex. App.—Amarillo 2010, no pet.).
64. *Id.* at 844 (referring to physical presence standard set forth in Quill Corp. v. North Dakota, 504 U.S. 298, 315 (1992)).
65. *Id.* at 844–45.
66. *Id.* at 845.
67. *Id.* at 846.
68. *See id.*

B. COMPTROLLER HEARINGS

A few administrative decisions address the margin tax specifically. In one of these, Comptroller Hearing No. 103,263, the administrative law judge denied a taxpayer's claim that the franchise tax as modified was incompatible with the constitutional ban on taxation of interstate commerce.[69] The administrative law judge found unpersuasive the arguments of the North Carolina taxpayer that the tax could not properly apply to it and also rejected the taxpayer's alternative claim that it was entitled to a lower calculation of the tax.[70]

Another margin tax decision, Comptroller Hearing No. 103,083, focused on whether a taxpayer could amend its original franchise tax report by changing the method it used to calculate taxable margin.[71] In computing margin, taxpayers are generally (subject to multiple exceptions) permitted to claim a deduction for cost of goods sold (COGS), compensation, or thirty percent of revenue.[72] As the administrative law judge noted, the resolution of this case turned on the construction of section 171.101(a) and (d) of the Tax Code although, nothing in the statute affirmatively denies the taxpayer the ability to change selection from one method of calculation (COGS or compensation) to the other, the comptroller's rules purport to prohibit a taxable entity from amending its report to change to a COGS deduction or compensation deduction after the due date of the original return.[73] In the view of the administrative law judge, the taxpayer's ability to report seventy percent of its total revenue (i.e., essentially claiming a thirty percent deduction in order to arrive at margin) "is not described as an election, but rather operates as a baseline or default for calculating margin."[74] With this interpretation in mind, the administrative law judge concluded that "it is not inconsistent for the comptroller to allow a taxpayer to amend its report to change from using the COGS or compensation deduction to the seventy percent of revenue method, yet prohibit a reverse switch."[75] Not surprisingly, the administrative law judge relied on the comptroller's staff's view of the legislative history of section 171.101(d).[76] As originally drafted, that section specifically permitted a taxpayer to change its election from COGS to compensation or vice versa by filing an amended report.[77] Significantly, although the legislature repealed that particular provision, it did not enact language to prohibit such an amended report.[78] Thus, nothing in the Tax

69. *See* Tex. Comptroller Pub. Accounts, Hearing No. 103,263 (July 29, 2010).
70. *Id.*
71. *See* Tex. Comptroller Pub. Accounts, Hearing No. 103,083 (July 28, 2010).
72. As a technical matter, the thirty percent deduction is not a deduction, but is instead the result of basing the tax calculations on seventy percent of revenue, rather than claiming a COGS or compensation deduction. *See* TEX. TAX CODE ANN. §171.101 (2011).
73. *See* 34 TEX. ADMIN. CODE § 3.584(d)(1), (f)(1) (2009).
74. Tex. Comptroller Pub. Accounts, Hearing No. 103,083 (July 28, 2010).
75. *Id.*
76. *Id.*
77. *Id.*
78. *Id.*

Code prohibits taxpayers from amending their returns.[79] As the courts have made clear, including in *Fleming Foods*, they will not expect a taxpayer, when faced with a statute that appears clear on its face, to review legislative history to see what the legislature might have had in mind.[80] Particularly given the uncertain interpretations of the newly effective tax, taxpayers may find themselves at a significant disadvantage if the comptroller prevails in her view that—notwithstanding subsequent changes in law or comptroller interpretation—a taxpayer may not amend the return to shift its calculation to COGS or compensation. On the other hand, the practical reality of a fiscal shortfall during the current biennium makes it unlikely that the comptroller will have a fiscal incentive to alter her interpretation.

C. Comptroller Rules

The comptroller continued issuing informal interpretations and administrative guidance, often in consultation with taxpayers and their representatives, concerning multiple issues related to the margin tax. While many of the rules simply set forth changes required by the statutory amendments some controversial issues merit discussion. As noted last year, the tax treatment of passive entities has continued to give rise to substantive discussions and disagreements.[81]

Another controversial issue involves exemption from the franchise tax for certain non-profit entities: a disregarded LLC whose single member qualifies for exemption from federal income tax pursuant to section 26 U.S.C. § 501(c)(3)of the Internal Revenue Code and from the Texas franchise tax. Texas generally treats each separate legal entity as a separate taxpayer for franchise tax purposes (albeit often as a member of a combined group of taxable entities), and the comptroller had initially indicated that a disregarded LLC would be subject to the Texas franchise tax unless it had its own exemption from the Internal Revenue Service.[82] However, a disregarded LLC is not required to have a separate 501(c)(3)

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79. *Id.*

80. *See* Cynthia M. Ohlenforst et al., *Taxation*, 53 SMU L. Rev. 1297, 1299–1301 (2000) and Cynthia M. Ohlenforst et al, *Taxation*, 55 SMU L. Rev. 1315, 1342 (2002), discussing Fleming Foods of Tex., Inc. v. Rylander, 6 S.W.3d 278, 285 (Tex. 1999):

> Citizens, lawyers who represent them, judges, and members of the Legislature should not be required to research the law that preceded every codification to determine if there had been some change and accordingly whether the prior law rather than the current law prevails. We must be able to accept and to rely upon the words written by the Legislature if they are clear and unambiguous, their meaning is plain when the code in which they appear is read in its entirety, and they do not lead to absurd results.

81. At one point during the Survey period, the comptroller proposed (but did not adopt) a regulatory interpretation that would have characterized rental income that flows through a partnership to a partner as passive income, notwithstanding the fact that the partner is receiving partnership distributions rather than rental income. *See* Cynthia M. Ohlenforst et al., *Taxation*, 63 SMU L. Rev. 821, 834–35 (2010) (discussing 34 Tex. Admin. Code § 3.582 (2008)).

82. Ohlenforst, *supra* note 81, at 835.

exemption from the IRS in order to be exempt from federal income tax.[83] Thus, the comptroller's position created potential roadblocks for these disregarded entities.[84] Although the comptroller had not published a change in her position by the end of the Survey period, it appears that the comptroller was willing to reconsider and grant exempt status to disregarded LLCs whose sole members are 501(c)(3) exempt entities.[85]

Also noted in last year's survey, additional changes to Rule 3.584 address a change in policy regarding the initial report due date for entities that become subject to franchise tax on or after October 4, 2009 (for which an annual report is now the first franchise tax report that such an entity will file) and take into account the statutory changes that increase the no-tax-due threshold from $300,000 to one million for reports due on or after January 1, 2010 and to $600,000 for reports due on or after January 1, 2012.[86] The comptroller also made changes to Rule 3.587 regarding calculations for uncompensated care charges and to the definition of a management company, in each case to reflect the comptroller's current policy.[87] As in prior years, the comptroller continues to make good use of the Window on State Government website to answer taxpayer questions, including in the FAQs section of the website.[88]

Based on anecdotal evidence as well as reports from the comptroller's policy staff and auditors, it appears that some of the most hotly contested issues regarding the franchise tax relate to taxpayers who have claimed the one-half percent rate available to wholesalers and retailers in circumstances when the comptroller's office believes the rate is not applicable, as well as to taxpayer claims for COGS deductions that are higher than the comptroller believes appropriate. Some of the tension arising from interpretations of the COGS deduction has arisen because these deductions are significantly higher than the comptroller staff anticipated when preparing the revenue estimates. Although a significant portion of the

83. *Id.*

84. *Id.*

85. *See* 34 TEX. ADMIN. CODE § 3.581 (2008).

86. Ohlenforst, *supra* note 81, at 835 (discussing 34 TEX. ADMIN. CODE § 3.584 (2009)).

87. *Id.* at 836 (discussing 34 TEX. ADMIN. CODE § 3.587 (2009)). Portions of this rule remain controversial as commentators have pointed out that the amendment to the definition of a management company in subsection (b)(6) appears to add an additional requirement (requiring management companies to conduct all the operations of the managed entity or of the distinct revenue-producing component of the entity) that is not justified by the statute. *See* 34 TEX. ADMIN. CODE § 3.587 (2009).

88. Window on State Government, Franchise Tax Frequently Asked Questions, http://www.window.state.tx.us/taxinfo/franchise/faq_questions.html (last visited May 13, 2011). The comptroller's use of the Window on State Government site to provide additional information is a double-edged sword. On the plus side for both the comptroller and taxpayers, this mechanism allows the comptroller to provide information to taxpayers quickly and efficiently. However, some taxpayers are concerned that the comptroller will treat her informal interpretations as more authoritative than they actually are, and note that these informal interpretations should not be accorded the same stature as duly adopted regulations. The comptroller faces some risk from the prompt and quick advice as well, as she may sometimes be required to honor the advice given, even when she chooses to change her mind later. *See* discussion *infra* Part IV.

margin tax shortfall is undoubtedly due to macroeconomic pressures, a portion of the shortfall is also due to the difficulty of estimating accurately the cost of goods sold claimed by taxpayers (a number that, to be fair to the comptroller's office, may not always match the amount of deductions that such taxpayers are entitled).

IV. PROPERTY TAX

A. Reported Cases

As is often the case, this Survey period saw a number of taxpayers confounded by the Tax Code's jurisdictional and standing requirements in the property tax context. As is always the case, those opinions serve as important reminders of how crucial it is to meet those criteria when a taxpayer challenges property tax.

Taxpayers struggled again during this Survey period with the Texas Tax Code section 42.01 limitation on which parties may appeal appraisal review board orders, including determinations with respect to property valuation and qualification for exemptions. *Woodway Drive LLC v. Harris County Appraisal District*[89] involved a fact pattern that is strikingly similar to the one in *BACM 2002 PB2 Westpark Drive LP v. Harris County Appraisal District*, from last year's survey.[90] In *Woodway*, the subject property had been conveyed to the taxpayer by deed dated December 14, 2006.[91] The grantor nevertheless filed a notice of protest of the property's appraised value for 2007[92] and later appealed the Houston Appraisal Review Board's denial of the protest in district court.[93] Apparently realizing its error, the grantor later amended its petition to include the taxpayer as a plaintiff, and simultaneously submitted a motion to substitute the name of the true party.[94] The trial court granted the appraisal district's plea to the jurisdiction and dismissed the case, and the taxpayer appealed.[95]

Because the grantor "did not own the [subject] property as of January 1, 2007," the Houston Court of Appeals held that the grantor "lacked standing to pursue judicial review as a 'party who appeals' under section 42.21(a)."[96] Further, because the grantee "was not named as a party until February 18, 2009," the court of appeals held that the Appraisal Review Board "had not determined a protest by the actual property owner . . . upon which it would then premise a right to appeal as the property owner."[97] In response to the taxpayer's urging that section 42.21(e)(1)

89. 311 S.W.3d 649, 649 (Tex. App.—Houston [14th Dist.] 2010, no pet.).
90. No. 14-08-00493-CV, 2009 WL 2145922, at *1 (Tex. App.—Houston [14th Dist.] June 21, 2009, no pet.) (mem. op.); *see* Ohlenforst *supra* note 81, at 840 n.143.
91. 311 S.W. 3d at 651.
92. *Id.*
93. *Id.*
94. *Id.*
95. *Id.*
96. *Id.* at 653.
97. *Id.*

allows amendment of a timely filed petition "to correct or change the name of a party," the court of appeals held that because the actual property owner at the time in question had never filed a timely appeal, the trial court had never acquired subject matter jurisdiction.[98] The court of appeals affirmed the trial court's dismissal of the case.[99]

Property tax cases during the Survey period also featured a number of taxpayers who failed to exhaust administrative remedies prior to filing suit to challenge property tax determinations, and who therefore were not able to pursue their disputes with taxing jurisdictions. *F-Star Socorro, L.P. v. El Paso Central Appraisal District* involved a taxpayer who had negotiated a tax abatement agreement pursuant to which local taxing authorities, in each of the first ten years after the taxpayer completed development of the property, were to abate by fifty percent of the property taxes assessed on the property.[100] Separately, the taxpayer had negotiated a lease of the property to a third party, pursuant to which the taxpayer claimed the third party lessee was to pay the full, unabated amount of property taxes assessed with respect to the party.[101]

Rather than appraise the property at its actual value and abate the taxes due, the El Paso Appraisal District had prepared tax bills reflecting an appraised value of fifty percent of the actual property value.[102] The taxpayer sued the district, seeking a declaratory judgment that the district had misapplied the abatement agreement; the district responded with a successful plea to the jurisdiction based on the taxpayer's failure to exhaust its administrative remedies, and the trial court dismissed the case for lack of jurisdiction.[103]

On appeal, the taxpayer argued that its complaint of the district's application of an exemption rather than an abatement was not the kind of property tax challenge with respect to which Tax Code section 41.41 requires taxpayers to exhaust administrative remedies prior to seeking judicial relief.[104] Tax Code section 41.41 provides that "a property owner is entitled to protest before the appraisal review board [several actions, including] . . . determination of appraised the value of the owner's property . . . ; denial to the property owner . . . of a partial exemption; [and] any other action of the chief appraiser, appraisal district, or appraisal review board that applies to and adversely affects the property owner."[105]

The El Paso Court of Appeals concluded that the district's alleged misapplication of the tax abatement agreement fell within the "any other

98. *Id.*
99. *Id.* at 654.
100. 324 S.W.3d 172, 173 (Tex. App.—El Paso 2010, no pet.).
101. *Id.* at 174. The taxpayer represented to the court that it had negotiated for this property tax provision in the lease with the third party in order "to 'partially recoup its costs for developing [the property] and the investment which it made for the utilities and other infrastructure. . . .'" *Id.*
102. *Id.* at 173–74.
103. *Id.*
104. *Id.* at 176–77.
105. TEX. TAX CODE ANN. § 41.41(a) (West 2011).

action" catchall provision in Tax Code section 41.41(a)(9) and, therefore, that the taxpayer had failed to exhaust administrative remedies as required by that provision.[106] As a result, the court of appeals concluded that the taxpayer's failure had deprived the trial court of jurisdiction to consider the case, and that the lower court's dismissal was appropriate.[107]

In *Houston Independent School District v. Morris*, several taxing units had brought suit against a group of taxpayers for unpaid taxes on eight accounts—some of which the taxpayers owned and some of which they did not.[108] To stop further penalties and interest from accruing, the taxpayers paid the taxes and then filed a counterclaim for a refund of that portion of the payment relating to the property they did not own.[109] Once they received the taxpayers' payment, the taxing units nonsuited their claims for delinquent taxes and filed a plea to the jurisdiction to the taxpayers' counterclaim on the grounds that the taxpayers had failed to exhaust their administrative remedies.[110] The trial court denied the taxing units' plea, and the taxing units brought an interlocutory appeal of that ruling.[111]

On appeal, the taxpayers argued that because they were not "property owners" as that term is used in Tax Code section 42.09(a)(2), the provision's requirement that property owners exhaust administrative remedies prior to filing suit does not apply to them.[112] The Houston Court of Appeals noted that, under section 42.09(a), a taxpayer's failure to exhaust administrative remedies will deprive the trial court of jurisdiction to hear the taxpayer's claim unless the exception in section 42.09(b) applies; section 42.09(b) allows taxpayers to raise several affirmative defenses, including a claim that the taxpayer is not the owner of the subject property, in response to a taxing unit's suit against the taxpayer.[113]

Because the taxing units had nonsuited their claim for delinquent taxes after they had received the taxpayers' payment, the appellate court held that the taxpayers' affirmative defense that they were not the owners of the subject property could not continue after the taxing units' nonsuit as a claim for relief.[114] Based on that technical reading of the relevant procedural provisions, the appellate court reversed the trial court's denial of the taxing units' plea to the jurisdiction and ordered a dismissal of the taxpayers' suit.[115]

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106. *F-Star*, 324 S.W.3d at 177.

107. *Id.*

108. No. 01-10-00043-CV, 2011 WL 837157, at *1 (Tex. App.—Houston [1st Dist.] Mar. 4, 2010) (not designated for publication), *withdrawn and superseded on denial of reh'g by* 2011 WL 1936005 (Tex. App.—Hous. [1st Dist.] May 19, 2011).

109. *Id.*

110. *Id.* at *1–2.

111. *Id.* at *1.

112. *Id.* at *3.

113. *Id.* at *6–7.

114. *Id.* at *6.

115. *Id.* at 7.

B. COMPTROLLER RULES

The comptroller spent some of the first part of the Survey period working on new rules and forms relating to Chapter 313, which allows school districts to offer tax credits and appraised value limitations in order to attract new taxable property.[116] The sweeping package of property tax reforms from the 2009 legislative session included House Bill 3676, which extended certain provisions of the Texas Economic Development Act (which includes Chapter 313), added new incentives for clean energy projects beginning on or after January 1, 2020, and amended the procedures for some for the required incentive applications.[117] As required by the significantly changed legislation, the comptroller adopted a number of new rules and promulgated new forms relating to Chapter 313 agreements during the Survey period.[118]

C. ON THE LEGISLATIVE HORIZON . . .

Prior to the November 2010 elections, the Texas Secretary of State, Hope Andrade, felt compelled to respond to swirling rumors—including some that had spread through forwarded chain e-mails—that the Texas ballot included a constitutional amendment that would allow the state to tax homesteads.[119] Though the issue of a state-level property tax was not on the table in November of 2010, that possibility has been discussed for years in Texas with markedly increased frequency each time the state has found itself in a financial pickle, as it does now. The idea may well gain attention during the 2011 and 2013 legislative sessions as legislators look for ways to cover the state's growing expenses in the face of lower-than-expected margin tax revenue and slower-than-expected sales tax revenue growth. Tune in to next year's survey for more on the proposals and for a discussion of what—if anything—makes it out of the legislature and onto the governor's desk.

V. PROCEDURE

A. LIMITATIONS ON THE COMPTROLLER'S CHANGING HER MIND?

In an interesting case that focuses on the extent to which the comptroller can change policies without notice to taxpayers, the Austin Court of Appeals essentially limited the comptroller's ability to bypass the rulemaking process. *Combs v. Entertainment Publications*, a 2009 sales tax case still on remand, is noteworthy because it denied the comptroller the ability to simply change her mind about a policy without giving tax-

116. TEX. TAX CODE ANN. §§ 313.025, 313.102 (West 2011).
117. H.B. 3676, 81st Leg., Reg. Sess. (Tex. 2009).
118. 34 TEX. ADMIN. CODE ANN. §§ 9.1051–.58 (2011).
119. Tex. Sec'y of State, *Despite rumors, Nov. 2 ballot does not include statewide propositions* (Oct. 18, 2010), *available at* http://sos.state.tx.us/about/newsreleases/2010/101810-no-props.shtml.

payers adequate notice and the right to comment on the policy change.[120] The case focused on the comptroller's attempt to implement a new policy that would require publishers to collect sales tax on the sales of products through school fundraising activities.[121] Entertainment, the taxpayer, was a brochure fundraising firm that contracted with schools to sell merchandise and food products to raise funds for student groups.[122] Relying on a 2007 comptroller letter ruling, Entertainment treated the schools as the actual sellers of the goods that were responsible for collecting and remitting any sales tax due on the items sold to the end consumer.[123] Entertainment therefore accepted resale or exemption certificates from the schools instead of charging them sales tax.

In March 2008, the comptroller sent a letter to the Association of Fundraising Distributors and Suppliers, an industry umbrella organization, citing section 151.024 as support for her position that fundraising firms would always be deemed the seller in transactions like Entertainment's and would therefore always be responsible for collecting tax, regardless of the factors discussed in the 2007 letter ruling.[124] The next month, the comptroller sent a follow-up letter in which she asserted that her office had "consistently held" that companies taking orders through brochures and sales forms for school fundraising were considered sellers of taxable fundraising items and, as such, were responsible for collecting and remitting sales tax on the sales prices of items sold.[125] The taxpayer sued the comptroller for declaratory and injunctive relief to prevent the new "rule" that would require Entertainment to collect and remit tax on the sales of its fundraising products.[126] The resulting court case focused on whether the position expressed in the comptroller's 2008 letters constituted a validly adopted "rule."[127] The comptroller argued (among other jurisdictional complaints) that the policy in question as stated in the 2008 letters was not a "rule" that could be challenged.[128]

The court of appeals reasoned that, in order to constitute a rule, comptroller statements must meet the definition of "rule" in the Administrative Procedure Act (APA); they must be "generally applicable" and "may not pertain only to the internal management of the agency without affecting private rights or procedures."[129] According to the court of appeals,

120. *See* Combs v. Entm't Publ'ns, 292 S.W.3d 712, 715 (Tex. App.—Austin, 2009, pet. denied).

121. *Id.*

122. *Id.*

123. *Id.* at 716. The letter ruling addressed a vendor's questions regarding when the PTA is the "seller" and when the PTA is merely an "agent" for the seller; *see* Tex. Comptroller Pub. Accounts, Doc. No. 200704926L (Apr. 25, 2007).

124. *Entm't Publ'ns*, 292 S.W.3d at 717; *see* TEX. TAX CODE ANN. § 151.024 (West 2011).

125. *Entm't Publ'ns*, 292 S.W.3d at 715.

126. *Id.*

127. *See id.* at 720.

128. *Id.* at 718.

129. *Id.* at 721 (citing Administrative Procedure Act, TEX. GOV'T CODE ANN. § 2001.003(6) (West 2011)).

"there is no question in this case that the . . . letters are statements implementing, interpreting, or prescribing law or policy."[130] The court of appeals noted that it could remand the "rule" to the agency to allow the agency to revise or readopt the rule through properly established procedures, and enjoined the comptroller from implementing and enforcing her new interpretation without first having adhered to those procedural requirements.[131]

The court of appeals in *Entertainment Publications* found that the comptroller's policy statements as set forth in the 2008 letters regarding the taxability of items sold through brochure fundraising fit within the APA's definition of rule.[132] The court of appeals determined that the comptroller's statements met the "general applicability" requirement because they were "statements that affect the interest of the public at large such that they cannot be given the effect of law without public input."[133] Because the interpretations in the comptroller's 2008 letters applied not only to the specific taxpayer who sought to challenge them, but also to all brochure-fundraising firms engaging in business across the state, the court of appeals considered the statements generally applicable.[134] There was also no question in the view of the court of appeals that the statements in the comptroller's letters were implementing, interpreting, or prescribing law or policy.[135] The court of appeals found that the comptroller's new interpretation would be applied uniformly "without regard to the individual factors considered under the comptroller's previous guidelines," so that it modified a prior rule.[136] Finally, the statements were determined to be "aimed at placing the regulated public on notice of the comptroller's . . . application" of a certain section of the Tax Code.[137] The case was remanded, enabling the comptroller to follow proper procedures if she chooses to adopt the new policy.[138] Although the court of appeals' holding surprised many observers on both sides of the docket, it pleased some taxpayers who fear that the comptroller's discretion to change policies places taxpayers at an unfair disadvantage. On the other hand, the decision will have a negative impact on taxpayers if it discourages the comptroller from providing informal advice. Thus, as

130. *Id.* at 723–24
131. *Id.*
132. The court of appeals referred to the APA definition of "rule":

> (A) means a state agency statement of general applicability that: (i) implements, interprets, or prescribes law or policy; or (ii) describes the procedure or practice requirements of a state agency; (B) includes the amendment or repeal of a prior rule; and (C) does not include a statement regarding only the internal management or organization of a state agency and not affecting private rights or procedures.

Id. at 721 (citing APA, TEX. GOV'T CODE ANN. § 2001.003(6) (West 2011)).
133. *See id.* (citing El Paso Hosp. Dist. v. Tex. Health & Human Servs. Comm'n, 247 S.W.3d 709, 714 (Tex. 2008)).
134. *Id.*
135. *Id.*
136. *Id.*
137. *Id.* at 722.
138. *Id.* at 723–24.

noted earlier in this Survey, the comptroller's successful and worthwhile efforts to provide taxpayers with efficient and quick tax advice is much appreciated, but also creates risks from time to time for both the comptroller and for the taxpayers.

B. Limitations on a Taxpayer's Ability to Prove What is "Reasonable"?

Whereas the *Entertainment Publications* case highlighted the difficulty the comptroller may face when she seeks to change her mind, Comptroller Decision No. 46,896 demonstrates the difficulty taxpayers may face in seeking to prove up their cases.[139] The case focuses on the pre-margin franchise tax, but the procedural aspects are relevant to taxpayers under current law as well, in part because of the way in which the burden of proof was interpreted by the administrative law judge and by the comptroller's office.[140] The petitioners, affiliated corporations headquartered in California, performed investment banking services, financial advisory services, and financial restructuring services for clients in Texas and throughout the country.[141] The dispute at the core of this case involved a disagreement over how to determine what services should be allocated to Texas and what should be allocated outside the state.[142] The taxpayer had prepared guidelines to show the time spent by client service professionals performing services at their home offices (e.g., advisory services were eighty percent at the office location and twenty percent at the client's location).[143] The taxpayer also provided tables showing Texas payroll for each of the two companies involved as a percentage of the total payroll. The administrative law judge noted that the Texas percentages varied from less than one percent to slightly over three percent.[144] The taxpayer further explained its proportionate formula was calculated by using a computerized project scheduler that tracks management information, incoming project locations, revenue type of project, and personnel assigned to a project.[145] Against that backdrop, it is interesting to note the administrative law judge's recognition that the comptroller's policy letters have stated that when revenues directly attributable to services performed in Texas cannot be determined, "a reasonable method can be used to apportion the revenue."[146] However, the comptroller's examin-

139. *See* Tex. Comptroller Pub. Accounts, Hearing No. 46,869 (Feb. 26, 2010). The original proposed decision was issued in September 2007, but the tax division filed exceptions and then filed exceptions to a subsequent decision. *Id.*

140. *Id.*

141. *Id.*

142. *Id.*; *see* 34 Tex. Admin. Code § 3.557(e)(33) (2010) as applicable before the new margin tax took effect Jan. 1, 2008, providing that if a service is performed both inside and outside the state, the amount of Texas receipts is based on the fair value of the services rendered in Texas.

143. Tex. Admin. Code Ann. § 3.557(e)(33) (2011).

144. *Id.*

145. *Id.*

146. *Id.*

ing auditor had asked the taxpayer to provide source documents, such as hourly time records indicating where the services were performed.[147] Although it is difficult to know with certainty, it appears that this is a case in which the auditor—and the administrative law judge—demanded a specific type of record that did not exist; that demand appears unjustified in the context of this case. On the other hand, in this particular case, the judge's decision appears to rest largely on the fact that the sworn statement submitted by the taxpayer could not be corroborated or verified and had not been presented in affidavit form. To the extent the taxpayer lost because its proof was not sworn and not creditable, the decision is unremarkable. However, it remains troubling to see that some auditors request documents that simply do not exist—and should not be required for either business or tax purposes.

C. Tax Clearance Certificates not so Clear . . . ?

An additional procedural issue that has triggered questions relates to the long-standing statutory right of a purchaser of a business to obtain a no-tax-due certificate. Section 111.020 of the Tax Code enables a buyer of a business to request that the comptroller issue a certificate stating that no tax is due from the acquired business or issue a statement of the amount required to be paid before a certificate may be issued.[148] This procedure offers a purchaser of a business protection against successor liability for certain taxes owed by the acquired business. Although the statute allows the comptroller ninety days to issue a certificate,[149] the comptroller has for many years frequently provided clearance certificates on an expedited basis that provides information to taxpayers in a much shorter time.[150] However, the combination of combined franchise tax reporting, budget shortfalls, and multiple types of taxes at issue appears to have slowed the comptroller's office. Some taxpayers have complained that the comptroller has been unable or unwilling to comply within the ninety days; such taxpayers fear that the comptroller will not address all the taxes at issue or may try to delay her response beyond the ninety-day period. Given the statutory rights of the purchaser, however, the comptroller should endeavor to comply with the statutory requirement, especially because such certificates are often critical to taxpayers.

VI. CONCLUSION

The 2011 legislative session undoubtedly faces extraordinary challenges as a result of the budget shortfall (estimated to be as much as $25 billion), continuing challenges to the method of funding public education, and confusion regarding sales and franchise tax issues. The Business Tax Ad-

147. *Id.*
148. Tex. Tax Code Ann. § 111.020 (West 2011).
149. *Id.* at § 111.020(c).
150. Window on State Government, Texas Sales Tax Frequently Asked Questions, http://www.window.state.tx.us/taxinfo/sales/faq_buy_sell.html (last visited May 13, 2011).

visory Committee, put into place pursuant to prior legislative directives, was tasked with providing reports to the legislature regarding the margin tax.[151] The final report was not in print until after the Survey period, but the preliminary draft reflects several interesting conclusions regarding the margin tax. Not surprisingly, some industries fared better under the revised franchise tax than under the former tax, while other industries (including air, truck, water, transportation, telecommunications, real estate, professional services, and health services) experienced a significant increase in their tax liability.[152] Perhaps most critical to the Texas legislators is that the margin tax failed to provide sufficient revenue to pay for the property tax relief that it was expected to provide, and that property tax rates and values continued to increase after the initial relief passed in conjunction with the modification of the Texas franchise tax.[153] Although the tax produced significantly less than its original estimate (it produced approximately $4.5 billion in fiscal 2008 as compared to the $5.9 billion original estimate and declined thereafter to $3.86 billion in fiscal 2010), the tax produced more revenue than the comptroller estimated its predecessor would have produced.[154] Moreover, the shift to a margin tax that reaches more types of entities eliminated some of the prior tax planning opportunities (e.g., operating through partnership structure rather than corporate structure) that had frustrated legislators and the comptroller's office for years.

No matter how the numbers are crunched, or by whom, the franchise tax yields significantly less revenue than sales taxes, and property taxes continue to fund public schools. So, those taxes and others will continue to be subject to legislative tinkering, judicial interpreting, and taxpayer and comptroller planning—as well as to discussion in next year's Survey.

151. TEX. COMPTROLLER PUB. ACCOUNTS, THE BUSINESS TAX ADVISORY COMMITTEE REPORT, Leg. 82, at 1 (2010), *available at* http://www.window.state.tx.us/taxinfo/btac/96-1364_BTAC_Report_2010.pdf.

152. *Id.* at 20–40.

153. *Id.* at 1–2.

154. *Id.* at 4.