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## Taxation

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# TAXATION

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“IN the complexity of today’s business and tax jungle, a corporate president who does not obtain tax advice before an acquisition, or merger or substantial dollar transaction ought to be fired.”<sup>1</sup>

Texas taxes continue to impact heavily many business planning decisions, as the state and taxpayers adapt and react to the other’s planning. The 1995 Legislature again amended sales, franchise and property tax provisions, but the changes were far less dramatic than the franchise tax

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1. *Brumley-Donaldson Co. v. Comm’r*, 443 F.2d 501, 510 (9th Cir. 1971) (Trask, J., dissenting) (a little extra incentive for reading tax articles).

changes adopted during the 1991 session. In some respects, the legislature's ability to tinker with specific provisions (and even to provide some new exemptions<sup>2</sup>) rather than press for wholesale overhaul of the tax system was based on the fact that the budget did not demand significantly higher revenue than the current tax structure could produce, coupled with the fact that no one has yet been able to design a practical, politically viable way to replace all (or at least a substantial portion) of the property taxes.

## I. SALES TAX

### A. APPLICATION OF THE TAX

During the Survey period the United States Supreme Court issued a sales tax decision that may prove to have far-reaching effects. In *Oklahoma Tax Commission v. Jefferson Lines, Inc.*<sup>3</sup> the Court held that the imposition of Oklahoma sales tax on the full value of bus tickets sold for interstate travel did not violate the Commerce Clause of the United States Constitution.<sup>4</sup> Jefferson Lines, a common carrier, collected Oklahoma sales tax on bus tickets for travel that originated and terminated in Oklahoma, but the carrier did not collect Oklahoma sales tax on bus tickets for interstate travel that originated in Oklahoma but ended outside of Oklahoma.<sup>5</sup> The Supreme Court, in reversing the lower courts, held that imposing Oklahoma sales tax on the full price of a bus ticket for travel from Oklahoma to another state is consistent with the Commerce Clause.<sup>6</sup>

In reaching its conclusion, the Court determined that the Oklahoma sales tax met the four prong *Complete Auto*<sup>7</sup> test: the tax must be applied

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2. See *infra* note 97 and accompanying text (cleanroom exemption from sales tax).

3. 115 S. Ct. 1331 (1995).

4. *Id.* at 1346.

5. Oklahoma imposes sales tax on certain services, including transportation for hire. See OKLA. STAT. tit. 68, § 1354(1)(C) (Supp. 1988).

6. *Jefferson Lines*, 115 S. Ct. at 1335-36, 1346. Jefferson Lines filed for bankruptcy and the Oklahoma Tax Commission filed proof of claims for uncollected sales tax on tickets sold for interstate travel. The bankruptcy court disallowed the claims, holding that allowing a sales tax on tickets sold for interstate travel would violate the Commerce Clause by imposing an "undue burden on interstate commerce" and creating the "potential for multiple taxation." *Id.* at 1335. The district court affirmed the bankruptcy court decision. *Id.* The court of appeals also affirmed the bankruptcy court decision and held that the tax was unconstitutional because it was not fairly apportioned. *In re Jefferson Lines, Inc.*, 15 F.3d 90 (8th Cir. 1994). The Oklahoma Tax Commission argued that application of the sales tax on the ticket's full value was justified because the sale of a bus ticket is a wholly local transaction. The Eighth Circuit rejected the Commission's argument and reasoned that there was no distinction between the sales tax at issue and an unapportioned New York state tax on an interstate busline's gross receipts that the Supreme Court had reviewed in an earlier decision. 15 F.3d at 92-93. The Supreme Court had previously held such a tax to be unconstitutional in *Central Greyhound Lines, Inc. v. Mealey*, 334 U.S. 653, 663 (1948) (holding that New York's taxation of an interstate busline's gross receipts was constitutionally limited to that portion reflecting miles traveled within the taxing jurisdiction).

7. *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274, 279 (1977) (establishing the test for determining the constitutionality of a state tax on interstate commerce).

to an activity with a substantial nexus with the taxing state, it must be fairly apportioned, it may not discriminate against interstate commerce, and it must be fairly related to the services provided by the taxing state.<sup>8</sup> The nexus prong of the test was met in that the bus ticket was purchased and the service originated in Oklahoma. The crux of the Court's decision lies in its analysis of the apportionment challenge, the second prong of the *Complete Auto* test.<sup>9</sup>

The Court found that the Oklahoma tax was internally consistent because the transaction would not be subject to multiple taxation if every state imposed a similar tax on ticket sales within the taxing state for travel originating within that state.<sup>10</sup> The Court noted that an internally consistent tax has long been held to be externally consistent as well and that Jefferson Lines offered no reason to reconsider such premise.<sup>11</sup> Therefore, the Court found that the tax was externally consistent and reached only the activity taking place within the taxing state, which activity is the sale of the service.<sup>12</sup> The Court declined to distinguish a sales tax on the sale of tangible personal property from the sale of a service. In the opinion of the Court, a sale of a service can ordinarily be treated as a local state event "just as readily as a sale of tangible personal property can be located solely within the [s]tate of delivery."<sup>13</sup>

The Court found the tax met the third prong of the *Complete Auto* test, that the tax must not discriminate against interstate commerce, since no argument was presented that Oklahoma discriminates against out-of-state

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8. *Jefferson Lines*, 115 S. Ct. at 1331, 1338.

9. The focus of the second prong is whether a tax is fairly apportioned, which requires that an apportioned tax be both internally and externally consistent. Internal consistency requires examining whether the identical application of a tax by every state would place interstate commerce at a disadvantage to intrastate commerce. External consistency examines the economic justification of the taxing state's claim on the value taxed to determine whether the tax extends "beyond the portion that is fairly attributable to the economic activity within the taxing [s]tate." *Id.* See *Container Corp. of America v. Franchise Tax Bd.*, 465 U.S. 169 (1983).

10. *Jefferson Lines*, 115 S. Ct. at 1338. The Court illustrates its reasoning with an example in a footnote: Texas could not tax the full value of bus service for a trip from Oklahoma City to Dallas when the ticket is sold in Oklahoma because such a tax would be internally inconsistent. *Id.* at 1342 n.6.

11. *Id.* at 1340-42. The Court disregarded Jefferson Lines' argument that apportionment on the basis of miles was the only way to ensure no threat of double taxation. *Id.* at 1343. In fact, the Court found that Jefferson Lines' reliance on *Central Greyhound* was misplaced and not controlling because the tax at issue in that case posed a threat of double taxation, unlike the tax at issue here. *Id.* at 1341.

12. *Id.* at 1344. The Court reasoned that the taxable event was the agreement, payment and delivery of some of the services in the taxing state. No other state could claim to have all three events also occur within their state and so the taxable event, a sale with partial delivery, could not also occur in another state. Thus multiple taxation would be precluded. *Id.* at 1341.

13. *Id.* at 1340. The Court notes that taxable sales are consistently upheld without any apportionment among states, regardless of any activity outside the taxing jurisdiction that may have preceded the sale or may occur in the future. *Id.* at 1339; see, e.g., *McGoldrick v. Berwind-White Coal Mining Co.*, 309 U.S. 33, 58 (1940) (finding that a necessary condition for imposing tax was "a local activity, delivery of goods within the [s]tate upon their purchase for consumption").

enterprises.<sup>14</sup> The Court also found no merit in the argument that the tax discriminates against interstate activity.<sup>15</sup> In the Court's opinion, the tax met the last prong, that the tax must be fairly related to the taxpayer's presence or activities in the state, because the tax was on a sale that took place wholly in the state of Oklahoma and was "measured by the value of the service purchased."<sup>16</sup> Justice Breyer, joined by Justice O'Connor, dissented from the decision.<sup>17</sup>

The Austin Court of Appeals issued an important decision during the Survey period that clearly shows the application of the "essence of the transaction" doctrine to the sale of services.<sup>18</sup> In *Direct Resources*, the court addressed the issue of whether the portion of a direct mail business which involved the application of mailing addresses on envelopes by means of an ink-jet machine was a taxable service pursuant to section 151.005(4) of the Tax Code, pertaining to printing or imprinting of tangible personal property, or if it falls under section 151.0101(a)(12), pertaining to data processing services.<sup>19</sup> Direct Resources asserted that the addressing of envelopes was not a taxable activity and that the "essence of the transaction" was providing a non-taxable direct-mail service.<sup>20</sup> The district court granted summary judgment in favor of Direct Resources on the taxability issue (but not on attorney fees), and the court of appeals affirmed.<sup>21</sup> In explicitly basing its decision on the essence of the transaction doctrine, the court confirmed that "[t]he established test for determining whether a transaction is subject to sales tax involves the

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14. *Jefferson Lines*, 115 S. Ct. at 1344.

15. *Id.* at 1345.

16. *Id.* at 1346.

17. The dissenters found that the tax at issue in *Jefferson Lines* and the tax at issue in *Central Greyhound* were identical for all relevant purposes and since the gross receipts tax in *Central Greyhound* was held unconstitutional, the Oklahoma sales tax should also be unconstitutional. *Id.* at 1346. The dissenters found multiple similarities in the two cases: both involved taxes imposed on interstate bus transportation, the respective states did not apportion their taxes to apply to the cost or value of the in-state portion only, there was similar statutory language for both taxes, and both taxes were imposed on gross receipts measured by sales. *Id.* at 1347. The dissenters conducted a careful analysis of the facts that the majority relied upon to distinguish the tax in *Central Greyhound* from that in *Jefferson Lines*. They also addressed the majority's reliance on *Goldberg v. Sweet*, 488 U.S. 252 (1989) (upholding an Illinois tax on interstate telephone calls that originated or terminated in Illinois). The dissenters concluded by quoting the court of appeals, "that this 'is a classic instance of an unapportioned tax' upon interstate commerce." *Id.* at 1349 (quoting *In re Jefferson Lines*, 15 F.3d 90, 93).

18. *Sharp v. Direct Resources for Print, Inc.*, 910 S.W.2d 535, 538 (Tex. App.—Austin 1995, writ requested). See Cynthia M. Ohlenforst *et al.*, *Annual Survey of Texas Law: Taxation*, 48 SMU L. REV. 1579, 1583 (1995) [hereinafter 1995 *Tax Survey*] for a discussion of the district court's disposition of this case.

19. *Direct Resources*, 910 S.W.2d at 538-40. The comptroller argued that the portion of the business which used the ink-jet machine was a taxable printing or imprinting service, and that such activity was a taxable data processing service since the ink-jet machine used computer components for the machine to read addresses off magnetic tape and apply addresses to envelopes.

20. See *Bullock v. Statistical Tabulating Corp.*, 549 S.W.2d 166, 167 (Tex. 1977); see also 1995 *Tax Survey*, *supra* note 18, at 1583 (discussion of essence of the transaction doctrine).

21. *Direct Resources*, No. 93-00796 (353d Dist. Ct., Travis County, Tex., July 11, 1994).

determination of the ultimate object or essence of the transaction.”<sup>22</sup> The court therefore held that, in *Direct Resources’* case,

[p]erformance of the addressing component by an ink-jet machine does not transform the essence of the transaction into printing for consideration. The customer’s desired finished product is not addressed envelopes but the receipt of advertising materials by addressees. We conclude that printing for consideration as contemplated by section 151.005(4) of the Tax Code does not apply to a printing component of a transaction, the essence of which is a mailing service.<sup>23</sup>

Numerous cases continue to challenge the comptroller’s interpretation of the manufacturing exemption. Determining what constitutes property “used” in manufacturing has been the focus of several recent court cases and administrative hearings. For example, in reviewing an appeal of an administrative decision, taxpayers won a significant victory in district court regarding the “one-step removed” exclusion to the manufacturing exemption.<sup>24</sup> In *Tyler Pipe Industries, Inc. v. Sharp*,<sup>25</sup> the taxpayer requested a refund of sales tax paid on machinery and equipment used to make sand molds that the taxpayer used in manufacturing cast-iron pipe fittings. At the administrative level, the judge had denied the refund and held that the mold-making equipment and machinery was one-step removed from the manufacturing process and thus was taxable.<sup>26</sup> The district court granted summary judgment in favor of *Tyler Pipe*.<sup>27</sup>

Taxpayers marked another victory at the district court level concerning the interpretation of an additional exclusion to the manufacturing exemp-

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22. *Direct Resources*, 910 S.W.2d at 538. See also *Bullock v. Statistical Tabulating Corp.*, 549 S.W.2d 166, 167 (Tex. 1977); *Comptroller of Public Accounts v. Multiple Listing Serv., Inc.*, 723 S.W.2d 163, 165 (Tex. App.—Austin 1986, no writ); *First Nat’l Bank v. Bullock*, 584 S.W.2d 548, 550 (Tex. Civ. App.—Austin 1979, writ ref’d n.r.e.); *Williams & Lee Scouting Serv., Inc. v. Calvert*, 452 S.W.2d 789, 792 (Tex. Civ. App.—Austin 1970, writ ref’d).

23. *Direct Resources*, 910 S.W.2d at 540-41.

24. The comptroller has refused to allow a manufacturing exemption for equipment used in a process one-step removed from the actual manufacturing process on the basis that only equipment directly used in manufacturing will satisfy the statutory exemption. See TEX. TAX CODE ANN. § 151.318(a)(2) (Vernon 1992).

25. No. 9307993 (126th Dist. Ct., Travis County, Tex., Dec. 14, 1994), *appeal docketed*, No. 3-95-00212-CV (Tex. App.—Austin 1995).

26. Tex. Comp. Pub. Acc’ts, Hearing No. 27,971 (Mar. 8, 1993), 1993 Tex. Tax LEXIS 83, at \*17.

27. *Tyler Pipe Indus.*, No. 9307993 (126th Dist. Ct., Travis County, Tex., Dec. 14, 1994). Similarly, the same district court had previously reviewed the one-step removed theory in *Gulf Marine Fabricators, Inc. v. Sharp*, No. 9308377 (126th Dist. Ct., Travis County, Tex., July 19, 1994). *Gulf Marine* was an appeal from Tex. Comp. Pub. Acc’ts, Hearing No. 28,900 (July 21, 1992), 1992 Tex. Tax LEXIS 212. At the administrative level, the judge had denied a manufacturer’s request for partial refund of taxes paid on cranes, winches and accessories under the phase-in manufacturing exemption. The standard employed by the administrative law judge was whether the machinery or equipment fabricated products. The administrative law judge held that the machinery or equipment was one-step removed from the actual manufacturing process and thus taxable. *Id.* at \*8-9. On appeal, the comptroller entered into an Agreed Judgment with taxpayer to refund the tax. *Gulf Marine* (126th Dist. Ct., Travis County, Tex., July 19, 1994).

tion, the intraplant transportation exclusion.<sup>28</sup> In *Chevron Chemical Co. v. Sharp*,<sup>29</sup> the court found that pipe used in the manufacture of polyethylene pellets is exempt manufacturing equipment and is not excluded as intraplant transportation.<sup>30</sup>

In *ADP Corp. v. Sharp*,<sup>31</sup> the district court examined the meaning of the statutory term "separately identified" as used in Tax Code Section 151.007(c)(4) which provides that, with respect to conditional or deferred payment sales, if finance charges are separately identified to a customer, then such charges are not included in the sales price and thus tax is not due on such receipts. The comptroller argued that in order to be "separately identified" as prescribed by the statute, the finance charge must be written plainly in the document signed by the customer. Furthermore, the fact that the finance charge can be calculated using various numbers in the document is not sufficient to meet the exemption. The court agreed with the comptroller and held for the state.<sup>32</sup>

During the Survey period, the comptroller faced several Commerce Clause challenges to the standards for what activities give rise to nexus for sales tax purposes. In Decision 32,349 the taxpayer, a retailer of computer products, contended it did not have sufficient nexus to require collection of use tax on items sold to Texas customers.<sup>33</sup> The administrative law judge found that the taxpayer was doing business in Texas because the company derived rentals from the lease of its software used in Texas and because the taxpayer's employees were sent to Texas to train customers in the use of the hardware and software.<sup>34</sup> The licensing of software and personnel training constituted a sufficient physical presence to meet the substantial nexus requirement of both the Commerce Clause<sup>35</sup> of the

28. *Chevron Chemical Co. v. Sharp*, No. 9306300 (201st Dist. Ct., Travis County, Tex., June 29, 1995), *appeal docketed*, No. 03-95-00628-CV (Tex. App.—Austin 1995). See TEX. TAX CODE ANN. § 151.318(c)(2) (Vernon 1992).

29. No. 9306300 (201st Dist. Ct., Travis County, Tex., June 29, 1995), *appeal docketed*, No. 03-95-00628-CV (Tex. App.—Austin 1995).

30. The statutory exemption for property used in manufacturing specifically excludes from exemption intraplant transportation equipment. TEX. TAX CODE ANN. § 151.318(c)(2). Numerous comptroller decisions have addressed what type of equipment qualifies as intraplant transportation. See, e.g., Tex. Comp. Pub. Acc'ts, Hearing No. 29,287 (Dec. 7, 1992), 1992 Tex. Tax LEXIS 403 (in-line conveyors); Tex. Comp. Pub. Acc'ts, Hearing No. 28,723 (Aug. 31, 1992), 1992 Tex. Tax LEXIS 204 (conveyors in assembly line); Tex. Comp. Pub. Acc'ts, Hearing No. 28,900 (July 21, 1992), 1992 Tex. Tax LEXIS 212 (cranes, man-lifts and winches); Tex. Comp. Pub. Acc'ts, Hearing No. 28,700 (July 15, 1992), 1992 Tex. Tax LEXIS 204 (towveyor and conveyor equipment); Tex. Comp. Pub. Acc'ts, Hearing No. 19,986 (Jan. 28, 1987), 2 [TEX.] ST. TAX. REP. (CCH) ¶ 401-387 (cranes); Tex. Comp. Pub. Acc'ts, Hearing No. 18,662 (Mar. 12, 1986), 1986 Tex. Tax LEXIS 575 (loaders).

31. No. 9204853 (167th Dist. Ct., Travis County, Tex., July 5, 1995), *appeal docketed*, No. 03-95-00508-CV (Tex. App.—Austin 1995) (examining TEX. TAX CODE ANN. § 151.007(c)(4) (Vernon 1992)).

32. *Id.*

33. Tex. Comp. Pub. Acc'ts, Hearing No. 32,349 (Jan. 30, 1995), 1995 Tex. Tax LEXIS 38.

34. *Id.* at \*7-8.

35. U.S. CONST. art. I, § 8, cl. 3.

United States Constitution and Supreme Court precedent,<sup>36</sup> according to the administration law judge.<sup>37</sup> Therefore, the taxpayer was required to collect use tax on its sales and rentals of hardware and sales and licenses of software.

The comptroller increasingly faces challenges to the taxable services provisions as the comptroller and taxpayers alike struggle to interpret and define those services subject to tax and those that qualify for applicable exemption. Data processing is one of the taxable services that is frequently the subject of controversy and adversarial proceedings. This is because the comptroller adheres to a very broad definition of data processing and taxpayers challenge such liberal interpretation of the statute. The issue of whether electronic calculators used in inventory services constitute data processing has been the subject of recent comptroller decisions.

In Decision 29,740 the comptroller held that a taxpayer's business of taking physical inventory for convenience stores by using a hand-held calculator designed for such purpose was not a taxable data processing service.<sup>38</sup> The tax division argued that the calculators were computers and that the taxpayer's service was taxable data processing under Rule 3.330.<sup>39</sup> The administrative law judge found that the taxpayer could not program the calculators, consequently, the calculators did not meet the dictionary definition of "computer" and the service was not data processing but rather it was non-taxable auditing services.<sup>40</sup>

Decisions 30,695 and 32,269 reached the same conclusion, but on different grounds.<sup>41</sup> In these cases, the taxpayer provided an inventory counting service which used small electronic calculators. The taxpayer had provided this service in the past without using the hand-held computer and continued to do so with some clients. The administrative law judge noted that the service involved more than just entry, retrieval, storage and manipulation of data into and from a computer. The judge held that the use of a hand-held computer did not make the taxpayer's inventory service a taxable data processing service because the computer simply facilitated the taxpayer's service and therefore was excluded from Rule 3.330.<sup>42</sup>

Decisions 30,794 and 31,025 held that a taxpayer's lease of a paved lot was not transformed into a taxable motor vehicle parking service, be-

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36. See *Quill Corp. v. North Dakota*, 112 S. Ct. 1904, 1912-13 (1992) (holding a North Dakota use tax requiring certain out-of-state vendors to collect the state's use tax violated the Commerce Clause); *National Bellas Hess, Inc. v. Dept. of Revenue*, 386 U.S. 753 (1967).

37. 1995 Tex. Tax LEXIS 38 at \*7-8.

38. Tex. Comp. Pub. Acc'ts, Hearing No. 29,740 (Feb. 22, 1995), 2 [TEX.] ST. TAX REP. (CCH) ¶ 401-854.

39. 34 TEX. ADMIN. CODE § 3.330 (West 1995).

40. 2 [TEX.] ST. TAX REP. at 26,465.

41. Tex. Comp. Pub. Acc'ts, Hearing Nos. 30,695 & 32,269 (Feb. 21, 1995), 2 [TEX.] ST. TAX REP. (CCH) ¶ 401-859.

42. *Id.* at 26,485. See also 34 TEX. ADMIN. CODE § 3.330 (West 1995).

cause even though taxpayer added a security fence and gate, painted stripes on the lot and used the lot for parking, the taxpayer did not provide a *service*.<sup>43</sup> The tax division attempted to tax the lease agreement as a taxable service but the administrative law judge determined that in order for the agreement to be taxable as motor vehicle parking it must include some element of a parking-related service.<sup>44</sup> The agreement at issue was the transfer of a real property interest which provided for no services.

In Decision 30,261 the comptroller found that services performed for an insurance company by a nationwide consulting firm were subject to sales tax as insurance services.<sup>45</sup> The taxpayer provided a variety of actuarial and management consulting services to insurance company clients, including analyzing assets for a potential purchase of an insurance company, historical analysis, profitability projections and financial repayment analysis. The administrative law judge held that under Rule 3.355 the taxpayer's activities came within the definition of insurance services and therefore were taxable.<sup>46</sup>

The phase-in of the manufacturing exemption has been the subject of many planning and purchasing decisions.<sup>47</sup> Recently, the comptroller held that the purchase of packaging materials used to assemble non-manufactured items is not exempt. In Decision 33,524, the comptroller assessed a tax on wrapping and packaging materials used in preparing non-sterile medical kits for hospital customers.<sup>48</sup> The administrative law judge determined that the taxpayer, who purchased finished goods from vendors, and then combined, repackaged and shrink-wrapped the goods into kits, was not engaged in processing or fabricating under the definitions of Rule 3.300; therefore, the taxpayer was not entitled to exemption.<sup>49</sup>

Decision 30,880 addressed what type of documentation is sufficient to prove the existence of an "agreement" which transfers ownership of tangible personal property in the absence of a comprehensive document or agreement concerning the sale of the property.<sup>50</sup> The taxpayer was in the

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43. Tex. Comp. Pub. Acc'ts, Hearing Nos. 30,794 & 31,025 (June 29, 1994), 2 [TEX.] ST. TAX REP. (CCH) ¶ 401-836.

44. *Id.* at 26,384-386.

45. Tex. Comp. Pub. Acc'ts, Hearing No. 30,261 (Feb. 13, 1995), 1995 Tex. Tax LEXIS 73.

46. *Id.* at \*15 (citing 34 TEX. ADMIN. CODE § 3.355 (West 1995)).

47. Prior to 1995, the amount of the refund or the reduced amount of tax due under the manufacturing exemption of section 151.318 of the Texas Tax Code was calculated on a graduated scale, ranging from 25% of the tax paid to the state for property purchased during 1990, to a 75% reduction for property purchased during 1994. The phase-in is now complete and property purchased on or after January 1, 1995 that qualifies for the manufacturing exemption is fully exempt. TEX. TAX CODE ANN. § 151.318(h)(6) (Vernon 1992).

48. Tex. Comp. Pub. Acc'ts, Hearing No. 33,524 (Mar. 14, 1995), 1995 Tex. Tax LEXIS 149.

49. *Id.* at \*9; see also 34 TEX. ADMIN. CODE § 3.300 (West 1995).

50. Tex. Comp. Pub. Acc'ts, Hearing No. 30,880 (June 30, 1995), 1995 Tex. Tax LEXIS 311; see 34 TEX. ADMIN. CODE § 3.300(b)(3) (West 1995). Rule 3.300(b)(3) provides that a separate charge for a manufacturing aid will be a sale to the customer "only if there is a

business of making molded components, custom packing parts and packaging materials for use in shipping electronic and other equipment. As evidence that a written agreement existed, the taxpayer produced an affidavit of the company's president, as well as several transactional documents, such as bids, purchase orders and purchase and sale invoices. The court found that the evidence was sufficient to show the existence of a written agreement concerning the customer's ownership of the molds. Therefore, the taxpayer proved by clear and convincing evidence that the molds were purchased for resale and no tax was due on taxpayer's purchase of the molds.<sup>51</sup>

Decision 28,916 involved a taxpayer who was in the business of selling and leasing computer equipment, including the sale of equipment leases it entered into initially with third parties.<sup>52</sup> The administrative law judge held, based on Rule 3.294 and comptroller policy, that the simultaneous assignment of leased property and the right to receive future payments under the lease constitute sales of tangible personal property.<sup>53</sup> The tax division also argued that amounts for transaction fees and commissions under remarketing agreements represented compensation for services as part of the lease assignments and should be included as part of the sales price. The administrative law judge found that such amounts were "memo entries" representing amounts contingent on future events and thus were not part of the sales price.<sup>54</sup>

In Decision 32,516 the administrative law judge faced the issue of when an agency relationship is established with a tax-exempt entity.<sup>55</sup> The taxpayer entered into contracts with tax-exempt entities to provide architectural services. The contracts provided that one original set of design and construction documents would be provided as part of the taxpayer's basic services and that the client would purchase, at its own expense, all additional sets of documents. On the basis of the contract language, the administrative law judge found that the purchase of additional sets of documents by the taxpayer was a purchase as agent for the tax-exempt entities and thus not subject to sales tax.<sup>56</sup>

There continues to be uncertainty concerning the availability of an exemption to a buyer who buys less than all the assets of a business or buys

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written agreement between [the] parties clearly making the customer the owner . . ." and that the customer will owe the tax unless the aid qualifies for the manufacturing exemption or is purchased for resale.

51. 1995 Tex. Tax LEXIS 311 at \*10-11. The administrative law judge, however, added that the audit should be revised to include sales tax on the sale of the property by the taxpayer, unless the taxpayer could show that its sale was exempt. *Id.* at \*13.

52. Tex. Comp. Pub. Acc'ts, Hearing No. 28,916 (Mar. 13, 1995), 1995 Tex. Tax LEXIS 95.

53. *Id.* at \*13 (citing 34 TEX. ADMIN. CODE § 3.294 (West 1995)). The administrative law judge noted that the lease assignments could be tax-free sales for resale if valid resale certificates were obtained. *Id.* at \*15.

54. *Id.* at \*22.

55. Tex. Comp. Pub. Acc'ts, Hearing No. 32,516 (Feb. 23, 1995), 1995 Tex. Tax LEXIS 130.

56. *Id.* at \*10.

a segment of a business. The comptroller has recently recognized a *de minimis* exception to the occasional sale exemption. In Decision 32,398 the taxpayer acquired all of the assets of a business, which consisted of approximately 25,000 separate assets.<sup>57</sup> Sixteen of the assets were excluded from the transfer (generally, chairs, desks, credenzas). The administrative law judge held that the assets that were not transferred were so insignificant in number and value that the transaction still qualified as the acquisition of the entire operating assets of the seller, and thus was exempt as an occasional sale.<sup>58</sup> The decision states (in a footnote) that, in determining whether assets that are not transferred are *de minimis*, consideration must be given to both the value and quantity of such assets.<sup>59</sup>

The Comptroller advanced similar arguments in an attempt to deny the occasional sales exemption to foreclosing entities in Decisions 31,839, 31,709, 31,711.<sup>60</sup> The tax division argued in these hearings that the transfer of assets from a subsidiary (Sub 1) to the parent and then to another subsidiary (Sub 2) would not qualify as an occasional sale. The tax division acknowledged the transfer from Sub 1 to the parent may qualify as the transfer of the entire operating assets of an identifiable segment. According to the tax division, however, the assets then cease to be assets of an identifiable segment of parent, and the transfer from parent to Sub 2 would not qualify as an occasional sale under section 151.304(b)(2).<sup>61</sup> The taxpayers argued that the transaction qualified as an occasional sale under section 151.304(b)(3) as the transfer of all or substantially all the property used by a person in the course of an activity, if the real or ultimate ownership of the property remains substantially similar. The tax division argued that the transfer from the parent to Sub 2 would not qualify because the parent would not have used the assets in the course of an activity. The administrative law judge held that the taxpayer failed to carry its burden of proof and therefore did not specifically rule on the tax division's assertions.<sup>62</sup>

Decision 32,305 addressed the issue of when tax applies to progress billings.<sup>63</sup> The taxpayer billed customers for refurbished industrial compressors by progress billing, but did not bill its customers for sales and use tax until the final billing, which occurred on the first of either the passing of title or possession. The tax division argued that the taxpayer was required to collect sales tax with each billing. The administrative law judge disagreed with the tax division and held that sales tax was due on the

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57. Tex. Comp. Pub. Acc'ts, Hearing No. 32,398 (Dec. 6, 1994), 1994 Tex. Tax LEXIS 589.

58. *Id.* at \*9.

59. *Id.* at \* 9-10 n.3.

60. Tex. Comp. Pub. Acc'ts, Hearing Nos. 31,839, 31,709, 31,711 (May 9, 1995), 1995 Tex. Tax LEXIS 249.

61. *Id.*; see TEX. TAX CODE ANN. § 151.304(b)(2) (Vernon 1992).

62. 1995 Tex. Tax LEXIS 249 at \*21.

63. Tex. Comp. Pub. Acc'ts, Hearing No. 32,305 (Feb. 13, 1995), 1995 Tex. Tax LEXIS 39.

total sales price at the earlier of transfer of title or possession.<sup>64</sup>

Decision 33,136 illustrates the increasing importance of careful tax planning and precise documentation.<sup>65</sup> In this hearing the taxpayer entered into contracts with two companies for the purchase of services. The contracts included the language "[c]ontractor shall assume full responsibility for and shall pay all taxes and licenses required in connection with the work."<sup>66</sup> The taxpayer contended that amounts with respect to these contracts were incorrectly assessed because the vendors assumed responsibility for the taxes under the tax-included contracts. The administrative law judge held that the generalized language contained in the contracts was too ambiguous to show that taxes were included in the contract.<sup>67</sup> With respect to one of the companies, however, the contract explicitly incorporated the taxpayer's purchase order and a notation on the purchase order clearly indicated "taxes included." The administrative law judge held that, since the vendor held a sales tax permit, the notation on the purchase order, together with the general contract language, was sufficient to show sales taxes were included in the selling price.<sup>68</sup>

The comptroller's strict scrutiny of resale and exemption certificates exemplifies the need for taxpayers to ensure they adhere strictly to the resale and exemption certificate procedural provisions. In Decision 32,297 the administrative law judge held that a lump sum subcontractor did not accept an exemption certificate in good faith because the subcontractor did not verify with the comptroller's office that the entity executing the certificate was a tax-exempt organization.<sup>69</sup> The subcontractor relied upon representations of the prime contractor and receipt of a properly completed exemption certificate. According to this decision, however, Rule 3.291 requires contractors to request additional evidence of the exempt status of the organization if the validity of the exemption is not clear.<sup>70</sup>

Decision 32,834 illustrates the importance of careful and correct payment of taxes.<sup>71</sup> The decision involved a contractor who performed improvements to residential realty under lump-sum contracts. The

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64. *Id.* at \*5. In explaining his decision, the administrative law judge noted that in a letter written after the audit period but directly on point, the Comptroller's Tax Administrative Division had confirmed that this is the correct standard. *Id.*

65. Tex. Comp. Pub. Acc'ts, Hearing No. 33,136 (June 13, 1995), 1995 Tex. Tax LEXIS 327.

66. *Id.* at \*2.

67. *Id.* at \*7.

68. *Id.* at \*8-9.

69. Tex. Comp. Pub. Acc'ts, Hearing No. 32,297 (Mar. 23, 1995), 2 [Tex.] ST. TAX REP. (CCH) ¶ 401-852.

70. *Id.* at 26,445; see 34 TEX. ADMIN. CODE § 3.291 (West 1995); see also Tex. Comp. Pub. Acc'ts, Hearing No. 30,768 (Jan. 24, 1994), 1994 Tex. Tax LEXIS 49 (holding that resale certificates which did not contain descriptions of the taxable items generally sold by the purchasers were not accepted by the seller in good faith and the sales were thus taxable).

71. Tex. Comp. Pub. Acc'ts, Hearing No. 32,834 (July 13, 1995), 1995 Tex. Tax LEXIS 336.

contractor did not pay tax on the materials used in the lump-sum contracts. The contractor, however, incorrectly added tax directly to the lump-sum billings of some of its customers. Technically, the state received most of the money due on the transactions at issue, but the tax was received from the wrong party (the buyers). The contractor sought to offset its tax deficiency from failure to pay tax on the materials with the erroneously submitted tax. The administrative law judge denied the offset, in part because the taxes were improperly collected from the buyers and those buyers could make refund claims that the contractor would be obligated to honor.<sup>72</sup>

## B. LEGISLATIVE CHANGES

The Regular Session of the Seventy-Fourth Legislature produced numerous amendments, additions, and revisions to the Texas Tax Code. Many of the tax revisions were intended as "cleanup" provisions to clarify existing law but the legislature made many substantive changes to the Tax Code as well.

As with past sessions, the legislature made numerous amendments to the taxable services provisions in a continuing effort to refine the proper application of sales tax to various services.<sup>73</sup> The legislature made several revisions to the definitions of certain taxable services in an effort to expand the definition of a particular taxable service or specifically exclude certain services from the taxable definition.

An amendment to the definition of "debt collection service" in section 151.0036 expanded the statutory definition to include a service performed for which a fee is collected under Article 9022<sup>74</sup> and to provide that the person collecting the check shall add the amount of tax to the fee and collect the fee from the drawer or endorser of the check.<sup>75</sup>

The definition of "information service" in section 151.0038 changed to exclude, and thus exempt from taxation, the furnishing of information to a member of a homeowners association of a residential subdivision or condominium development, if furnished by the association or on behalf of the association.<sup>76</sup>

Section 151.0048 excludes from the definition of "real property service" those services purchased by a contractor as part of the improvement of real property with a new structure to be used as a residence or other improvement immediately adjacent to the new structure and used in the

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72. *Id.* at \*11. However, since, under the comptroller's interpretation, the state would not pay refunds to the customers, the state could not be required to pay the refund amount more than once, so the state would not be harmed. *See also* Tex. Comp. Pub. Acc'ts, Hearing No. 32,838 (July 20, 1995), 1995 Tex. Tax LEXIS 441 (denying similar offset).

73. *See* S.B. 640, 74th Leg., R.S., (1000), 1995 Tex. Gen. Laws 5009 (Vernon).

74. TEX. REV. CIV. STAT. ANN. art. 9022 (Vernon Supp. 1996) (regarding a processing fee by the holder of a dishonored check).

75. TEX. TAX CODE ANN. § 151.0036(c) (Vernon Supp. 1996).

76. *Id.* § 151.0038(a)(1)(B).

residential occupancy of the structure.<sup>77</sup> The statute now includes a definition of "contractor" for purposes of this provision.<sup>78</sup>

The legislature also amended section 151.350 to clarify an exemption for labor to "restore" certain property damaged in a disaster area, and to define "restore" to include repair, restore or remodel to the extent the service is a real property repair or remodeling service or a taxable service.<sup>79</sup> The session also expanded the exemption for lawn services to allow exemption for services provided by self-employed individuals or by persons under 18 or over 65 if receipts from the services do not exceed \$5,000 in the most recent four quarters.<sup>80</sup> The legislature added an exemption for court reporting services relating to the preparation of a document or other record in a civil or criminal suit and sold to and prepared for a person involved in the suit.<sup>81</sup>

Several industry specific changes were made to the taxable service provisions. The amendment to section 151.0047 excludes, and therefore exempts from "real property repairs and remodeling," improvements to a manufacturing or processing production unit in a petrochemical refinery or chemical plant that provides increased capacity in the production unit.<sup>82</sup> Corresponding definitions for "increased capacity" and "production unit" were added.<sup>83</sup> In addition, the legislature amended sections 151.3111 and 151.3161 to provide a specific exemption for certain services and property used in commercial timber operations.<sup>84</sup>

The legislature also clarified and added provisions regarding exemptions for the sale of certain tangible personal property.<sup>85</sup> The amended exemption regarding newspapers and property used in newspaper publications deletes the provision that specified internal or external wrapping, packing and packing supplies were not exempt.<sup>86</sup> Section 151.313, which allows exemption for certain health care supplies, now includes hospital beds as medical equipment.<sup>87</sup>

The exemption for certain agricultural products, has been expanded to include certain pollution control equipment and to provide a definition of "original producer."<sup>88</sup> The amended section 151.342, which exempts certain agribusiness items, now includes an exemption for poultry cages used exclusively as containers in transporting poultry to processing.<sup>89</sup> The leg-

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77. *Id.* § 151.0048(b)(c).

78. *Id.*

79. *Id.* § 151.350. Prior to amendment the exemption referred to labor to "repair" certain property damaged in a disaster area. See TEX. TAX CODE ANN. § 151.350 (Vernon Supp. 1996).

80. TEX. TAX CODE ANN. § 151.347 (Vernon Supp. 1996).

81. *Id.* § 151.353 (Vernon Supp. 1996).

82. *Id.* § 151.0047(a)(3)(6).

83. *Id.* § 151.0047(b).

84. *Id.* §§ 151.3111(b)(5) and 151.3161 (Vernon Supp. 1996).

85. See S.B. 982, 74th Leg., R.S., (351), 1995 Tex. Gen. Laws 2881 (Vernon).

86. TEX. TAX CODE ANN. § 151.319(e)(5) (Vernon 1992 & Supp. 1996).

87. *Id.* § 151.313(a)(10) (Vernon Supp. 1996).

88. *Id.* § 151.316(a)(8), (c)(2) (Vernon 1992 & Supp. 1996).

89. *Id.* § 151.342(b) (Vernon Supp. 1996).

islature also revoked the sales tax exemption for food products, meals, soft drinks, and candy sold to prison inmates.<sup>90</sup> Under revised section 151.314, which exempts sales of certain food products by youth, the age of the seller to which the exemption applies is now 19 years, rather than 18.<sup>91</sup>

The legislature clarified the exemption for gas and electricity except when sold for commercial or residential use. "Residential use" is use by the owner of the building. The amendment expanded the definition of residential use to include such use by a tenant under a contract for an express initial term of more than 29 consecutive days.<sup>92</sup> In addition, the definition of "commercial use" now specifically excludes (and thereby exempts from sales tax) the off-wing processing, overhaul, or repair of a jet turbine engine or its parts for a certificated or licensed carrier of persons or property.<sup>93</sup>

Prior to 1995, the amount of the refund or the reduced amount of tax due regarding the manufacturing exemption of section 151.318 was determined on a graduated scale.<sup>94</sup> The phase-in is now complete and property that qualifies for the manufacturing exemption that is purchased on or after January 1, 1995, is exempted from the taxes imposed by Chapter 151.<sup>95</sup> The legislature made a significant amendment to the manufacturing exemption to include qualifying equipment leased for more than a year.<sup>96</sup> The exemption for property used in manufacturing was also extended to semiconductor fabrication cleanrooms and equipment and provided a definition of those terms.<sup>97</sup> In addition, the eligibility for manufacturing exemption regarding certain aircraft repair expands to include supplies used in electrochemical plating or a similar process, such as aluminum oxide, nitric acid, and sodium cyanide.<sup>98</sup>

The legislature made several transportation-related amendments to the sales and use tax provisions. The definition of exempt aircraft has changed to specify the conditions under which aircraft used for flight instruction are exempt.<sup>99</sup> The amendment also clarifies that the exemption

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90. *Id.* § 151.314(g). (Does this repeal mean that prisoners will allege cruel and unusual punishment?).

91. TEX. TAX CODE ANN. § 151.314(e)(1) (Vernon 1992 & Supp. 1996).

92. *Id.* § 151.317(c)(1)(B).

93. *Id.* § 151.317(c)(2)(A)(v).

94. *Id.* § 151.318(h) (Vernon 1992).

95. *Id.*; see *supra* note 47.

96. TEX. TAX CODE ANN. § 151.318(e) (Vernon Supp. 1996). The statute previously provided that the exemption did not apply to any taxable item rented or leased to a person engaged in manufacturing (except for certain video, broadcast, etc. under § 151.318(p)). See *id.* (Vernon 1992).

97. *Id.* § 151.318(b)(2)(9) (Vernon Supp. 1996). The exemption is for all tangible personal property used in connection with the manufacturing, processing or fabrication in a cleanroom environment of a semiconductor product, regardless of whether the property is actually used in the cleanroom environment. The exemption does not include the building or a permanent, nonremovable component of the building that houses the cleanroom environment, but does include moveable cleanroom partitions and cleanroom lighting. *Id.*

98. *Id.* § 151.318(n).

99. *Id.* § 151.328(a)(2)(B).

for repair, remodeling and maintenance services for certificated or licensed carriers is applicable to persons who provide flight instruction. The expanded list of exempt items now includes supplies used or consumed in the repair, remodeling or maintenance of aircraft, and exempts tangible personal property necessary in normal aircraft operations, as well as any property pumped, poured or otherwise placed in the aircraft.<sup>100</sup> The legislature adopted an exemption for electricity, natural gas and other fuel used predominately in repairing, maintaining, or restoring railroad rolling stock.<sup>101</sup> The legislature also amended the sales tax exemption regarding stevedoring services to include materials and supplies purchased for a ship or vessel operating exclusively in foreign or interstate coastal commerce, if the materials and supplies are loaded aboard the ship or vessel and are not removed before departure.<sup>102</sup>

The legislature amended section 151.154 regarding resale certificates to clarify that the liability of a purchaser for use other than resale applies to the divergent use of any taxable item (as opposed to the previous language which specified only tangible personal property).<sup>103</sup> Liability is imposed with respect to the value of the tangible personal property or the value of the taxable service.<sup>104</sup> The original purchase price is the measure of tax for tangible personal property without a fair market rental value or a taxable service with no fair market value; tax for divergent use may be paid on the original purchase price without credit for taxes previously paid.<sup>105</sup> Similar provisions regarding divergent use and the fair market value of tangible personal property and taxable services were also added to section 151.155 regarding exemption certificates.<sup>106</sup>

The legislature amended several sales tax provisions to specifically address the application of the resale provisions to sales made in Mexico as well as the exchange of confidential tax information between the two countries.<sup>107</sup> The amendment to section 151.006 broadens the sale-for-resale exemption to include the purchase of tangible personal property or a taxable service in Texas for resale, lease or transfer to another in the United Mexican States.<sup>108</sup> Correspondingly, section 151.152 now provides the resale certificate requirements for such sales.<sup>109</sup> The amendment allows resale certificates to be issued to persons reselling in Mexico if the reseller provides a United Mexican States federal identification number and any other comptroller required information, in addition to

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100. *Id.* § 151.328(b),(d),(e).

101. TEX. TAX CODE ANN. § 151.331(b) (Vernon Supp. 1996).

102. *Id.* § 151.329(4) (Vernon 1992 & Supp. 1996).

103. *Id.* § 151.154(d) (Vernon Supp. 1996).

104. *Id.* The value of a taxable service is the fair market value; the amount that a purchaser would pay on the open market to obtain the service for their own use.

105. *Id.* § 151.154(b).

106. *Id.* § 151.155(b).

107. See S.B. 982, 74th Leg., R.S., (351), 1995 Tex. Gen. Laws 2881 (Vernon).

108. TEX. TAX CODE ANN. § 151.006 (Vernon Supp. 1996).

109. *Id.* § 151.152(c). Prior to this amendment, the purchaser could obtain a refund from the Texas retailer after securing acceptable documentation proving the items were exported beyond the territorial limits of the United States.

the current requirements for resale certificates.<sup>110</sup>

The revised section 151.027, regarding confidentiality of tax information, authorizes the comptroller to allow the examination of certain confidential tax information by officials of the United Mexican States.<sup>111</sup> Section 111.006, which pertains to the confidentiality of information such as federal tax return information and information obtained during the course of an examination by the comptroller, now provides an exception to such confidentiality and allows examination by certain state, federal and United Mexican States officials or representatives, provided that the examination is authorized by the comptroller and a reciprocal agreement exists with respect to similar information.<sup>112</sup>

Several other amendments were made to various taxes including the motor vehicle tax,<sup>113</sup> insurance taxes,<sup>114</sup> severance taxes<sup>115</sup> and mixed beverage taxes.<sup>116</sup>

### C. REGULATORY UPDATE

Many administrative rules were amended during the Survey period, most of which were in response to the legislative changes enacted during the 1995 session. Some of the amendments remained in proposed form at the end of the Survey period and the comptroller was still in the process of drafting rules to implement the legislative changes.

During the Survey period the comptroller adopted an amendment to Rule 3.319 to deny prior contract relief to two-party contracts.<sup>117</sup> This amendment officially enacted a policy change instituted by the comptroller in 1992 that specified that only third-party contracts could qualify for exemption as a prior contract.<sup>118</sup> The amendment excludes two-party contracts if enabling legislation allows the exemption when the items are used "for or in the performance of a contract."<sup>119</sup> In addition, the amendments delete the requirement that both parties sign the contract<sup>120</sup>

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110. *Id.*

111. *Id.* § 151.027(c).

112. *Id.* § 111.006(d).

113. See S.B. 1445, 74th Leg., R.S., (1015), 1995 Tex. Gen. Laws 5077 (Vernon).

114. See S.B. 641, 74th Leg., R.S., (279), 1995 Tex. Gen. Laws 2619 (Vernon).

115. See H.B. 398, 74th Leg., R.S., (895), 1995 Tex. Gen. Laws 4415 (Vernon).

116. See S.B. 643, 74th Leg., R.S., (1001) 1995 Tex. Gen. Laws 5030 (Vernon).

117. 20 Tex. Reg. 1009 (1995), adopted 20 Tex. Reg. 3839 (1995) (to be codified as an amendment to 34 TEX. ADMIN. CODE § 3.319).

118. *Id.*

119. *Id.* Interestingly the preamble to Rule 3.319 provides that the amendment is applied retroactively "to ensure continuity in the comptroller's application" of *Calvert v. British-American Oil Producing Co.*, 397 S.W.2d 839 (Tex. 1965). Although the comptroller is relying on *British-American* to justify denying prior-contract status to two-party contracts, it appears that such a change in policy is subject to challenge. This is particularly likely in view of the comptroller's statement with respect to a prior version of this rule, that the rule "applies to two-party contracts as well as the traditional three-party contracts," as well as apparent lack of legislative authority for the change. See 13 Tex. Reg. 1340 (Mar. 18, 1988).

120. 20 Tex. Reg. 1009 (1995), adopted 20 Tex. Reg. 3839 (1995) (to be codified as an amendment to 34 TEX. ADMIN. CODE § 3.319(a)(2)). This change brings the rule into con-

and allow the exemption for contracts with open price terms.<sup>121</sup> The amendment to Rule 3.319 continues to provide that any renewal or extension of an option to extend the terms will be considered a new contract and deletes previous specific references to "renegotiation of terms" being considered a new contract.<sup>122</sup>

The comptroller also amended several rules regarding taxable services. The comptroller adopted amendments to the rules concerning data processing services, security services, information services, credit reporting services, debt collection services, insurance services and real property services to allow separation of nontaxable charges for unrelated services after a contract for taxable services has been executed.<sup>123</sup> The comptroller also amended the rule concerning motor vehicle parking and storage to reflect current comptroller policy on the taxability of charges for parking and storage services of vehicles when the services include transportation charges.<sup>124</sup>

Numerous amendments have been adopted or proposed in response to the statutory amendments to the Tax Code by the Seventy-Fourth Legislature. Rule 3.354 was amended to impose tax on the processing fee charged by a person collecting a dishonored check.<sup>125</sup> In December of 1995 the comptroller issued a draft of a proposed amendment to the rule concerning information services to reflect the statutory exemption for information provided to a homeowners association member.<sup>126</sup> A draft of a proposed amendment to Rule 3.356 concerning real property services, was issued to incorporate legislative changes that exclude services purchased by a contractor in connection with the building of new resi-

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formity with Tex. Comp. Pub. Acc'ts, Hearing No. 27,421 (June 26, 1991), 2 [Tex.] ST. TAX REP. (CCH) ¶ 401-540 (holding that prior contract exemption does not require both parties' signature).

121. 20 Tex. Reg. 1009 (1995), *adopted* 20 Tex. Reg. 3839 (1995) (to be codified as an amendment to 34 TEX. ADMIN. CODE § 3.319(c)(4)). This amendment provides that a contract would not lose its prior contract exemption solely due to a change in price if the parties intend that the contract shall remain binding regardless of the change in price and the contract does not expressly provide that changes in price terminate the contract. *See also* Tex. Comp. Pub. Acc'ts, Hearing No. 26,510 (Oct. 2, 1991), 2 [Tex.] ST. TAX REP. (CCH) ¶ 401-519.

122. *See* Tex. Comp. Pub. Acc'ts, Hearing No. 28,263 (Jan. 12, 1993), 1993 Tex. Tax LEXIS 3 (holding that the portion of Rule 3.319 which eliminated the prior contract exemption for a renegotiated contract is invalid when the parties to the contract intended to allow price increases pursuant to the terms of the contract).

123. 20 Tex. Reg. 1749 (1995) (to be codified as an amendment to 34 TEX. ADMIN. CODE §§ 3.330, 3.333, 3.342, 3.343, 3.354, 3.355, 3.356); 20 Tex. Reg. 1762 (1995) (to be codified as an amendment to 34 TEX. ADMIN. CODE § 3.357). *See 1995 Tax Survey, supra* note 18, 1591 for a discussion of the amendments as proposed.

124. 20 Tex. Reg. 1328 (1995), *adopted* 20 Tex. Reg. 6333 (1995) (to be codified as an amendment to 34 TEX. ADMIN. CODE § 3.315(a)). The amendment provides that if the charge for parking and storage services either includes a charge for transportation services or is in addition to a separately stated charge for transportation services, sales tax is due on the entire charge, including any separately stated transportation charges.

125. 20 Tex. Reg. 8991 (1995), *adopted* 21 Tex. Reg. 601 (1995) (to be codified as an amendment to 34 TEX. ADMIN. CODE § 3.354).

126. 34 TEX. ADMIN. CODE § 3.342 (West 1995).

dences and exclude lawn services provided by certain individuals.<sup>127</sup> Additionally, a draft of a new Rule 3.363 has been proposed concerning court reporting services to implement new legislation regarding taxation of certain court reporting and video photography services.<sup>128</sup> Generally the proposed rule provides that court reporting services sold to a participant in a suit is a nontaxable service, but such services are taxable when sold to nonparticipants.<sup>129</sup>

The comptroller also issued a draft of several proposed amendments to Rule 3.297 concerning carriers.<sup>130</sup> The amendments pertain to certain exemptions relating to stevedoring companies, aircraft and engines, including specific provisions regarding flight school aircraft, and the repair, maintenance or restoration of rolling stock.<sup>131</sup> The comptroller has proposed amendments to the rule regarding natural gas and electricity in order to conform to the legislative changes defining as noncommercial use certain rolling stock and aircraft engine processing and repair and expanding the definition of residential use.<sup>132</sup> The comptroller has also proposed amendments to Rule 3.295 to set forth the comptroller's policy that repairing tangible personal property of another is not exempt processing<sup>133</sup> and to implement a policy change waiving the requirement for a predominate use study for certain exempt industries.<sup>134</sup>

Amendments have been proposed to the manufacturing exemption to extend the exemption to equipment leased for more than one year and to implement the exemption added by the legislature for semiconductor fabrication cleanrooms and equipment.<sup>135</sup> Likewise, proposed amendments have been made to exclude from "real property repair and remodeling" those services that provide increased capacity in a production unit in a petrochemical refinery or a chemical plant.<sup>136</sup> Proposed amendments have been made to Rule 3.296 concerning agriculture, animal life, feed, seed, plants and fertilizer, in order to implement retroactively legislative changes and a policy change restating the qualifications for "origi-

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127. Draft of proposed revisions to 34 TEX. ADMIN. CODE § 3.356 (Dec. 5, 1995) (on file with the author). The draft of the proposed amendment adds a definition of contractor and specifically includes a definition of residence or residential real property, and a list of the type of services that are taxable real property services for residential or nonresidential real property, which include landscaping, lawn and yard maintenance, the removal or collection of garbage, building or grounds cleaning services, structural pest control service or the surveying of real property.

128. Draft of proposed Rule 34 TEX. ADMIN. CODE § 3.363 (Dec. 5, 1995) (on file with the author). The comptroller states in the preamble of the draft of proposed Rule 3.363 that the changes codify long-term administrative policy concerning the taxation of court reporting services. *Id.*

129. *Id.*

130. Draft of proposed revisions to 34 TEX. ADMIN. CODE § 3.297 (Dec. 5, 1995) (on file with author).

131. *Id.*

132. 20 Tex. Reg. 9379 (1995) (prop. amend. to 34 TEX. ADMIN. CODE § 3.295(a)(5),(8)).

133. *Id.* § 3.295(a)(7).

134. *Id.* § 3.295(e)(5).

135. 20 Tex. Reg. 10182 (1995) (prop. amend. to 34 TEX. ADMIN. CODE § 3.300).

136. 20 Tex. Reg. 8598 (1995) (prop. to be codified at 34 TEX. ADMIN. CODE § 3.362).

nal producer" to mean a person who produces at least fifty percent of the products which are ultimately processed, packed or marketed.<sup>137</sup> Amendments were also proposed to implement recent legislative changes adding exemptions for certain containers, bins or cages and for certain pollution control equipment.<sup>138</sup>

Proposed amendments to Rule 3.314 reflect the legislative exemption for certain wrapping and packaging supplies used by newspapers and the exemption for certain materials and supplies used in certain stevedoring services.<sup>139</sup> The comptroller proposed amendments to Rule 3.284 concerning drugs, medicines, medical equipment and devices to reflect the legislative codification of a long-term administrative policy that exempts hospital beds.<sup>140</sup> The amended rule clarifies the requirements for a patient to qualify for an exemption to obtain a hot tub, spa or similar appliance.<sup>141</sup>

Proposed amendments to Rule 3.293 concerning food and food products reflect the legislature's repeal of the exemption for food products sold to prison inmates and the legislative change which raised the maximum age of eligible members of certain nonprofit groups who can make exempt food sales to 19.<sup>142</sup> The comptroller also proposed an amendment to the occasional sale rule to exempt certain sales by colleges and student organizations and certain sales by senior citizen organizations.<sup>143</sup>

Amendments have also been proposed to the resale provisions to implement the statutory changes adopted by the legislature. One such proposal would allow the acceptance of valid and properly completed resale certificates from Mexican retailers.<sup>144</sup> Additional proposed amendments to Rule 3.285 conform to recent legislation and include the value of taxable items, the value of tangible personal property and the value of a taxable service, if a purchaser who gave a valid resale certificate makes a divergent use.<sup>145</sup> Likewise, the comptroller has adopted a similar amendment to the rule concerning exemption certificates.<sup>146</sup>

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137. 20 Tex. Reg. 8989 (1995) (prop. amend. to 34 TEX. ADMIN. CODE § 3.296).

138. *Id.* § 3.296(b).

139. 20 Tex. Reg. 8990 (1995) (prop. amend. to 34 TEX. ADMIN. CODE § 3.314(b)(2),(j)).

140. 20 Tex. Reg. 10745 (1995) (prop. amend. to 34 TEX. ADMIN. CODE § 3.284).

141. 19 Tex. Reg. 8098 (1995), *adopted* 20 Tex. Reg. 1337 (1995) (to be codified as an amendment to 34 TEX. ADMIN. CODE § 3.284).

142. 20 Tex. Reg. 10748 (1995) (prop. amend. to 34 TEX. ADMIN. CODE § 3.293(b)(9), (c)(2)(D)).

143. 20 Tex. Reg. 10749 (1995) (prop. amend. to 34 TEX. ADMIN. CODE § 3.316(j),(k)).

144. 20 Tex. Reg. 10368 (1995) (prop. amend. to 34 TEX. ADMIN. CODE § 3.285). The proposed amendment states that an acceptable form of resale certificate now includes a Border States Uniform Sale for Resale Certificate. *Id.*

145. *Id.* (prop. amend. to 34 TEX. ADMIN. CODE § 3.285(e)).

146. 21 Tex. Reg. 599 (1995) (to be codified as an amendment to 34 TEX. ADMIN. CODE § 3.287(e)).

## II. FRANCHISE TAX

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

Some of the most significant challenges to the franchise tax during the Survey period involved the validity of the tax itself rather than the question of whether particular taxpayers were "doing business" for purposes of the tax. Taxpayers challenged both the income tax component<sup>147</sup> and the capital component<sup>148</sup> of the franchise tax. For example, in *General Dynamics Corp. v. Sharp*<sup>149</sup> the district court upheld the constitutionality of the 1991 enactment of the earned surplus component of the franchise tax. In 1992, General Dynamics recognized almost one billion dollars of income from the completion of a long-term military aircraft manufacturing contract. General Dynamics made several constitutional challenges to the tax on earned surplus, including arguing that: (1) the addition of the earned surplus tax to the franchise tax statute was an unconstitutional retroactive income tax because it was based in part on income and receipts recognized prior to the passage or effective date of the law; (2) the single-factor gross receipts formula violates due process, equal protection and discriminates against interstate commerce; (3) the tax discriminates against the taxpayer because it used the completed contract method of accounting for federal income tax purposes; and (4) the tax violates equal protection and uniform taxation mandates.<sup>150</sup> The court granted summary judgment in favor of the state and General Dynamics has appealed.<sup>151</sup> In addition, several comptroller hearings have upheld the taxable capital portion of the Texas franchise tax.<sup>152</sup>

Since the tax applies only to corporations and certain other entities that do business in Texas, taxpayers continue relying on trusts, partnerships and reorganizations in an effort to mitigate the effect of Texas' franchise tax.<sup>153</sup> Fortunately for Texas businesses, significant tax planning opportunities remain.<sup>154</sup>

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147. The income component, officially called the "earned surplus" component (for the tax purists), is a 4.5% tax on a taxpayer's earned surplus apportioned to Texas and is computed by reference to federal income, as modified in accordance with the Texas Tax Code. See generally, TEX. TAX CODE ANN. §§ 171.002, 171.106, 171.110 (Vernon 1992 & Supp. 1996).

148. The taxable capital component is a .25% tax on a taxpayer's taxable capital apportioned to Texas. See generally, TEX. TAX CODE ANN. §§ 171.002, 171.106 (Vernon 1992). The amount of a taxpayer's tax liability is, for practical purposes, the greater of the earned surplus component and the taxable capital component.

149. No. 9211498 (353rd Dist. Ct. Travis County, Tex., Apr. 13, 1995), *appeal pending*.

150. *Id.*

151. *Id.*

152. See, e.g., Tex. Comp. Pub. Acc'ts, Hearing Nos. 31,578, 32,016, 32,017, 32,018 (Feb. 10, 1995), 1995 Tex. Tax LEXIS 56 (holding that the capital-based component of the Texas franchise tax does not violate Public Law 86-272 because the tax is not measured by net income); see also Tex. Comp. Pub. Acc'ts, Hearing No. 32,873 (Mar. 7, 1995), 1995 Tex. Tax LEXIS 139 (similar facts and holding).

153. See 1995 Tax Survey, *supra* note 18, at 1591-93 for a discussion of some of the more common planning alternatives.

154. The legislature faces a difficult—and continuing—challenge in its efforts to revamp the franchise tax while simultaneously keeping Texas an attractive home for businesses.

B. CALCULATION AND ALLOCATION OF TAXABLE CAPITAL AND  
EARNED SURPLUS

In a significant taxpayer victory, Decisions 27,377 and 27,378 held that the comptroller could not require the corporate taxpayer to use push-down accounting on the facts of that case.<sup>155</sup> The decisions point out that generally accepted accounting principles ("GAAP") do not require the corporate taxpayer to use push-down accounting and that, because section 171.109 of the Tax Code required only that the taxpayer employ GAAP principles, the comptroller may not by rule limit the taxpayer to only one GAAP principle.<sup>156</sup> The legislature has since prohibited the use of push-down accounting.<sup>157</sup> Likewise, the comptroller has amended Rule 3.547 to prohibit the use of push-down accounting in computing surplus on reports due on or after January 1, 1994.<sup>158</sup>

Several recent comptroller decisions have focused on the types of accounting changes the comptroller will permit. In Decision 30,118 the comptroller correctly held acceptable a pre-planned conversion from the double declining balance method of depreciation to the straight line method in accordance with the depreciation rules under the Internal Revenue Code.<sup>159</sup> The tax division argued that this automatic change constituted choosing a different method of accounting, so that a corporation could not make such a change more than once every four years without the comptroller's consent. This is one of several recent cases that focused on permitted accounting changes.<sup>160</sup>

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For example, the debate continues as to whether the legislature should impose the franchise tax on trusts and partnerships. Although these entities are sometimes formed to minimize franchise tax, it is also noteworthy that much investment in Texas property is currently through such entities—and has been through such entities since well before the earned surplus component of the franchise tax was enacted.

155. Tex. Comp. Pub. Acc'ts, Hearing Nos. 27,377 & 27,378 (Mar. 24, 1993), 2 [TEX.] ST. TAX REP. ¶ 401-701.

156. *Id.* at 25,828. TEX. TAX CODE ANN. § 171.109 (Vernon 1992); *see also* Tex. Comp. Pub. Acc'ts, Hearing Nos. 29,404 & 29,405 (Nov. 30, 1993), 1993 Tex. Tax LEXIS 288 (denying taxpayer's request to amend returns to use historical cost basis for 1987 report year, rather than push-down basis; contrasting taxpayer-favorable decisions); Tex. Comp. Pub. Acc'ts, Hearing No. 27,072 (June 8, 1995), 1995 Tex. Tax. LEXIS 277 (similar facts and holding).

157. *See* TEX. TAX CODE ANN. § 171.109(m) (Vernon Supp. 1996).

158. 20 Tex. Reg. 1277 (Feb. 21, 1995) (to be codified as an amendment to 34 TEX. ADMIN. CODE § 3.547 (Taxable Capital: Accounting Methods)). For periods prior to 1994, the corporation should use either the push-down method or historical cost method, but (according to the comptroller) not negative push-down.

159. Tex. Comp. Pub. Acc'ts, Hearing No. 30,118 (Apr. 14, 1995), 1995 Tex. Tax LEXIS 231.

160. *Id.* at \*7; *see also* Tex. Comp. Pub. Acc'ts, Hearing No. 31,592 (May 9, 1995), 1995 Tex. Tax LEXIS 244 (same conclusion with respect to change of depreciation method to a hybrid method, using double declining balance method until the midpoint of the asset's service life and then changing to straight line); Tex. Comp. Pub. Acc'ts, Hearing No. 26,765 (Nov. 2, 1994), 1994 Tex. Tax LEXIS 424 (permitting taxpayers to switch from units of production depreciation to the double declining balance; proposed administrative decision had ruled for state on this point); Tex. Comp. Pub. Acc'ts, Hearing No. 29,831 (Oct. 12, 1994), 1994 Tex. Tax LEXIS 441 (finding changes in length of estimated useful life and salvage value not permitted as change of accounting method); Tex. Comp. Pub. Acc'ts,

*Pennzoil Co. v. Sharp*,<sup>161</sup> which the parties settled is triggering changes in comptroller policy on apportionment of gross receipts for franchise tax purposes. Pennzoil had received a multi-million dollar judgment and, pursuant to the comptroller's rules, was required to allocate the entire award to Texas, thereby dramatically skewing its Texas receipts factor.<sup>162</sup> As a result of a summary judgment for Pennzoil based on the agreed final judgment, the court held that the rule which apportions litigation awards to the commercial domicile of the recipient corporation is contrary to the Tax Code and invalid.<sup>163</sup> Pennzoil was allowed, therefore, to apportion its litigation award based on the location of the payor, that is, the legal domicile of the entity paying the award. This decision resulted in a \$23,000,000 refund to Pennzoil and the parties agreed to waive their right to appeal or challenge the final judgment.<sup>164</sup> Comptroller representatives have indicated that the Comptroller will be reviewing and may revise some of the franchise tax apportionment rules, although no revisions had been adopted by the end of the Survey period.

A significant number of decisions addressed the computation of taxable capital for franchise tax purposes. Decision 31,669 for example, involved a taxpayer who wrote off the stock in two subsidiaries as worthless.<sup>165</sup> Under Rule 3.405 as then in effect, a direct write-off of an asset requires that a "specifically identifiable event" have occurred.<sup>166</sup> The administrative law judge concluded that the "specifically identifiable event" required under the rule is the actual dissolution of the subsidiaries.<sup>167</sup> The taxpayer did not show that the subsidiaries were legally dissolved; therefore, the value of the taxpayer's investment in the subsidiaries could not be written-off for franchise tax purposes. Similarly, in Decision 27,866 the comptroller held that a corporation could not write-off, for franchise tax purposes, the values of its shell subsidiaries.<sup>168</sup> The tax division argued that the losses in the shells were unrealized and could not be written off because the subsidiaries remained in existence,

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Hearing No. 29,757 (Sept. 21, 1994), 1994 Tex. Tax LEXIS 349 (permitting conversion from units of production to double declining balance); Tex. Comp. Pub. Acc'ts, Hearing No. 28,893 (Aug. 16, 1994), 1994 Tex. Tax LEXIS 374 (addressing accelerated depreciation versus straight-line; inquiry focused in part on whether taxpayer's first set of amended returns related back to the original filing date).

161. No. 9400974 (200th Dist. Ct., Travis County, Tex., Mar. 3, 1995) (Agreed Final Jmt., Mar. 3, 1995).

162. See 34 TEX. ADMIN. CODE § 3.403(e)(8) (Vernon 1995) (as then in effect); for current versions of the apportionment rules, see 34 TEX. ADMIN. CODE § 3.549 (West 1996) (Taxable Capital: Apportionment) and *id.* § 3.557 (Earned Surplus: Apportionment).

163. *Pennzoil*, No. 9400974 (200th Dist. Ct., Travis County, Tex., Mar. 3, 1995) (Agreed Final Jmt., Mar. 3, 1995).

164. *Id.*

165. Tex. Comp. Pub. Acc'ts, Hearing No. 31,669 (June 30, 1995), 1995 Tex. Tax LEXIS 295.

166. 34 TEX. ADMIN. CODE § 3.405 (currently 34 TEX. ADMIN. CODE § 3.551(e)(10) (West 1996)).

167. 1995 Tex. Tax LEXIS 295, at \*7-8.

168. Tex. Comp. Pub. Acc'ts, Hearing No. 27,866 (Apr. 30, 1992), 2 [TEX.] ST. TAX REP. (CCH) ¶ 401-596.

and the comptroller concluded that the shells had some residual value.<sup>169</sup>

In a debt-equity case raising an issue of first impression, the comptroller addressed whether the existence of a conversion provision requires a mandatorily-redeemable preferred stock to be considered equity, as opposed to debt. Decision 32,536 involved a taxpayer that issued shares of convertible preferred stock that had a mandatory redemption provision and an optional conversion provision. The administrative law judge determined that, at the end of each calendar year at issue, the taxpayer had no way of knowing how much of the preferred stock might be converted to common stock, and thus how much the taxpayer would be relieved of redeeming in cash. The judge therefore concluded that the stock did not meet the statutory definition of debt in that the convertibility provision was a contingency that made the redemption obligation less than certain in amount.<sup>170</sup>

In *Caterpillar, Inc. v. Sharp*,<sup>171</sup> one of the most significant decisions rendered during the Survey period, the court concluded that Caterpillar could deduct from its surplus certain retirement obligations. Caterpillar had argued that ERISA bars the state from including certain post-retirement benefit obligation accounts in its taxable capital franchise tax base and that the accounts at issue were "debt" and thus should be excluded from taxable surplus in determining Texas franchise tax.<sup>172</sup> The district court granted Caterpillar summary judgment. According to the comptroller's newsletter<sup>173</sup> the state currently does not plan to pay any related refunds unless the state loses all appeals, although the newsletter notes that refund claims should be addressed to the Refund Claims Verification Section in Revenue Accounting. Numerous administrative decisions address the same or similar issues, but hold in favor of the comptroller.<sup>174</sup>

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169. *Id.* at 25,473.

170. Tex. Comp. Pub. Acc'ts, Hearing No. 32,536 (Feb. 23, 1995), 2 [TEX.] ST. TAX REP. (CCH) ¶ 401-850.

171. No. 93-11176 (299th Dist. Ct., Travis County, Tex., Mar. 23, 1995), *appeal pending*.

172. *Caterpillar, Inc. v. Sharp*, No. 9311176 (229th Dist. Ct. Travis County, Tex., Oct. 28, 1994) (plaintiff's motion for summary judgment).

173. TAX POLICY NEWS, Apr. 1995, at 4-5. Oral argument on the appeal was scheduled for early 1996.

174. See, e.g., Tex. Comp. Pub. Acc'ts, Hearing No. 31,669 (June 30, 1995), 1995 Tex. Tax LEXIS 295 (prepaid pension assets; the amount by which the fair value of the pension plan assets exceeded the accumulated benefit obligations are includible in taxable surplus); Tex. Comp. Pub. Acc'ts, Hearing No. 31,659 (Jan. 17, 1995), 1995 Tex. Tax LEXIS 54 (overfunded pension amounts were held not to qualify as debt under TEX. TAX CODE ANN. § 171.109 (Vernon 1992 & Supp. 1996) and were thus included in taxable surplus); Tex. Comp. Pub. Acc'ts, Hearing No. 31,634 (Nov. 22, 1994), 1994 Tex. Tax LEXIS 538 (various accounts, including accrued vacation pay, royalties, product liability and others, not excludable from surplus); Tex. Comp. Pub. Acc'ts, Hearing No. 31,359 (Oct. 7, 1994), 1994 Tex. Tax LEXIS 483 (pension liability account, vacation pay liability account are not debt within meaning of TEX. TAX CODE ANN. § 171.109(a)(3)); Tex. Comp. Pub. Acc'ts, Hearing No. 30,563 (Oct. 28, 1994), 1994 Tex. Tax LEXIS 511 (taxpayer not entitled to deduct unfunded employee benefit accounts, including pension plan, vested vacation, worker's compensation and other plans from surplus); Tex. Comp. Pub. Acc'ts, Hearing No. 31,153 (Oct. 7, 1994), 2 [TEX.] ST. TAX REP. (CCH) ¶ 401-838 (holding that prepaid pension assets booked as non-current assets, in accordance with GAAP and FASB 87, must be included in surplus).

Similarly, numerous comptroller decisions support the comptroller's view that operating lease obligations are not considered debt for franchise tax purposes and may not be deducted from surplus.<sup>175</sup>

In *Central Power and Light Co. v. Sharp*,<sup>176</sup> the court focused on whether allocation for funds used during construction is debt. The taxpayer, a regulated utility, argued that it should be allowed to exclude from surplus capitalized interest on equity funds for construction projects (AFUDC), which are taken into account in setting taxpayer's rates. The taxpayer also argued that the comptroller's position created a violation of the constitutional requirement of equal and uniform taxes in that GAAP required different accounting for regulated and non-regulated companies, and that the legislature unconstitutionally delegated its authority to the Financial Accounting Standards Board (FASB) by adopting a GAAP standard. The district court granted summary judgment in favor of the comptroller and the taxpayer has appealed.<sup>177</sup>

Other decisions address issues raised in the context of affiliated groups of corporations. Decision 26,610 for example, addresses the taxpayer's investment in its subsidiary for purposes of determining surplus after the investment was converted from the equity basis to the cost basis.<sup>178</sup> Despite the taxpayer's argument that the comptroller's method of reporting resulted in consolidated reporting, which is prohibited by the Tax Code, the administrative law judge held that the pre-acquisition equity earnings of a second-tier subsidiary are included in a parent corporation's surplus.<sup>179</sup> In Decision 32,584<sup>180</sup> the administrative law judge found that a dividend could not be excluded from surplus until the date of normal declaration by the board, although book entries and intent to declare dividend occurred earlier.

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175. See, e.g., Tex. Comp. Pub. Acc'ts, Hearing No. 29,701 (June 28, 1995), 1994 Tex. Tax LEXIS 209 (no deduction from surplus allowed for operating lease obligations). *Texas Utilities Electric Co. v. Sharp*, No. 9307563 (250th Dist. Ct., Travis County, Tex.), filed June 23, 1993, is one of many cases still pending in which taxpayers have challenged the comptroller's assertion that operating lease obligations are not "debt" within the meaning of section 171.109(a)(3) of the Texas Tax Code and therefore may not be deducted from surplus.

176. No. 912800 (147th Dist. Ct., Travis County, Tex., Dec. 21, 1994), *appeal pending*.

177. By contrast, the legislature based franchise tax calculations on the Internal Revenue Code as of a particular date. See TEX. TAX CODE ANN. § 171.001(b)(5) (Vernon Supp. 1996).

178. Tex. Comp. Pub. Acc'ts, Hearing No. 26,610 (July 11, 1995), 1994 Tex. Tax LEXIS 270.

179. *Id.* at \*4-6.

180. Tex. Comp. Pub. Acc'ts, Hearing No. 32,584 (Dec. 29, 1994), 1994 Tex. Tax LEXIS 594; see also TAX POLICY NEWS, Aug. 1994 at 5, (noting that dividends are excluded from taxable capital as of the date of declaration if they are declared in accordance with the state of incorporation law and are paid within one year); TEX. TAX CODE ANN. § 171.109(f) (Vernon Supp. 1996).

C. LEGISLATIVE CHANGES AND CORRESPONDING REGULATORY DEVELOPMENTS

Several significant franchise tax amendments are in Senate Bill 644.<sup>181</sup> For example section 171.063 of the Tax Code, amended to expand the nonprofit corporation exemption from franchise tax, now includes corporations exempted under Internal Revenue Code sections 501(c)(8), (10) or (19).<sup>182</sup> A new section 171.087 exempts nonprofit corporations organized for student loan funds or student scholarship purposes.<sup>183</sup> Section 171.082, regarding the nonprofit corporation exemption for certain homeowners' associations, clarifies that in order to qualify for exemption, the owners of individual lots, residences or residential units must control at least 51% of the votes of the corporation. Voting control cannot be held by a single individual or family or developers, declarants, banks, investors or similar parties, and to provide a definition of "residential."<sup>184</sup>

The legislature "clarified" the meaning of a business loss by amending Section 171.110(e)<sup>185</sup> to provide that a business loss is any negative amount after apportionment and allocation. In September 1995, the comptroller informally issued a draft proposed amendment to Rule 3.555 to reflect this legislation. The draft rule also includes a restriction prohibiting a corporation from conveying, assigning or transferring a business loss to another entity, including by merger.<sup>186</sup>

Other changes affecting the calculation of the franchise tax include amendments to Section 171.112.<sup>187</sup> These changes require a corporation, except as otherwise provided, to use the same accounting methods to apportion its taxable capital as are used to compute its taxable capital.<sup>188</sup> Revised section 171.1531<sup>189</sup> precludes a refund to the survivor of a merger of franchise tax that was paid by nonsurvivors; only credits against tax computed on net taxable capital will be allowed. In response to this legislation, and 1991 legislation, the comptroller issued a draft of a proposed new Rule 3.577 in September 1995<sup>190</sup>, which provides that the surviving corporation of a merger may not take a credit under section 171.0021.<sup>191</sup>

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181. 74th Leg., R.S., (1002), 1995 Tex. Sess. Law Serv. 5033 (Vernon) (generally eff. Jan. 1, 1996, and applying to reports originally due on or after that date).

182. See TEX. TAX CODE ANN. § 171.063 (Vernon Supp. 1996).

183. *Id.* § 171.087.

184. *Id.* § 171.082.

185. *Id.* § 171.110(e).

186. If proposed, the amendments would be proposed to 34 TEX. ADMIN. CODE § 3.555 (Earned Surplus: Computation) [hereinafter *Draft Proposal*] (on file with author).

187. TEX. TAX CODE ANN. § 171.112 (Vernon Supp. 1996).

188. *Id.*

189. *Id.* § 171.1531.

190. If proposed, the new rule would be proposed as 34 TEX. ADMIN. CODE § 3.577 (Credit for Sales Tax Paid on Property Used in Manufacturing). The rule also addresses the sales tax credit.

191. TEX. TAX CODE ANN. § 171.0021 (Vernon 1992 & Supp. 1996) (temporary credit for sales tax paid on property used in manufacturing for tax paid by a non-surviving entity).

The legislature also amended section 171.203, with respect to the filing of a public information report, imposing the requirement to send a copy of the report to each person named in the report who is not currently employed by the corporation or a related corporation.<sup>192</sup> In addition, a certification by an officer or director that the information is true and correct to the best of their knowledge and that copies have been sent to the required persons is required to be included on the report.<sup>193</sup>

Although the Tax Code is drafted to follow GAAP (and its changes), the legislature defined the Internal Revenue Code at a single point in time, thereby requiring taxpayers to calculate their franchise taxes by reference to calculations of federal income tax under an outdated Internal Revenue Code.<sup>194</sup> To eliminate this problem (although only temporarily), the legislature amended section 171.001<sup>195</sup> to update the definition of Internal Revenue Code to a more current version; without this amendment, more taxpayers would have been required to continue preparing two sets of tax computations—one for federal tax under the current Internal Revenue Code, and another set under the old Internal Revenue Code for franchise tax purposes. The statutory changes to the franchise tax provisions also define “beginning date,”<sup>196</sup> which is used in reference to the definition of “privilege period” in section 171.151<sup>197</sup> and the determination of the applicable tax reporting and filing time periods of sections 171.152,<sup>198</sup> 171.153<sup>199</sup> and 171.1532.<sup>200</sup> The draft amendment to Rule 3.555<sup>201</sup> will incorporate this legislation updating the reference to the Internal Revenue Code. Likewise, drafts have been issued proposing amendments to update the definition of Internal Revenue Code in the following rules: Rule 3.556;<sup>202</sup> Rule 3.558;<sup>203</sup> and Rule 3.562.<sup>204</sup>

Faced with significant taxpayer concerns that section 171.1061<sup>205</sup> would regularly be used to allocate receipts from stock sales to Texas, the comptroller has provided taxpayers with limited assurances that most income will be “presumed” unitary, and that his efforts to tax income under this section will focus more on sourcing “nowhere income” to Texas than on

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192. *Id.* § 171.203 (Vernon Supp. 1996).

193. *Id.*

194. *See id.* § 171.001(b)(5).

195. *Id.* Several rule amendments were proposed or adopted with respect to this change; *see, e.g.*, 34 TEX. ADMIN. CODE § 3.548 (West 1996) (Taxable Capital: Close & S Corps).

196. TEX. TAX CODE ANN. § 171.001(b)(2) (Vernon Supp. 1996).

197. *Id.* § 171.151.

198. *Id.* § 171.152.

199. *Id.* § 171.153.

200. *Id.* § 171.1532.

201. *Draft Proposal, supra* note 186.

202. 34 TEX. ADMIN. CODE § 3.556 (Earned Surplus: S Corporations) (draft).

203. *Id.* § 3.558 (Earned Surplus: Officer and Director Compensation) (draft).

204. *Id.* § 3.562 (Limited Liability Companies) (draft).

205. TEX. TAX CODE ANN. § 171.1061 (Vernon Supp. 1996). This section provides that the comptroller may allocate all of certain income, excluding interest and dividends, to Texas if the corporation's commercial domicile is in Texas and the income cannot otherwise be taxed.

sourcing income to Texas in other circumstances.<sup>206</sup> The comptroller's draft Rule 3.576<sup>207</sup> presumes that all income to be unitary income and includes the following factors to determine whether income is unitary: centralization of management, functional integration and economies of scale. The draft rule also proposes that income may be allocated only when the income is investment, rather than operational and provides guidelines for the allocation of non-unitary income and related expenses.<sup>208</sup>

Another statutory amendment to the Tax Code provides that a corporation declaring a dividend shall exclude those dividends from its taxable capital and the corporation receiving dividends shall include those dividends in its gross receipts and taxable capital as of the earlier of: (1) the date the dividend is declared, if actually paid within one year of declaration; or (2) the date the dividend is actually paid.<sup>209</sup>

### III. PROPERTY TAX

#### A. APPLICATION OF TAX/EXEMPTIONS

Many of the important cases decided during the Survey period concerned exemptions. Several of these cases highlight that courts continue struggling to define concrete guidelines for use in determining when goods involved in interstate commerce can be subjected to property tax. The Texas Supreme Court in *Virginia Indonesia Co. v. Harris County Appraisal District*<sup>210</sup> held that goods purchased by an agent for a foreign entity and transported to Texas solely for inspection, approval and packaging are exempt from property taxes pursuant to the Import-Export Clause of the United States Constitution.<sup>211</sup> The taxpayer, a Delaware corporation, purchased goods from vendors located in the United States for export to Indonesia on behalf of an Indonesian joint venture. Upon purchase, the goods were transported from the vendors to an independent export packer in Houston. The export packer then checked the goods to confirm that the proper items were shipped and that the goods met specifications. Upon approval by the export packer, an international agency inspected the goods on behalf of the Indonesian joint venture. The goods were then packaged and shipped to Indonesia. In most instances, the goods remained in Houston for no longer than 45 days,

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206. See draft rule 34 TEX. ADMIN. CODE § 3.576 (Feb. 17, 1995) (on file with the author).

207. *Id.*

208. *Id.*

209. TEX. TAX CODE ANN. § 171.109(f) (Vernon Supp. 1996).

210. 910 S.W.2d 905 (Tex. 1995).

211. *Id.* at 915; see U.S. CONST. art. I, § 10, cl. 2. The court also concluded that property tax on the goods at issue would violate the "one voice" policy of the Import-Export Clause because the tax has the potential of interfering with the United States' relations with Indonesia in that Indonesia, in response to the property tax, might decide to purchase goods from another country or adopt retaliatory tariffs. 910 S.W.2d at 914-15.

although in exceptional circumstances the goods remained in Houston for up to 175 days.

The appraisal district asserted that the taxpayer owed property taxes on the goods located at the export packer's Houston facility on January 1, 1991. The Texas Supreme Court disagreed, holding that the Import-Export Clause applies.<sup>212</sup> The court applied the "stream of export" doctrine, which provides that goods are not subject to tax once exportation has commenced.<sup>213</sup> The court concluded that goods which have begun the export process retain their export status as long as the goods remain in transit, and that temporary interruptions to the in-transit process do not take goods out of export status if the interruption is due to necessities of the journey or for the purpose of safety and convenience.<sup>214</sup> However, stoppages that serve the owner's business purpose interrupt the goods' in-transit status.<sup>215</sup> In applying these principles, the court reasoned that the exportation process had begun after the taxpayer purchased the goods and that the stoppage in Houston was attributable to the exportation process and not a business purpose.<sup>216</sup>

Other cases decided during the Survey period illustrate that property tax exemptions are interpreted strictly against the party claiming the exemption. *Mission Palms Retirement Housing, Inc. v. Hidalgo County Appraisal District*<sup>217</sup> is a prime example. In this case, Mission Palms, a section 501(c)(3) organization, claimed that its property was exempt under the charitable organization exemption set forth in section 11.18 of the Tax Code.<sup>218</sup> The appraisal district denied the exemption because it

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212. 910 S.W.2d at 915.

213. *Id.* at 908. Exploration commences when goods "have been shipped, or entered with a common carrier for transportation to another state, or have been started upon such transportation in a continuous route or journey." *Id.*

214. *Id.* In his dissent, Justice Hecht (joined by Justice Owen) argued that in-transit goods can be taxed without necessarily violating the Import-Export Clause. The dissent asserted that in *Michelin Tire Corp. v. Wages*, 423 U.S. 276 (1976), the United States Supreme Court abandoned the "in-transit" rule employed by the majority. *Virginia Indonesia Co.*, 910 S.W.2d at 915.

215. *Id.* at 908.

216. *Id.* at 914. In another case addressing property taxation of goods in interstate commerce, the Court of Appeals in Houston [1st Dist.] held that an unapportioned property tax on shipping containers, which were frequently present in the district but which were used exclusively in foreign commerce, violated the Commerce Clause of the United States Constitution. *Harris County Appraisal Dist. v. Transamerica Container Leasing, Inc.*, No. 01-90-00768-CV, 1995 WL 555899 (Tex. App.—Houston [1st Dist.] 1995, no writ) (not designated for publication) (citing *Intel Containers Int'l Corp. v. Huddleston*, 113 U.S. 1095 (1993)). See Cynthia M. Ohlenforst et al., *Taxation: Annual Survey of Texas Law*, 47 SMU L. REV. 1649, 1668 n.175 (1994) [hereinafter, 1994 *Tax Survey*]. In *Houston Indep. Sch. Dist. v. Plexchem Int'l, Inc.*, No. 14-94-00417-CV, 1995 WL 505962 (Tex. App.—Houston [14th Dist.], writ requested) (not designated for publication), the Houston Court of Appeals [14th Dist.] held that property tax on plastic resin pellets stored in a customs-bonded warehouse in Houston while awaiting shipment to other countries did not violate the Commerce Clause or the Import-Export Clause of the United States Constitution.

217. 896 S.W.2d 819 (Tex. App.—Corpus Christi 1995, no writ).

218. Mission Palms also asserted that denial of an exemption would violate the Supremacy Clause of the United States Constitution. *Id.* at 822. Mission Palms' position was that federal laws governing public-housing loans are so comprehensive that Congress effectively preempted all state laws which might apply to HUD loan recipients. *Id.* The

believed that the dissolution provision of the Mission Palms' articles of incorporation did not comply with Section 11.18(f)(2)(A) of the Tax Code.<sup>219</sup> Among other requirements, this section provides that in order to qualify for the exemption, the organization's charter, bylaws or other regulations must direct that its assets be transferred to the state or to another educational, religious, charitable, or similar Section 501(c)(3) organization upon dissolution. Although Mission Palms' articles of incorporation generally provided for conveyance of its assets to another educational or charitable Section 501(c)(3) organization on dissolution, the articles also stated that Mission Palms could transfer its assets to the Secretary of Housing and Urban Development in satisfaction of "any indebtedness" to HUD.<sup>220</sup> The court held that because the language allowing transfers to HUD did not limit transfers to the amount of Mission Palms' indebtedness to HUD, the provision violated a strict construction of section 11.18(f)(2)(A).<sup>221</sup>

The Texas Supreme Court held in *Corpus Christi People's Baptist Church Inc. v. Nueces County Appraisal District*<sup>222</sup> that Section 11.433 of the Tax Code, which allows religious organizations to file applications for exemptions six years later than other entities qualifying for exemptions, does not violate the Texas Constitution.<sup>223</sup> The appraisal district asserted that section 11.433 operated to extinguish an existing tax debt, thereby violating Article III, section 52 of the Texas Constitution.<sup>224</sup> The Texas Supreme Court disagreed, reasoning that the statute operates as a statute of limitation tolling period, and does not extinguish tax debts.<sup>225</sup>

## B. PROCEDURE

There were numerous cases during the Survey period addressing motions under section 25.25(c) and (d) of the Tax Code. Section 25.25(c) provides that at any time before the end of five years after the beginning of a tax year, the appraisal review board, on the motion of either the appraisal district or the taxpayer, may change the appraisal roll to correct

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court concluded that conformity with Section 11.18 does not prevent compliance with the HUD legislation; thus, the Supremacy Clause does not apply in the facts at hand. *Id.* at 822-23.

219. *Id.*; see TEX. TAX CODE ANN. § 11.18(f)(2)(A) (Vernon 1992).

220. *Mission Palms*, 896 S.W.2d at 821.

221. *Id.* The court arguably takes the strict construction approach too far in this case. It appears that Mission Palms would have prevailed in this case had its articles provided that it could convey assets to HUD in satisfaction of "its" indebtedness to HUD rather than stating that it could convey assets to HUD in satisfaction of "any" indebtedness to HUD. Although the court correctly concludes that a literal reading of this language could conceivably allow Mission Palms to convey assets to HUD to satisfy a debt of another to HUD, it defies logic that Mission Palms desired or intended to pay others' debts to HUD. In order to achieve an equitable result, it seems that the court could have strained just slightly to interpret the language "any indebtedness to [HUD]" to mean indebtedness of Mission Palms to HUD.

222. 904 S.W.2d 621 (Tex. 1995).

223. *Id.* at 625 (applying TEX. TAX CODE ANN. § 11.433 (Vernon 1992 & Supp. 1996)).

224. *Id.*

225. *Id.*

(1) certain clerical errors, (2) multiple appraisals of a property for the tax year, or (3) the inclusion of property on the roll that does not exist in the form or at the location described in the roll.<sup>226</sup> Section 25.25(d) allows a taxpayer or the chief appraiser to file a motion with the appraisal review board at any time prior to the tax delinquency date, requesting the board to change the roll to correct an error that resulted in an incorrect appraisal.<sup>227</sup> No error, however, may be corrected under section 25.25(d) unless the error results in the appraised value exceeding the correct value by more than one-third.<sup>228</sup>

In *Harris County Appraisal District v. World Houston, Inc.*,<sup>229</sup> the taxpayer filed a motion under section 25.25(d) concerning the tax value of its property but did not receive a satisfactory determination from the appraisal review board and filed suit challenging the determination. The trial court referred the parties to binding arbitration pursuant to section 42.225 of the Tax Code and adopted the arbitrator's findings, which apparently were favorable to the taxpayer.<sup>230</sup> The appraisal district appealed, asserting that the trial court erred in adopting such findings because the Tax Code does not authorize the arbitration remedy for a property owner appealing from an appraisal review board's determination under section 25.25. The appraisal district claimed that the arbitration procedure is available only if the taxpayer is appealing an appraisal review board's determination of a protest filed under chapter 41 of the Tax Code and, thus, is not available for section 25.25 motions.<sup>231</sup> The Houston Court of Appeals agreed, concluding that because section 42.01 of the Tax Code, which sets forth the circumstances in which a taxpayer may appeal under Chapter 42, does not make any mention of section 25.25, the arbitration procedures under Chapter 42 of the Tax Code are not available in connection with litigation relating to section 25.25 mo-

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226. TEX. TAX CODE ANN. § 25.25(c) (Vernon 1992 & Supp. 1996). Motions under § 25.25 are made by taxpayers in circumstances in which the taxpayer failed to file a timely protest with the appraisal review board under TEX. TAX CODE ANN. § 41.41, failed to timely file suit after an adverse appraisal review board decision on a protest, or failed to appear at the protest hearing.

227. *Id.* § 25.25(d).

228. *Id.*

229. 905 S.W.2d 594 (Tex. App.—Houston [14th Dist.] 1995, no writ).

230. *Id.* at 595. Section 42.225 (as in effect with respect to the tax years at issue) provided that a property owner who appeals an appraisal review board order under Chapter 42 of the Tax Code is entitled to have the appeal resolved through binding arbitration. Amendments to section 42.225 provide that arbitration conducted pursuant to the section is non-binding. TEX. TAX CODE ANN. § 42.225 (Vernon 1992), amended by Act of 1993, 73d Leg., R.S. (1031), § 9, 1993 Tex. Gen. Laws 4440, 4441 (1993). Indeed, in *Hayes County Appraisal District v. Mayo Kirby Springs, Inc.*, 903 S.W.2d 394 (Tex. App.—Austin 1995, n.w.h.), the Austin Court of Appeals held that the prior version of Section 42.225, requiring binding arbitration if requested by the taxpayer, violated the open courts provision of the Texas Constitution. *Id.* at 396-97; *see also* TEX. CONST. art. I, § 13. Both *Mayo Kirby* and *Williamson County Appraisal District v. Nootsie, Ltd.*, 905 S.W.2d 289 (Tex. App.—Austin 1995, n.w.h.), confirm that appraisal districts have standing to challenge the constitutionality of certain Tax Code provisions. *Mayo Kirby*, 903 S.W.2d at 397.

231. *World Houston*, 905 S.W.2d at 595 (relying upon TEX. TAX CODE ANN. §§ 41.01-41.70 (Vernon 1992 & Supp. 1996)).

tions.<sup>232</sup> Indeed, the court in dicta indicated that the trial court's review of an appraisal review board's decision concerning a section 25.25 motion should only be in the context of compelling the board to perform the functions required of it by section 25.25.<sup>233</sup>

The Dallas Court of Appeals in *Dallas Central Appraisal District v. G.T.E. Directories Corp.*<sup>234</sup> considered whether property was eligible for corrective relief under section 25.25(c)(3) because it did not exist in the form or at the location described in the roll. The dispute concerned the 1988 and 1989 tax years, and the taxpayer claimed that due to foundation defects existing in those years, the property was useless at that time rather than being in 99% good condition as shown on the appraisal district's commercial worksheets (the worksheets also incorrectly indicated that the building had three stories rather than two). The taxpayer asserted that it was eligible for relief under section 25.25(c)(3) because the property was not "in the form" described on the appraisal roll. The trial court agreed with the taxpayer, and lowered the property's value from almost \$4.5 million to approximately \$550,000 for 1988 and approximately \$280,000 for 1989.<sup>235</sup> The court of appeals reversed, however, reasoning that the error at issue was an overstatement of appraised value, and that the property's appraised value is not a description of the "form" of the property.<sup>236</sup> Indeed, the court indicated that the term "form" in the context of section 25.25(c) refers only to whether the property is listed on the tax rolls correctly as real property, personal property, a real property improvement or some other physical description shown on the roll.<sup>237</sup>

The Texas Supreme Court in *Syntax, Inc. v. Hall*<sup>238</sup> held that taxing

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232. *Id.* In another case concerning section 25.25(d), the Dallas Court of Appeals held that the taxpayer was not barred from employing section 25.25(d) by virtue of filing a protest, which had later been withdrawn, on the relevant property for the year in question. *Jim Sowell Construction Co. v. Dallas Central Appraisal District*, 900 S.W.2d 82, 85 (Tex. App.—Dallas 1995, writ denied). Section 25.25(d) provides that the tax roll cannot be changed under section 25.25(d) if the property was the subject of a protest. TEX. TAX CODE ANN. § 25.25(d) (Vernon 1992). The court concluded that because there was never a hearing on the protest, it was not the subject of a protest. *Jim Sowell*, 900 S.W.2d at 86.

233. *World Houston*, 905 S.W.2d at 597. The court's dicta is highly questionable. Parties generally have a right to judicial review of an administrative decision, and there is nothing in the Tax Code which prevents taxpayers from seeking judicial review of an appraisal review board's decision on a section 25.25 motion. See *Schwantz v. Texas Dept. of Pub. Safety*, 415 S.W.2d 12, 15 (Tex. Civ. App.—Waco 1967, writ ref'd).

234. 905 S.W.2d 318 (Tex. App.—Dallas 1995, writ denied).

235. *Id.* at 319.

236. *Id.* at 323. This case is contrary to the dicta in *World Houston* indicating that judicial review of section 25.25 motions is limited to determining whether the appraisal review board performed its functions because the court in *G.T.E. Directories* considered the merits of the issue concerning whether section 25.25(c)(3) applies in the facts at hand. See also, *Himont U.S.A., Inc. v. Harris County Appraisal Dist.*, 904 S.W.2d 740 (Tex. App.—Houston [1st Dist.] 1995, no writ) (court also considered whether Section 25.25(c)(3) applies).

237. *G.T.E. Directories*, 905 S.W.2d at 321. In another case concerning section 25.25(c)(3), the Houston Court of Appeals [1st Dist.] held that the taxpayer's failure to render personal property does not prevent the taxpayer from relying on section 25.25(c)(3) to the extent the section is otherwise applicable. *Himont U.S.A.*, 904 S.W.2d at 744.

238. 899 S.W.2d 189 (Tex. 1995).

units cannot profit from excess proceeds derived from the sale of property taken in satisfaction of a judgment for delinquent taxes even if the resale occurs after the two-year redemption period under section 34.21 of the Tax Code.<sup>239</sup> Rather, the excess proceeds must be deposited with the court for distribution to the former property owner.<sup>240</sup> In *Syntax*, the county and school district secured a judgment against the property owner, foreclosed and conducted a tax sale. No bids were received and the property was "struck off" to the school district for the amount of delinquent taxes. More than two years later, the property was sold for \$42,000 more than the total tax bill and costs. The taxing units claimed that they were entitled to these excess proceeds, relying on section 34.01, which provides that when taxing units take title to property in the absence of a sufficient bid at the foreclosure sale, the taxing unit's title includes "all the interest owned by the defendant . . . subject only to the defendant's right of redemption."<sup>241</sup> The court disagreed, concluding that this section does not extinguish the landowner's rights to excess proceeds on sale, as provided in section 34.06.<sup>242</sup>

In *W.V. Grant Evangelistic Association, Inc. v. Dallas Central Appraisal District*<sup>243</sup> the Dallas Court of Appeals held that the provision in section 42.08(b) of the Tax Code providing that taxpayers forfeit their right to appeal if they have not paid the proper amount of taxes prior to the delinquency date, violates the Texas Constitution.<sup>244</sup> The taxpayer had filed an application for exemption as a religious organization, but was denied by the appraisal district and by the appraisal review board. The taxpayer then filed suit, but failed to tender the amount required under section 42.08(b) before the delinquency date.<sup>245</sup> (This minimum amount is the greater of (a) the amount of taxes not in dispute, or (b) the amount of taxes imposed on the property in the preceding year.<sup>246</sup>) Therefore, the taxpayer failed to comply with the prepayment requirements of section 42.08 and the trial court dismissed the lawsuit.<sup>247</sup> The taxpayer then filed an amended petition, contending that section 42.08 is an unreasonable

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239. Section 34.21 provides that the owner of real property sold at a tax sale may redeem the property within two years after the date on which the purchaser's deed is recorded by paying the purchaser the purchaser's bid for the property and certain costs, plus 25% of the aggregate total if the redemption occurs in the first year of the redemption period and 50% of the aggregate total if the redemption occurs in the second year of the redemption period. TEX. TAX CODE ANN. § 34.21 (Vernon Supp. 1996).

240. *Syntax*, 899 S.W.2d at 192.

241. *Id.* at 190; see also TEX. TAX CODE ANN. § 34.01(a) (Vernon 1992 & Supp. 1996).

242. *Syntax*, 899 S.W.2d at 192. The court noted that taxing units are not, and should not be, in the business of buying and selling real estate for profit. *Id.* at 191.

243. 900 S.W.2d 789 (Tex. App.—Dallas 1995, writ granted).

244. *W.V. Grant*, 900 S.W.2d at 791; see TEX. CONST. art. I, § 13 (persons have the right to open courts).

245. TEX. TAX CODE ANN. § 42.08(b) (Vernon 1992) (amended 1995). Section 42.08(b) provides that a property owner forfeits its right to appeal an order of an appraisal review board unless it pays a minimum amount of property taxes before the delinquency date.

246. *Id.* Taxpayers may also pay the entire tax bill without violating the voluntary payment rule. *Id.* § 42.08(b)(2).

247. *W.V. Grant*, 900 S.W.2d at 790.

restriction on access to the courts and is therefore unconstitutional.<sup>248</sup> The court of appeals agreed, reasoning that Section 42.08 violates the open courts provision of the Texas Constitution because the prepayment requirement is an unreasonable financial barrier to court access.<sup>249</sup> In response to this case, the Texas Legislature added section 42.08(d), which provides that a taxpayer may file an oath of inability to pay taxes, in which case the requirement of prepayment of tax as a prerequisite to appeal is waived.<sup>250</sup>

*Gregg County Appraisal District v. Laidlaw Waste Systems, Inc.*,<sup>251</sup> exemplifies the consequences of failing to satisfy the procedural requirements to filing suit on a property tax matter. The property at issue was owned by "Four-S." "Four-S" appointed "Laidlaw Texas" as its designated agent for property tax purposes. However, the tax suit was filed by "Laidlaw Delaware," which is the second-tier parent corporation of Laidlaw Texas. At trial, the taxpayer was able to substantially reduce the value of the property for tax purposes. The appraisal district, however, appealed on the grounds that the court did not have jurisdiction, given that neither the property owner nor its designated agent filed the lawsuit within the 45-day time requirement set forth in section 42.21 of the Tax Code.<sup>252</sup> The trial court had rejected the jurisdiction argument on the theory that the proper parties had ultimately been joined in the lawsuit and that Laidlaw Delaware was the de facto agent of the property owner.<sup>253</sup> But the court of appeals reversed, stating that Laidlaw Texas and Laidlaw Delaware are distinct and different entities, that no de facto relationship had been established, and even if such a relationship had been established, the statutory requirements for establishing an agent for property tax purposes had not been met.<sup>254</sup>

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248. *Id.*

249. *Id.* at 791. The court agreed that the prepayment requirement furthers the state's interests in assuring that tax suits are not filed to allow taxpayers to delay or avoid paying taxes. The court, however, believed that forfeiting one's right to sue is too severe a consequence of failing to pay the taxes by the delinquency date. *Id.* The court noted that other alternatives to the forfeiture provision might be accelerated administrative proceedings and expedited trial settings. The taxpayer in *General Motors Acceptance Corp. v. Harris County Municipal Utility District Number 130*, 899 S.W.2d 821 (Tex. App.—Houston [14th Dist.] 1995, no writ), had also not satisfied the prepayment requirements set forth in section 42.08, asserting the unconstitutionality of section 42.08 after learning of the decision in *W.V. Grant*. The constitutionality argument, however, had not been asserted at the trial court level; therefore, the court of appeals held that the taxpayer had failed to preserve error on the issue. *Id.* at 825. The court noted a constitutional violation can be considered on appeal without proper preservation of error if the violation was not recognized before the case was appealed. *Id.* Because the constitutionality claim was not novel, however, the failure to preserve error in this case was fatal to the taxpayer. *Id.*

250. See TEX. TAX CODE ANN. § 42.08(d) (Vernon Supp. 1996).

251. 907 S.W.2d 12 (Tex. App.—Tyler 1995, writ denied).

252. *Id.* at 15; see also TEX. TAX CODE ANN. § 42.21 (Vernon 1992).

253. *Laidlaw Waste*, 907 S.W.2d at 17.

254. *Id.* at 17-18. The court also ruled that past assessments can be admitted into evidence on the issue of a property's value if there is sufficient evidence of the landowner's participation in the prior year's proceedings. *Id.* at 21. If, however, there is not sufficient participation by the landowner, the court indicated that past assessments cannot be admit-

## C. LEGISLATION

The Seventy-Fourth Legislature passed nearly 50 bills relating to property tax during its last term. Much of the legislation concerned exemptions, with new exemptions being created (subject to voter approval in certain circumstances) and others being modified in important respects.<sup>255</sup> New sections 11.145 and 11.146 of the Tax Code exempt tangible personal property used in the production of income and mineral interests with values less than \$500.<sup>256</sup> New section 11.13(q) and (r) of the Tax Code enables the surviving spouse of a person who qualified for the over-65 homestead exemption to benefit from the exemption if the surviving spouse is at least 55 years old when the deceased spouse dies.<sup>257</sup> An amendment to the Texas Constitution modifies the exemption for property owned by disabled veterans.<sup>258</sup> Under the new exemption, disabled veterans can receive up to a \$15,000 exemption depending on their percentage of disability.<sup>259</sup> New section 23.51(7) adds wildlife management to the list of uses that qualifies for open-space land.<sup>260</sup> Amended section 11.18(d)(5) allows property owned by a theater for the performing arts to qualify for the charitable organization exemption.<sup>261</sup>

Several important changes were made to statutes relating to tax abatements. Most importantly, the sunset date for the tax abatement statute was changed from September 1, 1995, to September 1, 2006.<sup>262</sup> New sections 111.301 through 111.304 of the Tax Code provide that, if certain conditions are met, a taxpayer entering into a tax abatement agreement after January 1, 1996, is eligible for a rebate of sales and franchise taxes in an amount equal to the property taxes that would have been abated by the school district with jurisdiction over the relevant property had it

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ted into evidence concerning the valuation issue. *Id.*; see *Houston Lighting & Power Co. v. Fisher*, 559 S.W.2d 682 (Tex. Civ. App.—Houston [14th Dist.] 1977, writ ref'd n.r.e.).

255. Voters rejected constitutional amendments which would have created an exemption for commercial fishing boats, and an exemption for certain Masonic lodges.

256. TEX. TAX CODE ANN. §§ 11.145, 11.146 (Vernon Supp. 1996). For these purposes, all such property in a taxing unit is aggregated to determine if the \$500 threshold is met. *Id.*

257. *Id.* § 11.13(q), (r) (Vernon Supp. 1996).

258. See TEX. CONST. art. VIII, § 2(b), (d). This constitutional provision supersedes TEX. TAX CODE ANN. § 11.22 (Vernon 1992).

259. TEX. CONST. art. VIII, § 2(b), (d). The prior exemption capped at \$3,000. TEX. TAX CODE ANN. § 11.22 (Vernon 1992); see also TEX. TAX CODE ANN. § 31.031(a) amended to allow eligible disabled persons to pay property taxes in quarterly installments. *Id.* § 31.031(a) (Vernon Supp. 1996).

260. TEX. TAX CODE ANN. § 23.51(7) (Vernon Supp. 1996).

261. *Id.* § 11.18(d)(5) (Vernon Supp. 1996). The prior statute merely exempted property owned by a theater for the dramatic arts. *Id.* § 11.18(d)(5) (Vernon 1992 & Supp. 1996), amended by Act of June 16, 1995, 74th Leg., R.S., (781), § 4, 1995 Tex. Gen. Laws 4046, 4049 (Vernon). New section 11.20(g) of the Tax Code expanded the religious organization exemption relating to improvements incomplete on January 1 of a tax year. *Id.* § 11.20(g).

262. *Id.* § 312.006 (Vernon Supp. 1996).

joined in the abatement.<sup>263</sup> These conditions include the abatee increasing its payroll in the city or county granting the abatement by at least \$3 million and increasing the appraised value of the abatee's property subject to the abatement agreement by at least \$4 million.<sup>264</sup> The total rebate to all taxpayers under this provision is capped at \$10 million per year.<sup>265</sup>

New section 312.204(f) of the Tax Code provides that abatement agreements with property owners in an enterprise zone are not required to contain identical terms for the percentage of abatement and the duration of agreement.<sup>266</sup> Absent this provision, abatement agreements entered into by municipalities, counties, school districts and other jurisdictions generally must have identical terms with respect to the abatement percentage and the duration of the agreement.<sup>267</sup>

The Texas Legislature adopted the County Development District Act, which appears to offer significant revenue-raising opportunities for certain counties.<sup>268</sup> The statute governs counties with a population of not more than 400,000, and provides that a county development district with respect to any land in the county can be created in such a county if all of the landowners in the proposed district petition for the district's creation and the commissioners court grants the petition.<sup>269</sup> Upon creation of the district, a sales and use tax of up to one-half percent may be adopted if it is approved at an election of voters in the district.<sup>270</sup> This tax does not count toward the limitation on sales taxes imposed by Chapter 323 of the Tax Code<sup>271</sup> on counties, which generally limits county sales and use taxes to one-half or one percent.<sup>272</sup> A county development district also has the authority to issue bonds.<sup>273</sup>

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263. *Id.* § 111.301-.304. *See also*, TEX. TAX CODE ANN. § 312.210 (Vernon Supp. 1996) (joint agreements by municipalities, counties and junior college districts to offer tax abatements).

264. TEX. TAX. CODE ANN. § 111.301(d)(2) (Vernon Supp. 1996).

265. *Id.* § 111.302(a). There are other significant conditions to qualifying for the rebate. For example, the rebate does not apply if the school district with jurisdiction over the subject property enters into the abatement agreement. *Id.* § 111.301(a)(3). In addition, the taxpayer's refund is limited by the amount of franchise and sales taxes paid by it for the year. *Id.* § 111.301(c). If the \$10 million cap applies, the amount of each refund to the claimants is reduced proportionately until the \$10 million figure is reached. *Id.* § 111.302(c).

266. TEX. TAX CODE ANN. § 312.204(f) (Vernon Supp. 1996). This amendment provides important planning opportunities. Municipalities, counties and school districts often do not agree on the percentage of abatement to be granted or the duration of abatement. If this difficulty arises, taxpayers should consider whether an enterprise zone can be created with respect to the subject property to avoid having these tax units agree on these terms.

267. *Id.* § 312.206(a).

268. *Id.* §§ 312.601-312.640.

269. *See id.* §§ 312.605-312.610.

270. *Id.* § 312.637.

271. TEX. TAX. CODE ANN. § 312.637(a).

272. *Id.* § 323.103.

273. *Id.* § 312.634. An interesting aspect of this Act is section 312.638, which provides that the commissioners court on a unanimous vote may add or exclude property to or from the district. *Id.* § 312.638. Query whether added property would be subject to the sales

The Texas Legislature adopted several important procedural and administrative provisions as well. New section 31.115 of the Tax Code effectively repeals the voluntary payment rule<sup>274</sup> by providing that payment of a property tax is involuntary if the taxpayer indicates on the instrument by which the tax is paid or in a document accompanying the payment that the tax is paid under protest.<sup>275</sup> In somewhat confusing legislation, new sections 41.413 and 42.015 of the Tax Code provide that a lessee of personal or real property which is contractually obligated to reimburse the property owner for taxes imposed on the property is entitled to protest the property's appraised value if the owner does not file a protest, and is entitled to appeal an order of the appraisal review board if the lessee properly filed protest.<sup>276</sup> This legislation also requires the property owner to send the lessee a copy of any notice of the property's reappraisal the owner receives.<sup>277</sup> Although the legislation does not provide a remedy for the owner's failure to provide to the lessee notice of reappraisal, this legislation may pave the way for lessees disgruntled with the tax bill to sue owners if the owner fails to provide the lessee with a notice of reappraisal. In that regard, lessors may want to consider changing their leases to provide that no damages apply if a notice of reappraisal is not sent by the owner to the lessee.<sup>278</sup>

As in prior legislative sessions, changes were made relating to special appraisal of agricultural land, open-space land, timber land and other special appraisal categories. New sections 23.45 and 23.58 prohibit lenders from requiring as a condition to granting or amending a loan agreement that the borrower waive its right to open-space or agricultural valuation.<sup>279</sup> But lenders can require the taxes saved by open-space or agricultural valuation to be placed in escrow.<sup>280</sup> Amended sections 23.75(j), 23.84(e), and 23.94(e) provide that an appraisal district has only five years, rather than ten years under prior law, to discover that property has been erroneously allowed special appraisal as timber land, recrea-

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and use tax adopted by the district, and if so, whether the sales and use tax on added property would be constitutional given that voters in the added area would not have approved the tax.

274. *Id.* § 31.115. The voluntary payment rule provided that a person who voluntarily pays an illegal tax has no claim for repayment. See *Hunt County Tax Appraisal. District v. Rubbermaid Inc.*, 719 S.W.2d 215, 218 (Tex. App.—Dallas 1988, writ ref'd n.r.e.).

275. TEX. TAX CODE ANN. § 31.115 (Vernon Supp. 1996). Much of the teeth of the voluntary payment rule was eliminated in 1989 when section 42.08(b) was amended to provide that taxpayers could appeal by paying the amount of taxes due on the property under the order from which the protest is being appealed. 71st Leg., R.S., (796), § 43, 1989 Tex. Gen. Laws 3591, 3604 (Vernon).

276. TEX. TAX CODE ANN. §§ 41.413 and 42.015 (Vernon Supp. 1996).

277. *Id.* § 41.413(d). The statute does not expressly limit the requirement to furnish notices of reappraisals to lessees obligated to reimburse the owner for taxes; however, one presumes such is the intent of the statute.

278. Appraisal review boards and courts can raise as well as lower appraised values. Therefore, if the owner does not desire to challenge the appraised value of leased property, the owner may want to consider filing a protective protest to assure control of the administrative and judicial process.

279. TEX. TAX CODE ANN. § 23.45 and 23.58 (Vernon Supp. 1996).

280. *Id.*

tional land or public access airport property.<sup>281</sup>

Several amendments related to tax collections and tax liens. New legislation enables municipalities, through the use of tax warrants, to seize and sell abandoned real property of less than one acre if property taxes are delinquent for at least five years or if there has been a lien on the property for at least three years.<sup>282</sup> New section 32.065 and amended sections 32.06 and 34.02 address the transfer of tax liens, and clarify that a transferee of a tax lien is subrogated to and is entitled to exercise any right or remedy possessed by the transferring tax unit.<sup>283</sup>

In addition the legislature substantially rewrote the appraisal and collection procedures for automobile dealers.<sup>284</sup> The special appraisal rules for automobile dealers have been extended to smaller boat and outboard motors dealers.<sup>285</sup>

#### IV. OTHER DEVELOPMENTS, PROCEDURE, LIENS, SUCCESSOR LIABILITY

##### A. LEGISLATION

Following *R Communications, Inc. v. Sharp*,<sup>286</sup> which held that a taxpayer's right to challenge judicially a sales tax deficiency could not be conditioned on payment of the tax at issue, taxpayers began filing tax cases without payment of tax. Not surprisingly, the 1995 Legislature attempted to deal with the *R Communications* holding by providing that, in certain tax disputes, taxpayers could nonetheless be required to pay the tax prior to contest, unless they comply with certain statutory requirements relating to ability to pay. Specifically, the legislature amended section 112.108 to provide that after filing an oath of inability to pay the tax, penalties and interest due, a party may be excused from the requirement of prepayment of tax as a prerequisite to appeal if the court, after notice and hearing, finds that such prepayment would constitute an unreasonable restraint on the party's right of access to the courts.<sup>287</sup> In addition, the amendment provides that a grant of declaratory relief against the state or state agency shall not entitle the winning party to recover attorney fees.<sup>288</sup>

The 1995 Legislature continued the expansion of criminal penalties in the tax context by amending section 171.363 regarding willful and fraudulent acts. This section now provides that an offense is committed if an

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281. *Id.* §§ 23.75(j), 23.84(e) and 23.94(e).

282. TEX. TAX CODE ANN. §§ 33.91-33.95 (Vernon Supp. 1996).

283. *Id.* §§ 32.065, 32.06 and 34.02.

284. *Id.* §§ 23.12(f), 23.121, 23.122 and 23.123.

285. *Id.* §§ 23.12(g), 23.12D. Vessels more than 65 feet in length, and canoes, kayaks and similar crafts under 14 feet in length do not qualify. *Id.* § 23.12D(a)(14).

286. 875 S.W.2d 314 (Tex. 1994).

287. TEX. TAX CODE ANN. § 112.108 (Vernon Supp. 1996).

288. *Id.* §§ 23.12(g), 23.12D. Though this provision is part of the legislature's response to *R Communications*, there is a strong possibility that this amendment does not fully comply with the Texas Supreme Court's decision and intent.

accountant or agent or an officer or employee of a corporation knowingly provides false information on any report, return, or other document filed by the corporation.<sup>289</sup>

The 1995 Legislature also amended section 111.016 of the Tax Code to provide for collection from certain persons who fail to pay taxes of a business.<sup>290</sup> The amendments to this section specifically extend liability to "an individual who controls or supervises the collection of tax or money from another person" or "an individual who controls or supervises the accounting for and paying over of the tax or money," who willfully fails to pay or cause to be paid the amount at issue.<sup>291</sup> The penalty imposed is equal to the total amount of tax not paid, in addition to any other penalty provided by law.<sup>292</sup> A responsible individual's liability is not affected by dissolution of the entity.<sup>293</sup> "Responsible individual" is defined to include an officer, manager, director, or employee of a corporation, association, or limited liability company, or member of a partnership, who in such capacity, is under a duty to perform an act with respect to the collection, accounting, or payment of a tax or money subject to the "trust fund" provisions.<sup>294</sup> "Tax" is defined to include tax or money subject to the "trust fund" provisions, including penalty and interest.<sup>295</sup> This provision, which triggered substantial debate among taxpayers and comptroller staff, is somewhat more favorable to taxpayers than earlier versions of proposed legislation which did not include the willful requirement.

#### B. STATUTE OF LIMITATIONS

The court of appeals addressed the issue of whether a refund check constitutes a final decision for purposes of tolling the statute of limitations in *Sharp v. AMSCO Steel Co.*<sup>296</sup> On January 8, 1990, AMSCO filed franchise tax refund claims for years 1986 and 1987 on the basis of the *Sage Energy* decision<sup>297</sup> and pursuant to the comptroller's abbreviated refund procedure for such refunds. The comptroller issued AMSCO refund checks on February 2, 1990. On June 4, 1990, AMSCO filed an amended claim for the refund of additional taxes for 1986 and 1987, which were denied. The district court granted the later refund claims, and in February 1995, the court of appeals reversed as to part of the refund.<sup>298</sup> The court noted that the January 8, 1990 claim tolled the four year refund limitations period until a final decision was issued by the

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289. *Id.* § 171.363 (Vernon Supp. 1996).

290. *Id.* § 111.016.

291. *Id.* § 111.016(b).

292. TEX. TAX CODE ANN. § 111.106(a) (Vernon Supp. 1996).

293. *Id.* § 111.016(b).

294. *Id.* § 111.016(d)(1).

295. *Id.* § 111.016(d)(2).

296. 893 S.W.2d 742 (Tex. App.—Austin 1995, writ denied).

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

298. *AMSCO Steel*, 893 S.W.2d 742.

comptroller.<sup>299</sup> The appellate court found, however, that the refund check constituted an informal final decision by agreed settlement under the Administrative Procedure Act, which stopped the tolling of the statute. Thus, the statute of limitations barred the amended claim for 1986, but the amended claim for 1987 was within the four year limitations period, even if the period had not been tolled.<sup>300</sup>

The court of appeals also examined the statutory language of the refund provisions in *Borden, Inc. v. Sharp*<sup>301</sup> and held that a 1990 claim for refund of franchise tax for the 1982 tax year was not timely because previous timely refund claims for the same tax year did not indefinitely open the statute of limitations for that tax year. The court of appeals upheld the district court's grant of summary judgment for the comptroller on the basis that such claim was barred by the statute of limitations.<sup>302</sup> Based upon a literal reading of sections 111.205(4) and 111.107 of the Tax Code.<sup>303</sup> Borden argued that since it previously made a timely refund claim for 1982, Borden was subject to assessment by the comptroller "at any time." Therefore, Borden's time period to file refund claims for 1982 should be indefinite.<sup>304</sup> Employing statutory construction guidelines, the court of appeals looked beyond the plain meaning of the statute to determine the intent of the legislature. The court stated that Borden's interpretation of the statute would effectively result in a repeal of the statute of limitations with respect to taxpayers that had once filed a timely refund claim.<sup>305</sup> In addition, the court found that the comptroller interpreted the refund-assessment exception as granting the comptroller a limited counterclaim right during the pendency of the refund, but not granting an unlimited right to assess tax deficiencies; therefore, the limitations provisions did not grant the taxpayer an unlimited right to claim a refund.<sup>306</sup>

### C. SUCCESSOR LIABILITY

In Decision 30,262 the taxpayer succeeded in showing the comptroller that she should not be liable under the successor liability rules, since her acquisition of the "business" was more in the nature of an acquisition of a

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299. *Id.* at 744.

300. *Id.* at 745.

301. 888 S.W.2d 614 (Tex. App.—Austin 1994, writ denied).

302. *Id.* at 620.

303. TEX. TAX CODE ANN. § 111.205(4) (as then in effect). The legislature repealed this subsection in 1993. See *infra* note 306. Section 111.20 provides an exception to the four year statute of limitations and generally allows the Comptroller to assess a tax at any time if a taxpayer has filed a timely claim for refund for such period. Section 111.107 allows a taxpayer to claim a refund during the time in which the comptroller may assess a tax.

304. *Borden*, 888 S.W.2d at 617.

305. *Id.* at 618.

306. *Id.* at 619. Note that TEX. TAX CODE ANN. § 111.205(4) was repealed effective September 1, 1993 and replaced by TEX. TAX CODE ANN. § 111.2051 (Vernon Supp. 1996).

tradename than the acquisition of a continuing business.<sup>307</sup> In Decision 31,965 on the other hand, the comptroller held that a taxpayer who purchased a restaurant business was liable for the taxes of the restaurant seller pursuant to section 111.020.<sup>308</sup>

In a continuation of cases seeking to impose sanctions when a corporation has forfeited its charter,<sup>309</sup> a Houston court of appeals, in *El T. Mexican Restaurants, Inc. v. Bacon*<sup>310</sup> concluded that a sole shareholder of a corporation that had its charter forfeited for failure to pay franchise taxes, but that had not been dissolved, was not able to bring suit individually as a successor in interest to the corporation. The court recognized that the shareholder was the holder of the beneficial title to the corporation's assets and was entitled to prosecute actions necessary to protect his rights. Nonetheless, the court held that the shareholder could not recover individually on the corporation's claims or, since the corporation had not dissolved, as a successor in interest.<sup>311</sup>

In another court of appeals case, *Davis v. State*,<sup>312</sup> the court of appeals held that even before the 1987 amendment of section 111.016 of the Tax Code to include "trust fund" language, "the sales taxes collected by agent/sellers on behalf of the state, while not expressly characterized as trust funds, were of a trust fund nature and thus were the state's property."<sup>313</sup> This conclusion enabled the trial court to find that holding Davis responsible for taxes would not constitute a retroactive application to Davis of the 1987 amendment to section 111.016.<sup>314</sup>

## V. CONCLUSION

As the Governor and the legislature continue to assess the various alternatives for tax reform, taxpayers and the comptroller continue contesting the limits of the current tax structure. Both the new alternatives and the current struggles will further develop Texas tax law in the coming years.

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307. Tex. Comp. Pub. Acc'ts, Hearing No. 30,262 (Feb. 2, 1994), 1994 TEX. TAX LEXIS 83.

308. Tex. Comp. Pub. Acc'ts, Hearing No. 31,965 (Feb. 7, 1995), 1995 TEX. TAX LEXIS 83; see also Tex. Comp. Pub. Acc'ts, Hearing No. 32,202, 1995 TEX. TAX LEXIS 43 (Jan. 10, 1995) for a discussion of several successor liability cases and issues.

309. See, e.g., *Serna v. State*, 877 S.W.2d 516, 518 (Tex. App.—Austin 1994, writ denied) (holding that the "Tax Code no longer requires that debts be knowingly and consensually created for an officer to be held liable"); *Jonnet v. State*, 877 S.W.2d 520 (Tex. App.—Austin 1994, writ denied) (decided the same day as *Serna* and reached a similar result); *Cain v. State*, 882 S.W.2d 515 (Tex. App.—Austin 1994, no writ) (holding director and officer personally liable for corporate debt following forfeiture of charter for failure to pay franchise tax).

310. No. 01-92-00605-CV, 1995 WL 2622, at \*1 (Tex. App.—Houston [1st Dist.], Jan. 5, 1995, n.w.h.) (not designated for publication).

311. *Id.* at \*2.

312. 904 S.W.2d 946 (Tex. App.—Austin 1995, n.w.h.).

313. *Id.* at 954.

314. *Id.*