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## Taxation

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# TAXATION

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This year's Survey period saw a number of attacks to the state's various taxing regimes—brought not only by taxpayers but also by taxing authorities—and seemed to preview battles that would play out during the 85th legislative session in 2017.<sup>1</sup> However, following a sustained period of low commodity prices, the legislature had to scramble to find the dollars to cover various priorities in 2017 and spent much of the legislative session debating social issues, such as bathroom etiquette. As predicted by many tax practitioners and other political and legislative insiders, sweeping tax reforms did not materialize during the 85th legislative session. As a result, Texas courts' continuing focus on statutory construction, and their struggles to balance their own readings of the legislature's words against the comptroller's interpretations, are likely to take on increased significance in the short term and possibly for years to

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come.<sup>2</sup>

## I. SALES TAX

### A. REPORTED CASES

As is often the case, this Survey period saw several cases requiring courts to construe statutory language and to weigh their construction against alternate comptroller interpretations. Following past decisions that focused on the plain language of statutes, courts continued during the Survey period to divine legislative intent from the ordinary meaning of statutes, yielding results that caused taxpayers to both celebrate and lament the courts' efforts.<sup>3</sup>

In the long-awaited *Southwest Royalties, Inc. v. Hegar*,<sup>4</sup> the Texas Supreme Court considered whether equipment used in the extraction of oil and gas from underground reservoirs qualified for the manufacturing exemption in Section 151.318 of the Texas Tax Code.<sup>5</sup> In so doing, the supreme court affirmed the findings of both the trial court and the Austin Court of Appeals that physical changes to hydrocarbons brought to the surface during extraction only indirectly resulted from equipment used by Southwest.<sup>6</sup> The supreme court held that because such equipment did not itself alter the nature of the minerals, it did not qualify as "manufacturing, processing, or fabricating" equipment within the meaning of the statute, and therefore did not qualify for exemption from sales and use tax.<sup>7</sup>

Southwest Royalties had claimed exemptions for its casing, tubing, pumps, and related parts used to extract oil and natural gas from the ground, asserting that the equipment met the requirements of three manufacturing exemption provisions: a general manufacturing exemption,<sup>8</sup> a

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2. This Survey period covers selected developments from February 2016 to November 2016. Rather than describing every case and rule change during the period, this article comments on those developments most likely to change significantly the legal landscape or reflect an important trend.

3. One case offering a mixed bag for taxpayers during the Survey period was *Allstate Insurance Co. v. Hegar*, 484 S.W.3d 611 (Tex. App.—Austin 2016, pet. denied). Due to the timing of last year's publication, this decision, which involved temporary employment services, was reported in that Survey. See Cynthia M. Ohlenforst et al., *Taxation*, 2 SMU ANN. TEX. SURV. 479, 480–82 (2016).

4. 500 S.W.3d 400 (Tex. 2016).

5. See *id.* at 402.

6. See *id.* at 402–03.

7. *Id.* at 409.

8. See TEX. TAX CODE ANN. § 151.318(a)(2) (West 2015). This general manufacturing provision exempts:

[T]angible personal property directly used or consumed in or during the actual manufacturing, processing, or fabrication of tangible personal property for ultimate sale if the use or consumption of the property is necessary or essential to the manufacturing, processing, or fabrication operation and directly makes or causes a chemical or physical change to:

- (A) the product being manufactured, processed, or fabricated for ultimate sale; or
- (B) any intermediate or preliminary product that will become an ingredient or component part of the product being manufactured, processed or fabricated for ultimate sale . . . .

pollution control exemption,<sup>9</sup> and a public health exemption.<sup>10</sup> All three exemptions require that the equipment for which the exemption is sought be used or consumed in “the actual manufacturing, processing, or fabrication of tangible personal property.”<sup>11</sup>

In addressing the statutory language, the court of appeals noted that the text was unclear as to whether oil and gas extraction is included in “manufacturing, processing, or fabrication.”<sup>12</sup> On that basis, the court of appeals deferred to the comptroller’s interpretation, found the equipment failed to qualify for exemption, and upheld the trial court’s judgment in favor of the comptroller.<sup>13</sup>

Focusing on the ordinary meaning of the term “processing,” the supreme court concluded that “processing” in the manufacturing exemption is not ambiguous, and also concluded that the comptroller’s interpretation of the term in Rule 3.300(a)(10) of the Texas Administrative Code is consistent with its ordinary meaning.<sup>14</sup> The supreme court therefore adopted the definition of “processing” in Rule 3.300(a)(10): “[t]he physical application of the materials and labor necessary to modify or change the characteristics of tangible personal property.”<sup>15</sup>

The supreme court then looked to the facts developed in the trial court to determine whether the equipment Southwest used to extract oil fell within the scope of the exemption. The supreme court resisted the extensive briefing by both the parties and *amici* debating whether oil and gas production constitutes “processing” and focused instead on “whether the equipment for which Southwest is seeking an exemption was used in the actual physical application of materials and labor to the hydrocarbons that was necessary to cause, and caused, a physical change to them.”<sup>16</sup>

Finding that changes to the hydrocarbons were caused by changes in pressure and temperature as the hydrocarbons were brought to the surface—and not, as the taxpayer had urged, by the equipment at issue—the supreme court held that the equipment was not manufacturing equipment within the meaning of Section 151.318 and therefore did not qualify for

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9. *See id.* § 151.318(a)(5). The pollution control exemption exempts “tangible personal property used or consumed in the actual manufacturing, processing, or fabrication of tangible personal property for ultimate sale if the use or consumption of the property is necessary and essential to a pollution control process.”

10. *See id.* § 151.318(a)(10). The public health exemption exempts “tangible personal property used or consumed in the actual manufacturing, processing, or fabrication of tangible personal property for ultimate sale if the use or consumption of the property is necessary and essential to comply with federal, state, or local laws or rules that establish requirements related to public health.”

11. *Sw. Royalties*, 500 S.W.3d at 402 (quoting TAX § 151.318(a)(2), (5), (10)).

12. *Sw. Royalties, Inc. v. Combs*, 501 S.W.3d 95, 101 (Tex. App.—Austin 2014) (mem. op.), *aff’d sub nom.*, *Sw. Royalties, Inc. v. Hegar*, 500 S.W.3d 400 (Tex. 2016).

13. *Id.* at 104. For a discussion of the court of appeals’ opinion, see Ohlenforst et al., *supra* note 3, at 482–83.

14. *Sw. Royalties*, 500 S.W.3d at 405–07 (citing 34 TEX. ADMIN. CODE § 3.300(a)(10) (2017) (Comptroller of Pub. Accounts, Manufacturing; Custom Manufacturing; Fabricating; Processing)).

15. *Id.* at 406 (quoting ADMIN. § 3.300(a)(10)).

16. *Id.* at 407.

exemption under any of the three prongs on which Southwest Royalties had relied.<sup>17</sup> Whether a future court might make the subsequent inferential leap to conclude that extraction is therefore not processing within the meaning of the statute remains to be seen.<sup>18</sup> It also remains unclear the extent, if any, to which the supreme court was influenced by the comptroller's assertions that a taxpayer-favorable decision in this case would have dire financial consequences to the state fisc.<sup>19</sup>

Likewise, in *Hegar v. CheckFree Services Corp.*,<sup>20</sup> the Fourteenth Houston Court of Appeals looked both to the Tax Code and to the comptroller's interpretation in rules to decide whether an online banking company's offerings fell within the purview of the term "data processing services."<sup>21</sup> CheckFree contracted with banks to provide electronic bill-pay services to bank customers.<sup>22</sup> The comptroller argued that, because bank customers enter data into CheckFree's system in order to effectuate the payment of bills, CheckFree provides a taxable data processing service. The trial court, however, disagreed, and the court of appeals affirmed the trial court's judgment.<sup>23</sup>

In part because CheckFree, through its thousands of skilled and certified employees, was providing professional bill-pay services and using computers only incidentally to facilitate those services, the court of appeals found that such services did not constitute taxable data processing services.<sup>24</sup> Interpreting the definitions of "data processing" in Section 151.0035 of the Texas Tax Code and in Rule 3.330 of the Texas Administrative Code, and looking to the "essence of the transaction," the court of appeals held that "CheckFree's services do not fall within the Comptroller's definition of data processing services because that definition specifically excludes providers of other professional services who use a computer to facilitate the performance of their services."<sup>25</sup> Importantly,

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17. *See id.* at 407–09.

18. However, the supreme court did note that the comptroller had previously interpreted the term "processing" not to include mere oil extraction in Comptroller Hearing No. 31,253 (1998). *Id.* at 408 ("[T]he act of bringing oil to the surface of the earth is not processing. . . . [On the other hand,] injecting carbon dioxide for the purpose of thinning or increasing the gravity of the oil creates a physical change in the oil and is, therefore, a processing activity.").

19. *See, e.g.,* Ohlenforst et al., *supra* note 3, at 494–95. In any event, the comptroller continued to make such assertions in its briefing in at least one other case. *See infra* note 46 and accompanying text regarding *Am. Multi-Cinema, Inc. v. Hegar*, No. 03-14-00397-CV, 2017 WL 74416 (Tex. App.—Austin Jan. 6, 2017, no pet.) (mem. op.).

20. No. 14-15-00027-CV, 2016 WL 1576414 (Tex. App.—Houston [14th Dist.] Apr. 19, 2016, no pet.) (mem. op.).

21. *See id.* at \*1.

22. *Id.* at \*3.

23. *Id.* at \*1, \*6.

24. *Id.* at \*5–6.

25. *Id.* at \*2–4, \*6 (citing 34 TEX. ADMIN. CODE § 3.330(a)(1) (2017) (Comptroller of Pub. Accounts, Manufacturing; Custom Manufacturing; Fabricating; Processing); TEX. TAX CODE ANN. §§ 151.0101(b), 151.0035 (West 2015)). The court also noted that "[a]lthough the Comptroller has been granted exclusive jurisdiction to interpret what 'taxable services,' including 'data processing services,' means, the Comptroller may not interpret this term in a manner contrary to the tax code." *Id.* at \*2 (internal footnote omitted) (citing TAX

the comptroller's own rule, Rule 3.330, provides that "[d]ata processing does not include the use of a computer by a provider of other services when the computer is used to facilitate the performance of the service or application of the knowledge of the physical sciences, accounting principles, and tax laws."<sup>26</sup> The court of appeals emphasized that "the trial court's findings and conclusions properly focused on the 'essence of the transaction' at issue, rather than simply the involvement of a computer, to determine the nature of the services CheckFree provided."<sup>27</sup> In 1987, when the legislature first made data processing services taxable, both legislators and the comptroller recognized that not all services involving computerized data would be taxable data processing. With the subsequent expansion of computers into virtually every aspect of life, the lines between taxable data processing and nontaxable services sometimes seem blurred (especially in the context of a tax audit). Thus, the *CheckFree Services* analysis is particularly important for its recognition of the fundamental reality that current business enterprises that rely on computers, software, and related services are not necessarily using a taxable service.

The courts continue to wrestle with the sale for resale exemption. In a case reminiscent of *DTWC Corp. v. Combs*,<sup>28</sup> the Austin Court of Appeals in *Fitness International, LLC v. Hegar*<sup>29</sup> addressed whether gym equipment, including cardio and abdominal machines and weight racks, qualifies for the sale for resale exemption when customers, through a gym

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§ 151.0101(b); *Combs v. Home & Garden Party, Ltd.*, No. 03-09-00673-CV, 2010 WL 4367054, at \*5 (Tex. App.—Austin Nov. 3, 2010, no pet.) (mem. op.).

26. 34 TEX. ADMIN. CODE § 3.330(a)(1).

27. *CheckFree Servs.*, 2016 WL 1576414, at \*4. Also addressing computer-related issues, the district court in *Calavista, L.P. v. Hegar* determined that Calavista was entitled to a refund for third-party software modifications and custom software development services. See Final Judgment, *Calavista, L.P. v. Hegar*, No. D-1-GN-15-001662 (126th Dist. Ct., Travis County, Tex. Apr. 14, 2016); Plaintiff's Motion for Summary Judgment at 11, *Calavista, L.P. v. Hegar*, No. D-1-GN-15-001662 (126th Dist. Ct., Travis County, Tex. Mar. 22, 2016). The case addressed both substantive and procedural issues. Calavista relied on Section 151.0101(a)(5)(D) of the Texas Tax Code, which explicitly excludes from taxable services "the repair, maintenance, creation, and restoration of a computer program, including its development and modification, not sold by the person performing the repair, maintenance, creation, or restoration service." See Plaintiff's Motion for Summary Judgment, *supra*, at 6–7 (quoting TAX § 151.0101(a)(5)(D)). The comptroller ultimately agreed with Calavista on the merits, but filed a plea to the jurisdiction (a frequently-used tool in the attorney general's toolbox), asserting that because it had agreed to issue Calavista the refund it sought, the case had become moot. In its response to the plea, Calavista complained that it was entitled to a judicial decision, in part so it would not be at risk to yet another comptroller assessment on the very same issues, and pointed out that it had asked for a refund, not the promise of a refund. One day after Calavista filed its response to the plea, the trial court agreed that Calavista deserved certainty and issued its Final Judgment. See Final Judgment, *supra* (granting Calavista's motion for summary judgment and ordering the comptroller to refund \$196,902.38 in tax, penalty, and interest, plus statutory interest and court costs).

28. 400 S.W.3d 149 (Tex. App.—Austin 2013, no pet.).

29. No. 03-15-00534-CV, 2016 WL 3391606 (Tex. App.—Austin Jun. 16, 2016, pet. denied) (mem. op.).

membership, are allowed to use the equipment.<sup>30</sup> Fitness International argued that the equipment was effectively resold or rented to those members. Looking to Fitness International's operations and agreements with its members, the court of appeals was unpersuaded.<sup>31</sup> The court interpreted the terms "resell" and "transfer" in the resale exemption according to their common meanings, both of which—according to the court—required elements of possession and control.<sup>32</sup> Because Fitness International had "superior legal possession of the items and merely provide[d] access to and use of its facilities—including whatever exercise equipment may or may not be on site and functioning at any given time—under terms and conditions completely within its own discretion for a specified monthly fee," the equipment at issue was not resold or leased and thus did not fall within the sale for resale exemption.<sup>33</sup>

### B. COMPTROLLER RULES<sup>34</sup>

During the Survey period, the comptroller continued efforts to update rules, including by bringing rules into accord with current legislation, sometimes after years without an amending update.<sup>35</sup> Many of the rule amendments during the period, therefore, related to legislative changes from the 2015 legislative session and, in some cases, earlier legislative sessions.

Included in the list of rules the comptroller modified in response to legislative action are Rules 3.286 (involving nexus and taxpayers' responsibilities) and 3.355 (involving insurance services) of the Texas Administrative Code.<sup>36</sup> Amendments to Rule 3.355 implement the 84th Legislature's House Bill 1841, which excluded public insurance adjuster services from taxable insurance services.<sup>37</sup> The amendments to Rule 3.286, among other things, implement Section 151.0241 of the Texas Tax

30. *See id.* at \*1–2. The trial court determined that towels, basketballs, and consumables, such as body wash and shampoo, were exempt, but determined the equipment at issue on appeal did not qualify for the resale exemption. *Id.* at \*2.

31. *Id.* at \*3.

32. *Id.* (citing *McIntyre v. Ramirez*, 109 S.W.3d 741, 745 (Tex. 2003)).

33. *Id.*

34. Citations to agency materials are to the most recently amended Texas Administrative Code as of the time this article went to press, but readers should note that the rules originally appeared during the 2016 Survey period in the Texas Register.

35. Comptroller staff acknowledged that additional changes to some rules might be needed to address other issues, but noted that bringing rules up-to-date with statutory changes should not be further delayed as would be required by waiting to make all contemplated changes.

36. *See* 34 TEX. ADMIN. CODE § 3.286 (2017) (Comptroller of Pub. Accounts, Seller's and Purchaser's Responsibilities including Nexus Permits, Returns and Reporting Periods, and Collection and Exemption Rules); 34 TEX. ADMIN. CODE § 3.355 (2017) (Comptroller of Pub. Accounts, Insurance Services). The comptroller also amended Rule 3.320 (concerning the Texas emissions reduction plan surcharge) to reduce the surcharge rate from 2% to 1.5%, consistent with the legislative change in the 84th Legislature's House Bill 7. *See* 34 TEX. ADMIN. CODE § 3.320 (2017) (Comptroller of Pub. Accounts, Texas Emissions Reduction Plan Surcharge; Off-Road, Heavy-Duty Diesel Equipment); Act of June 15, 2015, 84th Leg., R.S., ch. 448 (H.B. 7), § 35, sec. 151.0515(b), 2015 Tex. Gen. Laws 1740, 1755.

37. *See* 34 TEX. ADMIN. CODE § 3.355.

Code, which was enacted in 2015 to provide that out-of-state entities entering Texas to perform certain disaster- and emergency-related work will not be deemed to have established nexus in Texas as a result of such activities.<sup>38</sup> The amendments to Rule 3.286 also memorialize a comptroller presumption that an out-of-state seller that does not identify tax on an invoice or contract as Texas sales or use tax did not collect Texas sales or use tax.<sup>39</sup> This presumption may help some taxpayers avoid an assessment for tax collected but not remitted, but it is also likely to make it more difficult for out-of-state taxpayers to demonstrate to the comptroller's satisfaction that Texas tax was properly collected and remitted.

Also in response to legislation, the comptroller adopted new Rule 3.353 of the Texas Administrative Code and amendments to Rule 3.369 of the Texas Administrative Code, both of which concern sales tax holidays.<sup>40</sup> New Rule 3.353 implements Section 151.3565 of the Texas Tax Code (which created a sales tax holiday for certain emergency preparation supplies),<sup>41</sup> and the amendments to Rule 3.369 implement Section 151.3335 of the Texas Tax Code (which created a sales tax holiday for certain water-efficient products).<sup>42</sup> Both rules include provisions that provide detailed guidance on items qualifying for exemption and the tax treatment of layaways, discounts, exchanges, delivery and installation charges, and pre-packaged bundles of taxable and exempt items.<sup>43</sup> Although the portions of the rules mirroring the statutory language often track that language fairly closely, there are some discrepancies. For instance, the definition of "water-conserving product" in Section 151.3335 includes two provisions—one for certain tangible personal property used on residential property and another that provides a list of items qualifying for exemption, including certain hoses, irrigation systems, and mulch.<sup>44</sup> The definition of "water-conserving product" in Rule 3.369, however, describes the latter list of items as examples of the types of items described in the former provision, thereby apparently taking the position that items such as hoses, irrigation systems, and mulch should be subject to the residential use requirement and other requirements listed in the first statutory provision.<sup>45</sup>

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38. See 34 TEX. ADMIN. CODE § 3.286(a)(3), (d)(2)(B); see also TEX. TAX CODE ANN. § 151.0241 (West Supp. 2016).

39. See 34 TEX. ADMIN. CODE § 3.286(d)(2)(B).

40. See 34 TEX. ADMIN. CODE § 3.353 (2017) (Comptroller of Pub. Account, Sales Tax Holiday—Certain Emergency Preparation Supplies); 34 TEX. ADMIN. CODE § 3.369 (2017) (Comptroller of Pub. Accounts, Sales Tax Holiday—Certain Energy Star Products, Certain Water-Conserving Products, and WaterSense Products).

41. See 34 TEX. ADMIN. CODE § 3.353; see also TEX. TAX CODE ANN. § 151.3565 (West 2015).

42. See 41 Tex. Reg. 3789, 3870 (2016) (codified at 34 TEX. ADMIN. CODE § 3.369); see also TAX § 151.3335.

43. See generally 34 TEX. ADMIN. CODE §§ 30353, 3.369.

44. TAX § 151.3335(a)(1).

45. See 34 TEX. ADMIN. CODE § 3.369(a)(7); see also 41 Tex. Reg. 3789, 3870 (codified at 34 TEX. ADMIN. CODE § 3.369 (2016) (preamble) ("New paragraph (7) defines the term 'water-conserving product' and includes examples of water-conserving products.")).



## II. FRANCHISE TAX

### A. REPORTED CASES

The Survey period saw several favorable outcomes for taxpayers challenging various aspects of the Texas franchise tax and its application to their businesses. The Texas Supreme Court continued to look to statutory language to resolve disputes, and the Austin Court of Appeals continued its trend of recognizing that cost of goods sold (COGS) is not as narrow as the comptroller sometimes argues, including in the context of certain real property construction services.<sup>46</sup>

In *Hallmark Marketing Co., LLC v. Hegar*,<sup>47</sup> the Texas Supreme Court addressed the meaning of “net gain from the sale” used to determine gross receipts from a taxpayer’s entire business for purposes of apportionment under Section 171.105(b) of the Texas Tax Code.<sup>48</sup> Hallmark had incurred substantial losses on sales of investments and capital assets, such that its losses on such sales during the tax year at issue were greater than its gains.<sup>49</sup> Section 171.105(b) provides that “[i]f a taxable entity sells an investment or capital asset, the taxable entity’s gross receipts from its entire business for taxable margin includes only the net gain from the sale.”<sup>50</sup> Hallmark argued that its net loss did not constitute a “net gain” within the meaning of the statutory language, and therefore it was not required to include the net loss in its apportionment formula.<sup>51</sup> However, the comptroller’s interpretation of this section, in Rule 3.591 of the Texas Administrative Code, provides that, “[i]f the combination of net gains

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46. Despite these mostly taxpayer-friendly decisions, some taxpayers were left holding their breath during the Survey period. Several significant cases remained pending throughout the entire Survey period. Two such cases were *Graphic Packaging Corp. v. Hegar*, 471 S.W.3d 138 (Tex. App.—Austin 2015, pet. granted), and *American Multi-Cinema, Inc. v. Hegar*, No. 03-14-00397-CV, 2017 WL 74416, at \*1 (Tex. App.—Austin Jan. 6, 2017, no pet.) (mem. op.). At issue in *Graphic Packaging* was a taxpayer’s claim that it was entitled to use the three-factor formula from the Multistate Tax Compact for purposes of apportioning its Texas franchise tax. See *Graphic Packaging*, 471 S.W.3d at 139. *American Multi-Cinema* involved a movie theater’s qualification to rely on the COGS calculation. After the Survey period, the Austin Court of Appeals withdrew its initial opinion, *American Multi-Cinema, Inc. v. Hegar*, No. 03-14-00397-CV, 2015 WL 1967877 (Tex. App.—Austin Apr. 30, 2015), *opinion withdrawn and superseded on overruling of reh’g sub nom.*, 2017 WL 74416 (Tex. App.—Austin Jan. 6, 2017, pet. granted), and issued a new decision, again holding for the taxpayer but instead relying on a different, industry-specific definition of tangible personal property that includes films, sound recordings, books, television and radio programs, and similar property. See *Am. Multi-Cinema*, 2017 WL 74416, at \*1–2 (citing TEX. TAX CODE ANN. § 171.1012(a) (West 2015)). Next year’s Survey should include a more complete discussion of the new decision, but it is important to note in this article that the court of appeals decision upheld the taxpayer’s right to claim COGS but left unclear the extent to which its holding would apply to taxpayers outside the industry-specific statutory provisions. The comptroller asserted, as it did in *Southwest Royalties*, that a taxpayer-favorable decision could trigger refund claims that could adversely impact the state’s budget. Query the extent to which it is appropriate for a court to even consider the comptroller’s budgetary arguments in a case of statutory interpretation.

47. 488 S.W.3d 795 (Tex. 2016).

48. *Id.* at 796–97.

49. *Id.* at 799.

50. TAX § 171.105(b).

51. *Hallmark Mktg. Co.*, 488 S.W.3d at 797.

and losses results in a net loss, the taxable entity should net the loss against other receipts, but not below zero.”<sup>52</sup>

Relying on *Calvert v. Electro-Science Investors, Inc.*,<sup>53</sup> which construed a former statutory section similar to Section 171.105(b) to require that gains and losses be offset in order to arrive at a net figure, the Corpus Christi Court of Appeals concluded that Section 171.105(b) is ambiguous.<sup>54</sup> The court of appeals concluded that Rule 3.591 is reasonable and therefore entitled to deference.<sup>55</sup> Therefore, Hallmark was required to include its net loss in its apportionment factor.<sup>56</sup>

The supreme court, however, identified the statutory ambiguity issue as a red herring. Without revisiting the issue in *Electro-Science Investors*, and pointing to the parties’ agreement that Hallmark had incurred a net loss, the supreme court focused on what was clear from the statutory language:

However net gain is calculated, a statutory net gain cannot simultaneously be a net loss. Accountants might dispute how to properly offset losses against gains and whether the correct calculation should result in a positive or negative figure, but none can dispute that if that end result is a positive number, it’s a net gain, and if it’s a negative number, it’s a net loss.<sup>57</sup>

The supreme court concluded that the comptroller’s interpretation of “net gain” to include a net loss constituted an unreasonable rewriting of the statute, and Hallmark was not required to include its net loss in its apportionment calculations.<sup>58</sup> The supreme court did not, however, specify whether, or how, losses should offset gains to calculate a “net gain” under the apportionment statutes.<sup>59</sup>

In *Hegar v. CGG Veritas Services (U.S.), Inc.*,<sup>60</sup> the Austin Court of Appeals addressed the meaning of the term “labor and materials” for purposes of the franchise tax COGS calculation.<sup>61</sup> CGG performed geoseismic work for companies engaged in oil and gas exploration. Relying on Section 171.1012(i) of the Texas Tax Code, which permits an entity to use the COGS calculation if it is “furnishing labor or materials to a project for the construction, improvement, remodeling, repair, or industrial

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52. 34 TEX. ADMIN. CODE § 3.591(e)(2) (2017) (Comptroller of Pub. Accounts, Margin: Apportionment).

53. 509 S.W.2d 700 (Tex. Civ. App.—Austin 1974, no writ).

54. See *Hallmark Mktg. Co., LLC v. Combs*, No. 13-14-00093-CV, 2014 WL 6090574, at \*3–4 (Tex. App.—Corpus Christi Nov. 13, 2014) (mem. op.), *rev’d sub nom.* *Hallmark Mktg. Co., LLC v. Hegar*, 488 S.W.3d 795 (Tex. 2016).

55. *Id.* at \*4.

56. *Id.* at \*4–5. For a discussion of the court of appeals’ decision, see Ohlenforst et al., *supra* note 3, at 492–93.

57. *Hallmark Mktg. Co., LLC v. Hegar*, 488 S.W.3d 795, 799 (Tex. 2016) (internal citation omitted).

58. *Id.* at 796.

59. *Id.* at 797.

60. No. 03-14-00713-CV, 2016 WL 1039054 (Tex. App.—Austin Mar. 9, 2016, no pet.) (mem. op.).

61. See *id.* at \*3.

maintenance [ ] of real property,” CGG argued that its work qualified for the COGS calculation.<sup>62</sup> The comptroller, however, argued that such work was a service that could not qualify for the COGS calculation.<sup>63</sup>

In deciding the case, the court of appeals looked to its own recent precedent exploring the meaning of “labor.”<sup>64</sup> In *Combs v. Newpark Resources, Inc.*, the court of appeals properly concluded that the legislature “intended section 171.1012 to permit taxable entities to deduct a wide range of labor expenses, including those associated with activities that might also be described as a ‘service.’”<sup>65</sup> Relying on the standard it established in *Newpark* for determining eligibility for the COGS calculation—“whether the particular activity is an essential and direct component of the ‘project for the construction . . . of real property’”—the court of appeals concluded that CGG’s activities qualified for the COGS calculation.<sup>66</sup> In reaching this conclusion, the court appears to have assigned some weight to the comptroller’s agreement that an oil and gas well constitutes real property and the trial court’s finding that CGG’s services were “an integral, essential, and direct component of the oil and gas drilling process.”<sup>67</sup>

#### B. COMPTROLLER RULES

Compared to sales tax rules, the comptroller proposed and adopted fewer franchise tax rules during the Survey period. Some amendments were meant as clarifications or to implement enacted legislation, and other changes codified comptroller policy.

The comptroller adopted amendments to Rule 3.582 of the Texas Ad-

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62. *Id.* at \*2 (quoting TEX. TAX CODE ANN. § 171.1012(i) (West 2015)).

63. *Id.*

64. *Id.*

65. *Id.* (citing *Combs v. Newpark Res., Inc.*, 422 S.W.3d 46, 56 (Tex. App.—Austin 2013, no pet.)).

66. *Id.* at \*3, \*5 (citing *Newpark Res.*, 422 S.W.3d at 56).

67. *See id.* at \*4. On June 30, 2016, following the Austin Court of Appeals’ decision in *Titan Transportation, LP v. Combs*, the comptroller’s Tax Policy Division issued a memorandum interpreting Section 171.1012(i) and effecting two policy changes following the appellate court’s decision. *See Titan Transp., L.P. v. Combs*, 433 S.W.3d 625 (Tex. App.—Austin 2014, pet. denied); TEX. COMPTROLLER OF PUB. ACCOUNTS, TAX POLICY DIV., STAR DOC. NO. 201606856L, POLICY CHANGE BASED ON *Titan* and *Newpark* (June 30, 2016), <https://star.cpa.texas.gov/view/201606856L> [<https://perma.cc/J3XA-MK25>]. The memorandum discusses the decisions in both *Titan Transportation* (addressing Section 171.1011(g) of the Texas Tax Code) and *Newpark Resources* (addressing Section 171.1012(i)), and it revises comptroller policies in response to those decisions. According to the memorandum, both Tax Code sections allow taxpayers in certain industries to claim either the COGS calculation or an exclusion from revenue for flow-through funds, but Section 171.1011(g) may have broader application because it includes payments related to “proposed” projects. Therefore, according to the memorandum, costs for architects and engineers, whether or not construction actually begins on a project, may qualify for the flow-through funds exclusion but may not qualify for the COGS calculation. The memorandum also states that costs “considered too far removed” from actual construction or improvement, including legal and accounting services, do not qualify for an exclusion or the COGS calculation. For a discussion of *Titan Transportation*, see Ohlenforst et al., *supra* note 3, at 491–92. For a discussion of *Newpark Resources*, see Cynthia M. Ohlenforst et al., *Taxation*, 1 SMU ANN. TEX. SURV. 101, 108–10 (2014) [hereinafter *Taxation I*].

ministrative Code related to filing requirements for passive entities.<sup>68</sup> Compared to the text of the rule prior to these changes, some of the amendments appear to impose additional filing requirements on some passive entities. For instance, a passive entity that is registered with the Secretary of State or the comptroller must now file a No Tax Due Report for each period that it qualifies as a passive entity.<sup>69</sup> Prior comptroller policy had required a passive entity to file an information report only for the first period that it qualified as a passive entity and did not require subsequent reports.<sup>70</sup> Also, new subsection (c)(3) provides that “[a]n entity with no federal gross income does not qualify as a passive entity.”<sup>71</sup> Passive entities that go dormant or otherwise do not have gross income for a period should review this rule carefully to determine their filing responsibilities, and consider whether the rule is consistent with the statutory requirements imposed on passive entities.

The comptroller also amended Rule 3.588 of the Texas Administrative Code<sup>72</sup> related to the COGS calculation to track more closely Section 171.1012 of the Texas Tax Code.<sup>73</sup> The prior version of the rule defined “goods” to include “the husbandry of animals; the growing and harvesting of crops; [and] the severance of timber from realty.”<sup>74</sup> The amendments move this definition of “goods” to a subsection addressing costs related to undocumented workers, consistent with the statute.<sup>75</sup> It is not clear whether taxpayers can or should rely on the prior version to claim COGS for report years during which the prior version was effective.

### III. PROPERTY TAX

#### A. REPORTED CASES

This Survey period highlighted mounting frustration with the Texas property tax system, not only among taxpayers, but also among taxing authorities. In addition to the typical property tax cases involving valuation and collection disputes between a property owner and an appraisal district or taxing unit, several taxing unit actions during this Survey period called the state’s property tax system into question. For instance, Houston Independent School District (ISD) elected not to participate in the state’s school finance recapture program. Some speculated that the likely outcome of this decision would be that property located in Houston ISD would be detached and assigned to another independent school dis-

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68. See 34 TEX. ADMIN. CODE § 3.582 (2017) (Comptroller of Pub. Accounts, Margin: Passive Entities).

69. See *id.* § 3.582(g)(1).

70. See Former Rule 3.582(g)(1), 34 Tex. Reg. 9265, 9464–65 (2009), amended by 41 Tex. Reg. 3205, 3241 (2016), adopted by 41 Tex. Reg. 4529, 4649 (2016).

71. 34 TEX. ADMIN. CODE § 3.582(c)(3).

72. *Id.* § 3.588 (2017) (Comptroller of Public Accounts, Margin: Cost of Goods Sold).

73. TEX. TAX CODE ANN. § 171.1012 (West 2015).

74. Former Rule 3.588(b)(3), 38 Tex. Reg. 3397, 3415–20 (2013), amended by 41 Tex. Reg. 3563, 3625–29 (2016), adopted by 41 Tex. Reg. 4911, 5073 (2016).

75. See 34 TEX. ADMIN. CODE § 3.588(g)(14).

trict but so far this has not occurred. Instead, voters authorized the district to fulfill its recapture obligation after the Texas Education Agency reduced that obligation.<sup>76</sup>

*City of Austin v. Travis Central Appraisal District*<sup>77</sup> involved a frontal assault on the property tax system by an aggrieved taxing unit. In that case, the City of Austin (the City) alleged that Sections 41.43(b)(3) and 42.26(a)(3) of the Texas Tax Code—both of which involve challenges to unequal appraisals<sup>78</sup>—were invalid because they encouraged taxpayer protests that led the appraisal review board to lower property values. These protests, the City argued, artificially depressed the median property value below market value. Thus, those property owners who were appraised at market value were taxed unequally relative to those who contested their taxes and successfully achieved a reduction toward the median value, presenting a problem of unequal taxation under the Texas Constitution.<sup>79</sup> *Junk Yard Dogs*, a property owner involved in the suit, argued that the City lacked standing because it failed to allege a particularized injury specific to itself, and that the City failed to exhaust its administrative remedies.<sup>80</sup>

The Austin Court of Appeals agreed with *Junk Yard Dogs*, concluding that the City's allegations faltered in both respects.<sup>81</sup> Fatal to the City's claims was its acknowledgment that it did not bring suit to raise tax revenue, but rather to "ensure equal and uniform taxation to all Austin residents."<sup>82</sup> While the court of appeals noted that some statutes empower governmental entities to bring constitutional challenges if they have been

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76. See Shelby Webb, *HISD Voters Flip on Subsidy*, HOUS. CHRON., May 6, 2017, <http://chron.com/news/houston-texas/houston/article/HISD-voters-flip-on-susidy-11127234.php> [<https://perma.cc/6555-S3H8>]. Several cases reported in past surveys remained stalled in the appellate courts during this Survey period. Those cases involve the property tax treatment of heavy equipment, *Harris County Appraisal District v. ETC Marketing, Ltd.*, 476 S.W.3d 501, 503–04 (Tex. App.—Houston [14th Dist.] 2015, *aff'd*, 518 S.W.3d 371 (Tex. 2017)), and *Galveston Central Appraisal District v. Valero Refining-Texas L.P.*, 463 S.W.3d 177 (Tex. App.—Houston [14th Dist.] 2015), *rev'd*, 519 S.W.3d 66 (Tex. 2017). For a general discussion of the heavy equipment case, see Ohlenforst et al., *supra* note 3, at 500–02. For a discussion of *ETC Marketing*, see Ohlenforst et al., *supra* note 3, at 503–04. For a discussion of *Valero Refining*, see Ohlenforst et al., *supra* note 3, at 502–03. After the Survey period, the Texas Supreme Court issued decisions in the *Valero Refining* and *ETC Marketing* cases. In *ETC Marketing*, the supreme court affirmed the First Houston Court of Appeals' decision, which found natural gas stored in Texas subject to property tax. See *ETC Marketing, Ltd. v. Harris Cty. Appraisal Dist.*, 518 S.W.3d 371, 374 (Tex. 2017). In *Valero Refining*, the supreme court reversed the Fourteenth Houston Court of Appeals' decision and concluded that Valero was permitted, as a matter of law, to challenge the appraised values of only a portion of its refinery in an unequal appraisal case. See *Valero Ref.-Tex., L.P. v. Galveston Cent. Appraisal Dist.*, 519 S.W.3d 66, 68 (Tex. 2017). Next year's Survey should include a more complete discussion of these decisions.

77. 506 S.W.3d 607 (Tex. App.—Austin 2016, no pet.).

78. See TAX §§ 41.43(b)(3), 42.26(a)(3).

79. *City of Austin*, 506 S.W.3d at 611, 616 (citing TEX. CONST. art. VIII, § 1).

80. *Id.* at 615–16, 618. In addition to bringing suit against the appraisal district, the City also named as parties the thousands of property owners implicated by its constitutional challenges. *Id.* at 611.

81. See *id.* at 620.

82. *Id.* at 616.

“charged with implementing” the statute, the provisions at issue in this case merely provided a procedural mechanism for the appraisal process, which is conducted by the appraisal district, not taxing units.<sup>83</sup> The injury alleged was therefore one that affected Austin property owners, not the City of Austin.<sup>84</sup>

Another case involving Section 42.26(a)(3) of the Texas Tax Code is *Duke Realty Limited Partnership v. Harris County Appraisal District*.<sup>85</sup> The Fourteenth Houston Court of Appeals’ decision demonstrates the deference appellate courts often give to a trial court’s findings of facts and credibility determinations. Duke Realty owned a parcel of land located near a major intersection in Harris County. The company filed suit challenging the appraisal district’s valuation of the property, alleging that the appraisal was not equal and uniform as required by Section 42.26(a)(3) for tax years 2013 and 2014. The court of appeals explained that, in determining whether property has been unequally appraised under Section 42.26(a)(3), an expert typically “identifies a reasonable number of comparable properties and then takes the appraised value of those properties from the public record and appropriately adjusts them to the subject property.”<sup>86</sup>

At trial, Duke Realty’s expert contended that properties of a similar size should be used for comparison, while the appraisal district’s expert concluded that properties of a similar location should be used. The court of appeals held that “[t]he trial court, as factfinder, was entitled to make credibility determinations and weigh the competing expert testimony and the variables and assumptions upon which that testimony was based.”<sup>87</sup> Because Duke Realty failed to demonstrate that the trial court was unreasonable in crediting the appraisal district expert’s testimony over that of its own expert, its legal sufficiency challenge failed.<sup>88</sup>

In *Sebastian Cotton & Grain, Ltd. v. Willacy County Appraisal District*,<sup>89</sup> the Corpus Christi Court of Appeals addressed whether Section 25.25(b) of the Texas Tax Code may be used to reapportion value in property between two different taxpayers when such reapportionment will increase one taxpayer’s liability. Section 25.25(b) provides that “[t]he chief appraiser may change the appraisal roll at any time to correct . . . a determination of ownership . . . that does not increase the amount of tax liabil-

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83. *Id.* at 616–17 (citing *Proctor v. Andrews*, 972 S.W.2d 729, 734 (Tex. 1998)).

84. *Id.* at 617. For a discussion of the Austin Court of Appeals’ determination of a procedural issue, see *infra* text accompanying note 120.

85. No. 14-15-00543-CV, 2016 WL 3574666, at \*3 (Tex. App.—Houston [14th Dist.] June 30, 2016, no pet.) (mem. op.).

86. *Id.* (citing *In re MHC B (USA) Leasing & Fin. Corp.*, No. 01-06-00075-CV, 2006 WL 1098922, at \*3 (Tex. App.—Houston [1st Dist.] Apr. 27, 2006, orig. proceeding) (mem. op.)).

87. *Id.* at \*3 (citing *Hedgepeth v. Diamond Offshore Drilling, Inc.*, No. 01-12-01156-CV, 2013 WL 6097798, at \*5 (Tex. App.—Houston [1st Dist.] Nov. 19, 2013, no pet.) (mem. op.)).

88. *Id.* at \*4.

89. 492 S.W.3d 824 (Tex. App.—Corpus Christi 2016, pet. filed).

ity.”<sup>90</sup> The appraisal district relied on that section to support its proposed redistribution of the tax liability between the taxpayers, arguing that the aggregate tax liability with respect to the property at issue was not being increased.<sup>91</sup> Sebastian Cotton, however, argued that liability in this subsection refers to *any one taxpayer’s* liability, not the net effect of a change in ownership.<sup>92</sup>

In analyzing the dispute, the court of appeals discussed three themes informing its interpretation of the Tax Code provision at issue: the Tax Code “(1) consistently treats the term ‘liability’ as an individual rather than net-effect concept, (2) grants a right of hearing to those facing tax increases, and (3) favors finality after all hearings have been completed.”<sup>93</sup> Because Section 25.25(b) used the term “liability,” did not grant a right of hearing, and would have imposed post-appraisal changes on taxpayers, the court of appeals concluded that the appraisal district was not authorized to shift taxes between taxpayers as it had attempted to do.<sup>94</sup> The appellate court ruled in Sebastian Cotton’s favor, finding that the district court erred in upholding the assessment against Sebastian Cotton for the increase in liability.<sup>95</sup>

## B. COMPTROLLER RULES

Although the Texas property tax is mostly administered at the local level, the comptroller has some property tax functions, including duties related to economic development agreements.<sup>96</sup>

During the Survey period, the comptroller adopted amendments to

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90. *Id.* at 831 (emphasis omitted) (quoting TEX. TAX CODE ANN. § 25.25(b) (West 2015)).

91. *Id.*

92. *See id.* Sebastian Cotton also argued that the appraisal district had failed to exhaust its administrative remedies with respect to a fraud claim because the appraisal district did not raise that issue with the appraisal review board. Addressing this argument, which has led to a split among appellate courts, the Corpus Christi Court of Appeals concluded that a failure to raise an issue before the appraisal review board does not deprive a district court, which exercises *de novo* review, of jurisdiction over that issue. *Id.* at 829. *But see* Harris Cty. Appraisal Dist. v. ETC Mktg., Ltd., 399 S.W.3d 364, 369 (Tex. App.—Houston [14th Dist.] 2013, pet. denied); Midland Cent. Appraisal Dist. v. Plains Mktg., LP, 202 S.W.3d 469, 475–76 (Tex. App.—Eastland 2006, pet. denied); Quorum Int’l v. Tarrant Appraisal Dist., 114 S.W.3d 568, 573 (Tex. App.—Fort Worth 2003, pet. denied).

93. *Sebastian Cotton & Grain*, 492 S.W.3d at 835.

94. *See id.*

95. *Id.* at 836.

96. During the Survey period, the comptroller also adopted rules pertaining to local government relief related to the disabled veterans property tax exemption. These rules provide guidelines for local governments to follow in order to qualify for offsets to revenue lost related to the exemption. *See* 434 TEX. ADMIN. CODE §§ 9.4321, 9.4323, 9.4325, 9.4327 (2017) (Comptroller of Pub. Accounts, Definitions (§ 9.4321); Application (§ 9.4323); Review by Comptroller (§ 9.4325); Payment to Qualified Local Government (§ 9.4327)). The comptroller also adopted appraisal guidelines for certain types of property, including airports and recreational property, parks, and scenic land. *See* 34 TEX. ADMIN. CODE § 9.4009 (2017) (Comptroller of Pub. Accounts, Appraisal of Recreational, Park, and Scenic Land); *see also* 34 TEX. ADMIN. CODE § 9.4010 (Comptroller of Pub. Accounts, Appraisal of Public Access Airport Property).

Rules 9.1052,<sup>97</sup> 9.1053,<sup>98</sup> 9.1054,<sup>99</sup> and 9.1059<sup>100</sup> of the Texas Administrative Code, and adopted new Rule 9.1060 of the Texas Administrative Code,<sup>101</sup> all of which relate to economic development agreements under Chapter 313 of the Texas Tax Code.<sup>102</sup> Among other changes, the comptroller shortened the amount of time a school district has to review a taxpayer's economic development agreement application prior to its meeting to discuss such application from thirty days to twenty days,<sup>103</sup> and changed the location used to evaluate whether an application has met the qualifying jobs requirements from the location of the school board's administrative office to the location of the job itself.<sup>104</sup>

#### IV. PROCEDURE

##### A. REPORTED CASES

While property tax cases still present the lion's share of procedural issues in any given survey period, several taxpayers struggled during this Survey period with procedural issues in other tax contexts.

*Brown v. Hegar*<sup>105</sup> involved a sales tax contest between a taxpayer and the comptroller regarding whether the taxpayer's purchase of an aircraft qualified for the occasional sale exemption and whether the taxes assessed against him were barred by the statute of limitations.<sup>106</sup> Brown purchased an aircraft from CMB Sales, Inc. in April 2003. Neither Brown nor CMB paid any state taxes on the transaction, and only CMB filed a sales tax return for the period in which the sale occurred. Three months after the general four-year statute of limitations would have expired with respect to the transaction, the comptroller assessed tax and penalty on Brown. Brown argued that the statute of limitations—which normally does not begin to run with respect to periods for which the taxpayer did not file a required return—should nevertheless apply to the transaction at issue in his case because CMB had filed a tax return with respect to that period.<sup>107</sup> The comptroller contended that Brown was required to file a tax report himself because he owed use tax on the item, that he had failed to file a required return, and that the four-year statute of limitations did

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97. 34 TEX. ADMIN. CODE § 9.1052 (Comptroller of Pub. Accounts, Forms).

98. *Id.* § 9.1053 (Comptroller of Pub. Accounts, Entity Requesting Agreement to Limit Appraised Value).

99. *Id.* § 9.1054 (Comptroller of Pub. Accounts, School District Application Review and Agreement to Limit Appraised Value).

100. *Id.* § 9.1059 (Comptroller of Pub. Accounts, Annual Compliance Review for Qualifying Jobs and Penalties).

101. *Id.* § 9.1060 (Comptroller of Pub. Accounts, Agreement for Limitation on Appraised Value).

102. *See* 34 TEX. ADMIN. CODE §§ 9.1051–9.1054, 9.1059, 9.1060 (2017).

103. *See id.* § 9.1053(f).

104. *See id.* § 9.1059(c).

105. No. 03-14-00492-CV, 2015 WL 7952259 (Tex. App.—Austin Dec. 3, 2015, no pet.) (mem. op.).

106. *See id.* at \*2.

107. *See id.* (citing TEX. TAX CODE ANN. § 111.205(a)(2) (West 2015)).



not apply.<sup>108</sup>

The Austin Court of Appeals rejected Brown's argument as a general matter, noting that

it seems reasonable to conclude that the legislature did not intend for the statute of limitations to bar recovery when a report is filed by someone other than the person who allegedly owes the taxes at issue, particularly in the circumstances present in this case where the filed report does not accurately reflect that a taxable transaction occurred.<sup>109</sup>

Further, the court of appeals noted that recognizing such a construction of the statute might enable tax evasion by allowing less scrupulous taxpayers to "avoid liability by having the other party to the transaction start the running of the limitations period by filing a tax report for the applicable period of time and deliberately conceal that a taxable event occurred."<sup>110</sup> However, the court of appeals was not able to determine whether Brown was required to file the underlying use tax return because a fact question remained as to whether the transaction had occurred in Texas or Alabama.<sup>111</sup> According to the comptroller, if the sale occurred in Alabama, Brown would have owed use tax, instead of sales tax, on the aircraft and would have been required to file a return.<sup>112</sup>

In *Anheuser-Busch, L.L.C., v. Harris County Tax Assessor-Collector*,<sup>113</sup> the Harris County Tax Assessor-Collector failed to send a tax bill to both Anheuser-Busch and its authorized agent for property taxes on seven of its factories located in the county.<sup>114</sup> Anheuser-Busch paid its taxes late with respect to those properties and incurred statutory penalties and interest for which it requested a waiver. The tax assessor countered that it had substantially complied with its statutory notice obligations and that penalty and interest waiver was therefore inappropriate.<sup>115</sup>

Contrary to the tax assessor's assertion, the First Houston Court of Appeals concluded that Section 31.01 of the Texas Tax Code contains an unambiguous requirement that both the taxpayer and the taxpayer's agent be notified of taxes assessed against the taxpayer; allowing otherwise would "rewrite the statute."<sup>116</sup> For five of the seven properties at issue, the appellate court ordered a full refund of penalties and interest for the tax assessor's failure to comply with Section 31.01(a).<sup>117</sup> For the other two properties, a fact question remained as to whether Anheuser-

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108. *Id.*

109. *Id.* at \*5.

110. *Id.* at \*6.

111. *Id.* at \*6-7.

112. *Id.* at \*6.

113. 516 S.W.3d 1 (Tex. App.—Houston [1st Dist.] 2016, pet. filed).

114. *Id.* at 4.

115. *Id.* at 6.

116. *Id.* at 10 (citing TEX. TAX CODE ANN. § 31.01(a) (West 2015)). In 2005, the legislature amended Section 31.01(a), which had required that the bill be mailed to the person listed on the tax roll "or the person's authorized agent." *Id.* at 8.

117. *Id.* at 13.

Busch had validly appointed an authorized agent, so the court of appeals remanded for a further determination on that issue.<sup>118</sup>

In addition to the underlying substantive dispute, the *City of Austin* case (discussed above)<sup>119</sup> also involved an interesting procedural issue.<sup>120</sup> Rather than present a full case on the merits before the appraisal review board, the City of Austin (the City) and the appraisal district submitted an agreed motion at the administrative level simply identifying its challenge and requesting that the appraisal review board deny the challenge so the City could proceed to district court. The Austin Court of Appeals granted the appraisal district's plea to the jurisdiction, concluding that, by merely going through the motions of appealing to the appraisal review board, the City had failed to exhaust the administrative remedies required by the Texas Tax Code.<sup>121</sup> According to the court of appeals, "the City decided to effectively forego the administrative determination of its challenge, depriving the district court of jurisdiction."<sup>122</sup>

Property tax accounts and the division of property among accounts continued to be a source of litigation during the Survey period.<sup>123</sup> In *Tomball Independent School District v. Mustang Machinery Company, Ltd.*,<sup>124</sup> the First Houston Court of Appeals addressed whether a property owner owes penalties and interest when it requests that certain property be moved from one account to another.<sup>125</sup> Mustang had two accounts with the Harris County Appraisal District—one for business property and one for inventory. Mustang filed a motion to correct the tax rolls under Section 25.25 of the Texas Tax Code, asking that \$1.7 million worth of property be transferred from the business property account to the inventory account.<sup>126</sup> After the correction was made, Tomball ISD billed Mustang for additional taxes, penalty, and interest.<sup>127</sup> In imposing penalty and interest despite the fact that Mustang had timely paid before the correction, Tomball ISD argued that "if a correction motion increases the amount due on an *account*, penalties and interest on the entire amount contained in the correction motion begin to accrue from the original delinquency date."<sup>128</sup> Mustang countered that the Tax Code "focuses on whether the taxpayer paid the tax on the *property* underlying the dispute" and that it therefore owed no additional tax on the property on

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118. *Id.*

119. See discussion *supra* Section III.A.

120. See *City of Austin v. Travis Cent. Appraisal Dist.*, 506 S.W.3d 607, 617–20 (Tex. App.—Austin 2016, no pet.).

121. See *id.* at 620.

122. *Id.*

123. Another case involving the effect of property tax accounts on a property owner's substantive rights is *Galveston Central Appraisal District v. Valero Refining–Texas L.P.* See discussion *supra* note 77. For a discussion of the *Valero* court of appeals decision, see Ohlenforst et al., *supra* note 3, at 502–03.

124. 497 S.W.3d 131 (Tex. App.—Houston [1st Dist.] 2016, no pet.).

125. See *id.* at 132.

126. *Id.* at 132–33 (citing TEX. TAX CODE ANN. § 25.25(c) (West 2015)).

127. *Id.* at 133.

128. *Id.* at 135.

which it had already paid taxes prior to the correction.<sup>129</sup>

The court of appeals agreed with Mustang, holding that “[b]ecause Mustang paid taxes on the original appraisal amount of the underlying property and the statute focuses on the payment of taxes for property, not for an account, it does not owe penalty and interest on the originally assessed value of the transferred property.”<sup>130</sup>

## V. OTHER SIGNIFICANT APPELLATE COURT DECISIONS

In *Morath v. The Texas Taxpayer and Student Fairness Coalition*,<sup>131</sup> a significant decision that surprised many, the Texas Supreme Court decided a broad challenge to the constitutionality of the Texas public school finance system without finding the system unconstitutional.<sup>132</sup> More than half of the state’s public school districts “brought the most far-reaching funding challenge in Texas history.”<sup>133</sup> The supreme court noted that “Texas’s more than five million school children deserve better than serial litigation over an increasingly Daedalean ‘system.’ They deserve transformational, top-to-bottom reforms.”<sup>134</sup> However, within its limited judicial role, the supreme court deferred to the legislature.<sup>135</sup> “Lawmakers decide if laws pass, and judges decide if those laws pass muster. But our lenient standard of review in this policy-laden area counsels modesty. The judicial role is not to second-guess whether our system is optimal, but whether it is constitutional.”<sup>136</sup> In a lengthy opinion, the supreme court ultimately determined that “[d]espite the imperfections of the current school funding regime, it meets minimum constitutional requirements.”<sup>137</sup>

In *Hegar v. Texas Small Tobacco Coalition*,<sup>138</sup> the Texas Supreme Court addressed another constitutional issue: whether a “fee” imposed on cigarettes and tobacco products under the Health and Safety Code violates the Texas Constitution’s equal and Uniform Clause. In 2013, the Texas legislature enacted a fee on tobacco products that applied only to tobacco companies that had not signed settlement agreements with the state relating to claims for antitrust violations and deceptive advertising.<sup>139</sup> Texas Small Tobacco Coalition (Small Tobacco) argued that the fee was unconstitutional because it violated the Equal and Uniform Clause of the Texas Constitution, as well as the Equal Protection and Due Process Clauses of the U.S. Constitution.<sup>140</sup> The trial court held that the

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129. *Id.*

130. *Id.* at 136.

131. 490 S.W.3d 826 (Tex. 2016).

132. *See id.* at 886.

133. *Id.* at 833.

134. *Id.* at 833–34.

135. *Id.* at 833, 886.

136. *Id.* at 886.

137. *Id.* at 833.

138. 496 S.W.3d 778 (Tex. 2016).

139. *Id.* at 780.

140. *Id.* at 784.

subchapter imposing the fee was unconstitutional under both constitutions, and the Austin Court of Appeals affirmed, but only on the basis of Small Tobacco's challenge under the Equal and Uniform Clause of the Texas Constitution.<sup>141</sup> Analyzing the reasonableness of the tax's subject matter classification, the court of appeals held that, although the purposes of the tax were laudable, "imposing a tax on only one class of identical products is not equal and uniform" where the only justification for the classification was whether a taxpayer had earlier entered into a settlement agreement with the state.<sup>142</sup>

In reversing the court of appeals' decision, the supreme court observed that the equal-and-uniform analysis focuses on the taxpayer at issue, not on the taxpayer's products, and as such, affords the legislature broad discretion in classifying taxpayers.<sup>143</sup> "Products do not pay taxes; taxpayers do. For that reason, in the non-property context, the nature of the taxpayer necessarily lies at the heart of any Equal and Uniform Clause inquiry."<sup>144</sup> The supreme court then determined that the classification between Small Tobacco and the tobacco companies that settled with the state was rational.<sup>145</sup> Under that standard, there were "sufficient differences in business operations to justify the non-settling-manufacturer and settling-manufacturer tax classifications."<sup>146</sup> The supreme court noted that the settling manufacturers, pursuant to their settlement, had to pay the state \$500 million per year and were restricted from challenging certain legislative initiatives, and the supreme court concluded that the classification was reasonably related to the legislative "goals of recovering health care costs and reducing underage smoking."<sup>147</sup>

## VI. CONCLUSION

Against the backdrop of the 2016 national political contests, Texas politics and law during the Survey period seemed more civilized but that civility would be put to the test at various times during the 2017 Texas legislative session. Although issues other than tax generally dominated the regular legislative session, several significant tax-related bills made their way to the governor's desk, while others were unable to attract the support needed—either in the legislature or from the governor—to become law. Despite the Texas Supreme Court's somewhat unexpected de-

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141. *Id.*

142. *Id.* at 785. For a discussion of the court of appeals' decision, see Ohlenforst et al., *supra* note 3, at 514.

143. *Id.* at 786 (citing *TracFone Wireless, Inc. v. Commc'n on State Emergency Commc'ns*, 397 S.W.3d 173, 181 (Tex. 2013); *In re Nestle*, 387 S.W.3d 610, 620 (Tex. 2012) (orig. proceeding); *Tex. Co. v. Stephens*, 103 S.W. 481, 485 (Tex. 1907)). "The discretion inherent in [the legislature's] authority is hobbled by no substantial handicap other than the overriding rule that any claimed difference be 'real.'" *Id.* at 791 (citing *Tex. Co.*, 103 S.W. at 485).

144. *Id.* at 786.

145. *Id.* at 792.

146. *Id.* at 787.

147. *Id.* at 787–88.

cision in *Morath v. Texas Taxpayer and Student Fairness Coalition*,<sup>148</sup> holding that the public education system is constitutional, legislators have acknowledged the need for property tax reform, and the governor requested that property tax reform be one of the key issues addressed in the 2017 special legislative session. As this article went to press, it remained unclear exactly what that reform would ultimately look like or when Texans would see such reform.

The regular legislative session gave rise to a few changes to the sales and franchise taxes, but most were rifle shots, addressing discrete issues or clarifications. It therefore remains likely that the most important sales and franchise tax changes (and perhaps property tax changes as well) will result as taxpayers and the comptroller's team continue to work—sometimes together and sometimes at the courthouse—to articulate the scope of these taxes as well as the circumstances in which comptroller guidance or budgetary financial results are relevant to the court's consideration.

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148. *See supra* Part V.