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Taxation

J. David Tracy

TAXATION

by

*J. David Tracy**

IN expanding the relevance and benefit of the *Survey* to Texas attorneys, the *Journal* is including in this issue for the first time an Article on taxation.[1] Although the main emphasis of this Article will be on Texas cases and statutes of general interest, selected federal tax decisions uniquely intertwined with the community property system or Texas law in general will also be discussed.

I. STATE TAXATION

Inheritance Tax. Although there was little activity in the area of the Texas inheritance tax,[2] some provocative questions have been raised by *Sloan v. Calvert*[3] concerning the application of the limitations statute to the collection of the Texas inheritance tax.[4] In *Sloan* the decedent died intestate in 1957 with a purported taxable estate of $35,564.70. The comptroller issued his receipt evidencing payment of $95.73 in inheritance taxes for the estate. In 1971 the decedent's daughter filed a federal estate tax return showing a taxable estate of $111,438.75.[5] The comptroller assessed additional Texas inheritance taxes, and the attorney general filed suit in 1972 for collection of the additional taxes and enforcement of the state's lien against the decedent's daughter.[6] The court in *Sloan* held that the five- and ten-year statutes of limitation for the collection of the Texas inheritance tax[7] as enacted in 1959 were not retroactive in their application; consequently, the state

* B.A., J.D., University of Texas at Austin; LL.M., Southern Methodist University. Attorney at Law, Fort Worth, Texas.

1. *See generally* Peters, *An Analysis of Important Recent Developments in the State and Local Tax Area*, 39 J. TAXATION 172 (1973).

2. In an interesting decision the hearings division of the office of the comptroller of public accounts has recently held that when a transfer of $15,375 is admitted to be in contemplation of death, it is a "material part" of the decedent's estate within TEX. TAX.-GEN. ANN. art. 14.01(B) (Supp. 1974), when it is 6.19% of the Texas and 7.51% of the federal taxable estate. 7 STATE BAR OF TEXAS, NEWSLETTER OF SECTION OF TAXATION, No. 1, Sept. 1973, at 14. Although there are no Texas cases on the contemplation of death statute, *compare* TEX. ATT'Y GEN. OP. No. 0-6678 (1945), where gifts of less than 2% were not "material," *with* TEX. ATT'Y GEN. OP. No. V-264 (1947), where gifts of 69.57% were "material."

3. 497 S.W.2d 125 (Tex. Civ. App.—Austin 1973).

4. TEX. TAX.-GEN. ANN. arts. 14.00A-.22 (1969).

5. The daughter did not file an amended or supplemental Texas inheritance tax return; rather, the Internal Revenue Service notified the comptroller of the filing of the federal estate tax return and the comptroller made his additional assessment on the basis of that information. 497 S.W.2d at 126.

6. The court did not discuss whether the daugher still had any of the bequest in her possession at the time the attorney general instituted suit to enforce the collection of additional inheritance taxes. Presumably, even though the suit is in rem, and no personal judgment can be obtained, it makes no difference that the daughter might have squandered the bequest, since she did receive property worth $111,438.75. *Cf.* Dodge v. Youngblood, 202 S.W. 116, 119 (Tex. Civ. App.—San Antonio 1918), *rev'd on other grounds*, 245 S.W. 225 (Tex. Comm'n App. 1922), *judgment adopted.*

7. TEX. TAX.-GEN. ANN. art. 14.18(D) (1969).

was not foreclosed from commencing a suit against the daughter for collection of additional Texas inheritance taxes. This holding is consistent with the wording of the statute in effect at the date of the decedent's death;[8] however, the court felt constrained to comment on what effect, if any, the five- and ten-year statutes of limitation would have had if they had been applicable in this case.

The court then proceeded, in dictum, to determine whether the daughter would have been able to plead successfully the statute of limitations if article 14.18(D) had been applicable to this estate.[9] Since the daughter had not filed with the comptroller a report of the determination of the federal tax, as required by article 14.14, the limitations statute was held inapplicable.[10] Although the court did not address itself to the question of whether the estate must file the report within thirty days of its receipt from the Internal Revenue Service in order for the limitations period to apply, a strict reading of the statute would certainly dictate that result.

Problems and inequities stemming from the statute are immediately apparent. First, in those estates required to file a federal estate tax return, if the executor neglects to file the federal estate tax closing letter with the comptroller until after thirty days from its receipt, the limitations period will apparently never begin to run.[11] In contrast is the small estate that has only to file an inventory with the probate court in order to commence the running of the limitations period.[12] Secondly, under the facts of the *Sloan* case, if the federal estate tax return had been filed eleven years after the decedent's death and the federal estate tax closing letter was forwarded to the comptroller within thirty days of its receipt, presumably the limitations period would have run and no additional inheritance taxes could be collected

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8. The statute in effect at the date of the decedent's death provided:
> A lien shall exist on all property subject to taxation under this Act to secure the payment of all taxes, penalties and costs provided for herein; and all persons acquiring any portion of said property shall be charged with notice of the existence of all such unpaid taxes, penalties and costs, and of the lien securing their payment, which may be enforced in any suit brought for the collection of said taxes, penalties and costs.

Ch. 29, § 10, [1923] Tex. Laws 66. The lien would attach at the date of the decedent's death and only payment of the tax rightfully due and owing the state would extinguish the lien. *See* TEX. ATT'Y GEN. OP. NO. V-769 (1949).

9. The limitation periods "shall have no force or effect unless the reports required by Article 14.14 . . . are filed *as provided in said Article.*" TEX. TAX.-GEN. ANN. art. 14.18(D) (1969) (emphasis added). Article 14.14 provides that "[*w*]*ithin thirty (30) days* after receiving notice or information of the final assessment and determination of the value of the estate" for the purposes of the federal estate tax, the executor shall report the same to the comptroller. TEX. TAX.-GEN. ANN. art. 14.14(D) (1969) (emphasis added).

10. "The Legislature plainly intended to place upon the representative of the estate the burden and responsibility to report a final value of the estate to the Comptroller, failing in which the defense of limitations would be denied the estate." 497 S.W.2d at 127.

11. It has been this author's observation that there are many attorneys who either never file a copy of the federal estate tax closing letter with the comptroller, or else make no effort to file it within 30 days of its receipt.

12. Of course, some sort of inheritance tax report would be due, but this could be in the form of an affidavit. *See* TEX. TAX.-GEN. ANN. arts. 14.14(B), (C) (Supp. 1974); COMPTROLLER OF PUBLIC ACCOUNTS, INHERITANCE TAX AND FEDERAL ESTATE TAX CREDIT 40 (1971).

by suit.[13] These inequities show the reasonableness of amending article 14.18(D) to provide that (1) the limitations period will begin to run from the date of the decedent's death if all of the reports required by article 14.14 are filed within the time limits prescribed, provided that this is within five years of the decedent's death; or (2) if all reports are not filed within the time limits set forth in (1), the limitations period will begin to run on the date all of these reports have been filed.

Finally, the court in *Sloan* proceeded to discuss, in dictum, the daughter's argument that it was against public policy to allow the comptroller to commence suit for the enforcement of the inheritance tax lien in this case, since the comptroller had issued his receipt for the payment of inheritance taxes in 1957. If the receipt were deemed a release, then the state would have no foundation upon which to commence the suit.[14] In determining that the comptroller's receipt in this case was not a release, the court stated:

> It appears that appellant regards the Comptroller's *receipt* as a *release* of the State's lien and claim for taxes. Manifestly, without a showing to the contrary, a receipt for taxes paid, based on calculations upon a preliminary value, cannot be termed a final release of lien and taxes justly due the State. Appellant failed to file with the Comptroller her amended or supplemental tax return . . . . Under the circumstances appellant has not shown that the Comptroller's receipt was in fact a release of the State's claim to such taxes as were justly due upon a final value of the estate, or that by granting judgment for additional taxes the court violated public policy.[15]

The statements by the court regarding the distinctions between a receipt and a release are quite logical when applied to facts bordering on misrepresentation. However, in view of the comptroller's current policy of issuing only "receipts" and not "releases,"[16] questions will arise as to how much proof is needed to show that the receipt is indeed a release. For example, if subsequent to the issuance of the receipt, the comptroller should attack the valuation of certain property listed in the inheritance tax return, is good faith on the part of the party filing the inheritance tax return sufficient to show that the receipt was intended to be a release? Further, consider the beneficiary who did not prepare the inheritance tax return. If the state is commencing suit to foreclose its lien for inheritance taxes, it made out a prima facie case that it did not intend that the receipt be a release simply by instituting the suit; consequently, the taxpayer has the burden of proving that the receipt was intended as a release. It seems the better approach would be that the issuance by the comptroller's office of a receipt for the

13. It might be possible for the state to overcome such a result on a theory akin to laches or fraud in failing to file the necessary returns.

14. This would certainly be true under the present statutory language contained in TEX. TAX.-GEN. ANN. art. 14.18(D) (1959), and apparently it would also have been true under the statute in effect at the date of the decedent's death. *See* TEX. ATT'Y GEN. OP. No. V-769 (1949).

15. 497 S.W.2d at 128.

16. Apparently, the underlying rationale for this is the comptroller's view that the receipt is the "notice" which the comptroller gives the county clerk "that the tax lien upon property listed on the inventory and appraisement is released." TEX. TAX.-GEN. ANN. art. 14.19(A) (1969).

payment of the Texas inheritance tax, which receipt is filed with the probate court or simply forwarded to the personal respresentative in cases of non-probate estates, be deemed a release of the Texas inheritance tax, except in those cases where the personal representative or estate beneficiaries have knowingly misrepresented facts to the state.

Franchise Tax. The Texas franchise tax is levied upon a corporation's "taxable debt"[17] and "taxable capital,"[18] the latter term including stated capital, surplus, and undivided profits. The Texas attorney general was recently confronted with the problem of determining the effect of a reserve account set up by a corporation in the steel production business for the firebrick linings of the company's furnaces which were used to smelt steel.[19] The firebrick linings had a useful life of approximately five years, and the reserve method was used in lieu of a depreciation account. Relying on the definition of "surplus" in the Texas Business Corporation Act as "the excess of the net assets of the corporation over its stated capital,"[20] the attorney general determined that the reserve account could be deducted by the corporation in the calculation of the amount of its taxable capital.[21] This decision is eminently reasonable, since both bad debt reserves and depreciation accounts have been allowed as deductions in computing a corporation's taxable capital.[22]

An interesting question arose in *Acme Color Art Printing Co. v. Brown*[23] in which the corporate charter of Acme Color was forfeited by the secretary of state in accordance with article 12.17[24] for failure to pay the corporate franchise tax. Acme filed a sworn account action against Brown, with Brown responding by a sworn plea in abatement alleging that Acme Color had no standing to sue because its charter had been forfeited. At a hearing on the plea in abatement Acme Color presented a certificate issued by the secretary of state showing that the franchise taxes had been paid and the corporation's charter reinstated subsequent to the filing of the lawsuit, but prior to the hearing on the plea in abatement. The court of civil appeals

17. TEX. TAX.-GEN. ANN. art. 12.01(1)(a)(ii) (1969); *see* Comptroller's Ruling Nos. 80-0.07, -0.12, 1 CCH TEX. STATE TAX REP. ¶¶ 5-301A, D. The franchise tax levied upon "taxable debt" expired April 30, 1973.

18. TEX. TAX.-GEN. ANN. art. 12.01(1)(a)(i) (1969); Comptroller's Ruling No. 80-0.08, 1 CCH TEX. STATE TAX REP. ¶ 5-301B.

19. TEX. ATT'Y GEN. OP. No. H-62 (1973).

20. TEX. BUS. CORP. ACT ANN. art. 1.02(12) (1956).

21. This same basic reasoning found fruition in TEX. ATT'Y GEN. OP. No. H-65 (1973), wherein the attorney general held that subordinated capital notes issued by a national bank were debt and not part of the bank's capital structure. A franchise tax, as such, is not levied upon banks; however, an ad valorem tax is levied upon the bank stock held by its shareholders. Under TEX. REV. CIV. STAT. ANN. art. 7166 (1960), each bank share is taxed "only for the difference between its actual cash value and the proportionate amount per share at which its real estate is assessed." Even though the comptroller of the currency considered these notes to be a part of the capital structure of the bank, the Texas attorney general found that the term "capital" obviously has its derivation from early financial characterization of large concentrations of money. By whatever name, these notes are still "debts" and they, thus, decrease the net asset value of the bank's shares.

22. Huey & Philp Hardware Co. v. Shepperd, 151 Tex. 462, 251 S.W.2d 515 (1952); *see* Comptroller's Ruling No. 80-0.14, 1 CCH TEX. STATE TAX. REP. ¶ 5-301F.

23. 488 S.W.2d 507 (Tex. Civ. App.—Dallas 1972), *error ref. n.r.e.*

24. TEX. TAX.-GEN. ANN. art. 12.17 (1969).

overruled Brown's plea in abatement,[25] noting that the purpose of the franchise tax statute was to raise revenue and encourage delinquent corporations to pay the franchise tax they owed. Presumably on the theory that the corporation could simply file a new lawsuit, the court stated that to dismiss the plaintiff's lawsuit because its charter was forfeited at the time it instituted the suit would be useless, since the charter had subsequently been reinstated. But it is still difficult to understand the court's contention that it was not deciding whether the reinstatement of the charter has any retroactive effect. The court implicitly gave retroactive effect to the reinstatement of the charter by allowing Acme Color to continue with the lawsuit. Apparently, however, the result could be different if a statute of limitations problem were involved.[26]

Sales and Use Tax.[27] The Texas sales tax is imposed upon the retail sale of taxable items. In a normal consumer purchase of goods, the sales tax is added to the purchase price of the item and collected from the purchaser by the retailer. The retailer is then required to remit the sales tax to the state.[28] However, when a "contractor" performs work for a lump sum, supplying both parts and labor, the consumer for whom the work is performed is not liable for the sales tax. Rather, the contractor is deemed the "consumer" of the goods and is liable for the sales tax upon the items of tangible personal property which are incorporated into his work product.[29]

In *Able Irrigation Co. v. Calvert*[30] the court of civil appeals was presented with the question of whether a taxpayer who built and installed irrigation systems on farms and ranches was a "lump sum contractor." Essentially, the taxpayer would contract with its customers to construct an irrigation ditch for a set price per linear foot, representing both labor and materials. In the actual construction of the facility, the taxpayer would dig the irrigation trench and line it with concrete. The court correctly held that the tax-

25. Presumably, Brown's plea in abatement would have been sustained if Acme Color's charter had not been reinstated prior to the hearing.

26. In limiting its opinion, the court stated: "We do not have before us the question of whether filing the petition tolled the statute of limitations, and we need not consider whether reinstatement of the charter had any retroactive effect." 488 S.W.2d at 508. *But see* TEX. BUS. CORP. ACT ANN. art. 7.01E (Supp. 1974); *cf.* TEX. REV. CIV. STAT. ANN. art. 1302-2.07 (1962).

27. New statutes have been passed by the legislature relating to the sales and use taxes: TEX. TAX.-GEN. ANN. art. 20.021(F) (Supp. 1974) (resale certificates relating to beer and malt liquor); TEX. TAX.-GEN. ANN. art. 20.04(M) (Supp. 1974) (sales tax exemption for ileostome, colostomy, and ileal bladder appliances); TEX. TAX.-GEN. ANN. art. 20.021(N) (Supp. 1974) (bond or security for collection of the sales tax); TEX. TAX.-GEN. ANN. art. 20.05 (Supp. 1974) (methods of payment of sales tax); and TEX. TAX.-GEN. ANN. arts. 20.021(N)(6)-(8) (Supp. 1974) (comptroller's reports and delinquent lists for Local Sales and Use Tax Act). *See generally* Cass, *Role of the Attorney General in the Enforcement of Limited Sales, Excise and Use Tax*, 6 STATE BAR OF TEXAS, NEWSLETTER OF SECTION OF TAXATION, No. 2, Apr. 1973, at 5.

28. TEX. TAX.-GEN. ANN. art. 20.021(A) (Supp. 1974). Not surprisingly the hearings division of the comptroller's office recently held that the Texas sales tax is a "privilege" tax like the franchise and inheritance taxes so that it does not violate the constitutional provisions of TEX. CONST. art. VIII, § 1, specifying four types of taxes: property, poll, occupation, and income taxes. *See* 7 STATE BAR OF TEXAS, NEWSLETTER OF SECTION OF TAXATION, No. 1, Sept. 1973, at 12.

29. TEX. TAX.-GEN. ANN. art. 20.01(T) (1969); *see* Comptroller's Ruling No. 95-0.09, 1 CCH TEX. STATE TAX REP. ¶ 60-087.

30. 495 S.W.2d 270 (Tex. Civ. App.—Austin 1973).

payer was a lump sum contractor and subject to the Texas sales tax on the items of tangible personal property which he purchased for his own use and not for resale.[31] In the instant case, this included not only items incorporated into the irrigation ditch itself, such as concrete mix, sand, and gravel, but also such items used by the taxpayer in the construction of the ditches as tools, concrete mixers, chains, steel sides, and concrete forms.

An interesting fact situation arose in *Calvert v. American International Television*[32] concerning the application of the Texas use tax[33] to a California corporation renting cartoons and short features to television stations in Texas. The company, whose offices were in California and New York, received orders by telephone, mail, or by two salesmen, neither of whom were domiciled in Texas. The salesmen would travel through Texas five or six times a year taking orders, all of which were tentative and required approval in the New York office. The company did not advertise in Texas, have a phone number listed in Texas, nor have a permit to do business in the State of Texas.

The court found that there was a sufficient link between American International and the State of Texas to satisfy the due process and commerce clause requirements, and thus to allow the state to require American International to act as its agent in collecting any use tax which might become due from users of American International's products within the state, and to insure the payment of such tax if American International failed to make collections from Texas residents.[34] In effect, American International will

31. A second argument presented by the taxpayer in the *Able Irrigation* case was that it was exempt from the sales tax because it was in the business of selling a product exclusively used or employed on farms within the meaning of TEX. TAX.-GEN. ANN. art. 20.04(N)(6) (1969). The court, in rejecting the taxpayer's contention, stated that the company's irrigation systems were not "farm machinery or equipment" because the system could not be placed on the open market and sold; that is, it was not an item of tangible personal property. Thus, by implication, the court stated that the items of personal property incorporated into the irrigation ditches built by the taxpayer were not equipment used on farms exclusively to maintain water facilities within the meaning of article 20.04(N)(6). It would seem that this result is certainly not compelled by the statute, even though Comptroller's Ruling 95-0.13, 1 CCH TEX. STATE TAX. REP. ¶ 60-253, exempts "parts of a pumping system or unit to be assembled at the well site or sections of pipe designed to be fitted into a *portable* irrigation system." (Emphasis added.)

32. 491 S.W.2d 455 (Tex. Civ. App.—Austin 1973).

33. The use tax, which is the complement of the sales tax, provides that the taxes imposed "on the storage, use or other consumption in this state of taxable items purchased, leased or rented from any retailer for storage, use or other consumption in this state . . ." shall be at the same rates prescribed on the sales price "or in the case of leases or rentals on said lease or rental prices." TEX. TAX.-GEN. ANN. art. 20.03 (1969). The use tax is collected by every retailer engaged in business in the State of Texas, *i.e.*, any retailer who has "any representative, agent, salesman, canvasser or solicitor operating in this State under the authority of the retailer . . . for the purpose of selling, delivering, or the taking of orders for any taxable item." TEX. TAX.-GEN. ANN. art. 20.031(B) (1969).

34. The court found unpersuasive the taxpayer's argument that since it had only two salesmen in the state the company was not doing business in Texas. The court gave the obvious response that the company would employ only the number of salesmen that it needed to carry on its business, whether that be one, two, or three. It is interesting to compare this with a recent decision of the hearings division of the comptroller's office reported in 6 STATE BAR OF TEXAS, NEWSLETTER OF SECTION OF TAXATION, No. 2, Apr. 1973, at 9, where a company having no offices, salesmen, or warehouses in Texas was held not to be a retailer doing business in Texas. The corporation was thus not liable for the sales or use tax on the sales made to its fifty franchise dealers

be required to collect the use tax on the rental of its films, or else bear the cost of this tax itself.[35]

Property Tax.[36] As usual, there has been a flurry of judicial decisions relating to Texas property taxes, most of which are not of general interest. Included in this category were those cases discussing whether the description of property was sufficient for assessment purposes,[37] whether certain farm and ranch lands were for "agriculture use" and thus subject to special assessment techniques,[38] whether tangible personal property acquired a situs other than that of the owner of the property,[39] and whether the procedures used in assessing or collecting taxes were valid.[40]

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in the State of Texas; rather, the use tax had to be collected from the local dealers. *Cf.* TEX. BUS. CORP. ACT ANN. art. 8.01(B)(1) (Supp. 1974).

35. For a general discussion of the taxation of interstate businesses, see generally W. BEAMAN, PAYING TAXES TO OTHER STATES 3.13-.19 (1963); Rudolph, *State Taxation of Interstate Business: The Unitary Business Concept and Affiliated Corporate Groups*, 25 TAX L. REV. 171 (1970); Comment, *Taxing the Out-of-State Corporation—A Congressional Awakening*, 22 SW. L.J. 627 (1968).

36. For a critique of the Texas property tax system, see Yudof, *The Property Tax in Texas Under State and Federal Law*, 51 TEXAS L. REV. 885 (1973). *See generally* Harriss, *Property Taxation and the Future of State-Local Finance*, 51 TAXES 683 (1973).

An interesting case was presented to the United States Supreme Court recently in Lehnhausen v. Lake Shore Auto Parts Co., 410 U.S. 356 (1973), wherein it was held that an Illinois constitutional provision having the effect of subjecting corporations but not individuals to ad valorem taxes on personal property was valid. The constitutional provision was found to be within the framework of the equal protection clause because of the wide latitude given states in developing a reasonable taxation system.

37. Hart v. Northside Ind. School Dist., 498 S.W.2d 459 (Tex. Civ. App.—San Antonio 1973) ("mobile home" was insufficient since there was no description of the land); Frossard v. State, 497 S.W.2d 473 (Tex. Civ. App.—Dallas 1973) (description from unrecorded plat was sufficient); Jamison v. City of Pearland, 489 S.W.2d 636 (Tex. Civ. App.—Houston [1st Dist.] 1973), *error ref. n.r.e.* (abstract number, lot, account number, and acreage held sufficient); Plyler v. City of Pearland, 489 S.W.2d 459 (Tex. Civ. App.—Houston [1st Dist.] 1972), *error ref. n.r.e.* (computer print-out held sufficient).

38. San Marcos Consol. Ind. School Dist. v. Nance, 495 S.W.2d 235 (Tex. Civ. App.—Austin 1973) (test of "agriculture use" is not relative amount of income from land as opposed to other sources, but rather bona fide effort to earn profit from land); Jamison v. City of Pearland, 489 S.W.2d 636 (Tex. Civ. App.—Houston [1st Dist.] 1973), *error ref. n.r.e.* (tax assessor-collector may use his discretion to determine whether land is for "agriculture use" and this decision may not be attacked collaterally). *See also* TEX. ATT'Y GEN. OP. No. M-1271 (1972).

39. The partnership is the taxpayer, not the partners, so that the domicile of the partnership determines the taxability of partnership personalty. McKinney v. Nacogdoches Ind. School Dist., 489 S.W.2d 161 (Tex. Civ. App.—Tyler 1973), *error granted* (personal property is taxed at the domicile of the owner absent proof of its permanency at some other location giving it a taxable situs there); Lawson v. Gorves, 487 S.W.2d (Tex. Civ. App.—Beaumont 1972).

40. Harvey v. Parks, 493 S.W.2d 286 (Tex. Civ. App.—Fort Worth 1973), *error ref. n.r.e.* (valuation placed on property by tax assessor-collector can be overturned only if it is grossly excessive); Duffey v. Union Hill Ind. School Dist., 490 S.W.2d 201 (Tex. Civ. App.—Texarkana 1973), *error ref. n.r.e.* (fact that all property subject to taxation is not taxed is unconstitutional, but taxpayer cannot overturn assessment on own property without showing of damage); Levisay v. Comanche Ind. School Dist., 487 S.W.2d 140 (Tex. Civ. App.—Eastland 1972), *error ref. n.r.e.*; Yamini v. Gentle, 488 S.W.2d 839 (Tex. Civ. App.—Dallas 1972), *error ref. n.r.e.* (taxes validly assessed in 1968 cannot be increased by a supplemental assessment for the year 1968 made in 1969, and failure of taxpayer to render property is not actionable fraud as tax assessor-collector also has this duty if the taxpayer fails to make the rendition); TEX. ATT'Y GEN. OP. No. H-80 (1973) (commissioners' court but not tax assessor-collector has authority to employ valuation experts for purpose of valuing all property in district); TEX. ATT'Y GEN. OP. No. M-1244 (1972) (taxpayer is not liable for costs in suit for collection of taxes when suit was dismissed for want of prosecution); TEX.

By far the most important case touching the area of Texas property taxation was the decision of the United States Supreme Court in *Rodriguez v. San Antonio Independent School District*,[41] concerning the Texas system of financing education by means of a fund which provided money to each school district for an "adequate" education of all children within the district. Each school district was given the power to raise additional supplementary funds by imposing an ad valorem tax on property within the district. Due to variances in the assessed value of property within each district and the manner in which the taxes were assessed, there was a wide disparity between districts as to the amount of supplemental income available to each district.

The plaintiffs in *Rodriguez* brought a class action on behalf of certain Texas school children challenging the Texas system of financing education as violative of the equal protection clause. The main thrust of the plaintiffs' argument was that members of poor families reside in school districts having a low property tax basis so that less money per pupil would be expended by the school district for education than would be expended per pupil in the wealthier school districts. Since this difference in expenditure arose chiefly from the differences in the value of assessable property among the various districts, the plaintiffs claimed that the Texas system favored the more affluent. The federal district court agreed,[42] finding the Texas school property tax system to be unconstitutional. In the view of the district court, wealth was a "suspect" classification and education was a fundamental right guaranteed to all citizens. Such being the case, the court called upon the state to prove that there was a compelling state interest for its system of taxation, and since the state failed to even establish a reasonable basis the system was declared unconstitutional.

The Supreme Court of the United States reversed and upheld the Texas school tax system in *Rodriguez* by using a different constitutional test than that applied by the district court. Essentially, the Supreme Court felt that the Texas school tax system should not be reviewed under the strict judicial scrutiny test because that test had historically been applied in cases where the class is *totally* disadvantaged by not being allowed to receive a benefit or exercise a fundamental right protected by the Constitution. In *Rodriguez* the plaintiffs were unable to show a definable disadvantaged class. Indeed, their basic premise that poor families resided in districts containing the least amount of assessable property was found to be without adequate factual foundation.[43] Furthermore, the Court held that education is not a "funda-

ATT'Y GEN. OP. No. M-1263 (1972) (when the state purchases land at delinquent tax sale, rents accruing from land are credited to benefit of taxing authorities holding liens, and property may be sold before end of two-year redemption period).

41. 411 U.S. 1 (1973). *See The Supreme Court, 1972 Term*, 87 HARV. L. REV. 55, 105-16 (1973); Note, *San Antonio Independent School District v. Rodriguez: Inequitable but Not Unequal Protection Under the Fourteenth Amendment*, 27 SW. L.J. 712 (1973). For a discussion of this case subsequent to the district court's decision, but prior to the Supreme Court's decision, see Porras, *The Rodriguez Case—A Crossroad in Public School Financing*, 26 TAX. LAW. 141 (1972).

42. 337 F. Supp. 280 (W.D. Tex. 1971); *see* Note, *An Attack on the Texas School Financing System: Rodriguez v. San Antonio Independent School District*, 26 SW. L.J. 608 (1972).

43. The Court noted that many poor families lived in heavily industrial districts,

mental" right. Even though a certain quantum of education is certainly needed to exercise rights such as voting, the plaintiffs made no showing that the Texas system failed to provide such minimal skills. Indeed, the state was shown to have endeavored to provide an "adequate" education for all children. Since the strict judicial scrutiny test was not appropriate, the Court applied the less stringent rational basis test to find that there was a rational relationship between the school taxing system and a legitimate state purpose. Consequently, the Texas system was held not to violate the equal protection clause of the Constitution.

The most important result of *Rodriguez* stems from its effects not only on the tax structure of Texas, but also on the tax structure of other states. The school tax system employed in Texas is essentially the same system as that employed by all other states. Had the Texas system been held unconstitutional, a general upheaval in the taxing system of all states would have ensued. Probably, this was at least a subliminal factor in the Court's decision.[44] However, the Texas system is far from perfect. As the Supreme Court stated:

> The need is apparent for reform in tax systems which may well have relied too long and too heavily on the local property tax. And certainly innovative new thinking as to public education, its methods and its funding, is necessary to assure both a higher level of quality and greater uniformity of opportunity. These matters merit the continued attention of the scholars who already have contributed much by their challenges. But the ultimate solutions must come from the lawmakers and from the democratic pressures of those who elect them.[45]

The exemption from ad valorem taxes accorded non-profit corporations[46] and the populous generally[47] was subjected to examination during the past year. One of the more interesting decisions is *City of Amarillo v. Amarillo Lodge No. 731, A.F. & A.M.*,[48] which dealt with the constitutionality of the

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which would have extremely high property tax bases. 411 U.S. at 23. *See The Supreme Court, 1972 Term, supra* note 41, at 108-10.

44. Apparently the plaintiffs did not present an alternative system of taxation which could be shown to be as good as or better than the present tax system. *See* 411 U.S. at 56; *The Supreme Court 1972 Term, supra* note 41, at 115-16.

45. 411 U.S. at 58-59.

46. The legislature passed a series of exemption statutes including: an exemption for volunteer fire departments, TEX. REV. CIV. STAT. ANN. art. 7150, § 28 (Supp. 1974); an exemption for property owned and held by a non-profit corporation for use in the development of a medical center, *id.*; an exemption for non-profit corporations providing homes for the handicapped or elderly persons, *id.* art. 7150, § 27, which was held invalid in TEX. ATT'Y GEN. ADVISORY LETTER No. 48 (1973) (*cf.* Hilltop Village v. Kerrville Ind. School Dist., 487 S.W.2d 167 (Tex. Civ. App.—San Antonio 1972), *error ref. n.r.e.*); and an exemption for art leagues, art museums, and museum schools, *id.* art. 7150, § 14.

47. Of general relevance is TEX. CONST. art. VIII, § 1-b, relating to homestead exemptions for the elderly. TEX. ATT'Y GEN. OP. No. M-1283 (1972) discusses the enabling statutes necessary for the exemption accorded the elderly, and TEX. ATT'Y GEN. OP. No. H-9 (1973) finds that the exemption for the elderly is available so long as there is a person in the "household" at least 65 years of age. Further, the enabling statutes enacted under TEX. CONST. art. VIII, § 2(b) relating to exemptions accorded disabled veterans and their families, TEX. REV. CIV. STAT. ANN. art. 7150h (Supp. 1974), was declared invalid by the attorney general for not conforming to the constitutional guidelines. TEX. ATT'Y GEN. OP. No. H-88 (1973).

48. 488 S.W.2d 69 (Tex. 1972).

ad valorem tax exemption accorded to property owned by fraternal organizations and used for charitable purposes.[49] In finding the statute unconstitutional, the Texas Supreme Court noted that merely because masonic lodges perform charitable and benevolent acts does not in itself mean that such lodges are "purely charitable" organizations qualifying for the constitutional exemption.[50] In order to qualify for the exemption, an organization must perform some service which the community would have to perform if not undertaken by the charitable organization.[51] Since an integral part of the masonic lodge was to cement bonds between its members and to practice the "art of masonry," the court held that the lodge had not met its burden of proof and that its property was not used exclusively for charitable purposes.

Miscellaneous Taxes.[52] Several cases arose during the preceding year concerning various aspects of Texas tax law, which are of little general inter-

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49. TEX. REV. CIV. STAT. ANN. art. 7150, § 22 (Supp. 1974).

50. *See* Masonic Temple Ass'n v. Amarillo Ind. School Dist., 14 S.W.2d 128 (Tex. Civ. App.—Amarillo 1928), *error ref.*; *cf.* Texas Alcoholic Beverage Comm'n v. National Sportsmen Fraternal Order, 495 S.W.2d 45 (Tex. Civ. App.—Houston [1st Dist.] 1973); TEX. ATT'Y GEN. OP. No. O-352 (1939). This result was predicted in Sullivan, *Local Government, Annual Survey of Texas Law*, 27 SW. L.J. 198, 206-07 (1973).

51. *Cf.* Thomas v. Howard County Hosp. Authority, 489 S.W.2d 403 (Tex. Civ. App.—Eastland), *error ref. n.r.e., per curiam*, 498 S.W.2d 146 (Tex. 1973). The test was set forth by the court in *Amarillo Lodge* in the following terms:

> While the benevolent ends sought to be accomplished may take some form other than almsgiving, it is essential that the organization assume, to a material extent, that which otherwise might become the obligation or duty of the community or the state. It is also essential that the institution be organized and operated exclusively for purposes of public charity. The fact that it performs some charitable acts or engages in some charitable activity is not enough to qualify it for the tax exemption authorized by Art. VIII, Sec. 2, of the Constitution . . . .
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> The exemption of an institution of purely public charity as such is not authorized by the constitutional provision in question. It is only property owned by such an institution and used exclusively for purely public charity that may qualify for the exemption. . . . The institution must be one of purely public charity in the purposes for which it is formed and in the means used to accomplish such purposes, and the property claimed to be exempt must be owned and used exclusively by the institution in furthering its charitable activities.

488 S.W.2d at 71-72.

52. The United States Supreme Court recently decided two interesting cases relating to the state taxation of Indians. In The Mescalero Apache Tribe v. Jones, 411 U.S. 145 (1973), the Court was concerned with the exemption afforded Indian lands under the Indian Reorganization Act, 25 U.S.C. § 465 (1970). The Court held that since § 465 contains no provision relating to the exemption of income derived from the land, the State of New Mexico could impose a non-discriminatory gross receipts tax on a ski resort operated by the tribe on off-reservation land, which the tribe leased from the federal government under the Reorganization Act. However, § 465 does bar the imposition of a tax on the use of personalty that the tribe had installed as a permanent improvement at the resort, because these improvements were so intimately intertwined with the land itself as to be covered by the statutory exemption.

In McClanahan v. Arizona State Tax Comm'n, 411 U.S. 164 (1973), the Court started with the proposition that Indians and Indian property on an Indian reservation are not subject to state taxation except by virtue of express authority conferred upon the state by an act of Congress. It then held that since the Navajo treaty precludes the extension of state law to Indians on the Navajo reservations, the State of Arizona had no jurisdiction to tax Indian incomes which were derived wholly from reservation sources.

est.[53] However, an interesting case was presented to the Texas Supreme Court in *Thompson v. Calvert*[54] involving a class action seeking a declaratory judgment that certain of the statutes relating to coin-operated machines were unconstitutional.[55] Article 13.17, section 27(1) provides that anyone required to obtain a license in order to sell or manufacture coin-operated machines cannot have a financial interest in a business which is engaged in the selling of alcoholic beverages for on-premises consumption. The court noted that the adoption of the statute was a result of investigations which indicated that there were increases in violence and illegal activities centered around nightclubs and taverns, and held the statute to be constitutional.[56] Although the statute was held clearly applicable to an individual who sold or manufactured coin-operated machines, the tavern owner was not prohibited by the act from owning a coin-operated machine on his own premises, so long as it was purely incidental to his tavern business.[57]

Another noteworthy decision was that of the court of civil appeals in *Calvert v. Zanes-Ewalt Warehouse, Inc.*[58] Plaintiff was a warehouseman who

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53. Gordon v. Calvert, 497 S.W.2d 313 (Tex. Civ. App.—Austin 1973) (admissions tax was imposed on combination of fee to enter building and fee to skate on wooden floor of a roller rink); Zale Corp. v. Calvert, 488 S.W.2d 177 (Tex. Civ. App. —Austin 1972), *error ref. n.r.e.* (chain store tax is applicable to corporation operating jewelry departments under licensing agreements with large discount stores); TEX. ATT'Y GEN. OP. No. H-122 (1973) (city can impose a charge on coin-operated amusement machines designed exclusively for children, so long as this is regulatory and not a tax measure); TEX. ATT'Y GEN. OP. No. H-119 (1973) (power of rapid transit authority to levy a "motor vehicle emission tax" based upon the number of cubic inches of cylinder displacement in automobiles in a given area is valid); TEX. ATT'Y GEN. OP. No. M-1245-A (1972) (maintenance fund cannot be collected into one fund by commissioners' court and spent county-wide without regard to precinct lines).

54. 489 S.W.2d 95 (Tex. 1972).

55. "No person shall engage in business to manufacture, own, buy, sell, or rent, lease, trade, lend, or furnish to another, or repair, maintain, service, transport within the state, store, or import, a . . . coin-operated machine . . . without a license issued under this Article." TEX. TAX.-GEN. ANN. art. 13.17, § 8(1) (1969).

"It shall be unlawful for a person who has a financial interest in a business required to be licensed by this Article to knowingly have a financial interest in a business engaged in selling or serving alcoholic beverages for on-premises consumption unless otherwise permitted in this Article." *Id.* art. 13.17, § 27(1).

56. The legislative committee whose study was the basis for the statute had apparently correlated the control of the alcoholic beverage business by the coin-operated machine industry with the increased corruption and violence.

57. *But see* TEX. ATT'Y GEN. OP. No. M-449 (1969). The dissenting opinion in *Thompson* is quite critical of the court's use of the "incidental" test. The problems, as viewed by the dissent, are as follows:

> The line which this court has drawn to exempt one from licensing is too vague to permit the law's enforcement. Does an 'incidental' coin-machine business arise when one owns twenty taverns in each of which is one coin machine? What about an owner who has three taverns and six machines? Will the 'incidental' nature of coin-machine operation be determined by the comparative revenue derived from each? In the case of the very large and active tavern, the business from each line of endeavor may be great, but one or the other may be the greater. In the case of the small tavern with a single machine, when each shows a small profit, which one is incidental when the revenue from both is essential to the continuance of the business? The rule announced by this court will require an audit of the books and records of every establishment in which even one coin machine is located.

489 S.W.2d at 100-01.

58. 492 S.W.2d 638 (Tex. Civ. App.—Austin 1973), *error granted.*

acted as the distributing agent for out-of-state tobacco companies. He would deliver the manufacturer's cigarettes to its customers in the original packages upon orders which the plaintiff received from the out-of-state companies. The customers paid the manufacturer directly for these cigarettes. Although the plaintiff was not charged with the duty of purchasing cigarette tax stamps nor affixing them to the cigarette packages,[59] the comptroller held him liable for $27,501.61 in taxes when an audit revealed that some 3,548,600 cigarettes were missing from the plaintiff's warehouse.

In attempting to levy the cigarette stamp tax on the warehouseman, the comptroller relied upon article 7.01(8) which provides that the incidence of taxation occurs when the cigarettes are sold, distributed, stolen, or otherwise unaccounted for.[60] In finding the definition of "first sale" in article 7.01(8) unconstitutional, the court noted that although as a general proposition tax legislation would be upheld and the definitions contained therein be binding upon the courts so long as they were reasonable and neither capricious nor arbitrary, the legislature by equating "theft" with "sale" was penalizing a distributing agent who was neither the owner of the cigarettes nor charged with the duty of buying the tax stamps or affixing them.[61] Since a writ of error has been granted in this case, the comptroller has another opportunity to argue its position relative to the imposition of this tax on a distributing agent. The holding of the court of civil appeals is certainly equitable and appealing in its result. However, the Texas Supreme Court might well hold that the statute is valid and application of its literal terms imposes the tax upon a distributing agent. This result would follow from article 7.02(1) which provides that a "tax shall be paid . . . by the *person* making the 'first sale' in this State . . ." and article 7.01(3) which defines "person" as "every individual, firm, association, joint stock company, syndicate, co-partnership, corporation, trustee, agency or receiver."

II. FEDERAL TAXATION

Although there were several decisions concerning the application of the

59. The warehouseman met the statutory definition of a "distributing agent" as an "agent of any person outside the State . . . receiving cigarettes in interstate commerce and storing such cigarettes subject to distribution or delivery upon order from said person outside the State to distributors, wholesale dealers and retail dealers." TEX. TAX.-GEN. ANN. art. 7.01(16) (1969). The liability for purchasing and affixing the cigarette stamps is set forth in *id.* art. 7.10 (Supp. 1974) (emphasis added):

> Every person, *other than a distributing agent*, . . . shall . . . obtain . . . the requisite . . . number of stamps necessary to stamp such cigarettes and the possession of any unstamped cigarettes without the possession of the requisite amount or number of stamps shall be prima facie evidence that said cigarettes are possessed for the purpose of making a 'first sale' thereof without stamps and without payment of the tax . . . .

60. *See* TEX. ATT'Y GEN. OP. NO. O-543 (1965). The obvious purpose of the statute is to guarantee that someone will pay the stamp tax no matter what disposition is made of the cigarettes. TEX. TAX.-GEN. ANN. art. 7.01(8) (1969) provides: " 'First Sale' shall mean and include the first sale or distribution of cigarettes in intrastate commerce, or the first use or consumption of cigarettes within this State, or the loss of cigarettes in this State whether by negligence, theft, or any other unaccountable loss."

61. "This statutory definition of a first sale, within the whole scheme or pattern of taxes sought to be collected so strains the ordinary meaning of the terms as to render the definition arbitrary and unreasonable to the point of denying due process." 492 S.W.2d at 640.

federal tax laws to the community property system or Texas law, a complete discussion of all of these decisions is beyond the scope of this Article.[62] One of the more interesting Treasury pronouncements was Revenue Ruling 73-309.[63] In this ruling, the deceased husband and his surviving spouse were residents of a community property state. They were divorced in 1958, at which time their community property was converted into the separate property of each, with the husband obtaining property worth $20,000 and the wife acquiring property worth $15,000. In 1961 the husband and wife were remarried, followed by the husband's death in 1970. The ruling took the position that the husband's separate property, which was previously owned as community property with his surviving spouse in the former marriage, is "held as such community property" for the purposes of determining the adjusted gross estate under section 2056(c)(2)(B) of the Internal Revenue Code.[64] The stated rationale for this holding is that this is one of the circumstances which Congress sought to prevent, namely, the allowance of a marital deduction with respect to community property when that community property has changed character by virtue of the state property law.[65] However, since apparently the separate property arising from the prior marriage would be available in determining the marital deduction if the husband had not remarried his former wife, it seems that logic would dictate that the same consequences should flow from the instant facts.

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62. In Northington v. United States, 475 F.2d 720 (5th Cir. 1973), the executor of a decedent's estate had elected to pay the federal estate tax in 10 annual installments, pursuant to INT. REV. CODE of 1954, § 6166, and before all payments were made, the executor sold this property to a third party. The court held the special tax lien of *id.* § 6324(a)(1), attached to this property in the hands of the third party purchaser because the third party purchaser had not proved that the proceeds of the sale were actually used to satisfy obligations of the estate. In another Fifth Circuit case, Lumpkin v. Commissioner, 474 F.2d 1092 (5th Cir. 1973), the court held that the right of an employee under a group term life insurance policy to designate the manner and time in which the proceeds were paid, even though the employee could not designate the beneficiary of the proceeds, was an "incident of ownership" making the proceeds includable in the employee's estate under INT. REV. CODE of 1954, § 2042. In Babb v. United States, 349 F. Supp. 792 (S.D. Tex. 1972), the district court held that rice allotments allocated to the husband "producer" under the Agricultural Adjustment Act of 1938, 7 U.S.C. §§ 1351-57 (1970), were items in which, under federal law, the wife had no property interests. Consequently, one-half of the value of these rice allotments was not to be included in the wife's gross estate.

63. Rev. Rul. 73-309, 1973 INT. REV. BULL. No. 29, at 9.

64. INT. REV. CODE of 1954, § 2056 provides a marital deduction to decedents in community property states only if the estate contains separate property. The maximum marital deduction is essentially one-half of the decedent's separate property, less a certain portion of the administrative expenses. In determining "separate property" in the estate, the statute starts with the total gross estate and subtracts therefrom all community property and all property "held as such community property." On the facts presented in the ruling, since the husband received $20,000 and the wife $15,000 after the divorce, the limitation of provision of *id.* § 2056(c)(2)(c)(ii) will be applicable.

65. The apparent objective of the statute is to prevent residents of community property states from partitioning their community property and then claiming that the separate property arising from the partition is available for the calculation of the maximum marital deduction. Without this provision, the statute could not effect its purpose of equalizing estate taxation between community property and common-law states. This equalization occurs because in community property states only one-half of the community property is included in the decedent's gross estate, whereas in a common-law state, the husband's gross estate will include all of the couple's property less the maximum marital deduction, that is, roughly one-half of the gross estate.

In *Sallie B. Hambleton*[66] the Tax Court was presented with an interesting fact situation concerning a joint and mutual will executed by Texas residents. The will provided in part:

> [T]he first to die will bequeath his or her interest in our community estate to a trustee for the use of the survivor for life and upon the death of the survivor, for the use of our children and their descendants, as in our mutual wills hereinafter specifically provided; and, in consideration therefor, the survivor has agreed, and hereby does agree to bequeath all of the survivor's portion of the community estate to the same trustee and for the same uses and purposes; and, further: . . . .
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> . . . .
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> The survivor's portion of the community estate existing at the death of the survivor shall pass by the will of the survivor as hereinafter set forth, and not otherwise.[67]

The Commissioner of Internal Revenue had assessed a gift tax against the surviving wife in the amount of $150,880.61. The court held that the surviving wife did not make a gift of the remainder interest in her community property on the date of her husband's death, reasoning that a contractual promise to transfer an indefinite amount of property at one's death is not a present gift. Under the terms of the joint and mutual will, the wife's property would revert to her estate and pass under the terms of her will. Coupled with this was the right of the wife to withdraw and use the property during her lifetime so that if no property remained on her death, no property would pass to the remaindermen.[68]

In contrast is the case of a joint and mutual will whereby all of the community property passes to the survivor in trust for her life, and upon death of the survivor to designated beneficiaries. This is the typical widow's election will under which it is held that the wife makes a taxable gift of the remainder interest in her community property to the remaindermen on the date of the husband's death, to the extent that this remainder interest exceeds the value of the life estate which she receives in the husband's community property.[69]

One of the important ramifications of the *Hambleton* case is that since the wife has not made a taxable gift on the date of her husband's death, in like manner, on her death her estate is not allowed a consideration offset under section 2043.[70] In most instances, there would be either no taxable gift or a very small taxable gift on the date of the husband's death in the

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66. 60 T.C. 558 (1973).
67. *Id.* at 559.
68. *See* Treas. Reg. § 25.2511-2 (1961).
69. INT. REV. CODE of 1954, § 2512(b). *See generally* Johanson, *Revocable Trusts, Widow's Election Wills and Community Property: The Tax Problems*, 47 TEXAS L. REV. 1247 (1969); Smith, *The Draftsman Vis-à-Vis the Widow's Election and Its Tax Consequences*, 21 SW. L.J. 591 (1967); Westfall, *Estate Planning and the Widow's Election*, 71 HARV. L. REV. 1269 (1958); Comment, *The Widow's Election—A Study in Three Parts*, 15 SW. L.J. 85, 134-62 (1961).
70. INT. REV. CODE of 1954, § 2043. *See generally*, Morrison, *The Widow's Election: The Issue of Consideration*, 44 TEXAS L. REV. 223 (1965).

widow's election will.[71] Consequently, it is usually advantageous in wills of this type to receive the consideration offset. Thus, if the consideration offset is to be of value to the overall estate plan careful draftsmanship is needed to insure its applicability.

71. If the husband's net estate and the wife's property subject to the election are of equal value and the wife receives a life estate in the total assets of the couple, the wife will not have made a gift of any portion of the remainder interest in her property unless she were age 69 or older on the date of her husband's death. Treas. Reg. § 20.2031-10(f), table A(2) (1970). *See generally* Johanson, *supra* note 69, at 1267-82.