2001

Taxation

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Recommended Citation

Cynthia M. Ohlenforst, et al., Taxation, 54 SMU L. Rev. 1595 (2001)
https://scholar.smu.edu/smulr/vol54/iss3/19

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AS several court cases and administrative hearings from this Survey period indicate, tax officials and taxpayers continue to struggle to find the fine line that separates taxable transactions from nontaxable ones. This task, always a difficult one, becomes increasingly challenging in the face of a changing economy and a changing emphasis on e-commerce and the Internet. Several legislative interim committees, as well as committees like the E-Commerce and Technology Advisory Group to the comptroller spent much of the Survey period working to define policies to be implemented in practice and considered for possible legislation for the 2001 session. In the meantime, it's time for our annual look at what happened with existing legislation and its interpretation.

I. SALES TAX

A. APPLICATION OF THE TAX

*Rylander v. Haber Fabrics Corp.*¹ addresses the distinction between

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¹ 13 S.W.3d 845 (Tex. App. – Austin 2000, no pet.)
manufacturing and remodeling. Haber Fabrics is a manufacturer that purchases second quality fabrics and converts the fabric to first quality fabric that is sold to retailers. According to the court’s findings, Haber thoroughly inspects the purchased fabric to locate and remove or repair any defects in the fabric.\(^2\) Haber claimed the manufacturing sales tax exemption for the electricity, gas and packaging materials it purchased for its manufacturing business. The comptroller argued that the process used by Haber was remodeling or sorting and grading, which is not the same as manufacturing, and that Haber was therefore not entitled to the manufacturing exemption.\(^3\) The court rejected this view, holding that Haber’s activities satisfied the comptroller’s rule defining processing\(^4\) because Haber actually used labor to change the second quality fabric to first quality fabric.\(^5\) Additionally, the court noted other factors indicating whether or not a process is considered to be manufacturing. Among these factors was the fact that Haber’s change in the fabric actually made the fabric marketable and resulted in a product with a different purpose from the original fabric.\(^6\) The court also considered the fact that Haber’s processing added value to the fabric.\(^7\) The court dismissed the comptroller’s argument that Haber’s activities were considered remodeling since remodeling is by definition a process performed on items owned by another, and Haber was the actual owner of the fabric it \(\text{processed.}\(^8\) In permitting Haber’s claim for exemption from sales tax for the electricity used in its processing of the fabric, the court rejected the comptroller’s attempt to divide the processing into separate processing and non-processing parts, holding that the succession of acts performed by Haber constituted a continuous act of processing.\(^9\) The court was not concerned by the fact that the actual floor space used for processing tasks was less than that used for non-processing tasks because the electricity used for manufacturing was proven to be more than fifty percent.\(^10\)

In a companion case related to the taxability of line-engineering services used to reconfigure mobile telephone networks, \textit{Rylander v. San Antonio SMSA Ltd. Partnership},\(^11\) the comptroller asserted that the purchase of such services along with the purchase of telecommunications equipment from the same vendor rendered the services subject to sales tax under section 151.007(b) of the Texas Tax Code. In Texas, the “essence of the transaction” doctrine is used to determine the taxability of a transaction that bundles nontaxable services with taxable goods or services. If the true essence of the transaction is the receipt of the nontax-

\begin{footnotesize}
\begin{enumerate}
\item \textit{Id.} at 847.
\item \textit{Id.} at 848.
\item See 34 \textsc{Tex. Admin. Code} § 3.295(a)(7) (West 2000).
\item Haber, 13 S.W.3d at 848.
\item \textit{Id.}
\item \textit{Id.}
\item \textit{Id.}
\item \textit{Id.}
\item \textit{Id.}
\item \textit{Id.}
\item 11 S.W.3d 484 (Texas App. - Austin 2000, no pet.).
\end{enumerate}
\end{footnotesize}
able service, then the entire transaction should be considered nontaxable. On the other hand, if the true essence of the transaction is the receipt of the taxable goods or services, then the entire transaction is considered to be taxable. Relying on *Sharp v. Direct Resources For Print, Inc.*, the court noted that “[w]hen a nontaxable service is bundled with a taxable sale or service, [the Court applies] the ‘essence-of-the-transaction’ doctrine to determine whether the service is a part of the sale.” The Austin Court of Appeals took guidance from the Rhode Island Supreme Court’s decision in *New England Telephone & Tel. Co. v. Clark*, in which the court determined that the purchase of engineering services and telecommunications equipment did not fit neatly into either essence-of-the-transaction category. The *Clark* court found that this combination transaction fit into a third category, in which the elements of a mixed transaction involving both a service and tangible personal property are “readily separable.” According to the Rhode Island court, if there was a “fixed and ascertainable relationship between the value of the article and the value of the services rendered, and each is a consequential element capable of a separate and distinct transaction, then the elements must be analyzed as separate transactions for tax purposes.”

Accordingly, the Austin Court of Appeals found that neither the line-engineering services nor the telecommunications equipment were incident to each other and that both the receipt of the service and the receipt of the equipment were considered to be the true essence of the transaction. Both the service and the equipment were found to have a separate value that was distinct and identifiable. Under such circumstances, the court held that the elements of the transaction must be considered separately to determine the taxability of each element. Additionally, the court found that under the comptroller’s Rule 3.357, similar treatment is already accorded to sales of taxable services with nontaxable services. Thus, the comptroller’s attempt to treat the sale of taxable goods with nontaxable services in a different manner (in favor of the taxing authority) was found to be unreasonable. The court summarily rejected the comptroller’s proposal to treat the services as taxable because they were invoiced on one contract, pointing out obvious manipulations that would occur if such a rule were adopted. Therefore, the fact that a single in-

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15. Id. at 301.
16. Id. (emphasis added) (citations omitted).
18. Id.
19. Id.
20. 34 TEX. ADMIN. CODE § 3.357 (West 2000).
21. *San Antonio SMSA*, 11 S.W.3d at 489. This rule is one of several rules recognizing that “unrelated services,” as defined in the rule, does not become taxable merely because it is sold with a taxable service.
22. Id.
23. Id. at 488.
voice or contract exists was specifically found to have no effect on the taxability of this taxpayer’s transaction.24

In *Serna v. H.E. Butt Grocery Co.*,25 Serna, an individual taxpayer, claimed that H.E. Butt Grocery Company (“H.E.B.”) overcharged sales tax on certain items and requested a refund of such overcharge in the form of damages. Although H.E.B. discovered that it did indeed overcharge customers for sales tax during a two-and-one-half year period, it did not seek a refund of such overpaid taxes.26 The court turned to federal law for guidance in resolving Serna’s claims, holding that H.E.B. was merely acting as an agent of the state in collecting sales tax.27 The court also noted that limiting cases such as Serna’s was appropriate based on policy considerations; to permit otherwise would make investigation and resolution of tax claims inadministerable by the comptroller and harmful to judicial economy.28 Thus, the court determined that Serna’s claim for refund from H.E.B. was improper since Serna’s claim under the Texas Tax Code was exclusively against the comptroller, not the vendor who collects on behalf of the state.29

**B. Administrative Hearings and Letters**

As in prior years, the comptroller issued several decisions analyzing the distinction between nontaxable new construction and taxable repair and remodeling. Although many decisions rejected the taxpayers’ attempts to achieve non taxable status for their services,30 following are a few decisions in favor of the taxpayer.

Whether the installation of a roadway by taxpayers was nontaxable new construction as opposed to taxable non-residential real property repair and remodeling was one of the issues raised in a recent hearing.31 The taxpayer argued that the road contract required the complete removal of the asphalt road and replacement with a steel-reinforced con-

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24. *Id.* at 489.
26. *Id.* at 332.
27. *Id.* at 333-34.
28. *Id.* at 334.
29. *Id.* at 336. See Fleming Foods of Tex., Inc. v. Ryland, 6 S.W.3d 278 (Tex. 1999) (declining to accept comptroller interpretation that required indirect taxpayer to collect refunds from its vendor rather than directly from state) (discussed at *Ohlenforst et al., Taxation*, 52 SMU L. REV. 1297, 1333 (1999)).
30. See Tex. Comp. Pub. Acc’ts, Hearing No. 38,069 (Dec. 15, 1999) (holding that installation of a new roof that adds nonusable space is not new construction); Tex. Comp. Pub. Acc’ts, Hearing No. 37,501 (Dec. 29, 1999) (holding that taxpayer failed to prove that finish out costs on warehouse qualified as new construction); Tex. Comp. Pub. Acc’ts, Hearing No. 30,911 (Dec. 6, 1999) (holding that new installations of various safety systems in two commercial office buildings were not non taxable as scheduled maintenance, but were taxable modifications); Tex. Comp. Pub. Acc’ts, Hearing No. 36,262 (Apr. 10, 2000) (holding that services performed on a parking garage used for twenty years before such “modernization” do not qualify as new construction); Tex. Comp. Pub. Acc’ts, Hearing No. 38,733 (May 11, 2000) (holding that taxpayer failed to prove that asphalt pavement repairs were substantial enough to be considered new construction).
crete roadway, making this a new construction project. The tax division argued that the road contract, titled “Contract for Plant Roadway Repairs,” was replete with references to repairs to be made pursuant to the terms of the contract. Additionally, the tax division claimed that the length of the contract period (six years at the time of audit) was not reasonable for new construction and that due to the length of this contract, some areas of the road may require repair before the roadway is entirely complete. Referring to a 1997 hearing that involved the replacement of a cable system, the administrative law judge used the segmentary approach to determine the character of the roadway installation. Because the entire roadway was to be replaced at the inception of the contract, the contract was held to be new construction. The judge held that although the three-year delay in construction was primarily due to the financial limitations of the taxpayer, such new construction did not convert to a taxable repair or remodel job during the audit period.

In another hearing analyzing the difference between nontaxable new construction and taxable maintenance, the administrative law judge addressed several types of services. The taxpayer installed two ramps, one that was a new ramp and the other that was a new ramp replacing an existing sidewalk. The administrative law judge held that the new ramp was considered new construction since it added new footage to the facility, while the ramp that replaced the sidewalk would be treated as a remodeling of the sidewalk. The taxpayer also performed scheduled work on some parking lots necessary to keep the lots safe, efficient and in continuous operation. The administrative law judge found that while a parking lot overlay and the subsequent restriping of the lot are tax-free maintenance, the excavation and installation of a new asphalt base, repair of broken concrete curbs, parking lot crack sealing, and other nonperiodic, nonscheduled work orders are considered taxable repairs. Additionally, the judge determined that the bond costs associated with the contract should be prorated proportionately between taxable and nontaxable costs.

In Hearing No. 36,375, the Administrative Hearings section failed in its attempt to classify the costs to build a new roof that created additional, usable cubic footage to the building as taxable remodeling. By raising the roof on its processing plant, the taxpayer was able to accommodate taller processing equipment. This fact was sufficient to satisfy the requirement that the additional footage be usable. However, the installation of a new HVAC system in the same processing plant was held to be taxable remodeling since the new HVAC system cooled the entire plant and not just the new footage.

In this new digital economy, the taxation of computer and internet related assets and services arises in numerous comptroller hearings. A re-

cent hearing on the taxability of software contains a discussion of the application of use tax to computer software. In this hearing, the taxpayer owned separate entities that provided mobile telephone services to various areas in the United States. In 1995, the taxpayer agreed to license software from another entity to assist in customer billing. The software was to be used in one location within Texas and one location outside of Texas, with special software configurations required for each location. The software was shipped to Texas for testing, with such testing a condition of the purchase. The software was retained after the testing was complete. The administrative law judge held that even though the software was purchased out of state, the testing of the software in Texas constituted a taxable use of the software in Texas. Another issue raised in this hearing relates to proper rate of MTA taxes imposed on sales. If the taxable sale is delivered from one MTA area to another area with its own MTA, the MTA of the delivery destination is imposed. However, if the taxable sale is delivered from an MTA area to another area that does not have an applicable MTA, the MTA of the origination location is imposed. Because the taxpayer failed to prove that delivery was made into another MTA area, the origination MTA rate applied to the transactions of the taxpayer.

According to a letter ruling analyzing computer-related services, a business that provides advertising banners on its website for a fee is considered to be providing taxable data processing services. However, the comptroller considers any charges for audio and video commercials shown on the website to be taxable telecommunications services. The comptroller also noted that the local tax due is based on the rate applicable to the location of the server and that TIF charges of 1.25 percent are payable on such charges. Additionally, the letter explains that if such telecommunications services originate outside of Texas, they are exempt under section 151.323 of the Texas Tax Code.

The comptroller’s office has classified digitally downloadable music as tangible personal property subject to sales tax on the grounds that “the downloaded music causes a physical change to the medium on which it is stored.” Thus, according to this letter ruling, digitally downloaded music “can be measured and is tangible personal property.” The letter concludes that digital products, such as photographs and music, are tangi-
ble personal property. Thus, the purchase of a digital CD over the Internet is, according to the comptroller, taxable.

The comptroller also issued a letter that provides a current update of the taxability of various computer and website related transactions. In this letter ruling, the analysis of the taxability of computer virus cleaning services is interesting. The taxability of such services range from taxable data processing services or sale and installation of software to nontaxable software modification.

In one of many hearings interpreting the manufacturing exemption, the taxpayer requested a refund of sales tax under the exemption for baking pan glazing and repair. The taxpayer in this hearing based its claim on the analogy that the use of the pan glaze is similar to lubricants consumed in the operation of manufacturing equipment, which are exempt under section 151.318(a)(2) of the Texas Tax Code and comptroller Rule 3.300(d)(3)(A). Based on a prior ruling, the administrative law judge maintained that the glazing performed by a third party is a taxable repair service. However, the administrative law judge awarded the taxpayer a reduction in tax under section 151.3111. Because the purchase of baking pans is eligible for the phased-in reduction in sales tax under section 151.318(g) and (h), the administrative law judge found that repairs to such pans qualify for the related exemption under section 151.3111. In reaching this holding, the administrative law judge overruled a prior decision to the extent it conflicted with the current decision.

During the Survey period, returnable water bottles used by the taxpayer to package its products were found to be subject to tax when purchased. Additionally, the comptroller has determined that paper towels used by meat-processor employees are not considered to be taxable hand tools under Tax Code section 151.138 but rather are exempt as materials necessary to comply with public health requirements.

The comptroller issued opinions on a variety of other topics during the Survey period, including the following interesting rulings.

The lease of an airplane by a Delaware taxpayer to a Texas taxpayer that results in the sales tax being calculated on the price of the lease

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43. TEX. TAX CODE ANN. § 151.318(a)(2) (Vernon Supp. 2001); 34 TEX. ADMIN. CODE § 3.300 (West 2000).
45. Tex. Comp. Pub. Acc'ts, Hearing No. 36,698 (July 18, 2000). After lengthy analysis of the relevant Tax Code provisions and comptroller rules, the administrative law judge in this case recommended that 34 TEX. ADMIN. CODE § 3.314(b)(1) be amended to clarify that such returnable containers are not exempt from tax.
46. Note the decision's discussion of "partial exemption" versus "reduction of tax."
under the Tax Code section 151.007,51 as opposed to the purchase price of the airplane, is not considered a sham solely because it lowers a taxpayer's taxes.52 Consequently, in a recent hearing under these facts, the comptroller held that tax should be assessed only on the negotiated lease price, regardless of the fact that the airplane was delivered to the lessee in Texas. The comptroller also confirmed her position in finding that long term leases entered into before October 1, 1995 are not eligible for an exemption from sales tax under Rule 3.300(e)53 since a lease is treated as a single sale on the date the lease is executed as opposed to a series of mini-sales.54

In order to be considered a tax-exempt service purchased for resale, the service must be transferred by the purchaser as an integral part of a taxable service.55 Thus, in a hearing regarding the resale exemption, the taxpayer's purchase of "residential or nonresidential grounds cleaning" services were not considered qualified purchases for resale since such services were not included in the garbage collection services offered by the taxpayer.56

Recent taxpayer challenges to the 1991 amendment to Rule 3.356, which relates to property management companies, on the basis of legislative acceptance were rejected in comptroller hearings.57 Decision 31,77058 is a significant case that focuses on the circumstances in which construction pursuant to a contract between a contractor and a non-exempt entity with respect to real property owned by the exempt entity will be eligible for exemption. The administrative law judge correctly concluded that tangible personal property used in hangar construction at a municipal airport, including construction of hangars pursuant to lump-sum contract, is exempt under section 151.311.59 As in effect at the time, this section exempted tangible personal property used in the performance of a contract to improve realty for, among others, a city, county, special district or other political subdivisions of Texas. The airport at issue in this hearing was public property. While the hangars benefited the airline that paid for their construction, they were not used exclusively to benefit the airline and, as the taxpayer proved, contributed to the safety and efficiency of the airport generally. The tax division had argued that the construction failed to satisfy the comptroller's requirement that construction had a primary public purpose. The taxpayer had

53. 34 TEX. ADMIN. CODE § 3.300 (West 2000).
55. 34 TEX. ADMIN. CODE § 3.356(c)(2) (West 2000).
argued that there was no public purpose requirement in section 151.311, and that if such a requirement existed, the airport construction qualified. Because the administrative law judge concluded that the hangar construction served a public purpose, he noted that he did not need to address the taxpayer’s contention that the statute does not require a public purpose. The tax division conceded that tangible personal property transferred pursuant to separated contracts is exempt.

And on an end note to the sales tax rulings discussion, if you want to get a tax-free cookie on your next shopping trip to the mall, look for the cookie store that is not in the food court and that doesn’t have seating.\(^\text{60}\)

### C. REGULATORY DEVELOPMENTS

As expected following the flurry of legislation from the 1999 Session of the Texas Legislature, the comptroller’s office was busy amending the rules relating to the sales and use tax provisions.

Rule 3.252,\(^\text{61}\) Collection and Allocation of County Tax, was amended to add a provision for the clothing and footwear exemption,\(^\text{62}\) which provides that such sales are exempt for county tax purposes during the sales tax holiday unless such exemption is repealed by the commissioners court of a county.\(^\text{63}\)

In Rules 3.253,\(^\text{64}\) 3.375\(^\text{65}\) and 3.425,\(^\text{66}\) a provision was added stating that a retailer who has been engaged in business in a county, city, or authority remains responsible for collecting use tax on sales made for 12 months after ceasing to be engaged in business in the county, city, or authority.\(^\text{67}\) These rules were also modified to conform to the changes in Rule 3.286 requiring a physical presence in the authority for imposition of the tax to apply.\(^\text{68}\)

The rule relating to auditing taxpayer records, Rule 3.282,\(^\text{69}\) was

\(^\text{60}\) See Tex. Comp. Pub. Acc’ts, Hearing No. 38,053 (Jul 19, 2000) (holding that since the taxpayer’s lease included provisions related to the inclusion of the cookie store in the food court area, taxpayer’s sales of cookies in quantities of five or less are taxable under Tax Code section 151.314 and 34 Tex. Admin. Code § 3.293(a)(9)). This ruling is a corollary of Texas’ long time “six doughnut” rule which treats doughnuts purchased in quantities of five or less as purchased for immediate consumption and therefore taxable. See Tex Comp. Pub. Acc’ts, Letter No. 8804L0880E10 (Apr. 1, 1988).


amended to provide guidance on managed audits. There are now definitions describing managed audits as well as the percentage-based reporting method. Also included are factors used to determine if a taxpayer is authorized to participate in a managed audit.

Rule 3.293 was amended to reflect an increase in the exemption for certain foods sold through bulk vending machines. Clarifications were also made relating to nontaxable employee meals and certain catering changes.

Rule 3.295 was largely rewritten to reflect the changes made to the Tax Code section 151.317 in 1999. As amended, this rule now reflects the comptroller’s long-standing policy of using the predominant use test to determine the taxability of gas or electricity measured through a single meter that is used for both exemption and taxable purposes. The comptroller also clarified through amendment that natural gas and electricity used to operate equipment permanently affixed to realty is exempt.

Changes were made to Rule 3.299 to reflect the 1999 amendment to Tax Code section 151.132, which added audio tape, videotape and computer disk to the definition of exempt writings that are published and distributed by qualifying not-for-profit organizations.

Rule 3.310 relating to laundry, cleaning and garment services, was amended to clarify that services such as cleaning, laundering, repairing, treating or applying protective chemicals to items in a disaster area are included in the types of labor exempt from tax. The exemption under this Rule was also amended to include restoration of real property, as well as tangible personal property.

Modifications were made to Rule 3.322 which governs the treatment of exempt organizations, to clarify the statutory provision that allows certain organizations to hold two one-day, tax-free sales per year. In light of several Texas’ cities bid to host the Olympic Games in 2012, this Rule


71. Id.

72. Id.

73. 34 Tex. Admin. Code § 3.293 (West 2000).


77. Id.


82. Id.


was also modified to include certain exempt, local organizing committees that are pursuing selection of their city as the host site for the 2007 Pan American Games or the 2012 Olympic Games to the list of entities that may qualify for exempt status.\textsuperscript{85}

The amendments to Rule 3.323\textsuperscript{86} relate to the provision of refunds on imports and exports.\textsuperscript{87} The new rule provides that retailers in counties bordering the United Mexican States must wait 24 hours from the documented time of export before issuing a refund of tax paid.\textsuperscript{88} For all other retailers, the waiting period is seven days.\textsuperscript{89} Rule 3.360\textsuperscript{90} was amended to refer Custom Brokers to Rule 3.323(e) for information regarding the treatment of a request for refund of tax on exports.\textsuperscript{91}

The 1999 Texas legislature enacted new Tax Code section 151.351 to provide an exemption for 20 percent of the value of data processing and information services, effective on October 1, 1999.\textsuperscript{92} An early draft version of the revisions to the rule related to data processing, Rule 3.330,\textsuperscript{93} indicated that the exemption would not apply to services provided pursuant to a contract that was entered into prior to October 1, 1999. However, the comptroller’s staff has since concluded (correctly) that the exemption applies to services provided on or after October 1, 1999, without regard to the date of the underlying contract, if any. This result is confirmed by the new and improved version of Rule 3.330, proposed on June 23, 2000 and adopted effective August 24, 2000.\textsuperscript{94} As adopted, the rule provides that the exemption “applies to services performed on or after October 1, 1999.”\textsuperscript{95}

Rule 3.342\textsuperscript{96} was amended to reflect changes made relating to information services.\textsuperscript{97} It was proposed and adopted at the same time as the data processing rule and also confirms the October 1, 1999 effective date for the twenty percent exemption.\textsuperscript{98} Spokespersons with the comptroller’s office have also confirmed orally that both data processing and information services, if purchased for resale, will continue to be exempt under the

\begin{enumerate}
\item Id.
\item 34 Tex. Admin. Code § 3.323 (West 2000).
\item Id.
\item Id.
\item 34 Tex. Admin. Code § 3.360(b) (West 2000).
\item 34 Tex. Admin. Code § 3.330 (West 2000).
\item 34 Tex. Admin. Code § 3.330 (West 2000).
\item 34 Tex. Admin. Code § 3.342 (West 2000).
\item Id.
\end{enumerate}
resale exemption. This result is justified not only by the fact that eighty percent of the services are subject to tax but also by the fact that the services are classified as "taxable services," notwithstanding the exemption.

Rule 3.344, Telecommunication Services, was amended to reflect the 1999 Tax Code amendment removing prepaid calling cards from the definition of telecommunications services. Also excluded from telecommunications services, pursuant to the 1999 Tax Code amendment to section 151.0103, was Internet access services. In addition, the definitions of Internet and Internet Access Service were also added to revised Rule 3.344.

The comptroller issued Rule 3.365 to replace the expired emergency rule issued in 1999 regarding the sales tax holiday in August of every year. Since this revised rule was written following the first sales tax holiday in 1999, many of the issues that arose in the initial holiday were addressed in this final rule. Rule 3.372 was amended in 2000 to reflect local taxing authorities' option to repeal the local tax portion of the sales tax exemptions, provided under the annual three-day sales tax holiday for certain clothing and footwear.

A new rule, Rule 3.366, relating to Internet Access services was added in 2000. This new rule is designed to implement the 1999 legislative changes that defined Internet access service and reflects the new $25 per month exemption. The rule also provides guidance on the use of resale certificates for such services, allocations based on service benefit locations and allocations for local tax purposes.

Rule 3.378 relating to municipal sales and use tax on natural gas and electricity, was amended to reflect changes to Tax Code section 151.317, which codified the comptroller's long-standing policy relating to the "pre-

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100. 34 Tex. Admin. Code § 3.344 (West 2000).
102. Id.
103. Id.
107. 24 Tex. Reg. 12022-23 (1999), adopted 25 Tex. Reg. 5916 (2000) (to be codified as an amendment to 34 Tex. Admin. Code § 3.372). To date only the City of Sunset Valley in Travis county has elected not to participate in the sales tax holiday pursuant to this provision.
dominant use" test\textsuperscript{112} for natural gas and electricity measured through a single meter.\textsuperscript{113} Also, reference in this rule to a one percent local tax was removed since municipalities have imposed varying rates of tax under this section.\textsuperscript{114} The provisions of this rule relating to the reimposition of tax were clarified,\textsuperscript{115} and the provision for continuation of taxation was revised to clarify that the requirements of this provision must have been satisfied in 1979.\textsuperscript{116}

There were also a few proposed rules not yet enacted during the Survey period. An amendment to Rule 3.316,\textsuperscript{117} relating to occasional sales, was proposed in September, 2000 to reflect changes made regarding tax-free sales of items over $5000 by certain organizations.\textsuperscript{118} The proposed amendment also adds a provision relating to the tax-exempt adoption of animals from nonprofit animal shelters and deletes the provision requiring college and university organizations to re-certify their status every two years.\textsuperscript{119}

The proposed amendments to Rule 3.302\textsuperscript{120} were made largely to reflect statutory changes related to accounting for debt deductions and receipt of interest on erroneously paid sales tax made in the 1999 legislative session.\textsuperscript{121}

Proposed Rule 3.292, Repair, Remodeling, Maintenance and Restoration of Tangible Personal Property, adds provisions related to exemptions allowed under Tax Code section 151.311\textsuperscript{122} for certain services that were not previously enumerated in the rule.\textsuperscript{123} This rule is also being amended to clarify that labor to repair, remodel, maintain or restore clothing or footwear purchased during the three day sales tax holiday remains subject to taxation.\textsuperscript{124}

The comptroller's office also proposed a new Rule 3.126\textsuperscript{125} to provide guidance relating to reports, payments and record keeping requirements for oyster sales fees.\textsuperscript{126}

\begin{thebibliography}{99}
\bibitem{112} 34 TEX. ADMIN. CODE § 3.295 (West 2000).
\bibitem{114} Id.
\bibitem{115} Id.
\bibitem{116} Id.
\bibitem{117} 34 TEX. ADMIN. CODE § 3.316 (West 2000).
\bibitem{119} 25 Tex. Reg. 9192-95 (2000) (to be codified as an amendment to 34 TEX. ADMIN. CODE § 3.316) (proposed Sep. 15, 2000).
\bibitem{120} 34 TEX. ADMIN. CODE § 3.302 (West 2000).
\bibitem{122} TEX. TAX CODE ANN. § 151.311 (Vernon Supp. 2001).
\bibitem{124} Id.
\end{thebibliography}
II. FRANCHISE TAX

A. APPLICATION OF THE TAX

*Rylander v. Bandag Licensing Corp.*[126] surprised many tax practitioners. This interesting franchise tax case involved a wholly-owned subsidiary of Bandag Corporation. During the audit period in question, the subsidiary possessed a certificate of authority to do business in Texas but did not own, possess, use or maintain any real property or tangible property in Texas. The facts showed that the subsidiary, BLC, owned three patents that were licensed to Bandag under a 1985 agreement executed by Bandag and BLC outside Texas. Pursuant to that agreement, Bandag sent royalty payments to BLC's Iowa office; however, the comptroller's policy during the audit period provided that the licensing of such intangibles did not create franchise tax nexus. Instead, the comptroller sought to impose franchise tax solely because of BLC's certificate of authority. Noting that the franchise tax extends "only 'to the limits of the United States Constitution and the Federal law adopted' thereunder,"[127] the court turned to the traditional *Complete Auto Transit, Inc. v. Brady*[128] Commerce Clause analysis. Accordingly, the court examined whether the tax is applied to an activity with substantial nexus, fairly apportioned, does not discriminate against interstate commerce, and is fairly related to the services provided by the state. Concluding that BLC was not physically present in Texas (and therefore would not have had sales/use tax nexus under *Quill Corp.*[129]) and that BLC's holding the certificate of authority failed to constitute "an activity" in the ordinary sense of the definition, the court concluded that when a corporation, like BLC, conducts its activities "solely through interstate commerce and lacked any physical presence in the state, no sufficient nexus exists to permit the state to assess tax."[130] In addition to holding that the comptroller's franchise tax claim against BLC fails under the Commerce Clause, the court additionally concluded that BLC's "passive possession of the Certificate of Authority to do business in Texas" standing alone provides insufficient contact under the Due Process Clause to subject BLC to jurisdiction.[131]

At the trial, the comptroller had requested an additional finding of fact that BLC's reported business activities in Texas included receiving royalties from Bandag for one of the years at issue. However, because the trial judge denied that request and because the comptroller had not complained on appeal that such denial was in error, the Court of Appeals decision did not discuss the royalty issue in depth. The case also presents important procedural issues regarding the Uniform Declaratory Judg-

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126. 18 S.W.3d 296 (Tex. App.—Austin 2001, pet. filed.).
127. Id. at 298 (citing Tex. Tax Code Ann. § 171.001(c) (Vernon Supp. 2001)) (emphasis added).
130. Bandag, 18 S.W.3d at 300.
131. Id. at 301.
B. Administrative Hearings and Letters

Decision 36,304A\textsuperscript{133} again highlights the difficulty of determining with certainty how receipts from a trust will be sourced for Texas franchise tax purposes. The taxpayer in this case asserted that the proceeds from the disposition of the assets of the trusts should be treated as non-Texas receipts because the payor of the proceeds was a Delaware corporation. The evidence showed that the parties had entered into a series of documents, including a Participation Agreement, an Owner-Trust Agreement, a Tax Indemnity Agreement, and other agreements typically used in certain financing/lease-back transactions. As is typical in such transactions, the Owner Trustee held legal title to the property (in this case, property related to a chemical company plant complex). During the audit period, the parties had executed a “Termination Agreement.” For franchise tax purposes, the administrative law judge considered whether the petitioner had (as it claimed) transferred its interest in the trust. A comptroller letter issued to the taxpayer a month after the Termination Agreement provided that a distribution through the trust would not be treated as Texas gross receipts. (The letter had been issued in response to the taxpayer’s question as to whether gain realized from the sale or exchange of securities by the trust would be treated as Texas gross receipts.) Although the taxpayer ultimately prevailed in this case and was able to treat the receipts as non-Texas receipts, perhaps the more interesting part of this decision is its extensive discussion of the comptroller’s treatment over the years of distributions from a trust.

The administrative law judge found, as a matter of fact, that until September 1994, when an internal memorandum recommended that distributions from a trust should be apportioned based on the “principal place of business of the trust” (legal domicile of trust) for earned surplus purposes, there had been no consistent policy in place regarding trust distributions for taxable earned surplus purposes.\textsuperscript{134} In December 1996, Rule 3.557\textsuperscript{135} was revised to provide that distributions to beneficiaries of a trust are apportioned based on a legal domicile of the trust. As the administrative law judge noted, the comptroller’s policy in effect in 1992 was to source trust distributions based on the state of trust formation or the legal domicile of the trustee. Indeed, the administrative law judge notes that an internal comptroller letter written in September 1994 acknowledged that there were four inconsistent trust distribution sourcing policies in the comptroller’s office at that time. In this case, the tax division attempted unsuccessfully to apply its then current (2000) interpretation to an old

\textsuperscript{132} Id. at 301-04. The award of attorney fees also presents interesting possibilities for taxpayers. See infra note 281 and accompanying text.


\textsuperscript{134} Id.

\textsuperscript{135} 34 TEX. ADMIN. CODE § 3.557 (West 2000).
(1992) fact pattern. Interestingly, the tax division also argued in this case that the "legal domicile" of the trust is determined by the location of the trust's "day-to-day activities, which, in [this] case, would be determined by the location of the assets." After tracking through a history of several decisions (not always consistent), the administrative law judge recommended that the trust distributions at issue in this particular case be apportioned based on the location of the payor test and that the location of the payor test should be based upon the "legal domicile of the trusts." Under the facts at issue, the administrative law judge concluded that the legal domicile was "the principal place of business, the location of the trustee."

A letter ruling issued a few months prior to Decision 36304A also involved trusts utilized for non-recourse financing to purchase large assets that were then leased to a lessee. For federal income tax purposes, these grantor trust leases were treated as true leases, i.e., leases in which the trust was treated as the asset owner. For GAAP purposes, however, the taxpayer, which was a Delaware corporation that was the beneficiary of the trust, did not record the cost of the underlying asset or the non-recourse debt on its ledger. Instead, it reported its net out-of-pocket investment in the underlying assets (i.e., its equity) as lease receivables. The letter discusses seven separate trusts, some formed under Texas law, some under Connecticut law, some with a Texas trustee, and others with a Connecticut trustee. In determining how the distributions to beneficiaries from the trust would be apportioned, the letter concludes that the apportionment will be based on "the legal domicile of the trust." By cross-reference to section 3.549(b)(6), a trust's legal domicile is defined as the trust's "principal place of business," i.e., "the location of its day-to-day operations." Three of the trusts held office buildings as their assets. The letter concludes that, in these three cases, the location of the office building is the location of the day-to-day operations of the trust, apparently without regard to the law under which the trust was established or the location of the trustee.

Several decisions focused on "throw back" rules, pursuant to which sales receipts are "thrown back" to Texas for franchise tax purposes when the taxpayer has no nexus with the state to which the receipts would otherwise be sourced.

Decision 38,716 focused on the taxpayer's claim that it had nexus through property and payroll in each of several other states, so that its sales under those states should not be thrown back to Texas for franchise tax purposes. Although the taxpayer stored inventory in some other states, the evidence showed that its inventory storage consisted of storing

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138. Id. (citing 34 Tex. Admin. Code § 3.549(e)(47) (West 2000)).
perishable food items for only a short period of time in rented locations when customers cancelled orders. The comptroller concluded that this situation constituted nothing more than a necessary delay in transit, so that—under the terms of Rule 3.557(e)(37)(G)—it did not result in nexus. Although the taxpayer contended that it had property and payroll in several other states, the comptroller concluded that the taxpayer had failed to provide adequate documentation or evidence to support this contention.

In Decision 38,309, the taxpayer manufactured and sold plastic laminate. The taxpayer asserted that it was not required to throw back receipts from sale of tangible personal property that it delivered to non-Texas destination states with its own trucks. The tax division ultimately agreed with this assertion as to taxable capital. However, the tax division disagreed with the taxpayer's assertion that it was not required to throw back receipts for earned surplus purposes when it sold and shipped tangible personal property from Texas to other destination states with whom it had constitutional nexus but not nexus for tax of "a like-kind" to the earned surplus. The taxpayer essentially argued that the standard for both taxable capital and earned surplus is identical, so that the taxpayer should not be subject, for earned surplus purposes, to a throw back rule with regard to those states. As the administrative law judge points out, the validity of the comptroller's rule on this point has been confirmed (by the comptroller anyway) by Decision No. 35,480 (1998). However, as the administrative law judge noted, litigation is pending on this issue. Another issue not specifically addressed by the comptroller decision is a statute of limitations one; the tax division conceded that the taxpayer's franchise tax refund claim had been made within six months of the date the tax assessment became final. However, the tax division indicated that if the taxpayer's claim were expanded to "transactions" not included in the audit, the tax division would then insist that the claim with respect to these other transactions was subject to the four-year statute of limitations rather than to the later, six-months after final assessment.

As telecommunication issues continue to proliferate, it is not surprising to find telecommunication receipts cases. Decision 36,385 addressed the contention of a Texas corporation operating as an independent local exchange telephone company ("LEC") that its apportioned gross receipts should not include revenues from access charges and billing and collection charges to long distance carriers and any user charges to the taxpayer's customers. Noting that Rule 3.557 provides that revenues for

141. 34 TEX. ADMIN. CODE § 3.557(e)(37)(G) (West 2000).
143. Anyone remember the old movie The Graduate?
144. As part of this argument, the taxpayer asserted that the legislature's substantive amendment to section 171.1032(a) of the Tax Code applied to reports due after January 1, 1994, but not to earlier reports.
telephone calls in Texas are Texas receipts, "except for revenues from calls in interstate commerce," the taxpayer asserted that its interstate access charges, interstate billing and collection charges, and interstate end users charges were all "revenues from calls in interstate commerce," and therefore not Texas receipts. The tax division replied that the quoted language had been included in the rule since December 30, 1987 and that thereafter, the United States Supreme Court decision of Goldberg v. Sweet had eased the constitutional restraints on including receipts from interstate services in the Texas Tax Code. In other words, relying on Tax Code section 101.002(b), the tax division asserted that because the constitutional interpretation had changed, the comptroller was authorized to change its interpretation (regardless of the fact that the rule had not changed). The Proposed Comptroller Decision recommended that the interstate access charges be deleted from gross receipts; however, following the tax division's exceptions, the comptroller decided to agree with the tax division. Thus, the final Comptroller Decision concludes that the interstate access charges are Texas receipts "because they represent payments for access to local networks or the use of local facilities." Moreover, finding that the contested charges were includable not because of a change in the comptroller's interpretation but because the receipts were held not to be receipts from interstate calls, the comptroller also ruled against the taxpayer's detrimental reliance arguments. The administrative law judge did waive interest for a portion of the time because the length of time that elapsed between the closing of the record and the decision.

Fortunately, ruling letters continue to be somewhat more favorable to taxpayers in the franchise tax area than are the bulk of the franchise tax redetermination and refund hearings. Most crucially, the letters offer additional planning certainty for taxpayers who desire to know, prior to the completion of their transaction, what the tax impact will be.

An October 1999 letter, for example, addressed the sourcing of receipts in connection with the sale of communication equipment containing both integrated circuits and stand-alone software. The stand-alone software contains both operating and applications software, and the applications software is customized. The customer pays a separate right-to-use fee and receives a non-exclusive license to use the software. There is no licensing fee for the software embedded in the chips, although there is a separate licensing fee for the software installed on the circuit. The comptroller indicated that if separate licenses are issued for the stand-

147. 34 TEX. ADMIN. CODE § 3.557 (West 2000) (emphasis added).
149. TEX. TAX CODE ANN. § 101.002(b) (Vernon 1992) (that all-time favorite section providing that "the jurisdiction and authority of the state to determine the subject and object of taxation shall extend to the limits of the then-current interpretation of the Texas Constitution and United States Constitution and laws").
alone software and the software installed on a circuit, the receipts attributable to software licenses would be apportioned based on the location of payor. The receipts attributable to sale of the software embedded on the chips and the sale of equipment would then be apportioned as sales of tangible personal property.

Another interesting letter\(^{152}\) focused on the contribution of property by a Texas corporation to a limited liability company treated as a partnership for federal tax purposes, in exchange for interest in the LLC. At the time the property was contributed to the LLC, it had a cost-basis of $1,000 and a fair market value of $600,000. The contributed property is subject to the provisions of Internal Revenue Code\(^ {153}\) concerning built-in gains. Relying on Rule 3.562(c)\(^ {154}\) which provides for the computation of an LLC's taxable capital, and Article 5.01(a) of the Texas Limited Liability Company Act,\(^ {155}\) the comptroller concluded that the member's contribution is the sum of the cash contributed and "the agreed value" of the contributed property in computing its taxable capital.

C. REGULATORY DEVELOPMENTS

The comptroller issued a draft version of Rule 3.557\(^ {156}\) and Rule 3.549,\(^ {157}\) dealing with taxable capital apportionment. The amendments to Rule 3.557 include definitions of the Internal Revenue Code with respect to dates, a definition of legal domicile, and definition of location of payor. The rule also adopts changes with respect to regulated investment companies and provides that a corporation with a 52-53 week accounting year (such as certain retailers) ending in the first four days of January during the year in which the report is originally due may use the preceding December 31 as the date through which taxable earned surplus is computed. The rule also includes a provision that gross receipts related to income described under section 171.1061 of the Tax Code\(^ {158}\) should not be included in either gross receipts or Texas gross receipts for apportionment purposes. In addition, there were several other changes to the rule, including an amendment with respect to natural gas production and a new provision providing that distributions to the beneficiaries of a trust are apportioned to the legal domicile of the trust.

Shortly after the current Survey period, the comptroller proposed changes to Rule 3.549.\(^ {159}\) As the preamble to the rule points out, the rule has been amended to provide a new apportionment requirement for dividends and/or interest received by banking corporations to reflect changes

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156. 34 Tex. Admin. Code § 3.557.
The comptroller also revised Rule 3.560\(^{162}\) to take into account the changes made during the 1999 legislative session, including a revised definition of “banking corporation” and to provide that for reports originally due on or after January 1, 2000, a banking corporation’s dividend and/or interest are apportioned to the legal domicile of the payor.\(^{163}\) The rule also includes a definition of legal domicile.\(^{164}\) Other rule changes included the rule on enterprise zones and defense economic zones\(^{165}\) and savings and loan associations.\(^{166}\) Like banks, savings and loan associations are subject to new rules for dividends and interest following the 1999 legislative changes.

III. PROPERTY TAX

A. Application of the Tax/Exemptions

Some of the more noteworthy decisions issued during the Survey period involved property tax arrangements that are used as vehicles by local jurisdictions to spur economic development, such as tax abatement agreements, tax increment financing and economic development agreements. The message from these decisions is unambiguous—radical departures from the statutory requirements (as interpreted by the Attorney General) for the particular incentive can result in the loss of incentive.

In Letter Opinion JC-0300,\(^{167}\) the Attorney General ruled that a tax abatement agreement entered into by the lessee of the property instead of the owner of the property is not valid.\(^{168}\) The abatement agreement at

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\(^{161}\) Id. If adopted in its proposed form, the rule would provide that all advertising revenue, including that from out of state advertisements of a newspaper or magazine that transacts “its primary business activities within Texas” are Texas receipts, and that all other receipts are apportioned in accordance with the apportion rules otherwise applicable.


\(^{164}\) Id. (providing that the legal domicile of a corporation is its state of incorporation; that the legal domicile of a partnership or trust is its principle place of business; and that the principle place of business of a partnership or trust is the location of its “day-to-day operations”; further providing that where the day-to-day operations are conducted equally or fairly evenly in more than one state, the commercial domicile will be considered the principle place of business).


\(^{168}\) Id.
issue was between Bexar County and Boeing Aerospace Operations, Inc. ("Boeing"), the lessee of the real property.\(^{169}\) The agreement abated county property taxes on Boeing's tangible personal property located at the site, provided that Boeing made specified tangible personal property investments on the property.\(^{170}\) In rejecting the validity of this tax abatement agreement, the Attorney General's interpretation relied on sections 312.204(a)\(^{171}\) and 312.206(a),\(^{172}\) which state that cities and counties may enter into tax abatement agreements with the real property owner.\(^{173}\) The Attorney General rejected the argument that a lessee of real property is an owner of the leased real property for these purposes.\(^{174}\)

Two Attorney General opinions addressed the requirement in the tax abatement statute that property that is owned or leased by a member of the municipality's governing body is not eligible for tax abatement by the municipality. Letter Opinions JC-0155\(^{175}\) and JC-0236\(^{176}\) involved a circumstance in which a tax abatement agreement was granted to a corporation and subsequently the major shareholder of the corporation was elected to the city council of the city that granted the tax abatement agreement.\(^{177}\) The Attorney General ruled that although the major shareholder was not barred from serving on the city council merely because his or her corporation had been granted a tax abatement, the corporation loses the tax abatement on the date the individual assumes office as a member of the city council,\(^{178}\) with taxes prorated for that year based on the date he or she assumed office.\(^{179}\)

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\(^{169}\) Id.

\(^{170}\) Id.


\(^{172}\) Id. at § 312.206(a) (Vernon Supp. 2001). One possible way of avoiding this issue would be for the owner of the leased property to enter into the tax abatement agreement along with the lessee, thus satisfying the statutory requirement that the tax abatement agreement be with the owner of the real property. There is nothing in the abatement statute that indicates other parties besides the government entity and the real property owner cannot be a party to the tax abatement agreement.


\(^{174}\) Id. In McCormick Mkt'g, Inc. v. City of Colorado City, 2001 Tex. App. LEXIS 284 (Tex. App.—Eastland 2001, no pet.), the Eastland Court of Appeals held that a tax abatement agreement between a city and a property owner was invalid because the parties failed to comply with the tax abatement statute in several respects, including failing to establish a reinvestment zone in which the property is located and failing to have a written tax abatement agreement that included the specific terms that must be included under section 312.205 of the Tax Code. Id. at 3-4. The court also denied estoppel-type arguments raised by the property owner. Id. at 4-5.

\(^{175}\) Tex. Att'y Gen. LO JC-0155 (Dec. 8, 1999).

\(^{176}\) Tex. Att'y Gen. LO JC-0236 (June 22, 2000).


\(^{179}\) Tex. Att'y Gen. LO JC-0236 (June 22, 2000). In another Attorney General opinion addressing the tax abatement statute, Letter Opinion JC-0133 addressed the 1989 statutory amendment that changed the maximum abatement term from fifteen to ten years. Tex. Att'y Gen. LO JC-0133 (Oct. 28, 1999). Specifically, the Letter Opinion addressed a tax abatement agreement that was entered into one year before the 1989 amendment, providing for a five-year abatement that would automatically be extended for two additional five year periods for a total of fifteen years, if certain employment conditions were met. Id.
The Attorney General, in Letter Opinion JC-0092, ruled that section 381.004 of the Local Government Code does not authorize a county to make payments of county funds to a private company in order to spur economic development. The opinion concerned an economic development agreement (the "Dallas County Agreement") between Dallas County and a private company owning real property in the county. Pursuant to the Dallas County Agreement, Dallas County agreed, subject to conditions, to make yearly payments to the company for a ten-year period equal to one-half of the property taxes collected by the county on the relevant property's incremental value from its 1996 value. The conditions were that (a) the company met certain employee, payroll and property value requirements, and (b) the Attorney General opined that the tax abatement statute does not preclude agreements such as the one at issue. The Dallas County Agreement provided that it is entered into pursuant to section 381.004 of the Local Government Code, which provides that, to encourage economic development, a county may develop or administer a program for economic development or to stimulate commercial activity in the county and that a county may, inter alia, "use county employees or funds for the program."

The Attorney General first addressed whether Chapter 312 of the Tax Code dealing with tax abatement agreements, precludes grants and economic development agreements of the type provided for in the Dallas County Agreement. The primary concern was that section 312.206(a) of the Tax Code, as in effect when the Dallas County Agreement was entered into, provides that the terms of a county tax abatement must be

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These employment conditions were met, thereby meaning that the owner was entitled to a fifteen-year abatement under the terms of the abatement agreement. Id. However, the conditions were met by a new owner of the property. Id. The Attorney General ruled that if the original agreement was a fifteen-year agreement, then the 1989 amendment would not operate to shorten the abatement period granted by the agreement because the 1989 legislation does not affect the validity of abatement agreement extensions granted before the effective date of the 1989 legislation. Id. However, if the original agreement was properly treated as a five-year agreement, then the 1989 legislation would reduce the maximum term of the abatement agreement to ten years. Id. The Attorney General considered this to be a question of fact, which would not normally be addressed by the Attorney General. Id. Given that the conditions to the extension of the tax abatement were outside the control of the city, it is difficult to understand how the agreement could be treated as a five-year agreement. Because the conditions to the extension of the tax abatement agreement were outside the control of the city, the agreement should be viewed as a fifteen-year agreement that is terminated early if certain conditions are not met.

183. Id.
184. Id. This agreement essentially embodied tax increment financing-type concepts (i.e., capturing a portion of property taxes on the property value in excess of the value existing in a base year) without requiring that the captured taxes be used for public works.
185. Id.
186. Id.
189. Id. § 312.206(a) (Vernon Supp. 2000).
identical to the terms of the city agreement, with certain exceptions.\textsuperscript{190} The Attorney General ruled that Chapter 312 is not relevant to the kind of arrangement described in the Dallas County Agreement because the Dallas County Agreement is not a tax abatement agreement—Chapter 312 neither authorizes nor precludes agreements like the Dallas County Agreement.\textsuperscript{191}

The Attorney General, however, raised and answered another critical issue—whether section 381.004 authorizes the Dallas County Agreement.\textsuperscript{192} In concluding that the Dallas County Agreement is outside the scope of powers granted to a county under section 381.004, the Attorney General relied on the principle that in circumstances in which the Texas Legislature authorizes grants, it generally expressly does so.\textsuperscript{193} Section 381.004 provides no such express authorization;\textsuperscript{194} thus, the Attorney General concluded that the statute does not authorize the grant of funds contemplated by the Dallas County Agreement.\textsuperscript{195} Simply, the statute does not expressly authorize a county to agree to make grants of county funds to a private entity.

Because Dallas County relied on article III, section 52-a of the Texas Constitution\textsuperscript{196} for its construction of section 381.004 to allow for grants to private companies, the Attorney General examined the relationship of section 381.004 to this constitutional provision.\textsuperscript{197} Article III, section 52-a provides that the Texas Legislature may “provide for the creation of programs and the making of loans and grants of public money” for economic development and other specified economic purposes.\textsuperscript{198} The Attorney General reasoned that this constitutional provision is not self-enacting;\textsuperscript{199} rather it permits the Texas Legislature to enact legislation providing for economic development.\textsuperscript{200} The Attorney General reasoned that where the Texas Legislature has desired to enable a governmental entity to grant public funds to private entities under the authority of this constitutional provision, it has expressly done so, such as in section 380.001 of the Local Government Code, which provides that municipalities may grant and loan public money for economic development.\textsuperscript{201} No such express language is present in section 381.004.

\textsuperscript{190} Id.
\textsuperscript{191} Tex. Att'y Gen. LO JC-0092 (Aug. 11, 1999).
\textsuperscript{192} Id.
\textsuperscript{193} Id. Although the wording of sections 380.001 (for municipalities) and 381.004 (for counties) are different, query whether the Texas Legislature really intended to give municipalities broader power than counties to make grants and loans of public funds.
\textsuperscript{194} TEX. LOCAL GOV'T CODE ANN. § 381.004 (Vernon 2001).
\textsuperscript{195} Tex. Att'y Gen. LO JC-0092 (Aug. 11, 1999).
\textsuperscript{196} TEX. CONST. art. III, § 52-a.
\textsuperscript{197} Tex. Att'y Gen. LO JC-0092 (Aug. 11, 1999).
\textsuperscript{198} TEX. CONST. art. III, § 52-a.
\textsuperscript{199} Tex. Att'y Gen. LO JC-0092 (Aug. 11, 1999).
\textsuperscript{200} Id.
\textsuperscript{201} Id. Indeed, in Letter Opinion JM-185, the Attorney General indicated in 1992 that grants and rebates by municipalities of public funds pursuant to an economic development program established in accordance with section 380.001 of the Texas Local Government Code are valid and constitutional. See Tex. Att'y Gen. LO DM-185 (1992).
Letter Opinion JC-0152 addresses qualification of property for tax increment financing. The Attorney General ruled that a tax increment financing reinvestment zone established under section 311.005(a)(5) must be in an "unproductive, underdeveloped or blighted" area. Section 311.005(a) sets forth four different ways a property may be designated as a reinvestment zone. Section 311.005(a)(5) is different than the other three ways property may be designated as a reinvestment zone because it merely requires the landowner or landowners to petition requesting that the area be designated as a reinvestment zone, whereas the other methods essentially require that the property be in a blighted area. Although section 311.005(a)(5) does not, by its terms, require that the property designated as a reinvestment zone be in a blighted area, the Attorney General ruled that such property must be "unproductive, underdeveloped or blighted" because the constitutional amendment authorizing tax increment financing states that tax increment financing is to be used for "unproductive, underdeveloped or blighted area[s]." The Attorney General further ruled that an area may not be designated as a reinvestment zone simply because the municipality believes that greater development will occur if the tax increment financing zone is created. Finally, the Attorney General ruled that the city's determination in this regard must be made in good faith, exercising reasonable discretion, which is subject to judicial review.

In Letter Opinion JC-0311, the Attorney General addressed whether doctors' offices owned by a hospital district and leased to private physicians are tax-exempt. Courts have repeatedly held that publicly-owned medical offices leased to private physicians are not tax exempt.
under section 11.11\textsuperscript{213} of the Tax Code because the office buildings are not used exclusively for public purposes.\textsuperscript{214} However, the twist in the facts of this Opinion is that each lease between the hospital district and the physician restricts the equipment that the physician may own in order to encourage his or her to send all patients requiring X-rays and laboratory work to the hospital district's hospital.\textsuperscript{215} The hospital district asserted that the offices are tax exempt because their use increases the hospital's income thereby benefiting the residents of the county.\textsuperscript{216} The Attorney General disagreed, reasoning that the receipt by a government entity of proceeds arising from commercial use of property does not qualify the use of the property as public.\textsuperscript{217} Because the offices are not devoted exclusively to public use, they are not exempt.\textsuperscript{218}

The Waco Court of Appeals in \textit{Destec Properties Ltd. Partnership v. Freestone Central Appraisal Dist.}\textsuperscript{219} held that the income approach to valuing an overriding royalty interest is not, as a matter of law, an impermissible method of appraising property in a circumstance in which the overriding royalty interest produces no net income to its owner, thus resulting in a $0 taxable value.\textsuperscript{220} The overriding royalty interest in this case is unusual because the taxpayer owned the overriding royalty interest (in lignite) merely to insure that it had a lignite supply.\textsuperscript{221} The essence of the financial aspects of the royalty is that the taxpayer could not realize net income from the royalty.\textsuperscript{222} The appraisal district asserted that this relationship is akin to a bargain lease (which is ignored for property tax purposes in valuing the fee interest) and that the unusual financial aspect of the royalty should thus be ignored.\textsuperscript{223} The court disagreed, reasoning that an overriding royalty is completely severable from the fee estate whereas a lease is not, as a below market lease burdens the value of the fee.\textsuperscript{224}

\section*{B. Procedure}

In \textit{Anderton v. Rockwall Cent. Appraisal Dist.}\textsuperscript{225} the Dallas Court of Appeals addressed the time limit for a taxpayer challenging under section 25.25(d)\textsuperscript{226} the market value of open-space land. Open-space land is

\begin{itemize}
\item \textsuperscript{213} \texttt{TEX. TAX CODE ANN.} § 11.11 (Vernon Supp. 2001).
\item \textsuperscript{214} See \textit{Grand Prairie Hosp. Auth. v. Dallas County Appraisal Dist.}, 730 S.W.2d 849, 851 (Tex. App.—Dallas 1987, writ ref'd n.r.e.); \textit{Grand Prairie Hosp. Auth. v. Tarrant Appraisal Dist.}, 707 S.W.2d 281, 284 (Tex. App.—Fort Worth 1986, writ ref'd n.r.e.).
\item \textsuperscript{215} Tex. Att'y Gen. LO JC-0311 (Nov. 30, 2000).
\item \textsuperscript{216} \textit{Id.}
\item \textsuperscript{217} \textit{Id.}
\item \textsuperscript{218} \textit{Id.}
\item \textsuperscript{219} 6 S.W.3d 601 (Tex. App.—Waco 1999, pet. denied).
\item \textsuperscript{220} \textit{Id.} at 607.
\item \textsuperscript{221} \textit{Id.} at 605-06.
\item \textsuperscript{222} \textit{Id.} at 606.
\item \textsuperscript{223} \textit{Id.}
\item \textsuperscript{224} \textit{Id.}
\item \textsuperscript{225} 26 S.W.3d 539 (Tex. App.—Dallas 2000, pet. denied).
\item \textsuperscript{226} \texttt{TEX. TAX CODE ANN.} § 25.25(d) (Vernon Supp. 2001).
\end{itemize}
taxed at its productive value rather than its market value; however, if a change in use of the land occurs whereby it no longer qualifies as open-space land, then rollback taxes are imposed. Rollback taxes are based on the difference between the market value and the productive value of property for the five years preceding the change in use. In order to be able to determine the rollback taxes for open-space land that would be imposed were there a change in use, the appraisal district determines both the productive value and the market value of open-space land each year. The procedures and time limits for a taxpayer’s challenging the market value and productive value for open-space land are the same. In 1997 the appraisal district notified Anderton that rollback taxes would apply because there had been a change in use. In January 1998, Anderton filed a motion with the appraisal review board to correct under section 25.25(d) the tax appraisal rolls of the property for the preceding five years. Under section 25.25(d) a taxpayer may move to change the appraisal roll to correct a substantial error (i.e., the appraised value exceeds the market value by more than one-third) in the appraised value of the taxpayer’s property. Such a motion may be filed “at any time prior to the date the taxes become delinquent . . . .” Anderton asserted that her motion was timely because the rollback taxes were not due until February 1, 1998. The appraisal district asserted that the reference to “taxes” above are not to the rollback taxes but to the date Anderton’s yearly property taxes become delinquent, thus making her motion untimely. Reasoning that there is nothing about the assessment of rollback taxes itself that creates a new reason for a property owner to have the right to challenge past determinations of appraised values, the court held that the term “taxes” as used in section 25.25(d) refers only to yearly property taxes and not rollback taxes. Thus, Anderton’s motion was not timely.

Several decisions issued during the Survey period addressed the valuation of property. The Dallas Court of Appeals in Sears Roebuck & Co. v. Dallas Cent. Appraisal Dist. addressed the valuation of inventory. At trial, the appraisal district asserted that the market value of Sears’ inventory equaled the book value under generally accepted accounting principles of Sears’ inventory; the trial court agreed. The trial court

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227. Id. § 23.52(a) (Vernon Supp. 2001).
228. Id. § 23.55(a) (Vernon Supp. 2001).
229. Id.
230. Id. § 23.52(b) (Vernon Supp. 2001).
231. Anderton, 26 S.W.3d at 541.
232. Id.
233. Id. at 543-44.
235. Id. at 1.
236. Id.
rejected arguments by Sears that certain reductions should be made to book value to arrive at fair market value, such as reductions for the cost of maintaining warranties, reductions for the value of brand names, and physical, functional and economic obsolescence as indicated by turnover ratios. In response, the appraisal district stated that Sears kept the book value of inventory in accordance with GAAP, which values inventory at the lower of cost or value. Sears' primary position at the court of appeals was that book value cannot equal market value as a matter of law. The court disagreed, reasoning that (a) the trial court did not conclude as a matter of law that book value equals market value, it merely used the book values as a strong indication of value that was not overcome by any evidence presented by Sears, and that (b) book value can serve as an indication of market value. The court distinguished several authorities cited by Sears in support of its position that book value does equal market value. In *Polk County v. Tenneco, Inc.*, the Texas Supreme Court concluded that the court of appeals erred in equating book value to market value. The Dallas Court of Appeals distinguished this case because it involved real property; under the property tax rules, real property and personal property are valued by very different methods. In *Cheek v. Humphries* the Houston Court of Appeals [14th Dist.] concluded that "book value is an improper method of determining the value of partnership equipment on dissolution of the partnership." Again, the Dallas Court of Appeals noted that equipment and inventory are valued quite differently for property tax purposes. Finally, in *Coastal States Petroleum Co. v. Corpus Christi Indep. Sch. Dist.*, the Corpus Christi Court of Appeals stated that "book value is not necessarily the true market value of . . . inventory . . ." In response, the Dallas Court of Appeals reasoned that the language does not preclude using book value as an indication of market value.

In *Tex-Air Helicopters, Inc. v. Harris County Appraisal Dist.*, the Texarkana Court of Appeals held that a taxpayer that prevailed in court,

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241. *Id.* at 3.
242. *Id.*
244. *Id.* at 17.
245. *Id.* at 17-18.
246. 554 S.W.2d 918 (Tex. 1977).
247. *Id.* at 923.
249. See *Tex. Tax Code Ann.* § 23.01 (Vernon Supp. 2001) (real property is appraised at market value); but see *id.* § 23.12 (Vernon Supp. 2001) (inventory is appraised based on the price a purchaser would pay for inventory is a bulk sale).
250. 800 S.W.2d 596 (Tex. App.—Houston [14th Dist.] 1990, writ denied).
251. *Id.* at 598.
253. 707 S.W.2d 206 (Tex. App.—Corpus Christi 1986, writ ref'd n.r.e.).
254. *Id.* at 211.
claiming that its helicopters were being improperly taxed at their full value rather than an allocated value based on use in Texas, was not entitled to an award of attorney's fees. 257 The taxpayer's helicopters were used in connection with off-shore drilling. 258 Because of the helicopters' non-Texas use, the taxpayer asserted, and ultimately prevailed at the Texas Supreme Court, that it was entitled to an allocation of values for its helicopters under section 21.05 of the Tax Code. 259 The taxpayer then sought an award of attorneys' fees under section 42.29, 260 which provides that a property owner that prevails in an action under section 42.25 261 or section 42.26 262 may be awarded attorney's fees. 263 Section 42.25 relates to controversies concerning the appraised value of property, 264 and section 42.26 relates to controversies relating to unequal appraisals. 265 Although the taxpayer's success in the case concerning the allocated value of its property lowered the taxable value of its property it did not lower the appraised value of its property and clearly did not involve an unequal appraisal issue. 266 Therefore, the court concluded that the taxpayer was not entitled to attorney's fees under section 42.29. 267

In Robinson v. Budget Rent-A-Car Sys., Inc. 268 the Houston Court of Appeals held that section 22.01, 269 which provides that a person shall render for taxation all tangible personal property used for the production of income, 270 is mandatory and that compliance can be judicially compelled. 271 Although section 22.01 uses the term "shall," 272 it had long been a common belief that section 22.01 is not mandatory given that the Tax Code does not impose a penalty for failure to render tangible personal property.

IV. PROCEDURE

The Bandag decision cited above 273 is interesting not only for its substantive holding but also for its procedural circumstances. The taxpayer sought and received a declaratory judgment under the Uniform Declaration of Rights Act, as well a judgment for attorney's fees authorized by

257. Id. at 177. For a discussion of the Houston [14th District] decision that addressed the proper taxation of these helicopters, which decision was affirmed by the Texas Supreme Court, see C. Ohlenforst, et al., Taxation, 51 SMU Law Review 1345, 1370 (1998).
258. Tex-Air Helicopters, 15 S.W.3d at 174.
260. Id. § 42.29 (Vernon Supp. 2001).
261. Id. § 42.25 (Vernon 1992).
262. Id. § 42.26 (Vernon Supp. 2001).
263. Id. § 42.29 (Vernon Supp. 2001).
264. Id. § 42.25 (Vernon 1992).
265. Id. § 42.26 (Vernon Supp. 2001).
266. Tex-Air Helicopters, 15 S.W.3d at 177.
267. Id.
270. Id.
273. Bandag, 18 S.W.3d 296; see supra note 126 and accompanying text.
the Act.\textsuperscript{274} The court discussed \textit{R Communications, Inc. v. Sharp}\textsuperscript{275} as well as the legislature’s subsequent amendment of section 112.108.\textsuperscript{276} Ultimately, the court addressed the comptroller’s argument that BLC could not seek declaratory judgment. As the comptroller pointed out, BLC had paid the franchise tax and did not file an oath of indigency; therefore, BLC could not complain of an inability to pay the tax.\textsuperscript{277} The court concluded, however, that a corporation that pays an illegal tax to avoid the possible forfeiture of its right to do business in the state has a legal claim for repayment, and that this claim is a well-recognized cause of action that antedates the statutory provisions at issue.\textsuperscript{278} Noting a parallel to section 42.08(b) of the Tax Code\textsuperscript{279} (dealing with property tax suits), the court essentially held that section 112.108, even as amended, is unconstitutional.\textsuperscript{280}

The court further disagreed with the comptroller’s argument that the doctrine of governmental immunity barred attorney’s fees. The court concluded that the prohibition against attorney’s fees in section 112.108 was “not severable from the remainder of that section and must fall within the entirety of section 112.108 as an unreasonable financial barrier against access to the courts.”\textsuperscript{281}

\textit{Interaction, Inc. v. State of Texas}\textsuperscript{282} is a reminder to all taxpaying entities to keep information filed with the secretary of state current. In this case, the state sued the operator of a convenience store for unpaid gasoline and sales taxes. Interaction was named as a defendant in this suit, as an alleged statutory or common law successor to the store operator. The state failed in its attempt to serve notice of this suit on Interaction’s registered agent because the agent had moved back to Lebanon.\textsuperscript{283} Although the Texas address for the vice president of Interaction was handwritten on the return of the notice to the state, the state chose to substitute service on Interaction through the secretary of state rather than attempting notice on the vice president of Interaction.\textsuperscript{284} In its suit, the state obtained a default judgment against both the store operator and Interaction. Interaction’s first actual notice of this judgment came when the state garnished its bank accounts. At that time, Interaction filed for a bill of review based on its claim that it had neither actual nor constructive notice

\begin{itemize}
\item \textsuperscript{274} \textsc{Tex. Civ. Prac. & Rem. Code Ann.} § 37.001 et. seq. (Vernon 1997).
\item \textsuperscript{275} 875 S.W.2d 314 (Tex. 1994) (which found that the then-in-effect version of Tax Code § 112.108, which required taxpayers to pay the contested assessment prior to seeking a judicial remedy, was unconstitutional).
\item \textsuperscript{276} \textsc{Tex. Tax Code Ann.} § 112.108 (Vernon Supp. 2001) (designed to prohibit declaratory judgment except on the filing of an indigency oath and a determination by the court that the prepayment would constitute an unreasonable restraint on open courts).
\item \textsuperscript{277} \textit{Bandag}, 18 S.W.3d at 303.
\item \textsuperscript{278} \textit{Id}. at 304.
\item \textsuperscript{279} \textsc{Tex. Tax. Code Ann.} § 42.08(b) (Vernon Supp. 2001)
\item \textsuperscript{280} \textit{Bandag}, 18 S.W.3d at 304.
\item \textsuperscript{281} \textit{Id}. at 305.
\item \textsuperscript{282} 17 S.W.3d 775 (Tex. App.—Austin, 2000, no pet.).
\item \textsuperscript{283} \textit{Id}. at 777.
\item \textsuperscript{284} \textit{Id}.
of the suit.\textsuperscript{285} Under article 2.11 of the Texas Business Corporation Act, service of process may be made to the president, vice presidents and the registered agent of a corporation.\textsuperscript{286} However, when, after reasonable diligence, the registered agent cannot be found, service of process may be given to the secretary of state as agent of the corporation.\textsuperscript{287} Although the court noted that Interaction would have received actual notice of the lawsuit if the vice president would have been served at the address written on the return, it found that the state's choice to effect service of process through the secretary of state was not in error.\textsuperscript{288} Further, the court held that Interaction was not denied due process by not receiving actual notice of the default judgment since this lack of actual notice was due to Interaction's failure to keep the address of its registered agent current with the secretary of state.\textsuperscript{289}

Detrimental reliance cases continue to present challenges to taxpayers. Decision 38,635\textsuperscript{290} involved a taxpayer who contended that interest should be waived because it had detrimentally relied on a prior audit.\textsuperscript{291} The taxpayer argued that the disclaimer statement, the all too familiar “conclusions to this audit are not to be taken as approval of your tax/fee reporting system. You are cautioned that in the future you will still be held liable for all taxes/fees owing and due,” might be appropriate in situations in which an auditor simply overlooked a tax that is clear, straightforward, and unambiguous, but not on the facts here. In this case, the prior auditor had raised the issue specifically with the taxpayer, and apparently accepted the corporation’s manner of determining what part of its business should be allocated to Texas for gross receipts purposes. While the taxpayer lost this case,\textsuperscript{292} there are situations in which taxpayers have been able to show specific evidence that an auditor affirmatively, if unintentionally, misled the taxpayer and have therefore successfully claimed detrimental reliance in connection with a prior audit.

Decision 37,843\textsuperscript{293} is yet another detrimental reliance case. In this one, the taxpayer claimed that it had relied to its detriment on proposed franchise Rule 3.572.\textsuperscript{294} The taxpayer in this hearing argued that it relied to its detriment on that rule, by “reasonably and in good faith [forbear] its legal right to be a party to a merger, reorganization and asset

\begin{thebibliography}{99}
\bibitem{285} Id. at 778.
\bibitem{287} Id. art. 2.11(B).
\bibitem{288} \textit{Interaction}, 17 S.W. 3d at 779.
\bibitem{289} Id. at 779-80.
\bibitem{291} Can you guess the answer to this one yet?
\bibitem{292} (You guessed right, didn't you?)
\bibitem{294} Proposed Rule 3.572, announced in November 1991, essentially provided that the comptroller would disregard certain mergers, reorganizations and asset transfers, by including a presumptive conclusion in the rule that the principal purpose of such transactions was "evasion or avoidance" of the Texas franchise tax.
\end{thebibliography}
The taxpayer argued that it should not be punished for its reliance on a rule that the comptroller pronounced as policy and then failed to enforce. Although the comptroller's ruling on this assertion is not a surprise (surely everybody guessed that this taxpayer failed to obtain detrimental reliance relief), the reasoning is worth noting.

The decision's conclusion about proposed rules is noteworthy: "An agency rule proposed under 2001.023 of the Texas Government Code is merely a notice of the agency's intention to adopt a rule. A proposed rule may be withdrawn prior to adoption." The administrative law judge therefore concluded that reliance on a proposed rule was not a basis for relief under the comptroller's detrimental reliance policy. Although this taxpayer lost its case (and deserved to), it is worthwhile to have the agency confirm that a proposed rule is just that—proposed.

In other cases decided during the Survey period, several taxpayers did receive some type of tax relief due to detrimental reliance on comptroller office's advice.

Decision 37,556, a statute of limitations case, focused on computations of business loss carry-forward. The taxpayer, whose audit period was 1992 through 1996, argued that all issues suggested in determining taxable earned surplus or taxable capital for those years were open for debate, protest and redetermination. Accordingly, the taxpayer sought confirmation through the hearing process that the gain from its sale of 100%-owned subsidiaries, which occurred during the fiscal year ending January 25, 1995, was not unitary and should therefore be excluded from the earned surplus tax base. The tax division argued to the contrary, pointing out that the fiscal year 1995 had a negative earned surplus, so the issue the taxpayer raised related to a potential loss carry forward rather than to the determination of the amount due for the audit period. The comptroller accepted the tax division's assertion that the comptroller would be able to audit a future year that was impacted by the 1995 transaction. The tax division further noted, and the administrative law judge agreed that "conversely, if the tax division may examine the appropriateness of the 1996 loss carry-forward on the 2001 report, then petitioner is not barred by limitations from taking the 1996 loss carry-forward in 2001." Thus, either party could consider and contest the 1995 trans-
action when the 2001 report was filed. Essentially, the administrative law judge accepted the tax division’s contention that the issue was not a “contested case” at this point.\textsuperscript{302}

In a hearing relating to tax assessed based on comptroller estimates, the comptroller was limited in her attempted extension of the audit beyond the statute of limitations.\textsuperscript{303} The taxpayer in this case was a convenience store operator who was audited by the comptroller’s office for sales tax compliance. Due to the unavailability of accounting records, the auditor resorted to an estimate of taxes due based on the information available. The gross error rate calculated by the auditor based on this information was 237.63\% for a six-month period. Based on this calculation, the auditor sought to extend the audit assessment beyond the four-year statute of limitations period, since the error rate calculated exceeded the 25\% threshold in section 111.205(b) of the Texas Tax Code. However, the administrative law judge found that it was improper to apply the comptroller’s estimated gross error rate for periods prior to the four-year audit period, because the evidence in the record did not show that the volume and nature of the taxpayer’s sales at the beginning of the “extended” audit period were comparable to those for the six-month period.\textsuperscript{304} Thus, the exception to the four-year statute of limitations was not available to the comptroller (at least with regard to most of the extended audit).

The comptroller’s office adopted several procedural changes during 2000, including re-naming its “Hearings Attorneys” as “Assistant General Counsel,” and re-naming the “Tax Division” as the “Administrative Hearings Section.” In addition, the comptroller made significant headway in reducing the number of backlogged cases and in resolving some disputed cases through mediation.

V. CONCLUSION

As this article went to print, the Texas Legislature was analyzing numerous tax-related provisions, including several recommended by Comptroller Carol Keeton Rylander. In addition to proposing technical amendments, the comptroller urged legislators to adopt the recommendations of the E-TAG Committee, a group of industry and local representatives (officially the Texas E-Commerce and Technology Advisory Group) who met throughout the Survey period to review and analyze issues related to electronic commerce and tax issues. The group recommended, for example, that Texas should become a “participating state” in the Streamlined Sales Tax Project, and Texas had already elected to do so by the time this article went to print. In addition, the group recommended other changes focused on treating sales of goods the same—i.e, taxable or nontaxable—regardless of whether they were delivered over the Internet.

\textsuperscript{302} Id.
\textsuperscript{304} Id.
or through a traditional brick and mortar retailer, and on continuing to help Texas businesses and consumers face the e-commerce age successfully (e.g., recommending an increase to the current exemption for data processing information services from twenty percent to forty percent, and by increasing the exemption for Internet access from $25 to $50 per month).