I. TEXAS FRANCHISE TAX

The Texas Legislature enacted House Bill 3, a significant revision to the Texas franchise tax, in a special session in the summer of 2006. The revised Texas franchise tax went into effect January 1, 2008, but the 2008 tax report will be based on 2007 financial activity. The new tax contains provisions that may render ineffective some tax planning measures implemented during the 2007 calendar year. During the 2007 legislative session, the Texas Legislature passed one significant bill, House Bill 3928, to correct, clarify, and refine the new margin tax. Other bills affecting the tax were also enacted. This section of the Texas tax update provides a complete overview of the margin tax.

Beginning in late 2007, the Comptroller released a series of answers to Frequently Asked Questions on her website. The “FAQs” are updated continuously and represent the Comptroller’s most up-to-date statement of policy positions on various aspects of the margin tax. The Comptroller’s website can be found at www.cpa.state.tx.us.

The standard formula for calculating the margin tax is set forth below:
Lesser of:
(A) 70% of Total Revenue from Entire Business or
(B) Total Revenue from Entire Business
- Deduction equal to the greater of:
  (i) Compensation and Benefits; or
  (ii) Cost of Goods Sold
Unapportioned Taxable Margin
x Texas Apportionment Factor
Apportioned Taxable Margin
- Deductions for Solar Energy/Clean Coal
x Tax Rate (either 1% or 0.5%)
Franchise Tax Due Before Credits
- Applicable Credits
Final Franchise Tax Liability (for non-small business)
x Applicable Small Business Discount (for small businesses)
Final Franchise Tax Liability (for small businesses)

The addition of an optional E-Z Computation for businesses with less than $10 million in total revenue (on an annualized basis) was added during the 2007 legislative session. The formula for the E-Z Computation is set forth below:

Total Revenue from Entire Business
x Texas Apportionment Factor
Apportioned Total Revenue
x Tax Rate of 0.575%
Final Franchise Tax Liability (for non-small business)
x Applicable Small Business Discount (for small businesses)
Final Franchise Tax Liability (for small businesses)

Another important 2007 legislative change was the addition of a Small Business Discount. The applicable percentage discount is applied to the franchise tax liability determined after applying the applicable tax rate and subtracting any applicable credits. The following discounts will apply:

A taxable entity with Total Revenue from Entire Business greater than $300,000 but less than $400,000 (on an annualized basis) will receive a discount of 80%.
A taxable entity with Total Revenue from Entire Business equal to or greater than $400,000 but less than $500,000 (on an annualized basis) will receive a discount of 60%.

A taxable entity with Total Revenue from Entire Business equal to or greater than $500,000 but less than $700,000 (on an annualized basis) will receive a discount of 40%.

A taxable entity with Total Revenue from Entire Business equal to or greater than $700,000 but less than $900,000 (on an annualized basis) will receive a discount of 20%.

The amounts listed above will be adjusted based on CPI on January 1 of every even-numbered year beginning in 2010.

Some important aspects of the Margin Tax and the various components of the Margin Tax formula are briefly described in this outline.

**TAXABLE ENTITIES**

Only corporations and limited liability companies were required to pay the franchise tax in its pre-2008 form. Under the revised tax, all entities with limited liability under state law (with the exception of “passive entities,” as explained below) will be taxed. This includes partnerships, limited liability partnerships, corporations, banking corporations, savings and loan associations, limited liability companies, business trusts, professional associations, business associations, joint ventures, joint stock companies, holding companies, and other legal entities. Sole proprietorships and general partnerships comprised of only natural persons (including the estates of natural persons) will not be subject to the revised tax. The statute also clarified that the following types of trusts are not taxable entities: (i) grantor trusts taxable under Section 671 and IRC § 7701(a)(30)(E), not taxable as a business entity pursuant to Treasury Regulation Section 301.7701-4(b), and in which all of the grantors and beneficiaries are natural persons or charitable entities as defined in IRC § 501(c)(3); (ii) nonprofit self-insurance trusts for health care liability claims; (iii) trusts that are part of an employer’s stock bonus, pension, or profit-sharing plan; and (iv) trusts that are voluntary employees’ beneficiary associations. For the first time under the Texas franchise tax, some entities will be required to file combined tax returns (see discussion below).

The revised tax contains an exemption for certain “passive entities.” An entity qualifies as a passive entity if: (1) the entity is a general or limited partnership or a trust, other than a business trust; (2) during the period on which margin is based, the entity’s federal gross income consists of at least 90% of the following income: dividends, interest, foreign currency exchange gain, periodic and nonperiodic payments with respect to notional principal contracts, option premiums, cash settlement or termination payments with respect to a financial instrument, and income from a limited liability company; distributive shares of partnership income to the extent that those distributive shares of income are greater than zero; capital gains from the sale of real property, commodities traded on a commodities exchange, and securities; and royalties, bonuses, or delay rental income from mineral properties and income from other nonoperating mineral interests; and (3) the entity does not receive more than 10% of its federal gross income from conducting an active trade or business.
A taxable entity will not owe any tax if the calculated tax is less than $1,000. A taxable entity will not owe tax if its “revenue from entire business” is less than or equal to $300,000 on an annualized basis; this $300,000 amount will be indexed based on CPI on January 1 of every even-numbered year beginning in 2010.

The Comptroller recognizes in her FAQs that the margin tax statutes allow taxpayers to combine the E-Z Computation, Small Business Discount, and $1,000 baseline exemption. Based on the combination of these statutory provisions, a taxpayer may have up to $434,782 in Total Revenue on its 2008 Franchise Tax Report and owe no tax.

**TOTAL REVENUE FROM ENTIRE BUSINESS**

Revenue is defined by references to federal income tax forms. One of the 2007 legislative changes requires that the amounts entered on federal income tax forms used to calculate total revenue must comply with federal tax law.

The total revenue of a taxable entity treated for federal income tax purposes as a corporation is an amount computed by adding the following: (a) the amount entered on line 1c, Internal Revenue Service Form 1120; (b) the amounts entered on lines 4 through 10, Internal Revenue Service Form 1120; and (c) any total revenue reported by a lower tier entity as includable in the taxable entity’s total revenue. The following are then subtracted from such sum: (a) bad debt that corresponds to the computed revenue; (b) to the extent included in revenue, foreign royalties and foreign dividends, including amounts determined under IRC § 78 or IRC § 951 through IRC § 964; (c) to the extent included in revenue, net distributive income from partnerships and from trusts and limited liability companies treated as partnerships for federal income tax purposes and net distributive income from limited liability companies and corporations treated as S corporations for federal income tax purposes; (d) allowable deductions from Internal Revenue Service Form 1120, Schedule C, to the extent the related dividend income is included in total revenue; (e) to the extent included in revenue, items of income attributable to an entity that is a disregarded entity for federal income tax purposes; and (f) to the extent included in revenue, revenue reported to an upper tier entity.

The total revenue of a taxable entity treated for federal income tax purposes as a partnership is an amount computed by adding the following: (a) the amount entered on line 1c, Internal Revenue Service Form 1065; (b) the amounts entered on lines 4, 6, and 7, Internal Revenue Service Form 1065; (c) the amounts entered on lines 3a and 5 through 11, Internal Revenue Service Form 1065, Schedule K; (d) the amounts on Form 8825, line 17; and (e) any total revenue reported by a lower tier entity as includable in the taxable entity’s total revenue. The following are then subtracted from such sum: (a) bad debt that corresponds to the computed revenue; (b) to the extent included in revenue, foreign royalties and foreign dividends, including amounts determined under IRC § 78 or IRC § 951 through IRC § 964; (c) to the extent included in revenue, net distributive income from partnerships and from trusts and limited liability companies treated as partnerships for federal income tax purposes and net distributive income from limited liability companies and corporations treated as S corporations for federal income tax purposes; (d) to the extent included in revenue, items of income attributable to an entity that is a disregarded entity for federal income tax purposes; and (e) to the extent included in revenue, revenue reported to an upper tier entity.
The total revenue of a taxable entity other than a taxable entity treated for federal income tax purposes as a corporation or partnership is computed in a substantially equivalent manner.

**POLICY NOTE**: In the April 2008 issue of the *Tax Policy News*, the Comptroller announced a policy that landlords may not exclude property tax, insurance, or expense reimbursements received from tenants under triple net leases from total revenue. The Comptroller reached this policy by relying on federal income tax rules that treat such amounts as part of a taxpayer’s gross rental income.

**DEDUCTIONS**

Each taxable entity will be able to take the largest of three deductions—cost of goods sold, compensation and benefits, and what amounts to a 30% deduction (by paying tax based on 70% of total revenue instead of electing to deduct compensation or cost of goods sold). A 2007 amendment prohibits taxpayers from changing their deduction election by filing an amended franchise tax report.

**COST OF GOODS SOLD**

Cost of goods sold is defined in the new statute; it does not follow the federal tax concept. A taxable entity’s cost of goods sold is calculated by adding (i) the direct costs associated with acquiring or producing the goods, (ii) certain indirect costs associated with the goods, and (iii) certain administrative or overhead costs allocable to the acquisition or production of goods. Cost of goods sold includes only costs associated with real property or tangible personal property, not intangible property or services. The definition of cost of goods sold does include production, however. So, many construction and manufacturing expenses will qualify as deductible costs of goods sold. In addition, cost of goods sold for a particular good may only be included in the deduction if the taxpayer, or a member of its consolidated group, “owns” the goods based on “all of the facts and circumstances.”

**COMPENSATION AND BENEFITS**

Deductible compensation includes wages, tips, net distributive income from certain types of entities reported as distributions to natural persons (whether or not actually distributed), and stock awards and stock options deducted for federal income tax purposes. A taxable entity electing to deduct compensation may deduct wages and cash compensation and the cost of all deductible benefits. The amount of compensation that may be deducted for any person cannot exceed $300,000. There is no limit on the amount of deductible benefits. Deductible benefits include the cost of all benefits the taxable entity provides to its officers, directors, owners, partners, and employees, including workers’ compensation benefits, health care, employer contributions made to employees’ health savings accounts, and retirement to the extent deductible for federal income tax purposes.
The franchise tax allows “Small employers,” as that term is defined in Insurance Code § 1501.002, that have not provided health care benefits to any of their employees in the calendar year preceding the beginning date of a report period, but that (i) elect to begin providing health care benefits to all of their employees and (ii) elect to deduct compensation and benefits, to take bonus deductions. For the first 12-month period on which margin is based after which health benefits are provided to all employees, the taxable entity may deduct an additional 50% of the cost of the health care benefits. For the second 12-month period on which margin is based after which health benefits are provided to all employees, the taxable entity may deduct an additional 25% of the cost of the health care benefits. Insurance Code § 1501.002 defines “small employer” to mean a person or entity “who employed an average of at least two employees but not more than 50 eligible employees on business days during the preceding calendar year and who employs at least two employees on the first day of the plan year.”

THIRTY PERCENT DEDUCTION (option to pay on 70% of Revenue)

The 30% deduction ensures that no more than 70% of a taxable entity’s revenue will be taxed in any year. The 30% deduction is not actually described as a deduction in the statute. The technical calculation in the statute provides that taxable margin is equal to the lesser of (i) total revenue minus the greater of cost of goods sold or compensation and benefits or (ii) 70% of total revenue.

APPORTIONMENT

For the most part, apportionment rules have not changed for the new tax. A taxable entity’s apportionment factor will be determined by dividing its gross receipts from business done in Texas by its total gross receipts. The comptroller has already adopted lengthy rules that describe when receipts are considered Texas receipts; the rules are expected to remain mostly unchanged for the revised tax.

TAX RATE

The default franchise tax rate is 1%. For taxpayers engaged primarily in retail or wholesale trade, the tax rate will be 0.5%. A taxable entity is engaged primarily in retail or wholesale trade only if: (a) the total revenue from its activities in retail or wholesale trade is greater than the total revenue from its activities in trades other than the retail and wholesale trades; (b) less than 50% of the total revenue from activities in retail or wholesale trade comes from the sale of products it produces or products produced by an entity that is part of an affiliated group to which the taxable entity also belongs (this does not apply to total revenue from activities in a retail trade described by Major Group 58 of the Standard Industrial Classification Manual published by the federal Office of Management and Budget); and (C) the taxable entity does not provide retail or wholesale utilities, including telecommunications services and electricity or gas. “Wholesale trade” means the activities described in Division F of the 1987 SIC Manual published by the
federal Office of Management and Budget, and “retail trade” means the activities described in Division G of the 1987 SIC Manual.

CREDITS

Most credits available under the current franchise tax are eliminated by the revised tax. Taxpayers are allowed to carryforward economic development credits and business losses accruing under the current tax into the calculation of the revised tax, subject to certain limitations. The provisions of the revised tax related to the carryforward of business losses were clarified in 2007. The temporary margin tax credit is calculated by (a) determining the entity’s unused business loss carryforwards; (b) multiplying such amount by (i) 2.25% for the first 10 margin tax reports (to January 1, 2018) and (ii) 7.75% for the next 10 margin tax reports (to September 1, 2027); and (c) multiplying that amount by 4.5%. Under the statute, a taxpayer must notify the comptroller in writing of its intent to claim this credit on the first report due under the margin tax.

Note that because the new tax is a tax on an entity’s “margin” and not its net income, the concept of a business loss or net operating loss does not come into play (an entity may owe tax even if it has a net loss in a particular year).

In order to qualify for the credit, a taxpayer must file a form claiming the credit with the Comptroller on or before the due date of the taxpayer’s initial franchise tax return based on margin.

COMBINED REPORTING

The requirement to file combined reports may be the most complicated change in the franchise tax. Members of a “combined group” will be required to file combined franchise tax reports. Entities are members of a combined group if they are “affiliated” and if they are engaged in a “unitary business.”

Members of a group are “affiliated” if a controlling fifty percent (50%) or greater interest is owned by a common owner or owners or by one or more members of the affiliated group. The definition includes both direct and indirect ownership. Entities that do not have nexus with Texas are included in the affiliated group if they meet the 50% ownership test.

Comptroller Rule 3.590 defines an “affiliated group” as a group where a Controlling Interest is owned by a common owner (excluding the statutory reference to “or owners”). The Comptroller Rule contains a number of examples showing how entity ownership in various tiered arrangements will be attributed to other entities. The Comptroller Rule does not contain any provisions concerning familial attribution, but the Comptroller FAQs do announce a policy of spousal attribution so that husbands and wives will be deemed a single owner for purposes of the affiliated group test. The Comptroller FAQ does not differentiate between community property and separate property.
Members are conducting a “unitary business” if their business is a single economic enterprise that is made up of separate parts of a single entity or of a commonly controlled group of entities that are sufficiently interdependent, integrated, and interrelated through their activities so as to provide a synergy and mutual benefit that produces a sharing or exchange of value among them and a significant flow of value to the separate parts. In determining whether a unitary business exists, the comptroller will consider three factors, including whether: the activities of the group members are in the same general line, such as manufacturing, wholesaling, retailing of tangible personal property, insurance, transportation, or finance, or are steps in a vertically structured enterprise or process, such as the steps involved in the production of natural resources, including exploration, mining, refining, and marketing; and the members are functionally integrated through the exercise of strong centralized management, such as authority over purchasing, financing, product line, personnel, and marketing. The Comptroller Rule on combined reporting provides that entities will be presumed to be engaged in a unitary business if they are part of an affiliated group; the rule does not say how this presumption will be applied.

The mechanics of combined reporting require each entity to calculate its total revenue separately. To determine the combined group’s revenue, each revenue figure is added together, and intragroup revenue is subtracted. Each member of the combined group must elect the same deduction; the deductions are calculated separately and then added together to obtain the total deduction. The combined group’s apportionment factor is determined by dividing the entities’ aggregate Texas receipts by the entities’ aggregate total receipts; intragroup receipts are ignored. Under the current version of the revised tax, the gross receipts of members of a combined group that do not have nexus with Texas will be treated as non-Texas gross receipts (and will be included in the bottom part of the fraction). The combined group’s tax rate will be determined by applying the retail/wholesale classification to the entire group’s receipts.

The margin tax includes a second type of combined reporting for tiered partnership arrangements. In a “tiered partnership arrangement,” an “upper tier entity” may report its share of a “lower tier entity’s” taxable margin, in which case, the lower tier entity is not required to pay tax on such portion of its taxable margin. The lower tier entity is required to file a report showing the amount of its taxable margin that each upper tier entity should include in its taxable margin. A “tiered partnership arrangement” means an ownership structure in which any of the interests in one taxable entity treated for federal income taxes as a partnership or as an S corporation (a “lower tier entity”) are owned by one or more other taxable entities (an “upper tier entity”). A tiered partnership arrangement may have two or more tiers.

In the case where an upper tier entity is not subject to the margin tax, the lower tier entity must report the share of its taxable margin that is attributed to the non-taxed upper tier entity. The statute also provides that an upper tier entity may not be exempt for having less than $300,000 in revenue or $1,000 in tax owed if, before the attribution of any total revenue by a lower tier entity to the upper tier entity, the lower tier entity is not exempt for having less than $300,000 in revenue or $1,000 in tax owed.
OTHER 2007 STATUTORY CHANGES TO THE FRANCHISE TAX\(^1\):

1. **House Bill 3928.** The following changes (in addition to the italicized changes noted above) were made to the margin tax by House Bill 3928:

   **Changes related to definitions**
   - The definition of “lending institution” now includes certain entities regulated by the Department of Savings and Mortgage Lending, certain brokers and dealers, and certain agricultural lenders.
   - A three-factor test is adopted for determining whether affiliated companies are participating in a unitary business.

   **Changes related to the calculation of the tax**
   - The indexing of the amounts for the $300,000 taxability threshold, $300,000 compensation cap, and the revenue amounts for small business discount qualification is amended to adjust according to CPI in each even-numbered year beginning in 2010.
   - A taxpayer must elect the cost of goods sold or compensation deduction by the due date of its annual report, and the election cannot be changed on an amended report.

   **Changes related to the calculation of Total Revenue from Entire Business**
   - Law firms are permitted to deduct from revenue $500 per pro bono case handled during the report year.
   - Pharmacy cooperatives may exclude flow-through funds from rebates from pharmacy wholesalers that are distributed to the pharmacy cooperative’s shareholders.

   **Changes related to the calculation of Cost of Goods Sold**
   - The definition of tangible person property was expanded to include television and radio programs and other media. Film, television, broadcasting, and distribution companies are permitted to treat depreciation, amortization, and other expenses related to the acquisition, production, or use of the media as a deductible cost of goods sold.

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\(^1\) All bills and statutory changes referenced in this paper refer to bills passed by the 80\(^{th}\) Texas Legislature during the 2007 regular session.
• Depreciation, depletion, and amortization are tied to the amounts reported on the taxpayer’s federal income tax return.

• The taxpayer is permitted to capitalize or expense a cost of goods sold; the taxpayer is not required to follow its federal reporting.

Changes related to the calculation of Compensation and Benefits

• Provisions concerning the $300,000 compensation cap are clarified to provide that the cap applies to a combined group as a whole, not to each entity in a combined group, so that the combined group may not deduct, in the aggregate, more than $300,000 in compensation paid to one natural person.

Changes related to Combined Reporting

• The “standard deduction” for a combined group is clarified to provide that the taxable margin of a combined group may not exceed 70% of the group’s total revenue.

• A member of combined group is permitted to deduct a cost of goods sold if the related good is owned by another member of the combined group.

• The period on which the report for the combined group is based must be the same for each member of the group.

• The statute clarifies that each member of the combined group is jointly and severally liable for the tax owed by the group.

Changes related to Apportionment

• A combined group is required to report to the Comptroller, for information purposes only, certain information for group members that do not have nexus in Texas. This provision is viewed as a possible precursor to adopting a “Finnigan” method of apportionment.

• If a loan or security is treated as inventory for federal tax purposes, the receipt is treated as a gross receipt for apportionment purposes.

Miscellaneous changes

• An entity may be required to file information with the Comptroller to prove that it is not subject to the franchise tax.
• A client company of a staff leasing company is permitted to rely on information provided to it by the staff leasing company for margin tax purposes on a form promulgated by the Comptroller or on an invoice.

• House Bill 3928 provides that if (i) an entity that is not doing business in the state on January 1, 2008, (ii) would have been subject to the margin tax if it was doing business on January 1, 2008, (iii) but was not subject to the prior franchise tax, and (iv) was doing business after June 30, 2007—THEN such an entity will file a final report and pay tax if it dissolves between July 1, 2007, and January 1, 2008. The tax due on the final report will be based on the taxable entity’s margin as calculated for the period beginning January 1, 2007, and ending on the date of dissolution. A entity that changed form prior to June 30, 2007, so that it was not subject to the margin tax is not required to file a final franchise tax report.

2. House Bill 3694. This bill added a new tax credit for certain enterprise projects. In order to qualify as an enterprise project, an entity must be designated as such by the Texas Department of Economic Development between September 1, 2001, and September 1, 2003, or the Texas Economic Development Bank between September 1, 2003, and January 1, 2005. The credit is equal to 7.5% of the qualified capital investment made on or after January 1, 2005. The credit claimed may not exceed 50% of the tax due before other credits. Unused credits may be carried forward for 5 years. A “qualified investment” means tangible personal property first placed into service in an enterprise zone by a qualified business that has been designated as an enterprise project; the term does not include real property.

3. House Bill 387. Under this bill, certain franchise tax exemptions for the Texas National Research Laboratory Commission are repealed.

4. Senate Bill 377. Requires taxpayers who paid $10,000 or more in one of a list of particular state taxes during the preceding year to remit payments by electronic transfer for the following year. The list of affected taxes includes the sales tax and the franchise tax.

B. Judicial Developments

1. TGS-NOPEC Geophysical Company v. Combs, No. 03-07-00640-CV (Tex. App.—Austin, August 15, 2008, no pet h.) This is an apportionment case under the franchise tax. The taxpayer licensed geophysical and seismic data for use by third parties. Under Texas apportionment rules, receipts from the licensing of such data are sourced to the location where the data is used. The Comptroller’s auditor deemed that the customer shipping addresses on the taxpayer’s invoices were the places of use for apportionment purposes. The taxpayer attacked the “place of use” rule as being unconstitutional under the Complete Auto Transit factors, but the court upheld the rule.

2. Home Interiors & Gifts, Inc. v. Strayhorn, 175 S.W.3d 856 (Tex. App.—Austin 2005, pet. denied Mar. 9, 2007). In this case, the Third Court of Appeals held that the Texas throwback provision, which is part of the franchise tax’s apportionment formula, is
unconstitutional in circumstances where a Texas-based taxpayer is protected from taxation in other states by Public Law 86-272. The court held that, in this situation, the throwback provision of the Texas franchise tax violates the commerce clause of the U.S. Constitution.

The throwback rule is an apportionment provision that plays a role in determining what percentage of a corporation’s earned surplus or taxable capital will be taxed in Texas. The apportionment fraction is calculated by dividing a corporation’s Texas gross receipts by its total gross receipts; therefore, a corporation pays less tax when its Texas gross receipts are less than its total gross receipts. As a general rule, sales of tangible personal property are apportioned to the state where the delivery of the product is made (the “destination state”). The throwback rule is an exception to this general rule. Under the throwback rule, if the taxpayer does not have sufficient contact with the destination state to require it to pay taxes in the destination state, gross receipts that would otherwise be apportioned to the destination state are “thrownback” to Texas.

In *Home Interiors*, Home Interiors was located in Texas and did not have sufficient contact to pay net income taxes in any other state because its solicitation activities in the other states were protected under Public Law 86-272. The Comptroller applied the throwback rule to these sales, thus causing an increase in Home Interior’s apportionment fraction and total franchise tax due. Home Interiors argued that applying the throwback rule to it violated the commerce clause of the U.S. Constitution.

The Third Court of Appeals reversed the trial court’s granting of the Comptroller’s motion for summary judgment in this case and rendered judgment for Home Interiors. The court held that the application of the throwback rule to Home Interiors violated the commerce clause’s internal consistency test. When analyzing a tax statute under the internal consistency test, the court must (1) suppose a hypothetical world in which all fifty states have a tax system identical to Texas’ and (2) judge whether or not interstate commerce would be discriminated against in favor of intrastate commerce in this hypothetical world. If interstate commerce is discriminated against, then the state tax system violates the commerce clause.

When applying the internal consistency test, the court determined that, because of Public Law 86-272, Home Interiors, as an interstate seller, would be subject to higher cumulative state taxes than would a fictional taxpayer that made sales to only Texas customers (an “intrastate seller”). The intrastate seller in the hypothetical would owe Texas franchise tax on 100% of its earned surplus, but would not owe taxes to any other state.

The interstate seller, on the other hand, would owe Texas franchise tax on 100% of its earned surplus but would also owe franchise tax based on its taxable capital in any state where it had sufficient connection to create an obligation to pay the taxable capital component of the franchise tax but was exempt from the earned surplus component of the franchise tax by Public Law 86-272. The court cited the holding in *INOVA Diagnostics, Inc. v. Strayhorn* for the proposition that Public Law 86-272 does not protect a taxpayer from taxation based on taxable capital. The court’s ultimate conclusion was that the interstate seller would owe a greater aggregate tax than the intrastate seller. This result causes the throwback rule to fail the commerce clause’s internal consistency test, thus rendering the throwback provision, as applied in the facts of this case, unconstitutional.
The Comptroller filed a Petition for Review with the Texas Supreme Court on January 1, 2006. The Texas Supreme Court denied the Petition for Review on March 9, 2007. As a result of the holding in this case, many Texas taxpayers with operations similar to Home Interiors may be entitled to a refund of franchise taxes. These taxpayers should take appropriate action under Texas law to prevent their refunds from being time-barred under the four-year statute of limitations that applies to tax refunds. The Comptroller recently issued a letter ruling describing the process for taxpayers seeking refunds based on the decision in *Home Interiors*:

If you decide to file amended franchise tax reports for [the corporation] based upon the recent Home Interiors decision concerning the unconstitutionality of throwback in that situation, all supporting documentation should be attached to your request. The refund request will be denied. [The corporation] will then need to properly request a refund hearing. [The corporation]’s request will be held in hearings, along with similar requests from other entities, until the final appeal on the Home Interiors case is completed. (Comptroller Letter of September 28, 2005, STAR Document No. 200509289L).

Taxpayers should note that this case will not have significant effect on the Margin Tax (which became effective January 1, 2008) because the throwback rule was repealed and will not apply to the Margin Tax.

**C. Administrative Developments**

1. **Comptroller Letter Ruling 200807139L (July 24, 2008).** In this letter, the Comptroller requires a brokerage company that processes stock trades initiated by customers over the internet to apportion its receipts to Texas based on the “fair value” of the services performed by the broker in Texas. The Comptroller opined that the fees that the company received for processing stock trades initiated over the internet were receipts from the performance of a service. Texas Tax Code § 171.103 apportions receipts from services performed in Texas to Texas. Comptroller Rule 3.591(e)(26) addresses situations where services are performed both inside and outside Texas; in this case, the receipts are apportioned to Texas based on the fair value of the services performed in Texas. The Comptroller letter states that “The costs attributed to the services in Texas relative to the costs attributed to the out-of-state processing may be the best means of determining the fair value of the services performed in Texas.”

2. **Comptroller Letter Ruling 200696694L (June 1, 2006).** In this letter, the Comptroller advises a Canadian corporation that the corporation does not need to obtain the Comptroller’s approval to change its accounting year, the filing of a short period return is not required, and the change in accounting year should be reflected on the next annual report.

3. **Comptroller Letter Ruling 200606695L (June 1, 2006).** This letter ruling clarifies the Comptroller’s policy concerning nexus in certain LLC ownership structures. In the letter ruling, the Comptroller considers an ownership structure where a single-member LLC (which is disregarded for federal tax purposes) is owned by a multi-member LLC. The single-member
LLC does business in Texas, but the multi-member LLC does not. Under Texas law, the single-member LLC must report Texas franchise tax based on its own financial condition. The multi-member LLC will not be required to pay Texas franchise tax because the mere ownership of an interest in a LLC doing business in Texas does not create nexus for the owner.

4. Comptroller Ruling 200607697L (July 19, 2006). The Comptroller advised a nonprofit library that it was required to prove its exempt status before it could claim an exemption from Texas franchise tax. Once the exemption is granted by the Comptroller, the unrelated business income of the nonprofit corporation will not be subject to franchise tax.

5. Comptroller Letter Ruling 200606693L (June 1, 2006). In this letter, the Comptroller responds to an LLC’s request that it be refunded a pro rata portion of its franchise taxes paid during its year of dissolution. The Comptroller advised that the LLC was not entitled to a refund because a dissolving entity is required to pay tax through the end of the privilege period containing the effective date of the dissolution.

6. Comptroller Hearing 44,982 (January 5, 2006). The taxpayer challenged the auditor’s determination that certain accounts were not excludable from surplus as reserves for uncollectible accounts or as deductible debts. The taxpayer’s customers had the option of financing equipment purchases through third-party lenders. The taxpayer and the lenders had an arrangement where the taxpayer would purchase uncollectible accounts from the lenders. The difference between the loan payoff amount and the fair market value of the collateral was recorded as a reserve in the taxpayer’s books and records. The Comptroller argued that (1) these accounts were not excludable as bad debt reserves because the taxpayer did not have corresponding accounts receivable for the items and (2) they were not excludable as debts because they were contingent in nature. The administrative law judge ruled for the Comptroller.

7. Comptroller Hearing 45,598 (March 2006). In this hearing, the administrative law judge ruled that an S corporation whose only shareholder was a federal-tax-exempt employee stock ownership plan (ESOP) was required to pay franchise tax based on its earned surplus despite the tax-exempt status of the shareholder. Texas law provides that an S corporation’s reportable income (which is the starting point for the franchise tax’s earned surplus calculation) is the amount of income reportable to the IRS as being taxable to its shareholders. The taxpayer argued that the fact that its sole shareholder was a tax exempt ESOP prevented it from having income that is taxable to its shareholders. But, Texas law and Comptroller policy state that limitations or restrictions related to the S corporation’s shareholders are ignored for franchise tax purposes. The administrative law judge ruled that an S corporation must use the amount of reportable federal taxable income shown on its federal tax form 1120 to calculate its earned surplus, regardless of whether its shareholders will pay any tax.

8. Comptroller Hearing 43,881 (July 12, 2006). In this hearing, the taxpayer argued that the unitary business principle required the exclusion of the receipts from three of taxpayer’s divisions from the taxpayer’s earned surplus component and taxable capital component calculations because the three divisions had no functional integration with taxpayer’s core business. The Tax Division agreed that the divisions’ receipts should be excluded from earned surplus but argued that the unitary business principle did not apply to the taxable capital
component. The administrative law judge disagreed with the Tax Division and held that the unitary business principle applies to both the earned surplus component and the taxable capital component of the franchise tax.

9. Comptroller Hearing 46,585 (September 21, 2006). The taxpayer in this hearing provides taxable security services to customers throughout the nation. The taxpayer’s main alarm monitoring facility is located in Texas. The taxpayer argued that its receipts from the sale of its services should be apportioned based on where the monitored property is located while the Comptroller argued that all of its receipts should be apportioned to Texas because its monitoring facility is located in Texas. The issue in the case was where the taxpayer’s services are performed—at the monitored property or at the Texas monitoring facility. The administrative law judge ruled that the services are performed at the monitoring facility, thus all of the taxpayer’s gross receipts were apportioned to Texas.

10. Comptroller Hearing 46,702 (October 3, 2006). The taxpayer in this hearing was an airline company. The company argued that two of its general ledger accounts—an accident receivables account and a related accident liabilities account for insurance claims related to the September 11, 2001, terrorist attacks—should be excluded from surplus in the calculation of net taxable capital. The administrative law judge held that the two accounts should be included in surplus. The receivables account was included in surplus because it was a GAAP asset. The liabilities account was included in surplus because it contained only estimated and contingent obligations.

11. Comptroller Letter Rulings 200605665L (May 18, 2006) and 200606622L (June 26, 2006). These letter rulings clarify the Comptroller’s policy concerning certain membership fees, enrollment fees, and discount fees collected by independent marketing representatives and credit card issuers. Under Comptroller franchise tax policy, membership fees and enrollment fees are deemed receipts from the sale of intangible rights and are apportioned to the location of the payor. Discount fees, which consist of a discount retained by the credit card company when the card is used to purchase goods from retailers, are considered fees from the performance of a service and are apportioned based on where the service is performed.

D. Outlook for 2007-08

Audits of the initial franchise tax returns based on margin will not begin for some years now, so we will not see hearings decisions or court decisions shape policy under the new tax law any time soon. Practitioners should continue to follow the Comptroller’s release of FAQs on her website and watch the 2009 legislative session for any amendments to the tax statute.

In addition, in an August presentation by the Comptroller to the Senate Finance Committee, the Comptroller indicated that state revenues under the revised franchise tax had thus far been less than projected. It will be interesting to see how this fact shapes the legislative debate in 2009.
II. TEXAS SALES AND USE TAX

A. Legislative Developments

1. House Bill 3319. This bill makes a number of significant changes to the sales tax. The most significant changes are described below:

   • Makes services performed by a landman necessary to negotiate or secure land rights or mineral rights not taxable as a real property service.

   • Provides that a wireless voice communication device transferred as an integral part of a taxable service, whether or not there is a separate charge for the device, and whether or not the purchaser is a provider of the service, exempt as a sale for resale if payment for the service is a condition for receiving the device.

   • Requires a ready-mix concrete contractor to separately and individually invoice its customer for each yard of concrete produced and consumed for an improvement to real property and to collect and remit applicable taxes on the concrete.

   • Provides that pharmaceutical biotechnology cleanrooms and installed equipment that are part of a new cleanroom facility, regardless of value, are exempt so long as construction began after July 1, 2003.

   • Moves the three-day sales tax holiday from the first weekend in August to the third weekend in August and establishes that backpacks that cost less than $100 are tax-free during the tax holiday. This provision is also contained in House Bill 3314.

   • For state and local tax purposes, provides that local sales taxes for taxable services will be based on the location of the service provider (i.e., “origin” sourcing as opposed to “destination” sourcing). Local sales taxes for the repair, remodel, or restoration of nonresidential real property will be based on the location of the job site (i.e., “destination sourcing”).

   • Repeals the requirement that retailers must collect local sales taxes for a local taxing entity even if the retailer does not have a nexus with the local taxing entity.

2. Senate Bill 377. Requires taxpayers who paid $10,000 or more in one of a list of particular state taxes during the preceding year to remit payments by electronic transfer for the following year. The list of affected taxes includes the sales tax and the franchise tax.
3. **House Bill 1459.** Makes coin-paid telephone calls not subject to sales tax by removing them from the definition of telecommunications service.

4. **House Bill 373.** Exempts the sale of property by an individual as an occasional sale if the individual or his family originally bought the property for personal use, the individual does not hold a sales tax permit, and the individual’s total sales of personal use items do not exceed $3000 during the year. The individual is not permitted to employ an agent to sell the property but may sell the property in an online auction.

5. **House Bill 3693.** This bill creates a new sales tax holiday for energy efficient products. The holiday will occur on Memorial Day weekend. Tax-free items include certain appliances and other products that have an Energy Star designation and that do not exceed a maximum sales price (which varies based on the type of item).

6. **House Bill 387.** The bill repeals sales tax exemptions related to the Texas National Research Laboratory Commission.

7. **House Bill 3694.** Establishes a sales tax refund for all sales taxes paid on taxable items purchased for use at a qualified business site related to an enterprise project. The amount of the refund is subject to certain limitations.

8. **House Bill 4.** Exempts tangible personal property used to process, reuse, or recycle wastewater from fracturing work at an oil and natural gas well.

9. **House Bill 142.** Repeals the exemption from sales and use tax assessed by special purpose taxing authority, such as a mass transit authority, of a taxable item shipped outside of the authority’s boundaries.

10. **House Bill 3314.** Establishes a presumption that a responsible person who files a sales tax return showing sales tax being owed actually collected and failed to remit the tax. The presumption is rebuttable.

**B. Judicial Developments**

1. *Houston Wire & Cable Co. v. Combs, 2008 Tex. App. LEXIS 1820 (Tex. App.—Austin 2008, pet. denied).* The Court of Appeals held that a cable supplier’s purchases of reels to spool cable sold to customers were taxable. The supplier’s purchases of cable were exempt as purchases for resale, but the spools were deemed to be packaging materials, which are not exempt under the resale exemption. If the taxpayer had been a manufacturer of cable, the spools could have been exempt under the manufacturing exemption, but the taxpayer was merely a reseller of the cable.

2. *Combs v. Chevron USA, Inc., No. 03-07-00127-CV, Tex. App.—Austin (pending).* In this case the taxpayer purchased scaffolding services as part of a construction project. The taxpayer argues that it purchased nontaxable scaffolding services and/or that the
separately stated labor charged for installing, dismantling, etc. the scaffolding are not taxable. The Comptroller argues that the taxpayer rented tangible personal property (the scaffolding) and that sales tax is due on the full rental price. The Comptroller prevailed in the administrative hearing in this case, but the taxpayer prevailed in the trial in district court. The case is currently pending in the Court of Appeals.

3.  *Reynolds Metals Company v. Combs*, No. 03-07-00709-CV, Tex. App.—Austin (pending). The taxpayer in this case argues that its purchases of repair and replacement parts for ship unloaders are nontaxable because the unloaders were exempt rolling stock. The unloaders are operated on and are supported by rails. The Comptroller argues that the rails are not standard gauge, the taxpayer is not a common carrier, and that the unloaders are merely used for intraplant transportation. The Comptroller argues that these factors exclude the unloaders from the definition of exempt rolling stock. The Comptroller prevailed in the administrative hearing and in the trial in district court in this case. The case is currently pending in the Court of Appeals.

4.  *Levy v. OfficeMax, Inc.*, 228 S.W.3d 846 (Tex. App.—Austin 2007, no pet. h.). In this case, the Austin Court of Appeals held that purchasers may pursue a class action against a retailer to force the retailer to assign claims for refund of sales taxes to the class. By state statute, a purchaser may not pursue a tax refund claim directly against the State unless it first obtains an assignment of the claim from the retailer who remitted the tax. The Tax Code does not provide a procedure for a purchaser to force the retailer to assign the claim for refund. The district court in this case dismissed the purchasers’ action to force the retailer to assign a claim for refund for want of jurisdiction. The Court of Appeals reversed and remanded the case.

5.  *E. de la Garza, Inc. v. Strayhorn*, 2005 W.L. 3004138 (Tex. App.—Austin 2005, no pet.) (unpublished opinion). The Austin Court of Appeals held that paper bags and plastic sacks sold by a manufacturer of the items to grocery stores, convenience stores, bakeries, and restaurants do not qualify for the sale for resale exemption. Such items are taxable because they are used by the stores and not resold to customers. The court also rejected the taxpayer’s argument that it relied on resale certificates in good faith because the certificates, which claimed the resale exemption on behalf of such stores, were facially invalid.

C.  Administrative Developments

1.  **Review of Aircraft Sales and Purchases.** In the spring of 2007, the Comptroller announced that it would be reviewing all aircraft purchases from August 1, 2003, to April 30, 2007, for sales tax compliance. Since then the Comptroller has sent out thousands of letters to parties involved in airplane sales transactions. Some of the issues involved in the review of aircraft sales include:

   - **Transitory Entities No Longer Respected:** In a Comptroller Letter No. 200611755L dated November 15, 2006, the Comptroller announced a new policy of ignoring entities that are used solely for tax planning purposes. The genesis of this new policy was to undo what the Comptroller considered to be abusive transactions involving the purchase of airplanes. The letter states:
Such a transaction should be analyzed by looking at all of the facts and circumstances from its inception to its ending. If the method of transfer of ... tangible personal property does not have a business purpose other than tax avoidance, then the transitory entity should be ignored and use [or sales] tax should be assessed accordingly. This analysis will be applied to all transactions that occur on or after December 1, 2006...

- **Occasional Sales Exemptions:** Non-dealers are allowed to sell two airplanes in a 12-month period tax-free as occasional sales. Sales of an “identifiable segment” of a seller’s business (an aircraft may qualify as an identifiable segment) also qualifies as an occasional sale. Purchasers of airplanes from occasional sellers should obtain a statement of the qualification under the exemption from the seller.

- **“More-Than-One Year” Use Tax Rule:** In general, property purchased outside the state, used outside the state for more than one year, and then brought into the state for use is not subject to use tax. In Comptroller Hearing 46,207, however, the administrative law judge ruled that where an airplane was kept outside the state for more than one year for the sole purpose of avoiding the use tax (per the testimony of the taxpayer’s representative), use tax is still owed. The judge reasoned that the “more-than-one-year” rule merely serves as a presumption that no use tax is due, but in this case, the presumption is overcome by testimony showing that the aircraft was in fact purchased for use in Texas.

2. **Streamlined Sales Tax.** A December 13, 2007, press release from Comptroller Combs indicates that a change recently made by the Streamlined Sales Tax Governing Board may move Texas one step closer to adopting the Streamlined Sales Tax Agreement (“SST”). The major roadblock to Texas’ adoption of the SST has been the SST’s requirement of destination sourcing for local sales taxes (Texas uses origin sourcing for local sales taxes for most taxable transactions). A new amendment to the SST permits SST states to use origin sourcing for all intra-state transactions. Interstate transaction require the implementation of destination based sourcing. This change may make SST more palatable to Texas lawmakers.

3. **Comptroller Letter Ruling 200805132L (May 16, 2008).** The Comptroller ruled that a veterinarian’s purchase of animal collar tags that are given to animal owners as proof of vaccination are not subject to sales or use tax because they are purchased from the city as a license or permit.

4. **Comptroller Letter Ruling 200803134L (March 7, 2008).** This Comptroller letter ruling concerns whether contact lens solution is an exempt over-the-counter drug (because it has a drug facts panel) or a taxable medical device. The Comptroller ruled that since the FDA considers lens solution to be a medical device and not a drug, purchases of the solution are taxable.
5. **Comptroller Letter Ruling 200806118L (June 18, 2008)**. In this letter ruling, the Comptroller opines that reimbursements of health insurance premiums are subject to sales tax when the reimbursements are paid as part of the sales price of a taxable service. The letter ruling addressed taxable charges for janitorial and security guard services that included a reimbursement of health insurance premiums.

6. **Comptroller Hearing No. 45,975 (May 2, 2008)**. In this Hearing, the ALJ determined that computer servers that were used in the pre-press area of a company that produces catalogs and other materials were exempt manufacturing equipment under Tax Code § 151.318(t). The judge ruled that subsection (t) of the manufacturing exemption statute was a standalone provision that exempted certain press-related equipment even if it did not make a direct change to the final product for sale.

7. **Policy change concerning direct payment exemption certificates.** In the June 2008 issue of Tax Policy News, the Comptroller reminds retailers that they should collect exemption certificates from purchasers who claim exemption as direct payment permittees. This appears to be a tightening of a prior Comptroller audit policy that directed auditors not to assess sales made by retailers to direct payment permittees even if an exemption certificate was not obtained.

8. **Comptroller Letter Ruling 200806103L (June 9, 2008)**. This letter ruling serves as a reminder that the determination of whether a piece of equipment is tangible personal property or real property affects the taxation of some services. In this ruling, the Comptroller determined that a large paper making machine was real property (a fixture), thus services to repair it were taxable. If the machine was tangible personal property, the repair services would have been exempt as repairs performed on exempt manufacturing equipment.

9. **Comptroller Letter Ruling 200805095L (May 28, 2008)**. In this letter, The Comptroller determined that a party that provides an online computer program that manages a customer’s business data is performing taxable data processing services even though the customer enters all of the data itself. In the Comptroller’s opinion, the key issue is what the computer program does with the information after the customer enters it. The Comptroller determined that the program processes the data in a taxable way.

10. **Comptroller Letter Ruling 200805091L (May 27, 2008)**. The Comptroller clarified that charges for parking spaces, even on a first-come, first-served, are taxable motor vehicle parking services when charged to customers, tenants, or other parties.

11. **Comptroller Hearing 47,007 (November 1, 2007)**. The decision in this hearing clarified the difference between the burdens of proof in a redetermination and a refund claim related to taxable services. In a redetermination, the Comptroller must first prove that taxable services were performed, then the burden would shift to the taxpayer to prove that the services were exempt. In a refund claim, the Comptroller is not required to make its initial showing, and the taxpayer is required to prove the exemption from the outset.
12. **Comptroller Letter Ruling 200802047L** (February 22, 2007). This complex letter ruling addresses the taxability of several different services performed during the turnaround of a refinery, chemical plant, or other similar facility.

13. **Comptroller Letter Ruling 200802045L** (February 4, 2007). In this letter, the Comptroller opined that once manufacturing operations have ended, a taxpayer cannot seek a refund of sales taxes paid on electricity that should have been treated as exempt.

14. **Comptroller Hearing No. 47,797** (February 15, 2008). The administrative law judge in this hearing ruled that the taxpayer, which constructed utility improvements for an exempt electric cooperative, was not the authorized agent of the cooperative such that the taxpayer’s purchases of materials were sales-tax-free. The taxpayer did not have a written agency agreement with the electric cooperative, but the electric cooperative designed the utility improvements, directed the activities of the taxpayer, required the taxpayer to use certain materials, and inspected and approved the improvements before accepting them. The judge ruled that these factors did not indicate an agency relationship.

15. **Comptroller Letter Ruling 200704926L** (April 25, 2007). The Comptroller issued this letter ruling to clarify the sales tax effect of sales transactions involving PTAs. When a PTA is a seller or reseller of taxable items, it may hold two one-day sales-tax-free fundraising events. If a PTA acts as the agent of a seller, the sales-tax-free fundraising exemptions do not apply, the PTA must collect applicable sales tax from its customer, forward the tax to the seller for which it is acting as agent, and the seller must report and remit the tax (this situation in common when the PTA sells items like gift wrap, cookie dough, school pictures, etc.). Candy sales by a PTA or school organization are not taxable so long as all of the proceeds go to the group of its exclusive use.

### III. PROPERTY TAX

In 2005 the Texas Supreme Court ruled in *Neeley v. West Orange-Cove I.S.D.* (Nov. 22, 2005) that the Texas school finance system was unconstitutional. The Texas Constitution prohibits a statewide property tax, and state law caps school property taxes for operations at $1.50 per $100 of valuation. Because the legislature has failed to fund schools in an amount necessary to meet state standards, school districts have been forced to raise local property taxes to the maximum allowable rate. The court ruled that because nearly all school districts were taxing themselves at the maximum allowable rate, the school’s finance system violated the ban on a statewide property tax. The court further mandated that the legislature pass remedial legislation by June 2006.

On May 31, 2006, Governor Rick Perry signed into law a bill designed to reduce property taxes by one-third over the next two years. House Bill 1 was part of a package of five bills passed in a special session earlier this year that was devoted to the school finance reform that had been mandated by the Texas Supreme Court.

House Bill 1 provides for property tax relief through state aid to school districts. In 2007 aid will be provided to school districts in amounts that will effectively reduce their nominal maintenance
and operations tax rate to 88.67% of the M&O rate adopted for the 2005 year. In 2008 aid will be provided to reduce the rate to 66.67% of the district’s 2005 adopted M&O rate.

Therefore, the legislation requires school districts to lower their property tax rate for operations by 11% (from $1.50 to $1.33 per $100 valuation) in 2006, and by 33% (to a rate of $1.00 per $100) in 2007. The projected property tax savings on a $200,000 home will be approximately $1,000 in the second year.

A. Legislative Developments

1. House Bill 2. This bill makes a supplemental appropriation of $14.2 billion for the 2008-09 biennium to the Texas Education Agency. This appropriation was necessary to fund the decrease in funds received by the agency due to the one-third property tax reduction enacted in 2006.

2. House Bill 3496. Under this bill, school district tax bills are required to show the difference between the 2005 tax imposed and the 2007 tax imposed either on the bill itself or in a separate statement. The bill or statement will indicate the reduction attributable to the 2006 property tax legislation.

3. Senate Bill 812. Nonprofit corporations that provide chilled water and steam to certain health-related facilities are exempt from property taxes under this bill.

4. House Bill 1928. This bill exempts certain trailers used primarily as temporary living quarters for recreational use as tangible personal property not producing income.

5. House Bill 1742, Senate Bill 1908. Designates entities that acquire, hold, and transfer unimproved real property under an urban land bank program as exempt charitable organizations.

6. House Bill 3191. Organizations constructing or rehabilitating housing projects for the purposes of selling single family homes to low-income buyers will receive a 100% exemption for the property. The property must be located in a county with a population of at least 1.4 million.

7. House Bill 1022. This bill exempts an individual from property taxes for one personally owned car or truck used for both business and personal activities. This exemption was approved by the voters in a referendum and has now become state law.

8. House Bill 621. This bill adopts a property tax exemption for goods in transit. The exemption applies to property that (1) is acquired in or imported into Texas, (2) detained at a location in Texas not owned by the owner of the property, (3) is used for assembling, storing, manufacturing, processing, or fabricating purposes, and (4) is transported to another location (in Texas or out of Texas) not later than 175 days after it was acquired or brought into Texas. This exemption does not apply to: oil, natural gas, petroleum products, aircraft, motor vehicle
inventory, vessel and outboard motor inventory, heavy equipment inventory, or manufactured housing inventory.

9. House Bill 438. This bill limits the amount by which an appraisal district can increase the appraised value of a residential homestead to 10% of the appraised value of the property for the preceding tax year, plus the market value of any improvements. Current law allows an increase of 10% of the property value from the last year in which the property was appraised multiplied by the number of years since the last appraisal, plus the market value of any improvements. This statute must be approved by the voters in a referendum.

10. House Bill 41. Allows federal and state judges to request that their home address information contained in appraisal tax records be kept confidential.

B. Judicial Developments

1. Alaska Flight Services, LLC v. Dallas Central Appraisal District, NO. 05-07-0082-CV (August 26, 2008). The court of appeals upheld a trial court judgment that an airplane was used continually in Texas, and thus subject to ad valorem taxation, when 9 out of 42 of its departures were from Texas. The airplane was based primarily out of Alaska.

2. C.I.T. Leasing Corporation v. Dallas Central Appraisal District, No. 05-06-01546-CV (Tex. App.—Dallas, December 13, 2007, no pet. h.). In this case, the court of appeals held that the taxpayer was not required to have paid any taxes prior to the delinquency date in order to proceed in its lawsuit to have property removed from its personal property tax rolls.

3. Covert v. Williamson Central Appraisal District, No. 03-06-00218-CV (Tex. App.—Austin, November 30, 2007, no pet. h.). In this case, the appellate court upheld the trial court’s judgment that a taxpayer’s unequal appraisal challenge for real property ad valorem taxes must challenge the appraisal of the entire property, not just the land or improvements component.

4. TRO Captain’s Landing, L.P. v. Galveston Central Appraisal District, 212 S.W.3d 726 (Tex. App.—Houston [1st Dist.] 2005, pet granted Oct. 12, 2008). The issue in this case is whether an affordable housing project qualifies for the property tax exemption under Tax Code § 11.182 if the Community Housing Development Organization is merely the equitable owner of the project and the legal owner is a Texas limited partnership. The appellate court overturned the trial court’s judgment and held that the project did qualify for the exemption. The Texas Supreme Court has granted a petition for review in the case.

5. Irannezhad v. Aldine Independent School District, No. 01-07-00794-CV, Tex. App.—Houston [1st Dist.] (March 20, 2008). In this case, the appellate court held that a taxing district could recover delinquent property taxes from a resale purchaser. In the first tax sale after the delinquency judgment, the property was struck off to the taxing district at a bid that was not enough to satisfy the tax delinquency. While the taxing district owned the property, the property was exempt from tax. When the property was sold by the taxing district to the resale purchaser, the taxing jurisdiction sued the purchaser for the tax that had accrued from the date of the
original delinquency judgment until the date of the first tax sale. The Court of Appeals agreed that this was permitted under Texas law.

IV. OTHER TAXES

1. **House Bill 1571.** This bill imposes a $5 per customer fee on certain sexually-oriented business. The Comptroller is directed to deposit the first $25 million received from the fee each biennium into the sexual assault program fund. Excess fees must be deposited into the Texas health opportunity pool.

2. **House Bill 735.** The Telecommunications Infrastructure Fund assessment is repealed effective September 1, 2008.

V. TAX ADMINISTRATION

A. Legislative Developments

1. **House Bill 3314.** This bill does the following: (1) establishes Travis County as the exclusive venue for suits to challenge state tax liens; (2) requires that a suit challenging the validity of a state tax lien be brought within 10 years from the date the lien was filed; (3) establishes a rebuttable presumption that if a person files a tax return showing an amount of tax due, then the person is presumed to have collected the tax; (4) establishes personal liability for an officer, manager, or director of a taxpayer that engages in certain fraudulent tax evasion schemes; and (5) establishes a rebuttable presumption that a taxpayer received a notice of tax due if it was delivered to the taxpayer’s last address of record.

2. **Senate Bill 377.** Requires taxpayers who paid $10,000 or more in one of a list of particular state taxes during the preceding year to remit payments by electronic transfer for the following year. The list of affected taxes includes the sales tax and the franchise tax.

3. **Senate Bill 242.** This bill transfers the Comptroller’s administrative law judges to a new taxation division of the State Office of Administrative Hearings.

4. **House Bill 11.** Permits the Comptroller to require distributors of beer, wine, liquor, cigarettes, cigars, or tobacco products to file electronic report of monthly sales with the Comptroller’s office.

5. **House Bill 2010.** This bill allows Texas taxpayers to seek declaratory judgments in Texas district courts that another state’s attempts to collect taxes or impose tax obligations on the Texas taxpayer constitutes an undue burden on interstate commerce under applicable federal law.

B. Judicial Developments

1. **Texas v. Crawford,** No. 03-07-00622-CV (Tex. App.—Austin, August 21, 2008, no pet. h.). This case expanded the legal standard for holding officers and directors personally
liable for taxes collected but not remitted (such as sales taxes). Texas Tax Code § 111.016 makes any “responsible individual” that willfully fails to pay sales taxes collected but not remitted to the state personally liable for the taxes. “Responsible individual” is defined very broadly in the statute and specifically includes officers and directors. The court of appeals overturned the trial court’s interpretation that the “willfully” standard required only actually knowledge and instead adopted an interpretation that requires both actual knowledge that the taxes were not remitted and a reckless disregard of the risk that taxes were not remitted.

2. Texas v. Essentially Yours Industries, Inc., No. 03-07-00506-CV (Tex. App.—Austin, August 22, 2008, no pet. h.). In this case, the State sued Essentially Yours Industries, Inc., a Nevada corporation, for uncollected sales taxes on sales actually made by Essentially Yours Industries Corp., a Canadian corporation that was the parent of Essentially Yours Industries, Inc. The Comptroller’s auditor had misidentified the name of the corporation in the audit, and the taxpayer failed to correct the error until the State filed its collection lawsuit. The State proceeded in its lawsuit against the incorrect company arguing that “Essentially Yours Industries, Inc.” was an alias of Essentially Yours Industries Corp. and that the taxpayer should be estopped from raising the incorrect party defense because it was partly to blame for the confusion of the parties’ names. The taxpayer introduced evidence to show that the taxable sales in question were made by Essentially Yours Industries Corp., which was a separate entity from Essentially Yours Industries, Inc. The trial court held that the State sued the incorrect party and should take nothing in its lawsuit. The Court of Appeals confirmed.

3. Martin v. State, 2007 Tex. App. LEXIS 6167 (Tex. App.—Austin 2007, no pet. h.). In this case, the court held that a corporate officer was jointly and severally liable with the corporation for costs incurred by the State of Texas to clean up abandoned oil and gas waste sites. The corporation failed to pay franchise taxes, and its corporate privileges were forfeited. After the forfeiture of corporate privileges, the State used its own funds to clean up the waste sites. When a corporation’s corporate privileges are forfeited, the officers and directors of the corporation are personally liable for all debts of the corporation incurred after the date of forfeiture. The State proved that Martin was an officer of the corporation at the time the State incurred the cleanup costs, so he was held personally liable for the reimbursement of the costs.

VI. BIOGRAPHIES

Gilbert J. Bernal, Jr. is a partner in the law firm of Stahl, Bernal & Davies, LLP. Before joining a predecessor of the firm in January 1995, Gilbert J. Bernal, Jr., was an Assistant Attorney General for the State of Texas from 1975 to 1983 where he represented the Comptroller of Public Accounts, the Texas Alcoholic Beverage Commission, and the Texas Workforce Commission in tax litigation. He was the chief of the Attorney General’s Taxation Division from 1981 to 1983. In private practice since, 1983, Gilbert limits his practice to Texas tax controversies and litigation where he represents clients from all parts of the country in audits, administrative appeals, and in state courts, both trial and appellate, as well as in state tax planning. He has had numerous trials in the state’s district courts and has argued tax cases in the Courts of Appeals, the Texas Supreme Court, and the United States Fifth Circuit Court of
Gilbert has also taught Texas State Taxation and Tax Controversies and Litigation at The University of Texas School of Law. For several years, he has spoken at various continuing legal education seminars on topics such as state taxation, tax litigation in the district courts and administrative courts, and oral argument in the Court of Appeals. Gilbert received both his B.A., with honors, and his J.D. from the University of Texas at Austin. He is a former member of the Board of Directors of Volunteer Legal Services of Central Texas, Austin Literacy, and former member of the Board of Advisers of the University of Texas’ Hispanic Law Journal, and is also a former member of the Austin chapter of the Inns of Court. He is currently serving as a participating counsel on the Austin Diocesan Legal Aid Clinic providing pro bono counsel to indigent clients. Gilbert is fluent in Spanish.

David J. Sewell joined Stahl, Bernal & Davies in 1999 and became a partner in 2008. He practices in the firm’s Texas tax litigation, commercial real estate, wind energy development, and corporate law areas. David advises the firm’s corporate and real estate clients on Texas tax issues associated with various transactions and entity combinations and represents the firm’s tax clients in administrative proceedings before the Texas Comptroller’s office and in Texas state courts. David’s corporate and real estate practice areas include acquisition and sales transactions, mergers, lending transactions, business entity choice and formation, investment transactions, and leasing transactions. He also represents clients in wind energy project development. David is Board Certified in Commercial Real Estate Law by the Texas Board of Legal Specialization and is a member of the Real Estate Council of Austin. David received his B.A. degree, with highest honors and special honors, from the University of Texas at Austin. He received his J.D. degree, with honors, from the University of Texas School of Law, where he was a member of the Texas Law Review and the Board of Advocates and was a Teaching Quizmaster. David is also a member of Phi Beta Kappa and the Order of the Coif.