Texas Tax Update: Texas Supreme Court and Courts of Appeal Cases
April 2011 through March 20, 2012

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1) **Franchise Tax**
   a) **Texas Supreme Court has original and exclusive jurisdiction to hear some—but not all—constitutional challenges to the franchise tax.**
      i) **Fast-tracked to the Supreme Court. In re: Allcat Claims Service, L.P., 356 S.W.3d 455 (Tex. 11/28/11).**
         (1) Statutory and Constitutional provisions allow the Supreme Court to have exclusive and original jurisdiction over certain constitutional challenges to the franchise tax:
            (a) House Bill 3, § 24: "The supreme court has exclusive and original jurisdiction over a challenge to the constitutionality of this Act or any part of this Act and may issue injunctive or declaratory relief in connection with the challenge."
            (b) Texas Const. Art. 5, § 3: "The Legislature may confer original jurisdiction on the Supreme Court to issue writs of quo warranto and mandamus in such cases as may be specified, except as against the Governor of the State."
         (2) Allcat petitioned for mandamus against the Comptroller alleging that the Comptroller must refund franchise taxes because:
            (i) H.B. 3 violated the "Bullock Amendment" of the Texas Constitution
            (ii) The Comptroller's interpretation of the statute violated the partners' rights under the equal and uniform taxation clause of the state constitution. (the "as-applied" challenge).
         (3) Court determined that § 24 of H.B. 3 was a valid jurisdictional grant under Article 5 of the Texas Constitution, and therefore the Court could issue declaratory and injunctive relief to execute the writ.
         (4) Allcat's Bullock Amendment claim did fall within § 24's jurisdictional grant, but its "as-applied challenge" did not. The Bullock Amendment challenge was a "*challenge to the constitutionality of this Act***.**" The as-applied challenge was a challenge to the *Comptroller's interpretation and application* of the Act, not a challenge to the constitutionality of the Act itself.
            (a) The Court also states that it has no original jurisdiction over challenges to taxes other than the franchise tax, or over challenges to the franchise tax that are not constitutional. Such claims would fall outside of section 24.
            (b) Dissent fears that the majority's holding will encourage the Legislature to require the Supreme Court to take original jurisdiction for other issues.
         (5) The Court also held that it had no jurisdiction to award attorney's fees under a § 24 action.

ii) Supreme Court fast track denied. In re: Nestle USA, Inc., -- S.W.3d ----, 2012 WL 424562 (Tex. 2/10/12).

(1) Nestle and several other taxpayers petitioned for a declaration that the franchise tax was unconstitutional because it violated several state and federal constitutional provisions. They also petitioned for an injunction preventing collection of the tax, and a mandamus ordering the Comptroller to refund all taxes paid from 2008 through 2011.

(2) The taxpayers did not pay their taxes "in protest" in accordance with Chapter 112 of the Tax Code (Allcat did pay its taxes in protest).

(3) Generally, sovereign immunity bars taxpayer claims against the Comptroller. However, the Legislature waived immunity for claims that comply with Chapter 112 of the Tax Code. A taxpayer may:

(a) Pay in protest: Taxpayer must submit a "protest letter" with the tax payment, and file suit within 90 days of payment. (Tex. Tax Code §§ 112.051-112.060)

(b) Sue for injunction: Taxpayer must first give the attorney general five days written notice before filing suit, and either pay "all taxes, fees, and penalties then due," obtain a bond for twice the amount, or file an oath of inability to pay (Tex. Tax Code §§ 112.101-112.108)

(c) Sue for refund: Taxpayer must file for a refund with the Texas Comptroller, get denied, and fully exhaust administrative remedies (including filing a motion for rehearing) before filing suit. (Tex. Tax Code §§ 112.151-112.156)

(4) Nestle and other taxpayers took none of these steps, because they argued that § 24 was another waiver of sovereign immunity.

(5) The Court disagreed. It found that "a waiver of sovereign immunity must be 'clear and unambiguous'" and § 24 does not clearly waive Chapter 112's additional requirements. The Court also notes that the Chapter 112 requirements are important so that the Comptroller is on notice about the potential illegality of its tax collection scheme.

(a) Comment: The Court's reason for denying jurisdiction here is weak. The Comptroller was certainly on notice regarding the questionable constitutionality of the margin tax. In fact, *Section 24 itself provides the notice*. Moreover, if the taxpayers had paid all of the taxes they owed at the time they filed suit, the only Chapter 112 requirement not met was to provide the Attorney General *five days* written notice. They could then petition the Court for an injunction.

b) The Texas Franchise Tax does not violate the Bullock Amendment. (In re: Allcat Claims Service, L.P., 356 S.W.3d 455 (Tex. 11/28/11)).

i) Taxpayer is a limited partnership owned directly (in part) by natural persons. Allcat's partners argue that the revised franchise tax is an income tax on their share of partnership income and is therefore a violation of the "Bullock Amendment" of the Texas Constitution.

ii) The "Bullock Amendment": Article VIII, section 24: "a general law enacted by the legislature that imposes a tax on the net incomes of natural persons, including a person's share of partnership and unincorporated association income" must be approved by the voters before it becomes law. The margin tax was not approved by the voters.

iii) Allcat argues that for income recognition purposes, Texas follows the aggregate concept. Income of a partnership is also immediately the income of the partners, even before distribution.

iv) The Court disagrees. It looks to the Texas Revised Partnership Act, and the Texas Business Organizations Code, particularly § 152.056 "[a] partnership is an entity distinct from its partners," and concludes that a partnership is separate from its partners in all cases, including for income recognition:

(1) Court determines that the Texas Revised Partnership Act "does not provide that allocations of partnership profits are property of, subject to the control of, or income to the separate partners," and "the allocation of partnership income or profits to a partner does not convert the amounts allocated into property of or income to the partner."

(a) Comment: The Court also acknowledges that partners have creditor's rights in the partnership's undistributed earnings. How do the partners have creditor rights in earnings without a property interest in the earnings?

v) The court then uses the Texas Revised Partnership Act to interpret the language of the Bullock Amendment. Since the Act establishes that income to a partnership is not income to the partners until it is distributed, the phrase ". . . including a person's share of partnership and unincorporated association income" must mean something other than allocated but undistributed partnership earnings. Therefore, the Bullock Amendment merely prevents an income tax imposed directly on a natural person. An income tax on a partnership is fine.

(1) Comment: This holding will allow the Legislature to tax partnerships under the "old" franchise tax system, or any other federal income tax "piggyback system," if it so chooses.

vi) The court does not address whether the margin tax is or is not an "income tax."

(1) Comment: Whether the tax is an income tax remains relevant. For instance, if the tax is an income tax, Public Law 86-272 will apply, and protect out-of-state entities whose only connection with Texas is the presence of salespeople soliciting the sale of tangible personal property.

c) **Apportionment of income from the sale of intangibles via license agreements. TGS-NOPEC Corp. v. Combs, 340 S.W.3d 432 (Tex. 5/27/2011).**

i) Taxpayer owns seismic information in a database. It sells the use of its data to its customers via nonexclusive license agreements. In exchange for payment, taxpayer sends the data to the customer on magnetic tape. Each customer has unlimited use of the data, but may not share or transfer the data to anyone else.

ii) The question is, how are receipts from these sales sourced?

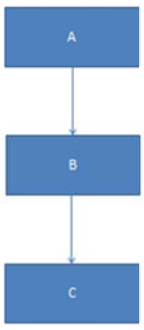
(1) Texas Tax Code § 171.006 states that Texas receipts include "the use of a patent, copyright, trademark, franchise, or license in this state."

(2) A Comptroller Rule states that receipts from the sale of an intangible are sourced to Texas if the "location of the payor" is in Texas. The location of a corporation is its state of incorporation.

iii) Many of the taxpayer's customers "used" the data in Texas (or at least received the magnetic tapes in Texas) but were "located" elsewhere because they were incorporated in another state. Therefore if the taxpayer's receipts are from the "use of a license," its Texas activity is much greater than if the activity is from the sale of an intangible.

iv) Court determines that the receipts are from the sale of an intangible. The taxpayer's customers aren't paying for "the use of a . . . license;" they are paying for the use of an intangible asset—the data. The license is just a transfer mechanism. Therefore receipts should be sourced based on location of payor.

v) Comment: What if the license agreements were not exclusive, and the customer could issue a sublicense of the data? The following result would likely occur:



A sells use of seismic data to B *via* a licensing agreement. B pays A to use the data, not the license. Therefore A's receipts are from the sale of an intangible—sourced to location of payor (B).

B sells its license to use seismic data to C. C pays B to use its license. Therefore B's receipts are from the sale of the use of its license with A—sourced to location of C's "use."

2) Sales & Use Tax

a) Sale for Resale

i) **Reselling to the Federal Government. Combs v. Health Care Service Corp. (Blue Cross Blue Shield)**, 03-10-00675-CV, 2011 WL 2652141 (Tex. App.--Austin July 7, 2011, pet. filed) AND **Combs v. Health Care Service Corp. (Blue Cross Blue Shield**) 03-09-00617-CV, 2011 WL 1005419 (Tex. App.--Austin Mar. 16, 2011, pet. filed).

(1) Taxpayer administers health care programs on behalf of the federal government under cost-plus contracts. Under these contracts, taxpayer purchases and is reimbursed for real property, tangible personal property, and various taxable services performed on these properties. Under the Federal Acquisition Regulations ("FAR"), title passes to the government generally upon delivery of materials. The taxpayer usually uses the purchased materials for their entire useful life—the federal government never actually takes possession of the property.

(2) Taxpayer paid sales tax on various materials and services it used to administer the contract. It eventually filed refund claims, claiming that it resold these items to the federal government since title passed.

(3) Comptroller denied the refund, claiming that:

(a) the taxpayer was providing a nontaxable service to the federal government, and any taxable items sold to the government are merely "incidental," and;

(b) The taxpayer cannot qualify for a sale for resale exemption because the resale was exempt. The purpose of the sale for resale exemption is to prevent an item from being taxed twice in the chain of commerce; here it was not taxed at all.

(4) Court disagrees with Comptroller:

(a) It finds that even if the contracts were primarily for a nontaxable service, under the contract's terms it still resold these taxable items to the federal government and therefore the sale for resale exemption applies.

(b) It follows earlier cases that establish that there is no reason to deny the sale for resale exemption only because the purchased materials will not be taxed.

(i) Comment: During the last legislative session, the Comptroller convinced the Legislature to amend the statute to "fix" this. Now, except for certain defense contracts, a sale for resale cannot include the sale of tangible personal property or a taxable service to a purchaser who acquires the item for the purpose of performing a service that "is not taxed" under the sales tax code.

(5) Comptroller also argues that taxpayer must prove—for every transaction—that it paid sales tax, and that it was not reimbursed for that tax from the federal government.

(6) The Court disagrees. It finds that the "undisputed and uncontradicted evidence" establishes that the taxpayer never "collected" sales tax from the federal government.

(a) Comment: This isn't really what the Comptroller is arguing. The taxpayer apparently did not "charge" the government sales tax, but it did "pass on" the cost of the sales tax that *it* was charged. Therefore, if the Comptroller pays the refund, the taxpayer will earn a windfall. It will receive tax dollars that the federal government has already reimbursed.

(7) Current Status: The Comptroller filed a Petition for Review with Texas Supreme Court and on February 17, 2012, the Supreme Court requested full briefing on the merits. Comptroller's brief is due April 18. Briefing is scheduled to be complete by May 23.

ii) **Selling a silt fence, or selling erosion control? The "essence of the transaction." Austin Eng'g Co., Inc. v. Combs**, 03-10-00323-CV, 2011 WL 3371557 (Tex. App.--Austin Aug. 5, 2011, no pet.)

(1) Taxpayer is a construction contractor. In order to prevent erosion runoff, taxpayer or its subcontractors must erect various erosion control devices (silt fences, etc.) on job sites. The devices are either removed or left at the job site to erode. The taxpayer bills its customers for "erosion control improvements." The amount includes both materials and installation labor.

(2) Taxpayer argues that it is providing a nontaxable erosion control service; Comptroller argues that the taxpayer is selling or leasing the devices (tangible personal property) and the installation charges are therefore taxable.

(3) Court sides with the Comptroller on this issue. The "essence of the transaction" is that the purchaser wanted "erosion control on the construction site," which was provided by the devices, not the incidental services.

(4) However, if the taxpayer can establish that the devices were "fully consumed" at the job site (i.e. if the devices are unusable at the end of a job), then sales are exempt, at least for devices consumed on sites owned by an exempt entity.

(a) The Comptroller argues that its letter rulings establish that silt fences are not "fully consumed" during use because they are used throughout a job. Court finds these letters to be unreasonable—as long as the devices cannot be reused at the *end* of a job, that's enough.

(b) Court remands to trial court for further determination on whether the devices are reusable at the end of a job.

b) Use Tax

i) **What it means to "attach." Combs v. Chapal Zenray, Inc.**, 357 S.W.3d 751, 753 (Tex. App.--Austin Nov. 18, 2011, pet. filed)

(1) Taxpayer purchases jewelry, jewelry boxes, and display cards from out of state vendors. It brings these materials into the state, "attaches" the jewelry to the box or card, and then ships everything to its out-of-state customers, which are retailers. The taxpayer also labels the jewelry with price, bar coding, etc. The retailer's customer—not the retailer—is the party that ultimately separates the jewelry from the box or card.

(2) The taxpayer paid no sales tax on its out of state purchases. Therefore the Comptroller claims that the taxpayer owes use tax because the taxpayer used the boxes and display cards in the state.

(3) There is an exception to the definition of "use". The tax code states that a taxpayer does not "use" property when "attaching the property to . . . other property to be transported outside the state for use solely outside the state."

(4) Taxpayer argues that this exception is *exactly* what it is doing with the jewelry boxes and display boards in Texas.

(5) Noting that the Legislature did not define the word "attach," the Court looks to its plain meaning. The word "attach" means that the attached component must be part of a "finished product."

(6) But a finished product to whom? Taxpayer argues that the jewelry boxes and display boards are a "finished product" to its immediate customer, the retailer. The retailer sells the assembled unit as-is. The Comptroller argues that the assembly is not a "finished product" to the ultimate consumer, because that consumer will separate the attachment before use. The Court concludes that both interpretations are reasonable, and declares the statute ambiguous.

(7) Because the statute is ambiguous, the Court inquires whether there is "formal agency interpretation." The only "formal" interpretation on record regarding this issue is a single hearing—*the hearing in this very case, which the taxpayer is effectively appealing.*

(8) The Court defers to the hearing decision's interpretation of the statute: for property to be "attached," it must remain attached in the hands of the ultimate consumer. The exception therefore does not apply; the taxpayer "used" the item in Texas; and owes use tax.

(9) Had the taxpayer filed in district court without first taking this case through an administrative hearing, it would have likely won, at least according to the Court's published reasoning. See section 3a, below.

(10) Status: Taxpayer petitioned Supreme Court for review on March 1, 2012. Petition argues that the statute is not ambiguous.

ii) **What is an "orthopedic device"? Zimmer US, Inc. v. Combs**, 03-11-00178-CV, 2012 WL 432160 (Tex. App.--Austin Feb. 9, 2012, no. pet. h.)

(1) Taxpayer sells surgical implants—artificial knees and the like. Taxpayer also purchases various "surgical instruments" used during surgery, including bone cutting guides and trial implants. The taxpayer "loans" these instruments to the doctors. The instruments are temporarily placed in the body—they are not permanent implants.

(2) Comptroller claims that the taxpayer owes use tax on the surgical instruments. But an exemption may apply: The tax code provides an exemption for "orthopedic . . . or prosthetic device[s] . . . or supplies or replacement parts for [these items.]" The statute defines none of these terms.

(3) The Comptroller defined both "orthopedic device" and "prosthetic device" via Rule. The instruments meet the regulatory definition of an "orthopedic device:" "any appliance or device designed specifically for use in the correction or prevention of human deformities, defects, or chronic diseases of the skeleton, joints, or spine."

(4) However, the Comptroller cites to several letter rulings that provide an additional requirement. An "orthopedic device" must support, correct or replace a body part on an *ongoing basis*. These instruments are used only before, during, or shortly after surgery.

(5) The Court determines that the letters are invalid. See section 3b, below. The instruments meet the Rule's definition, and are therefore exempt.

(6) Current status: Comptroller filed motion for rehearing on March 9, 2012.

3) Deference to Agency Interpretation

a) **Third Court of Appeals provides its roadmap for statutory construction in tax cases. Combs v. Chapal Zenray, Inc.**, 357 S.W.3d 751, 753 (Tex. App.--Austin Nov. 18, 2011, pet. filed)

i) There are two rules of statutory construction often applied to Texas tax contests:

(1) Statutory language providing *an exemption* from tax must be strictly construed against the *taxpayer*.

(2) Statutory language *not* providing an exemption from tax should be strictly construed against *the state*.

ii) However, in this case, the Court determines that it only must reach the above rules of construction if the "dominant rules of statutory construction" fail:

(1) Use legislative definitions, if there are any.

(2) Use the plain meaning of the word, if it is unambiguous.

(3) Show deference to the Comptroller's interpretation of the word, if it is reasonable and non-contradictory to the statute. The interpretation must be "formal opinions adopted after formal proceedings, not isolated comments during a hearing or opinions [in a court brief]."

(4) If there is still doubt, either because there is no "formal opinion" or because that opinion is ambiguous, only then should the Court apply the rules of statutory construction noted in (i) above.

iii) Here, if Comptroller interpretation did not exist, the taxpayer would have received the benefit of strict construction against the state, because it is not seeking an exemption. But "formal guidance" from the Comptroller did exist—the very hearing decision that the taxpayer paid in protest, and now contests. The Court finds such interpretation to be reasonable and non-contradictory. Effectively, the taxpayer loses because it pursued its claim administratively first.

iv) Comment: The lesson to learn here is that if you've got the benefit of the tax construction statutes (i.e. you're not arguing for an exemption) and the Comptroller hasn't published a "formal opinion" that is on point, get to district court as soon as possible and **do not** attempt to resolve administratively.

v) Another comment: Sections 112.054 and 112.154 of the Tax Code state that protest and refund suits are "de novo." How is this taxpayer's case de novo when the Court relies on a hearing for the same case?

b) **Deference for Comptroller letter rulings that interpret a Comptroller rule. Zimmer US, Inc. v. Combs**, 03-11-00178-CV, 2012 WL 432160 (Tex. App.--Austin Feb. 9, 2012, no. pet. h.)

i) In this case, the Court outlines under what circumstances it will give deference to comptroller letter rulings interpreting Comptroller rules:

(1) First, the Court must determine if the rule itself is valid. Is the statute that the rule interprets unambiguous? If so, there is no deference to the rule *or* the letter. If the rule's interpretation is unreasonable, or if it conflicts with the statute, the Court should also not show deference either to the rule or the letter.

(2) If the rule is valid, is it ambiguous? If it is unambiguous, the Court should give no deference to the letter. If it is ambiguous, the Court should give the letter deference as long as it does not conflict with the rule.

(3) In this case, the Court finds that the statute's use of the term "orthopedic device" is ambiguous, but the Comptroller's regulatory definition of the term is reasonable and unambiguous. The Court therefore does not allow the Comptroller to rely on letter rulings that add additional requirements to the rule.

(a) However, in **Austin Eng'g Co., Inc. v. Combs**, 03-10-00323-CV, 2011 WL 3371557 (Tex. App.--Austin Aug. 5, 2011, no pet.), the Court shows deference

to letter rulings without completing this analysis. This is likely because Austin Eng'g did not involve statutory construction.

(4) Comment: Are letter rulings "formal opinions adopted after formal proceedings?" See Chapal Zenray at section 3a, above.

4) Other Matters

a) **The Sexually Oriented Business Fee does not violate an exotic dancer's freedom of speech. Combs v. Texas Entm't Ass'n, Inc.**, 347 S.W.3d 277 (Tex. 2011) cert. denied, 132 S. Ct. 1146 (U.S. 2012).

i) Case relates to the $5 per customer "fee" that "sexually oriented businesses" must pay to the state.

(1) "Sexually oriented business" defined as a "nightclub, bar, restaurant or similar commercial enterprise" that provides "for an audience of two or more individuals live nude entertainment or live nude performances" and "authorizes on-premises consumption of alcohol." Statute also defines what "nude" means.

(2) The fee is earmarked for the state sexual assault program and health benefits for low-income persons.

ii) Both the trial court and the Third Court of Appeals determined that the fee was targeted at nude performers' right of self-expression. It is therefore protected speech and the fee violates the First Amendment.

iii) Texas Supreme Court reverses and remands. The fee is not meant to "regulate expression," but to regulate the negative secondary effects of the expression: sexual abuse caused by viewing nude entertainment in the presence of alcohol.

iv) Since the fee is not a regulation of expression, it need not pass strict scrutiny, but only the US Supreme Court's *O'Brien* test, which it passes.

v) Status: Taxpayers included various other constitutional challenges, which the trial court has not addressed. Remanded so that the district court can address these other claims.

b) **Managed audits and interest waiver. Bell Helicopter Textron, Inc. v. Combs**, 03-10-00764-CV, 2011 WL 6938491 (Tex. App.--Austin Dec. 29, 2011, no pet.)

i) Taxpayer and Comptroller agreed to a "managed audit," permitted by Texas Tax Code § 151.0231. In effect, the taxpayer may audit itself under Comptroller supervision. In exchange, the Comptroller must waive any penalty, and may also waive interest on "any amount identified to be due."

ii) After the managed audit, the taxpayer and the Comptroller agreed that for each period, taxpayer overpaid more tax than it underpaid. The taxpayer believes that the Comptroller must waive all interest on the underpayments, and pay interest on the gross amounts of the overpayments. The Comptroller believes that it should net the underpayments against the overpayments, and pay interest on the net amount.

iii) The taxpayer argues that under the Comptroller's interpretation, the taxpayer would receive no benefit from the managed audit. The court still agrees with the Comptroller's position. The Comptroller only agreed to waive interest on "any amount identified to be due," and there is nothing due. Netting the amounts is appropriate.

c) **In refund cases, keep administrative motions for rehearing broad. Combs v. Health Care Service Corp.** (Blue Cross Blue Shield) 03-09-00617-CV, 2011 WL 1005419 (Tex. App.--Austin Mar. 16, 2011, pet. filed).

i) For refund suits, the trial court only has jurisdiction to hear "the grounds of error contained in the motion for rehearing" filed at the administrative level. Effectively, this requires a taxpayer to exhaust administrative appeals for all grounds it raises in district court.

ii) In this case, the taxpayer's primary argument was that it qualified for the sale for resale exemption. However, in a trial brief, the taxpayer raised two additional claims for exemption that were not related to its sale for resale claim. These claims were not raised at the administrative hearing, or included in the motion for rehearing. The claims pertained to the *same transactions* as those in dispute in the hearing.

iii) The taxpayer's motion for rehearing included a statement that the taxpayer "is seeking a refund of sales tax paid on purchases made for and transferred to the federal government."

iv) That is enough for the Court to conclude that the motion for rehearing contained the additional grounds, and therefore the trial court had jurisdiction.

v) The lesson learned: Keep the language in a motion for rehearing broad.