Texas Tax Quarterly Update

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This outline provides information on general tax issues and is not intended to provide advice on any specific legal matter or factual situation. This information is not intended to create, and receipt of it does not constitute, a lawyer-client relationship. Readers should not act upon this information without seeking professional counsel.

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Introduction

These materials cover critical recent and ongoing developments in Texas sales tax and Texas franchise tax during the fourth quarter of 2020. They include the Comptroller's extensive changes to his franchise tax apportionment rule and legislation pre-filed in the 2021 legislative session, along with other important Texas sales tax and franchise tax developments.

The TXCPA provides these materials to its participants in its Texas Taxes: Quarterly Updates webcasts. Members of the TXCPA may attend the quarterly webinars free of charge. The TXCPA has agreed to provide access to the quarterly webinars to members of the Tax Section of the State Bar for a nominal charge. The sessions covering 2021 developments are scheduled to occur on the following dates from 12:00 p.m. through 1:00 p.m.:

Period Covered	Webcast Date
First Quarter 2021	Apr. 8, 2021
Second Quarter 2021	Jul. 8, 2021
Third Quarter 2021	Oct. 14, 2021
Fourth Quarter 2021	Jan. 13, 2022

Attendees can register through the TXCPA website at https://www.tx.cpa/education/cpe.

I. Franchise Tax

COVID-19 Deadline Relief

Extended Due Date. On April 2, 2020, the Comptroller announced that the due date for Report Year 2020 Texas franchise tax reports is automatically extended for all taxpayers to July 15, 2020.[1] The automatic extension includes both the report deadline and the payment deadline. The Comptroller extended the franchise tax deadline "to be consistent with the Internal Revenue Service" which has extended certain federal income tax filing deadlines to July 15, 2020.[2] The Comptroller's press release explained the rationale for extending the franchise tax deadline:

> "We recognize that the information aggregated from taxpayers' federal tax returns comprises the building blocks for their Texas franchise tax returns," Hegar said. "In addition to coping with the unprecedented impacts of the growing pandemic, we understand the difficulty Texas businesses will face in filing franchise tax returns now that the federal deadline has moved,

1 Texas Comptroller, *Comptroller's Office Extends Franchise Tax Deadline* (Apr. 2, 2020), *available at* https://comptroller.texas.gov/about/media-center/news/2020/200402-extend-tax-deadline.php.

2 Internal Revenue Service, IR-2020-58 *Tax Day now July 15: Treasury, IRS extend filing deadline and federal tax payments regardless of amount owed* (Mar. 21, 2020), *available at* https://www.irs.gov/newsroom/tax-day-now-july-15-treasury-irs-extend-filing-deadline-and-federal-tax-payments-regardless-of-amount-owed.

> and so we thought it appropriate to align the state's franchise tax deadline with the IRS deadline."[3]

In addition to the automatic extension, the Comptroller announced the process for requesting additional franchise tax extensions. These extensions, like those available every year, require taxpayers to file timely extension requests and include with those requests estimated tax payments. The extensions differ depending upon whether the taxpayer is required to pay franchise tax via electronic funds transfer (EFT).

Entities that paid $10,000 or more in franchise tax (or any other single category of payments or taxes) in the previous state fiscal year are required to pay using EFT.[4]

Extensions for Non-EFT Taxpayers. Taxpayers who are not required to pay via ETF can request one additional extension using the Comptroller's Webfile system or may file Form 05-164, Texas Franchise Tax Extension Request.[5] If the taxpayer properly requests the extension, the report will be due January 15, 2021.

Non-EFT taxpayers must request the extension before the original due date for the report (July 15, 2020). Along with the extension request, the taxpayer must make an "extension payment" equal to the lesser of the following:

1. 90% of the tax that will be due with the report that is ultimately filed; or
2. 100% of the tax reported as due on the prior franchise tax report.[6]

A taxable entity that became subject to the franchise tax for the first time during the 2019 calendar year cannot use the 100% payment option to calculate its extension payment. Also, a separate entity that was included in a combined group report in Report Year 2019 cannot use the 100% payment option.[7] Using the 90% payment option, however, requires the taxpayer to be able to calculate its expected Report Year 2020 franchise tax liability, which the taxpayer is typically unable to do before submitting its federal income tax return.

If the taxable entity fails to meet the "extension payment" requirements once it files its Report Year 2020 report, penalty and interest applies to any part of the 90% of tax not paid by the July 15, 2020 due date and to any part of the 10% not paid by the extended due date.[8] If a taxpayer does not meet

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3 Texas Comptroller, *Comptroller's Office Extends Franchise Tax Deadline* (Apr. 2, 2020), *available at* https://comptroller.texas.gov/about/media-center/news/2020/200402-extend-tax-deadline.php.

4 Comptroller Rule 3.9(b).

5 Texas Comptroller, Franchise Tax Extensions of Time to File, https://comptroller.texas.gov/taxes/franchise/filing-extensions.php (last visited Jan. 13, 2021). Access to the Comptroller's Webfile system and downloadable forms are available at https://comptroller.texas.gov/taxes/file-pay/.

6 *Id.*

7 *Id.*

8 *Id.*

the minimum payment threshold, the extension is denied and the taxpayer's report remains due on the July 15, 2020 due date.[9]

Extensions for EFT Taxpayers (Two-Step). Taxpayers required to pay Report Year 2020 franchise tax via EFT must request two extensions. The first extends the due date to August 15, 2020, and the second extends the due date to January 15, 2021.

If the taxpayer paid between $10,000 and $499,999.99 in franchise tax in Report Year 2019, they may meet the extension payment requirement by using the Comptroller's Webfile system to make their payment.

If the taxpayer paid $500,000 or more in franchise tax in Report Year 2019, they must use the Comptroller's TEXNET system. They may request an extension by making a timely TEXNET payment using tax type payment code 13080 (Franchise Tax Extension). They must complete the payment information by 8:00 PM (CT) on Tuesday, July 14, 2020.[10] Taxpayers do not use the Comptroller's Form 05-164, Texas Franchise Tax Extension Request when using TEXNET and payment code 13080 (Franchise Tax Extension).[11]

Along with the extension request, the taxpayer must make an "extension payment" equal to the lesser of the following:

1. 90% of the tax that will be due with the report that is ultimately filed; or
2. 100% of the tax reported as due on the prior franchise tax report.[12]

Special restrictions apply to the use of these two options for combined groups and separate entities that were included in a combined group in the prior year.[13]

After receiving the first extension to August 15, 2020, the taxable entity may request a second extension to January 15, 2021. The taxpayer must use either Webfile or TEXNET (depending on the amount of tax paid in the prior year) to make a second extension payment. The second extension payment must be the balance of the amount that will ultimately be due minus the first extension payment. This requires the taxpayer to know with certainty its ultimate franchise tax liability. If the

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9 Failing to secure a valid extension causes the statute of limitations to begin running on the original due date. Tex. Tax Code § 111.201 (four-year limitations period begins once tax is due and payable).

10 Texas Comptroller, Franchise Tax Extensions of Time to File, https://comptroller.texas.gov/taxes/franchise/filing-extensions.php (last visited Jan. 13, 2021). Access to the Comptroller's Webfile and TEXNET systems and downloadable forms are available at https://comptroller.texas.gov/taxes/file-pay/.

11 *Id.*

12 Comptroller Rule 3.585(f).

13 Comptroller Rule 3.585(f)(3)(B).

taxpayer has already paid 100% of the tax due for Report Year 2020 with its first extension request, it may use Form 05-164, Texas Franchise Tax Extension Request.[14]

Final Report Extensions. A final report and payment of tax are due within 60 days once a taxable entity no longer has Texas franchise tax nexus or is subject to Texas franchise tax.[15] Taxpayers may request extensions for these reports using the Comptroller's Webfile or TEXNET systems, or using the Form 05-164, Texas Franchise Tax Extension request. The appropriate method will depend on whether the taxpayer is required to pay the tax via EFT, and whether an EFT payor must use the Webfile or TEXNET systems. The taxpayer must make an estimated payment of at least 90% of the tax that is ultimately due. If the taxpayer files a timely extension request, the extended due date will be 45 days after the original due date, i.e., 105 days after it no longer has Texas nexus.[16]

Taxable Entities

Motor Carriers. Under Texas law, motor carriers are exempt from occupation taxes measured by gross receipts.[17] In a recent hearing, a motor carrier sought a franchise tax refund, arguing that the franchise tax is an occupation tax measured by gross receipts. The ALJ described the argument that the franchise tax is an occupation tax as "not without merit" because "a franchise tax . . . is very similar to an occupation tax."[18] The ALJ found that the franchise tax was not an occupation tax, for two reasons. First, franchise tax revenue is not appropriated consistent with occupations tax revenue under the Texas Constitution. Also, an occupation tax is imposed for the privilege of carrying on a business, whereas the franchise tax was imposed "in exchange for the state's liability shield."[19]

This issue formed the basis for several refund hearings.[20] As these hearings concluded with Comptroller's decisions denying the refund claims, several transportation companies brought district court lawsuits asserting that the Texas franchise tax is an occupation tax measured by gross receipts from which motor carriers are exempt. Once such suit, *Swift Transportation v. Hegar*, was decided in

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14 Texas Comptroller, Franchise Tax Extensions of Time to File, https://comptroller.texas.gov/taxes/franchise/filing-extensions.php (last visited Jan. 13, 2021). Access to the Comptroller's Webfile and TEXNET systems and downloadable forms are available at https://comptroller.texas.gov/taxes/file-pay/.

15 Comptroller Rule 3.584(c)(4).

16 Texas Comptroller, Franchise Tax Extensions of Time to File, https://comptroller.texas.gov/taxes/franchise/filing-extensions.php (last visited Jan. 13, 2021). Access to the Comptroller's Webfile and TEXNET systems and downloadable forms are available at https://comptroller.texas.gov/taxes/file-pay/.

17 Tex. Transp. Code § 20.001.

18 Comptroller Hearings 115,869; 116,055 (June 20, 2019) *quoting In re Nestle USA, Inc.,* 387 S.W.3d 610, 621 (Tex. 2012).

19 *Id.*

20 The Comptroller reached the same result in other hearings involving the same or similar issues. Comptroller Hearing 116,056 (Oct. 8, 2019); Comptroller Hearing 116,615 (Dec. 12, 2019).

favor of the Comptroller on December 11, 2020.[21] The taxpayer filed a notice of appeal with the Third Court of Appeals on December 18, 2020.[22] Other cases remain on hold in Travis County District Court pending the outcome of *Swift Transportation*.

21 *See, e.g.*, *Swift Transportation Co. of Arizona v. Hegar*, D-1-GN-20-001080 (126th Dist. Ct., Travis County, filed Feb. 21, 2020).

22 Cause no. 03-20-00600-CV.

COGS

Satellite Radio Service Not Engaged in Sale of Goods. In *Hegar v. Sirius XM Radio, Inc.* the court found that Sirius was not engaged in the sale of goods, and was therefore ineligible to claim the cost of goods sold subtraction.[23] Sirius provides subscription-based satellite radio service, producing most of its radio content exclusively for customers, transmitting content to satellites, and then receiving and unscrambling the satellite signals in its customers' vehicles.

Sirius paid car manufacturers to install satellite-enabled radios in vehicles, hoping to later sell subscriptions to those vehicles' owners. Sirius claimed that it was entitled to amend its cost of goods sold subtraction to include the payments to manufacturers to subsidize the installation of the satellite radios.[24]

To claim the cost of goods sold subtraction, a taxable entity must sell "goods," which are real or tangible personal property.[25] The subtraction is generally unavailable to an entity selling only services. "Tangible personal property" is defined as "personal property that can be seen, weighed, measured, felt, or touched or that is perceptible to the senses in any other manner."[26] This includes "films, sound recordings, videotapes, live and prerecorded television and radio programs, books, and other similar property embodying words, ideas, concepts, images, or sound."[27] A taxpayer engaged in the sale of goods is entitled to include all direct costs of producing the goods in its cost of goods sold subtraction.[28]

The court rejected Sirius XM's argument that it sold "live and prerecorded . . . radio programs" that were "produced" by its unscrambling of the satellite signals in the vehicles.[29] The court relied on the Texas Supreme Court's finding in *American Multi-Cinema* that "property with a physical or demonstrable—that is, tangible—presence must be transferred."[30] The Attorney General filed a supplemental brief in *Sirius XM*'s case just after the *American Multi-Cinema* Texas Supreme Court Opinion was published, noting that Sirius XM had "analogized satellite radio to the exhibition of films" in Sirius XM' briefing to the Texas Supreme Court.[31] The Court reasoned that, just like AMC's theatergoers, Sirius' customers did not transfer property with a physical or demonstrable

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23 *Hegar v. Sirius XM Radio, Inc.*, Cause No. 03-18-00573-CV (Tex. App.—Austin, May 1, 2020, pet. filed). The Third Court of Appeals also rejected an argument by Sirius that it was entitled to apportion its Texas receipts using the location where it produced its content. See **Apportionment** below**.**

24 Sirius also paid a share of revenue to these manufacturers. Slip op. at 6.

25 Tex. Tax Code § 171.1012(a)(1).

26 Tex. Tax Code § 171.1012(a)(3)(A)(i).

27 Tex. Tax Code § 171.1012(a)(3)(A)(ii).

28 Tex. Tax Code § 171.1012(c).

29 Slip op. at 18–19. Tex. Tax Code §

30 *Sirius XM* slip op. at 19 (citing *Hegar v. American Multi-Cinema, Inc.*, No. 17-0464 (Tex. 2020).

31 Appellant's Supplemental Brief at 1, *Sirius XM Radio, Inc.*, Cause No. 03-18-00573-CV (Tex. App.—Austin, May 1, 2020, no pet. h.)

form to its customers, but merely provided them temporary access to creative content.[32] Sirius XM has petitioned the Supreme Court for review, and amicus curiae briefs have been submitted by Tax Executives Institute (TEI), Texas Taxpayers and Research Association (TTARA), and Council on State Taxation (COST).

Ready-Mix Concrete. U.S. Concrete manufactured and delivered ready-mixed concrete using mixer-trucks whose constantly rotating drums kept the product in an unhardened state on its way to its customers' job sites. U.S. Concrete argued that its mixer-trucks constituted manufacturing plants on wheels, and that the unhardened concrete becomes a good only when poured from the truck at a job site. Accordingly, U.S. Concrete argued that it was entitled to subtract all of its costs related to its mixer-trucks, mixer-truck drivers, and the dispatchers who oversaw orders for ready-mixed concrete.

The Comptroller disagreed and disallowed 70% of U.S. Concrete's mixer-truck costs, 41% of its mixer-truck driver costs as costs relating to distribution or rehandling and not costs of producing the ready-mixed concrete, and capped the company's dispatcher costs at 4% as indirect costs.

The court found for the Comptroller, rejecting U.S. Concrete's argument that unhardened concrete becomes a "good" for purposes of COGS only upon being poured from the truck at the job site because, even in its unhardened state, it is still personal property that can be seen, weighed, measured, felt, touched and otherwise perceive by the senses, and therefore constitutes a "good" well before it is delivered to job sites. The court also found that evidence in the record supported the Comptroller's distinction between costs that U.S. Concrete incurred related to its trucks manufacturing, and costs related to transportation.

The court further determined that U.S. Concrete's dispatchers were not directly involved in the manufacture of the ready-mixed concrete and therefore it could not subtract the costs related to the mixer-truck dispatchers. The Texas Supreme Court denied review on December 11, 2020, leaving the Third Court of Appeals' decision to stand.[33]

Apportionment

Single-Factor Formula. An entity apportions its taxable margin to Texas by multiplying it by an apportionment fraction. The apportionment fraction is determined using only gross receipts. The numerator is the entity's gross receipts from business done in Texas and the denominator is the entity's entire gross receipts.

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32 Slip op. at 20.

33 *U.S. Concrete v. Hegar*, 03-17-00315-CV, 2019 WL 1388714, at *3 (Tex. App.—Austin Mar. 28, 2019, pet. filed) (pending before Texas Supreme Court, No. 19-0763).

Gross Receipts. The statutory definition of gross receipts means all revenues reportable by the entity on its federal tax return without deduction for the cost of the property sold, materials used, labor performed, or other costs incurred, unless otherwise provided.[34]

The Comptroller's Rule clarifies that in most cases, total gross receipts will equal total revenue as calculated under the revised franchise tax, except for three specific circumstances:[35]

- The entity is a health care provider or institution that takes the revenue exclusion for uncompensated care;
- The entity is a law firm that takes the revenue exclusion for pro bono services; or
- The entity is a broker or dealer that accounts for loans and securities as inventory for federal income tax purposes, or "Securities Available for Sale" or "Trading Securities" or the entity is a financial institution that categorizes a loan or security as "Securities Available for Sale or "Trading Securities" under Financial Accounting Standard No. 115.[36]

For the first two circumstances, total gross receipts is not reduced by the revenue exclusion. For the third circumstance, the entity will report the gain on the sale of securities as revenue, but it should report the gross proceeds, from the sale of total gross receipts.[37]

Texas Gross Receipts. Once "gross receipts from everywhere" is established, taxpayers must determine the gross receipts apportioned to Texas. Taxpayers determine Texas gross receipts by applying the general and specific rules that the Legislature, the courts and the Comptroller have fashioned over time.

Comptroller Adopts Sweeping Apportionment Rule Amendments. On January 15, 2021, the Texas Comptroller will adopt broad amendments to his Rule 3.591 governing franchise tax apportionment. In doing so, the agency rewrote numerous detailed rules for sourcing dozens of different types of receipts. Notably, for receipts from services that don't fall under one of the specific rules, the Comptroller's rule codifies the "end-product act" test which first appeared in a 1980 Comptroller Hearing[38] and was recently employed by the Third Court of Appeals in *Hegar v. Sirius XM Radio, Inc.*[39] The Comptroller intends to apply the adopted rule retroactively except for a few provisions which he concedes are changes in policy.

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34 Tex. Tax Code §171.1121(a).

35 34 Tex. Admin. Code § 3.591(b)(4).

36 Tex. Tax Code §171.106(f-1) (as amended by HB 4611, 81st Reg. Sess. 2009).

37 Tax Policy News, Texas Comptroller (June 2009).

38 Comptroller Hearing 10,028 (1980).

39 No 03-18-00573-CV (Tex. App.—Austin 2020, pet. filed).

The adopted rule also:

- Codifies recent policy excluding net losses from sales of investments and capital assets (prospectively)
- Distinguishes between financial derivatives sold for hedging and securities treated as inventory, but sources both categories to the location of the payor
- Restricts transportation companies who elect to apportion revenue using mileage from including uncompensated mileage (prospectively)
- Increases Texas' census-based apportionment to 8.7% (prospectively)
- Changes terminology throughout

The Comptroller has formally adopted these changes which were published in the January 15, 2021 issue of the Texas Register. Because some of the changes explicitly take effect in report year 2021, the Comptroller is poised to apply the other provisions retroactively. He signaled this intention by asserting in the proposed rule that they "reflect current guidance," while simultaneously admitting that the amendments require that he "supersede prior inconsistent rulings." 45 Tex. Reg. 8104, 8107.

End-Product Act

Texas Tax Code Section 171.103(a)(2) provides that receipts from "each service performed in this state" are sourced to Texas. For many years the Comptroller was relatively consistent in using the cost of performance method to source receipts from services. Under this method, taxpayers apportion their receipts to Texas based on the relative cost of providing the services in Texas as contrasted with the cost of providing services everywhere. The Texas Comptroller has decided to follow a number of states who have amended their statutes to adopt a sourcing method referred to as "market-based" sourcing. Under market-based sourcing, taxpayers apportion receipts to the location of the benefit of the services received by their customers. In other words, sourcing under this methodology is based on the state in which the services are delivered rather than the state in which the services are performed.

The Comptroller justifies his rule amendment by using the 1980 administrative decision referenced above. Under his new change in policy, the Comptroller provides general rules for sourcing receipts from performing services to the location of the "receipts-producing, end-product act." Rule 3.591(e)(26)(A). Under this test, if there is a receipts-producing, end-product act, the location of other acts will not be considered even if they are essential to the performance of the receipts-producing acts. The Comptroller's justification for disregarding essential activities is that to source receipts otherwise would devolve into using factors like property and payroll as proxies because "no activity of a corporation that generates services receipts is any more important than any other activity, since all are essential to the end-product performance of the service that is sold." 45 Tex. Reg. 8107 (quoting Comptroller Decision No. 10,028).

"If there is not a receipts-producing end-product act, the location of all essential acts may be considered." Rule 3.591(e)(26)(A). For example, receipts from sales of admissions to live or pre-

recorded events are sourced to the location whether the recipients observe the performance, not where a live performance was rehearsed, or where a pre-recorded performance was recorded, or the place where the admission fee was paid. Rule 3.591(e)(26)(A)(i).

If services are performed both inside and outside Texas for a single charge, the receipts can be apportioned to Texas based on the fair value of the service performed in Texas. To determine fair value, the relative value of each service provided on a standalone basis may be considered. Multi-state services can be apportioned based on hours worked. If costs are used as a proxy for value, taxpayers may only include direct costs, not overhead. The rule provides examples for attorneys (based on hours billed from in-state and out-of-state offices) and landscapers (based on number of customer's locations landscaped in-state and out-of-state, disregarding travel costs).

The Comptroller has issued inconsistent guidance when applying his end-product act rule. This has resulted in taxpayers with similar facts filing franchise tax reports using inconsistent sourcing methods. Since the Comptroller intends to apply his end-product act changes retroactively, we are interested to see how these changes will be applied during audits of taxpayers for prior periods.

Net Gains or Losses from Sales of Capital Assets or Investments

The Comptroller has fundamentally changed the calculation for apportioning gains and losses from the sale of non-inventory assets. Under his prior policy, net losses, in the aggregate, would offset net gains, in the aggregate, subject to certain limits. Under his new policy, net losses arising from individual sales of capital assets or investments are simply ignored. Thus, only the net gains are included in gross receipts. This transaction-level computation applies prospectively beginning with report year 2021. Rule 3.591(e)(2)(A), (C). We anticipate that taxpayers with high volumes of sales of investments and capital assets may face challenges obtaining the information necessary to apply a transaction-level analysis.

Transportation

Under the adopted rule, taxpayers may elect to apportion transportation services receipts using one of two formulas:

(A) *gross receipts* from Texas intrastate transportation / gross receipts from transportation

OR

(B) C*ompensated mileage* from Texas intrastate transportation / total compensated mileage

After proposing to do away with mileage-based apportionment altogether, the Comptroller acquiesced to public comments and retained the mileage option, but modified it. Under the new mileage option, taxpayers may no longer include "uncompensated mileage," which appears designed to exclude trips taken without cargo. Rule 3.591(e)(33). Previously, taxpayers electing to use mileage-based apportionment had a potential further option between including only miles from paid trips

(with passengers or cargo) in the numerator and denominator or including all mileage in the apportionment factors (which would include "empty miles" trips without passengers or cargo).

Census-Based Percentage Apportionment

Census-based percentage apportionment to Texas increases from 7.9% to 8.7%. This applies to sales of securities through an exchange to unidentified payors, and advertising where audiences cannot otherwise be determined. Rule 3.591(e)(1), (25).

Sourcing Rules for Various Categories of Receipts

The Comptroller has adopted new rules or modified existing rules for sourcing of receipts from various other types of transactions. Many of the more significant new apportionment provisions are summarized in the following table:

Type of Receipts	Sourcing Rule	Rule Subsection
Advertising	Regardless of the type of media in which an advertisement is transmitted, advertising receipts are sourced to the location of the audience. If the audience locations cannot be reasonably determined, taxpayers may use the fixed 8.7% census-based figure. For report year 2020 and earlier, advertisers may use the physical location of radio or TV station transmitters.	Rule 3.591(e)(1)
Computer Hardware and Software	Hardware and software receipts are sourced as the sale of tangible personal property if the hardware is sold with software installed on it. Digital property transferred by "fixed physical media" (e.g., compact disc) is sourced as the sale of tangible personal property. Digital property not transferred by fixed physical media is sourced as the sale of an intangible to the location of payor. Digital property as a service is sourced under the end-product act rule.	Rule 3.591(e)(3)
Financial Derivatives	Gross receipts from the settlement of financial derivative contracts (hedges, options, swaps, futures, forward contracts, etc.) are sourced to the location of payor.	Rule 3.591(e)(10)

Internet Hosting (Cloud Computing)	Internet hosting receipts are generally sourced to the customer location. New guidance also distinguishes between purchasing access to a computer service and purchasing or leasing hardware or digital property.	Rule. 3.591(e)(13)
Loan Servicing	Gross receipts from loan servicing are sourced to the location of real property secured by the loan. If the loan is not secured by real property, receipts are sourced based on the end-product act.	Rule 3.591(e)(16)
Loans and Securities Held as Inventory	Loans and securities held as inventory are sourced to the location of payor.	Rule 3.591(e)(17)
Single-Member LLCs	Single member LLCs sold by the sole member are sourced to the location of payor.	Rule 3.591(e)(27)

Vocabulary Changes

Along with the substantive changes to apportioning receipts, the proposed rule adopts a new set of apportionment vocabulary. Many of these changes appear aimed at improving clarity and readability:

Old Term	New Term
Intangibles	Intangible Assets
Computer Program	Digital Property
Receipts	Gross Receipts
Revenue	Gross Receipts
Gross Receipts Everywhere	Gross Receipts from an Entity's Entire Business
Apportioned	Sourced
Legal Domicile of Payor	Location of Payor
Commercial Domicile	Principal Place of Business

Commodity Hedging Receipts. In a recent hearing, the Comptroller held that a packaged food company must exclude its net gains from commodity hedging transactions from the denominator of its Texas apportionment factor. The taxpayer purchased futures contracts in order to protect against price increases in the raw materials it used to manufacture its products. These were "notional contracts" in which neither party actually owned the commodity, and the taxpayer settled the contracts for net gains. For federal tax purposes, the taxpayer treated the proceeds as an adjustment to cost of goods sold. For Texas franchise tax, the taxpayer included the proceeds in its apportionment factor denominator, but excluded them from the numerator, because the commodities exchanges were located outside Texas.

Under Tex. Tax Code § 171.106(f), when calculating apportionment of margin to Texas, "if a loan or security is treated as inventory of the seller for federal income tax purposes, the gross proceeds of the sale of that loan or security are considered gross receipts." A comptroller auditor found that the taxpayer did not treat the commodity hedges as inventory because the taxpayer reported the proceeds

of settling the commodities hedges on Line 2 (cost of goods sold) instead of Line 1 (income/loss). The Comptroller has also found that reporting gains and losses on Form 1120, Line 8, as capital gains or losses shows that the securities are held for the taxpayer's own investment, and therefore are not treated as inventory.[40]

A similar issue is pending before the Travis County District Court in *Equistar Chemicals, LP v. Hegar*.[41] Equistar entered into commodities futures contracts to hedge against fluctuations in oil prices. Equistar filed refund claims, amending its apportionment calculation by including the proceeds from these hedging transactions in its calculation of its apportionment factor. Equistar followed a Comptroller rule that requires apportioning a set rate of 7.9% of securities sold through an exchange for which a buyer cannot be identified.[42]

Sourcing of Services Under the "End Product Act" Test. Texas law requires taxpayers to source receipts from the performance of services to Texas if the services are "performed in this state."[43] Yet, the statute provides no guidance for determining where the vast majority of services are performed. The Comptroller has taken the position in his recently amended apportionment rule that receipts from the performance of services should be sourced to the location where the "end product act" is performed. This test attributes the receipts to the location of the purchasers (the market) rather than the seller. The Comptroller alleges that he has argued that certain service receipts should be apportioned based on the "end product act" for decades. In a 1980 hearing decision, the Comptroller found that a television broadcasting company's receipts from selling advertising should be based on the location of its broadcast towers.[44] The Comptroller has repeatedly cited this hearing decision for his policy that the location of the final act to deliver the service is the appropriate location to source franchise tax receipts.

The Comptroller has asserted this position with renewed fervor in the last decade, as more and more services are performed remotely. In 2013 the Comptroller found that receipts for satellite TV service should be sourced to the subscriber's address because the signal is descrambled there.[45] In a 2018 Private Letter Ruling the Comptroller found that software that allows customers to reserve airport parking should be sourced to the location of the parking spaces.[46]

Satellite Radio Subscription Service Receipts. In *Hegar v. Sirius XM Radio, Inc.*, the court rejected the taxpayer's apportionment methodology based upon the location where the satellite radio service

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40 Comptroller Hearing Nos. 114,432; 114,433; 114,434; 114,435 (Aug. 15, 2019).

41 D-1-GN-18-004006 (126th Dist. Ct., Travis County, filed Aug. 2, 2018).

42 34 Tex. Admin. Code 3.591(e)(25).

43 Tex. Tax Code § 171.103(a)(2).

44 Comptroller Hearing 10,028 (Nov. 12, 1980).

45 Comptroller Hearing 104,224 (May 17, 2013).

46 Comptroller Priv. Ltr. Rul. 20171115102316 (Aug. 13, 2018).

produced its subscription content.[47] The taxpayer produced its subscription content primarily from studios located outside Texas, transmitting its programs to satellites from facilities outside Texas.

The Comptroller audited Sirius, asserting that its subscription receipts should be apportioned to Texas based on the locations where the satellite transmissions were received by subscribers. The taxpayer's expert witnesses provided testimony that Sirius's apportionment methodology conformed to the "end product act test," focusing on the location where the receipt-producing activities occurred. Based on this test, the trial court found that the creation and broadcasting of original content from locations outside Texas supported sourcing the taxpayer's receipts outside Texas.

The Comptroller appealed this case to the Third Court of Appeals.[48] On May 1, 2020, the Third Court of Appeals reversed the trial court, finding that Sirius XM's satellite radio subscription receipts from subscribers in Texas must be apportioned to Texas regardless of the location from which the content was created or broadcast.[49]

Receipts from services are sourced to the Texas if a service "is performed" in Texas, so the parties took different positions what service Sirius XM actually sold. The Comptroller argued that Sirius provides the "service of unscrambling the radio signal" within each subscriber's vehicle, which occurs "at the radio receiver."[50] The Third Court observed Texas case law precedent, which found that a service is performed "where the act is done" to perform the service.[51] The Third Court accepted the Comptroller's position that the focus is on Sirius XM's "receipt-producing, end-product act."[52] The Third Court deferred to the Comptroller's interpretation of the franchise tax statute and applied the "end-product act" analysis to source the receipt based upon the locations where the satellite radio signals were receive, unscrambled, and played through the speakers in customers' vehicles.[53]

Sirius XM has petitioned the Supreme Court for review, and amicus curiae briefs have been submitted by Tax Executives Institute (TEI), Texas Taxpayers and Research Association (TTARA), and Council on State Taxation (COST).

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47 *Hegar v. Sirius XM Radio, Inc.*, Cause No. 03-18-00573-CV (Tex. App.—Austin, May 1, 2020, pet. filed). The court also rejected an argument by Sirius that it qualified for the cost-of-goods-sold subtraction based on the determination that it sold services rather than goods. See **Cost of Goods Sold**, above.

48 *Hegar v. Sirius XM Radio, Inc.*, Cause No. 03-18-00573-CV (Tex. App.—Austin, May 1, 2020, no pet. h.).

49 Tex. Tax Code § 171.103(a)(2).

50 Slip op. at 5.

51 Slip op. at 9 (quoting *Humble Oil & Refining Co. v. Calvert*, 414 S.W.2d 172, 180 (Tex. 1967) (embedded quotation and citation omitted).

52 Slip op. at 10.

53 Slip op. at 12–14.

II. Sales Tax

Local Tax Rule Revised

The Texas Comptroller has changed his local tax rule to undermine economic development agreements.[54] Local governments, like cities and counties, collect local taxes to finance their governmental operations. Generally, local governments receive local sales taxes based upon orders that local businesses receive within their boundaries. Local governments may also receive local use taxes when goods are delivered to customers within their boundaries. A seller collects local use taxes only when the local sales tax where the item is sold is less than the maximum rate (2%) and the local use tax is not of the same type (such as a city tax or a county tax) as the local sales tax that applied. This may occur, for example, when a seller receives an order outside city limits and sells the product for delivery to a customer residing within city limits.

Generally, local governments want businesses to relocate within their boundaries. In doing so, the relocated businesses provide jobs, goods, services and generate sales and property taxes for the local government's operations.

To induce a business to relocate to a particular city, the city may offer the business incentives, often in the form of shared local sales tax revenues. These offers are authorized under Chapter 380 of the Texas Local Government Code and are commonly known as "Chapter 380" agreements.

As an example, Apple decides to leave California and relocate its headquarters to Texas. To induce Apple to choose Austin, the City of Austin offers Apple a Chapter 380 agreement under which the City will give Apple one-half of the sales tax revenue Apple collects for the City for a five-year period.

Prior to the rule's amendment, whenever a customer places an order on the internet for a new iPhone, Apple would treat the order as received in Austin, and collect sales tax that it would split, for a five-year period, with the City of Austin under the Chapter 380 agreement. This result would follow regardless of where in Texas the customer lives.

Comptroller Hegar says that these types of arrangements are unfair to the local tax jurisdictions where the customers live, so he amended his rule to say the local tax revenue goes to the customer's location, where the item is shipped. Hegar penned an op-ed in the Dallas Morning News in an effort to justify his agency taking the initiative to change Texas' local sales tax rule without a change in the law. Hegar claims that taxpayers and cities use a Chapter 380 "loophole" to create sham facilities to "manipulate local sales taxes to their own benefit at the expense of other cities."[55]

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54 Comptroller Rule 3.334.

55 Glenn Hegar, *How Some Texas Cities and Retailers Are Using a Tax Loophole to Snatch Sales Tax Revenue from Other Communities*, DALLAS MORNING NEWS, Feb. 4, 2020, *available at* https://www.dallasnews.com/opinion/commentary/2020/02/04/how-some-texas-cities-and-retailers-are-using-a-tax-loophole-to-snatch-sales-tax-revenue-from-other-communities/.

When a Texas customer makes a purchase from a company's website, or by using its mobile app, Comptroller Hegar says the local tax should go to the location where that customer receives the product, since he or she lives there and receives the local governmental services there, which the local sales tax revenues should help fund. Instead, taxes have been split between the local government where the seller has its business and the seller itself.

Although the amended rule went into effect May 30, 2020, Comptroller Hegar has provided for a transition period through September 2021 before the new sourcing provisions go into effect. He did this to allow the e-retailers adequate time to adjust their systems to collect local tax at the rate in effect at their customer's location and to give interested parties a chance to get the Texas Legislature to craft a different solution during the regular session that began in January 2021.[56]

Data Processing Services

Online Management Reports Taxable. The sales of management reports to customers who use them to manage product inventory levels and achieve substantial reductions in their administrative costs constitute taxable data processing. Instill Corporation provides automated management solutions for the food service industry. Instill's customers and their customer's vendors provide raw data to Instill who compiles it into reports that its customers then use when purchasing inventory, and monitoring inventory levels. The reports enable Instill's customers to achieve substantial administrative cost reductions. Instill treated the revenues it derived from the sale of its solutions as non-taxable proprietary information. The Comptroller audited Instill Corporation and disagreed, assessing over $1 million in sales taxes on Instill Corporation's revenues.

The appeals court concluded that Instill's solutions constituted taxable data processing because they arose from the processing and storage of data on computers. The Texas Supreme Court denied review on August 28, 2020, letting the appeals court's decision stand.

Internet Access Services

Separately Stated Internet Access Charges No Longer Taxable. Effective July 1, 2020, internet access services are no longer taxable in Texas.[57] The federal Internet Tax Freedom Act, first passed in 1998 and last renewed in 2016, set an expiration date of June 30, 2020 for Texas and six other states whose taxes were grandfathered in that legislation. Previously, only the first $25 of a fee paid to access the internet was exempt. Comptroller Hegar's Biennial Revenue Estimate calculates a $500 million loss in tax revenue from the expiration of the tax on internet access.

Insurance Services

Medical Billing Services. The Comptroller's Tax Policy Division issued a memorandum notifying the Audit Division that the Comptroller's new policy will treat medical billing services as taxable

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56 45 Tex. Reg. 3505 (". . . giving interested parties an opportunity to seek a legislative change.").

57 Tax Policy News (May 2020).

insurance services. These will include services performed prior to submitting a claim to an insurance company, to provide additional information, or to adjust a submitted billing. "Insurance services" are included in the exclusive lists of services subject to Texas sales tax.[58] The Comptroller's Rule 3.355 defines these services broadly to include "any activities to supervise, handle, investigate, pay, settle, or adjust claims or losses" and makes these services taxable regardless of whether the purchaser of the service is the insurance company, the policy holder, or others.[59] Medical billing services are not defined by the statute or the Comptroller's rule. Medical billing services involve assigning codes for the preparation of claims, verifying insurance eligibility, preparing claim forms for filing, filing claims, resubmitting and adjusting claims, reviewing and appealing denied claims, settling claims, and posting payment for claims.[60]

On March 19, 2020, the Comptroller announced that he would delay the implementation of his policy change "until after the 2021 legislative session, allowing industry time to seek a legislative change." He clarified that, in the meantime, "Medical billing services that occur before a claim is submitted do not fall under 'insurance claims adjustment or claims processing' and are not taxable as insurance services."[61]

Occasional Sale Exemption

Court Imposes Fraud Penalty on Aircraft Claim for Occasional Sale Exemption. The Third Court of Appeals recently upheld a trial court decision finding that the 50% fraud penalty applied to a taxpayer who had purchased an aircraft through a broker who claimed the occasional sale exemption. In *HB Aviation, LLC v. Hegar*, HB Aviation, LLC purchased a Cessna Citation Excel aircraft in 2009 from James Creech. James Creech habitually bought and sold aircraft and brokered aircraft transactions through his solely-owned corporation Jim Creech Aircraft Services.[62]

James Creech entered into a "back-to-back" transaction, in which he ostensibly took title to the aircraft from the seller and immediately transferred it to the buyer. He made a roughly 1–1.5% profit on brokering the transactions, but the sale proceeds were never in his possession but passed from the buyer to an escrow agent to the seller. Mr. Creech, however, executed a "Statement of Occasional Sale" to support the exemption, and executed an "Aircraft Purchase & Sales Agreement."

At his deposition James Creech testified that "on paper I've got title to the airplane, but I—I never really owned it" and confirmed that he had no understanding of Texas' occasional sale exemption. The Third Court found that the occasional sale exemption could not apply because there had never been a "sale" of the aircraft to James Creech. As a result, the Court found that statements in the

58 Tex. Tax Code § 151.0101(a)(9).

59 Comptroller Rule 3.355(a)(8), (b).

60 Comptroller Letter No. 201911003L (Nov. 22, 2019).

61 Comptroller Letter No. 202003007L (Mar. 19, 2020).

62 *HB Aviation, LLC v. Hegar*, No. 03-19-00414-CV (Tex. App.—Austin Nov. 11, 2020, no pet. h.).

Aircraft Purchase & Sales Agreement and the Statement of Occasional Sale were misrepresentations to the extent they characterized Mr. Creech as receiving title to the aircraft. Since HB Aviation submitted the Aircraft Purchase & Sales Agreement and the Statement of Occasional Sale to the auditor, and these documents contained these misrepresentations, the Third Court upheld the 50% fraud penalty.[63] HB Aviation's deadline to file a motion for rehearing—thereby asking the three-justice panel to reconsider its decision—has been extended to January 15, 2021.

Health Care

Support Services. The Texas Comptroller issued a private letter ruling on a variety of health care support services, including "release of information services," "clinical data acquisition and insight services," and "healthcare information management services" provided to medical service providers and others.[64]

The taxpayer's "release of information services" involves operating the medical records departments of medical service providers such as hospitals and doctor's offices. Instead of charging for this service, the taxpayer uses its position as recordkeeper to provide a service of medical records retrieval for a fee, to those who request copies of records. The release of information service also involves offering medical service providers data storage, photocopying, scanning, record retrieval, and the provision of information. The Comptroller found that charges for retrieving and providing medical records, and providing photocopies of medical records, were not taxable. However, charges to medical providers for scanning, data storage, and electronic record retrieval were taxable as data processing services. Sales of photocopies of medical records are taxable as the sale of tangible personal property unless released under the authority of the patient.

The taxpayer's "clinical data acquisition and insights" provides records retrieval services to health insurers for records managed by the taxpayer and in databases the taxpayer does not operate. The taxpayer sometimes processes the retrieved records such as by using specialized coding and data extraction. The Comptroller found these services, when performed for insurance companies, were taxable insurance services.

The taxpayer's "healthcare information management" service involves coding services, scanning and storage services, and data abstraction (mining) services. The initial coding services in relation to the initial submission of an insurance claim are not taxable. Coding audits and reviewing codes related to insurance claims are taxable insurance claims. The taxpayer's software-as-a-service applications provided to perform coding services are taxable as data processing services, as are the data abstraction services.[65]

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63 *HB Aviation, LLC v. Hegar*, No. 03-19-00414-CV (Tex. App.—Austin Nov. 11, 2020, no pet. h.).

64 Priv. Ltr. Rul. 20190219095143 (Aug. 14, 2020).

65 Priv. Ltr. Rul. 20190219095143 (Aug. 14, 2020).

Energy

Flowback Services Charges Taxable as Rentals. The Comptroller's Tax Policy Division changed its policy finding that "flowback services" are generally not services at all, but are instead treated as the rental of flowback equipment.

After an oil & gas well is hydraulically fractured, a mixture of oil, gas, frac fluid, and saltwater from the formation—known collectively as "flowback"—returns to the surface where it must be filtered and managed to keep the well open and flowing and ensure that the well pressure can normalize after the intense pressure present during fracking. Typically, a service provider offers "flowback services" by providing the following types of equipment along with supervisors who temporarily manage it:

- A choke manifold;
- A sand separator with gauges to measure oil, water, and gas rates, diagnose problems, evaluate production performance, and manage the reservoir;
- Flowmeters for gas and liquids
- Tanks to hold recovered fluids
- Transfer pumps and piping to attach these components
- A flare boom to burn off flare gas
- Safety systems including emergency shutdowns; and
- A logging cabin to run the data acquisition system.

The Comptroller stated that, typically, the flowback service provider will provide a supervisor for this equipment, but the supervisor may only remain at the wellsite for a couple of weeks, while the flowback equipment typically remains for up to four months. The Comptroller determined that standalone flowback services are to be treated as the rental of tangible personal property, basing that characterization on the following factors:

- The customer has operational control of the equipment by determining where it is placed and the rate at which it operates;
- The equipment works automatically, needing only minor adjustments
- The customer may operate the equipment after the flowback personnel are no longer on site
- The flowback personnel do not "actively guide, drive, pilot, or steer the equipment."

Because "flowback services" are treated as the rental of tangible personal property, the "service provider" may purchase that property for resale. If, however, the flowback services are performed by the same service provider who does the frac job, then charges for those services are taxed under the Well Servicing Tax. As a result, in that instance the sale-for-resale exemption would not apply to the service provider's purchase. The Comptroller's memorandum lists four policy documents spanning over a decade as superseded by the new policy; however, the Comptroller finds that the new policy is a "clarification" and he therefore intends to apply it retroactively.[66]

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66 Comptroller Memo 202009002L (Sept. 21, 2020).

I. Legislation

Texas Legislature' 87th Regular Session Convenes

The Texas Legislature meets for its regular session once every two years on odd-numbered years. The 87th Regular Session began on January 12, 2021.

Texas Legislature 87th Regular Session Pre-Filed Bills

Legislators began pre-filing bills on November 9, 2020. Below are brief descriptions of relevant tax bills and other bills that might affect your clients or your practice. Each bill number below is a hyperlink that should take you to the Texas Legislature Online webpage for the bill. You can click on these links before, during, and after the legislative session to see the status of each bill. You can review the bill text by clicking one of the three icons on the "Text" tab under the word "Bill."

Sales Tax Bills

HB 288 – This bill would expand the sales tax base to make up for revenue lost by eliminating most school district property taxes. Legal, accounting, audit, engineering, real estate brokering and real estate agency services would all become taxable services. Tickets to high school and college sports events would be taxed as amusement services. The additional revenue would be deposited to a new "school district reimbursement trust fund" outside the state treasury to be used by the Comptroller to reimburse school districts.

HB 89 – This bill would exempt disinfectant cleaning supplies, face masks, and disposable gloves from sales tax for a limited period of time.

HB 174 / HB 406 – These bills would exempt college textbooks from sales tax for a week around the beginning of each fall and spring semester.

HB 211 / SB 216 – These bills creates a new sales tax that applies to e-cigarette vapor products.

HB 321 / HB 388 / HB 490 / SB 148 – These bills would create a sales tax exemption for feminine hygiene products.

HB 322 / HB 387 – These bills would create a sales tax exemption for child and adult diapers.

SB 60 / HB 524 – These bills would exempt firearm safety supplies from sales tax.

SB 140 / HB 447 – These bills would legalize cannabis and subject it to sales tax at a rate of 10%. We have included these bills as examples, but there are many other cannabis legalization bills, some of which may also have state tax implications.

HB 592 – This bill would create a sales tax exemption for fees charged for animals adopted from animal rescue groups. Animal adoption fees imposed by nonprofit shelters are already exempt.

SB 153 – This bill would exclude certain payment processing services from the definition of "data processing service." This applies broadly to any "processing of payment made by credit card or debit card."

SB 200 – This bill would remove "internet access services" from the list of taxable services. Texas is already prohibited from collecting tax on internet access services effective July 1, 2020 due to the federal Internet Tax Freedom Act.

HB 940 – This bill would make beer sold on the Fourth of July exempt from sales tax.

SB 296 – This bill would require that resale and exemption certificate be provided to an auditor at or before the exit conference. Current law allows certificate to be submitted up until 60 days after written notice, which occurs after the audit concludes and the taxpayer petitions for redetermination.

Franchise Tax Bills

HB 209 – This bill provides a franchise tax credit for establishing a grocery store or healthy corner store in a food desert.

HB 361 – This bill creates a franchise tax credit for four weeks of paid family care leave. The credit is the lesser of twice the costs attributable to the leave or the total tax due after applying all other credits.

HB 864 – This bill creates a franchise tax credit pilot program for taxable entities that contribute to an employee dependent care flex spending account. The credit is limited to entities with 500 or fewer employees and applies only to accounts for employees earning $65,000 per year or less. The credit is equal to the lesser of 50% of the contributions or $2,500 per employee but is capped at the entities' franchise tax liability.

Other Important Pre-Filed Legislation

HB 70 / HJR 6 – These bills would require legislative approval of proposed agency rules with an anticipated economic impact greater than $20 million, as determined by the agency. HJR 6 proposed a constitutional amendment to authorize this.

HB 207 – This bill would increase the gasoline and diesel fuels tax rate from 20 to 22 cents/gallon and provide for future rate increases to be tied to inflation.

HB 339 – This bill makes a statewide "reapportionment" of the court of appeals districts. The introduced version doesn't appear to affect the Third Court of Appeals, which handles all appeals of Texas franchise tax and Texas sales tax protest and refund cases unless those cases are reassigned by the Texas Supreme Court. The Texas Supreme Court routinely transfers cases—including tax cases—to other courts of appeals to level the courts' workloads through "docket equalization transfers."

HB 645 / HRJ 36 – These bills require "the use of honest state taxation terminology" in legislation, rules, materials, publication, and electronic media. They define a "regulatory tax" broadly, then prohibits the government from referring to any tax as a "fee," "levy," "surcharge," "assessment," "fine," or "penalty."

SB 133 – This bill would facilitate adjusting dollar amounts in Texas tax statutes for inflation by creating biennial reports from the Comptroller to the Legislature detailing how tax collections would change by adjusting statutory figures for inflation.

HB 433 – This bill would create a new tax on the generation of electricity—except by natural gas—imposed on the electric generator at a rate of 1 cent per kilowatt hour.

HB 477 – This bill would legalize gambling in some coastal areas and impose a new "Casino Gaming Tax" equal to 18% of a casino's gross gaming revenue. Revenue would be partially earmarked to cover costs of catastrophic flooding in those coastal areas.

HB 647 / HJR 37 – These bills would allow local governments to legalize or prohibit the operation of "eight-liners" and impose a $350 annual fee on each machine. The tax revenue would be split with 30% allocated to the state general revenue fund and 70% allocated to the municipality (or the county for machines outside city limits).

SB 159 – This bill would extend the prohibition against using the Texas Open Records Act to obtain lists of taxpayers currently under audit for solicitation to 30 days after the Comptroller makes the information available to the requestor. Using this information for solicitation is currently only prohibited for 6 days after the Comptroller makes the information available.

Links:

Separate lists of all bills filed to date in each chamber are available here:

- House bills: https://capitol.texas.gov/Reports/Report.aspx?LegSess=87R&ID=housefiled
- Senate bills: https://capitol.texas.gov/Reports/Report.aspx?LegSess=87R&ID=senatefiled

II. Jurisdiction

Texas Supreme Court Rejects Pay-to-Play Requirement

The Texas Supreme Court held that a taxpayer may gain access to the Texas courts without first paying the tax assessment in full if it satisfies the appropriate jurisdictional requirements.[67] EBS Solutions was audited for franchise tax and received an assessment of tax, penalties, and interest for four year of almost $300,000.[68]

EBS was unable to pay the full assessment. Generally, a taxpayer must pay the entire amount of tax, penalties, and interest assessed "under protest" in order to gain access to the courts.[69] For taxpayers with large assessments and limited funds, this has effectively barred access to a neutral judge, forcing the taxpayers to challenge their assessments in the administrative forum, where the Comptroller alone decides whether or not his assessment is correct.

The Legislature provided an exception to the prepayment to requirement based on inability to pay:

1. [a]fter filing an oath of inability to pay the tax, penalties, and interest due, a party may be excused from the requirement of prepayment of tax as a prerequisite to appeal if the court, after notice and hearing, finds that such prepayment would constitute an unreasonable restraint on the party's right of access to the courts. The court may grant such relief as may be reasonably required by the circumstances.[70]

EBS payed $150,000 and filed an oath of inability to pay for the remainder. EBS also filed a statement of grounds with the Texas Attorney General for seeking an injunction prohibiting the Comptroller from collecting the remainder of the assessment.[71] The Comptroller argued that the statute has been declared unconstitutional and, therefore, partial prepayment of taxes owed is insufficient to give a court jurisdiction over the taxpayer's suit.[72] The Texas Supreme Court found that the inability-to-pay exception quoted above made the statute constitutional, because it protects a party's right of open access to the courts even if that party cannot prepay the entire assessment.[73] The Court rejected the Comptroller's pleas that allowing EBS' suit to proceed would open the floodgates to taxpayers abusing the inability-to-pay exception.[74]

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67 *EBS Solutions, Inc. v. Hegar*, No. 18-0503 (Tex. May 8, 2020).

68 Slip op. at 2.

69 Tex. Tax Code § 112.052(a).

70 Tex. Tax Code § 112.108.

71 Slip op. at 2–3.

72 *EBS Solutions, Inc. v. Hegar,* No. 18-0503, slip op. at 1 (Tex. May 8, 2020).

73 Slip op. at 25.

74 Slip op. at 28–29.

Recent Wins and Losses for Taxpayers on Jurisdiction

Declaratory Relief Claims Allowed in Tax Protest Suit. The jurisdictional tide may be turning in Texas. Prior to May 9, 2019, Texas taxpayers were generally barred from pursuing claims for "declaratory relief" in tax protest and tax refund suits. As a result, taxpayers were unable to seek attorney's fees otherwise available for declaratory claims. In general, a claim for "declaratory relief" asks the court to determine the litigating parties' rights under a statute or rule. In a tax suit, a claim for "declaratory relief" would seek the court's ruling construing tax statutes and rules for the future.

Historically, courts have barred taxpayers from raising claims for "declaratory relief," reasoning that a court's judgment awarding recovery of the overpaid taxes implicitly provides the future guidance that taxpayers seek. As a result, the courts considered the claims for "declaratory relief" to be unnecessary and redundant.

However, times have changed. The Texas Comptroller no longer treats a court decision or judgment ordering the refund of taxes as providing any guidance on how the tax laws apply in the future. In *CSG Forte Payments, Inc. v. Hegar*, the Comptroller refuses to apply the decision in *Hegar v. CheckFree Services Corporation* as judicial precedent to Forte, a similarly-situated provider of electronic payment services.[75] In *Pointsmith Point-of-Purchase Management Services, LP v. Hegar*, the Comptroller went even further.[76] There, the Comptroller refused to apply the state court judgment rendered in favor of Pointsmith for one audit period to resolve the same tax issue arising in Pointsmith's subsequent audit period. So, Pointsmith was forced to file yet another lawsuit on the exact same issue. According to the Comptroller, a Texas judgment does not provide prospective guidance to any taxpayer, including the taxpayer to whom the judgment is issued.

In light of this change in the Comptroller's position, on May 10, 2019, a state district court issued its order in *CSG Forte Payments, Inc.* denying the Comptroller's challenge to Forte's right to pursue claims for declaratory relief. Specifically, the court's order allows Forte to proceed with its claims for declaratory relief under the Administrative Procedure Act, Uniform Declaratory Judgments Act (UDJA), and the *ultra vires* doctrine. The Third Court of Appeals reversed the district court and dismissed Forte's UDJA and *ultra vires* claims on December 9, 2020.[77]

Attorney's Fees Are a Two-Way Street. The Court of Appeals recently upheld a trial court's award of attorney fees to a state agency in a UDJA case. Two licensed deer breeders brought suit against the Texas Parks and Wildlife Department seeking declarations that certain department rules involving captive deer were unconstitutional. The breeder also sued department officials, alleging that they acted *ultra vires* (i.e., without authority) by adopting the rules. Texas law provides that, "[i]n any proceeding under [the UDJA], the court may award costs and reasonable and necessary attorneys

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75 *See* No. D-1-GN-18-006671 (345th Dist. Ct., Travis County, Tex. filed Nov. 2, 2018).

76 *See* No. D-1-GN-18-007023 (345th Dist. Ct., Travis County, Tex. filed Nov. 26, 2018).

77 03-19-00325-CV (Tex. App.—Austin 2020, no pet. h.).

fees as are equitable and just."[78] Although the Appeals Court agreed that the trial court lacked jurisdiction over the breeders' UDJA claims, it found the trial court still had jurisdiction to award attorney's fees.[79]

This case presents a cautionary tale for taxpayers seeking to pursue UDJA claims against the Comptroller. Although the UDJA may be appropriate for particularly meritorious claims involving bad faith by the Comptroller, raising the claim likely turns the case into a "proceeding under the

Judicial Review of Penalties & Interest Waiver. A Texas court ruled that the courts have jurisdiction to review the Comptroller's discretionary authority to waive all or part of the tax, penalty, or interest found due.[80]

J.D. Fields & Company is a pipe and piling distributer headquartered in Houston. The Comptroller initially audited J.D. Fields for sales tax compliance for reporting periods between April 2005 and May 2008. At the conclusion of that audit, the Comptroller found that J.D. Fields was incorrectly collecting local sales tax based on the location where pipes were delivered rather than where the sale took place.[81] At the conclusion of that audit, according to J.D. Fields, the auditor told the taxpayer that it was not necessary to begin collecting tax based on the location of the sale. When J.D. Fields' CFO asked the auditor if the company could wait until January 1, 2009 to begin collecting tax correctly, the auditor allegedly said "I think that will be fine."[82]

In 2012, the Comptroller audited J.D. Fields again, and assessed tax for June 2008 through December 2008 (among other periods) based on J.D. Fields' improper local tax collection. J.D. Fields requested relief from the assessment on the ground that it relied on the auditor's statement to the CFO that J.D. Field could correct the practice beginning January 1, 2009. The Comptroller's rules provide that "The [C]omptroller will give relief to a taxpayer who follows erroneous advice given to a taxpayer by an agency employee."[83] The Comptroller argued that his discretion in providing relief was absolute, based entirely on equitable discretionary considerations, and that a taxpayer could not even raise the issue in a suit challenging a tax assessment.[84] The court rejected this argument, stating:

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78 Tex. Civ. Prac. & Rem. Code § 37.009

79 *Bailey v. Smith*, Cause No. 03-17-00703-CV (Tex. App.—Austin 2019, pet. denied) (pending motion for rehearing at the Texas Supreme Court, No. 19-0695).

80 *Hegar v. J.D. Fields & Company, Inc.*, No. 03-19-00351-CV (Tex. App.—Austin Apr. 15, 2020, pet. filed).

81 Slip op. at 1–2.

82 Slip op. at 2.

83 Comptroller Rule 3.10(c). See also Comptroller Rule 3.5(b)(3)(K) (identifying "reliance on advice provided by the [C]omptroller's office" as a factor for penalty and interest waiver).

84 *Hegar v. J.D. Fields & Company, Inc.*, No. 03-19-00351-CV, slip op. at 2–3 (Tex. App.—Austin Apr. 15, 2020, pet. filed).

> That the Comptroller's rules require it to take certain equitable considerations into account when deciding claims for relief does not affect the Comptroller's obligation to follow those rules when deciding claims.[85]

The court followed with "[w]e do not agree that the Comptroller's discretion is absolute."[86] The court noted that the statute allowing the Comptroller to waive penalties and interest provided "a specific and objective standard to govern the Comptroller's exercise of judgment" because the statute provides for waiver if a taxpayer "exercised reasonable diligence to comply with" the tax laws.[87]

The Comptroller has appealed the decision to the Texas Supreme Court.

Franchise Tax Estimated Payments Made by ETF Must Be Made Under Protest. The Court of Appeals recently found that a taxpayer lacked jurisdiction to bring its Texas franchise tax protest suit when the taxpayer, an Electronic Funds Transfer (EFT) filer, did not make a proper protest payment along with its original extension request.

Franchise tax reports are generally due May 16 of each year. Taxpayers are granted extensions if they timely request the extension and make remit an estimate of their tax liability with the extension request. Under Texas law, certain taxpayers are permitted to wait and file their protest letters on the extended deadline. Other taxpayers must file a protest letter with the original payment and extension request, or they are treated as not having made the payment under protest. Reading convoluted Texas statutes, the court found that all taxpayers required to make payments via EFT must file their protest letters with their original payments or lose the critical procedural advantages that taxpayers enjoy when contesting tax issues after having properly made protest payments.[88]

The consequence of having a payment not treated as a protest payment can be dire. Before they can go to court, the taxpayer is forced to pursue their tax controversy through a lengthy administrative refund process during which the Comptroller almost invariably finds in his own favor. Further, the Comptroller has unilateral authority to delay the process indefinitely. Only after the Comptroller finally allows the taxpayer to exit the administrative process can the taxpayer bring its claim in court.

Quoting Refund Statute Insufficient to Maintain Jurisdiction. A two-justice majority of the El Paso Court of Appeals sided with the Comptroller and dismissed El Paso Electric Company's sales tax refund suit for failing to adequately raise its legal arguments at the administrative level. El Paso Electric Company is a fully integrated public utility in the business of manufacturing, generating, transmitting and distributing electricity in west Texas and southern New Mexico.[89] El Paso Electric filed an administrative sales tax refund claim for a variety of different types of equipment under a

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85 Slip op. at 5.

86 Slip op. at 6.

87 Tex. Tax Code § 111.103(a).

88 *Hegar v. 1st Global, Inc.*, No. 03-18-00411-CV (Tex. App.—Austin Dec. 13, 2019, no pet.) (mem. op.).

89 *Hegar v. El Paso Electric Company*, No. 03-18-00790-CV (Tex. App.—Austin Aug. 13, 2020, no pet. h.) (majority opinion).

variety of sales tax exemptions. Of the $5.1 million total refund El Paso sought, the Comptroller agreed to refund over $2.5 million.

The Comptroller would not agree to refund sales tax El Paso allegedly paid in error on the purchase of meters and disconnect collars that El Paso believed were exempt because they were "telemetry units related to step-down transformers," a specific type of exempt manufacturing equipment.[90] After the Comptroller denied El Paso's administrative refund claim, El Paso filed a district court lawsuit.[91] The Comptroller moved to dismiss the district court suit, arguing that the statement of grounds filed in El Paso's earlier administrative refund claim failed to adequately put the Comptroller "on notice" of El Paso's claim for telemetry units related to step-down transformers.[92]

El Paso's original administrative filing identified the refund claim by citing and quoting in full the subsection of the manufacturing exemption statute that contains a long list of exempt support equipment:[93]

> (4) actuators, steam production equipment and its fuel, in-process flow through tanks, cooling towers, generators, heat exchangers, transformers and the switches, breakers, capacitor banks, regulators, relays, reclosers, fuses, interruptors, reactors, arrestors, resistors, insulators, instrument transformers, and telemetry units that are related to the transformers, electronic control room equipment, computerized control units, pumps, compressors, and hydraulic units, that are used to power, supply, support, or control equipment that qualifies for exemption under Subdivision (2) or (5) or to generate electricity, chilled water, or steam for ultimate sale; transformers located at an electric generating facility that increase the voltage of electricity generated for ultimate sale, the electrical cable that carries the electricity from the electric generating equipment to the step-up transformers, and the switches, breakers, capacitor banks, regulators, relays, reclosers, fuses, interruptors, reactors, arrestors, resistors, insulators, instrument transformers, and telemetry units that are related to the step-up transformers; and transformers that decrease the voltage of electricity generated for ultimate sale and the switches, breakers, capacitor banks, regulators, relays, reclosers, fuses, interruptors, reactors, arrestors, resistors, insulators, instrument transformers, and telemetry units that are related to the step-down transformers.

El Paso also cited and quoted in full other subsections of the manufacturing exemption statute and various other provisions of the tax code. The majority held that "one its own, quoting every word of all of those subsections did not suffice to put the Comptroller on notice of the legal basis of a refund claim for telemetry units related to step-down transformers."[94]

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90 Tex. Tax Code § 151.318(a)(4).

91 *Hegar v. El Paso Electric Company*, slip op. at 2.

92 Slip op. at 7; see also Tex. Tax Code § 111.104 (requiring refund claim to (1) "be written"; (2) "state fully and in detail each reason or ground on which the claim is founded"; and (3) be filed before the expiration of the statute of limitations).

93 Slip op. at 9.

94 Slip op. at 11.

The third member of the three-justice panel issued a dissenting opinion.[95] She would have found that schedules El Paso submitted with its original statement of grounds sufficed to identify the equipment and put the Comptroller on notice of the exemption for telemetry units related to step-down transformers. These schedules "identif[ied] specific transactions involving "meters" by line items that included detailed information about the particular transaction including dates, invoice numbers, and amounts and specifically refer[red] to manufacturing exemption . . ."[96] Amicus briefs and letters have been filed by several groups, including the Texas Taxpayers and Research Association, the Texas Association of Manufacturers, and Martens, Todd & Leonard. These amicus briefs and letters ask the Third Court to re-hear the case en banc or to adopt the dissenting opinion in favor of the taxpayer.

A Taxpayer May Not Raise Entirely New Grounds After the Statute of Limitations Runs. Mahindra USA is a distributor of farm tractors and accessories. The Comptroller audited Mahindra for franchise tax report years 2008–2011 and assessed additional taxes, penalties and interest. Mahindra timely filed a petition for administrative redetermination, objecting to the audit finding with respect to its tax rate and its cost of goods sold subtraction.[97] On December 19, 2016, Mahindra submitted additional arguments, raising for the first time an issue with respect to its apportionment of sales to Texas.[98] The Comptroller issued his decision affirming his initial determination as to the tax rate and cost of goods sold issues.[99]

The Comptroller found that the apportionment issue could not be part of its administrative redetermination because they were first raised more than four years after the tax periods at issue, beyond the statute of limitations.[100]

Mahindra was dissatisfied with the result of the Comptroller's administrative proceeding, so it brough a district court protest suit challenging the assessment by raising the tax rate, cost of goods sold, and apportionment issues.[101] Mahindra argued that the district court had jurisdiction over its apportionment issue, because it was raised an contested during the pendency of the administrative redetermination proceeding.[102] Tex. Tax Code § 111.207 provides:

> (a) In determining the expiration date for a period when a tax imposed by this title may be assessed, collected, or refunded, the following periods are not considered:
> . . .

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95 *Hegar v. El Paso Electric Company*, No. 03-18-00790-CV, (Tex. App.—Austin Aug. 13, 2020, no pet. h.) (Goodwin, J., dissenting)) (pending motion for rehearing before the Third Court of Appeals).

96 Slip op. at 4–5 (Goodwin, J., dissenting).

97 *Hegar v. Mahindra USA, Inc.*, No. 03-18-00126-CV, Slip op. at 6 (Tex. App.—Austin Feb. 28, 2020,

98 Slip op. at 6–7.

99 Slip op. at 7.

100 Slip op. at 7.

101 Slip op. at 8.

102 Slip op. at 10; Tex. Tax Code § 111.207(a)(3).

> (3) The period during which an administrative redetermination or refund hearing is pending before the comptroller.
>
> . . .
>
> (b) The suspension of a period of limitation under Subsection [(a)(3)] is limited to the issues that were contested under those subdivisions.

The court determined it lacked jurisdiction over the apportionment issue because the taxpayer had not timely raised it in an administrative proceeding, either as an offset to its assessment or as a separate refund claim, before the four year statute of limitations expired.[103] The court rejected Mahindra's argument that the Comptroller opens a "two-way door" to the re-evaluation of any issues relating to its tax payments for the years at issue.[104]

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103 Slip op. at 11–17.

104 Slip op. at 16.

III. Interest Rates

Comptroller Publishes 2021 Interest Rates

Texas is in a minority of state which provide for different interest rates on tax delinquencies and overpayments.[105] The Texas Comptroller published 2021 interest rates for interest taxpayers owe on overdue payments and interest due to taxpayers for credits and refunds of tax paid in error.[106] The interest rate for overdue tax payments decreased from 5.75% in 2020 to 4.25% in 2021. The interest rate for credits or refunds decreased from 2.181% in 2020 to 0.511% in 2021.

105 Jan. 7, 2021 Texas Taxpayers and Research Association Webcast.

106 Interest Owed and Earned, TEXAS COMPTROLLER, https://comptroller.texas.gov/taxes/file-pay/interest.php (last visited Jan. 13, 2021).