



Texas Taxes Quarterly Update

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Introduction

These materials cover critical recent and ongoing developments in Texas sales tax, Texas franchise tax, tax administration, jurisdiction, and procedure during the third quarter of 2021. They include recent developments in Texas tax cases, the Comptroller's recent rule amendments, legislation proposed during the 2021 special sessions, and 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 upcoming 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	Registration Links
Third Quarter 2021	Oct. 14, 2021	Click Here to Register
Fourth Quarter 2021	Jan. 13, 2022	Click Here to Register

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

I. Franchise Tax

Cost of Goods Sold (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.¹ 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.²

To claim the cost of goods sold subtraction, a taxable entity must sell "goods," which are real or tangible personal property.³ 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,

¹ *Hegar v. Sirius XM Radio, Inc.*, Cause No. 03-18-00573-CV (Tex. App.—Austin, May 1, 2020, pet. granted) (Texas Supreme Court granted review, No. 20-0462). 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.

² Sirius also paid a share of revenue to these manufacturers. Slip op. at 6.

³ Tex. Tax Code § 171.1012(a)(1).

felt, or touched or that is perceptible to the senses in any other manner.”⁴ 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.”⁵ 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.⁶

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.⁷ 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.”⁸ 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.⁹ The Court reasoned that, just like AMC’s theatergoers, Sirius’ customers did not transfer property with a physical or demonstrable form to its customers, but merely provided them temporary access to creative content.¹⁰ Amicus curiae briefs were submitted by Tax Executives Institute (TEI), Texas Taxpayers and Research Association (TTARA), and Council on State Taxation (COST). The Supreme Court requested briefing on the merits.

The Texas Supreme Court has granted review, indicating it will evaluate whether the intermediate appellate court’s decision was correct. Oral argument is scheduled for November 30, 2021.

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.

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.¹¹

⁴ Tex. Tax Code § 171.1012(a)(3)(A)(i).

⁵ Tex. Tax Code § 171.1012(a)(3)(A)(ii).

⁶ Tex. Tax Code § 171.1012(c).

⁷ Slip op. at 18–19.

⁸ *Sirius XM* slip op. at 19 (citing *Hegar v. American Multi-Cinema, Inc.*, No. 17-0464 (Tex. 2020)).

⁹ Appellant’s Supplemental Brief at 1, *Sirius XM Radio, Inc.*, Cause No. 03-18-00573-CV (Tex. App.—Austin, May 1, 2020, pet. granted) (Texas Supreme Court granted review, No. 20-0462).

¹⁰ Slip op. at 20.

¹¹ Tex. Tax Code §171.1121(a).

Like the Comptroller's nexus rule, the Comptroller's apportionment 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:¹²

- 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. 115.¹³

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.¹⁴

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 adopted 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 Hearing¹⁵ and was recently employed by the Third Court of Appeals in *Hegar v. Sirius XM Radio, Inc.*¹⁶ The Comptroller intends to apply the adopted rule retroactively except for a few provisions which he concedes are changes in policy.

¹² 34 Tex. Admin. Code § 3.591(b)(4).

¹³ Tex. Tax Code §171.106(f-1) (as amended by HB 4611, 81st Reg. Sess. 2009).

¹⁴ Tax Policy News, Texas Comptroller (June 2009).

¹⁵ Comptroller Hearing 10,028 (1980).

¹⁶ *Hegar v. Sirius XM Radio, Inc.*, Cause No. 03-18-00573-CV (Tex. App.—Austin, May 1, 2020, pet. granted) (Texas Supreme Court granted review, No. 20-0462).

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.”¹⁷

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.”¹⁸ 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.”¹⁹

¹⁷ 45 Tex. Reg. 8104, 8107.

¹⁸ 34 Tex. Admin. Code § 3.591(e)(26)(A).

¹⁹ 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.”²⁰ 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.²¹

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.

Because the Comptroller’s apportionment rule relies on the “receipts-producing, end-product act” test endorsed by the appellate court, the Texas Supreme Court’s upcoming review of *Hegar v. Sirius XM Radio, Inc.*²² may impact the Comptroller’s apportionment rules. If the Texas Supreme Court doesn’t rely on the “receipts-producing, end-product act” test, the Comptroller may be forced to revise his recently-adopted apportionment rule, which expressly applies that test for services not covered by specific subsections of the rule.²³

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 2021.²⁴ 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.

²⁰ 34 Tex. Admin. Code § 3.591(e)(26)(A).

²¹ 34 Tex. Admin. Code § 3.591(e)(26)(A)(i).

²² *Hegar v. Sirius XM Radio, Inc.*, Cause No. 03-18-00573-CV (Tex. App.—Austin, May 1, 2020, pet. granted) (Texas Supreme Court granted review, No. 20-0462).

²³ 34 Tex. Admin. Code § 3.591(e)(26)(A).

²⁴ 34 Tex. Admin. Code § 3.591(e)(2)(A), (C).

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) *Compensated 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.²⁵ 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.²⁶

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.	Rule 3.591(e)(3)

²⁵ 34 Tex. Admin. Code § 3.591(e)(33).

²⁶ 34 Tex. Admin. Code § 3.591(e)(1), (25).

	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.	
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 the gross proceeds 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.²⁷

A similar issue is pending before the Travis County District Court in *Equistar Chemicals, LP v. Hegar*.²⁸ 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.²⁹

Equistar’s district court case has been stayed pending a final appellate decision in *CITGO Petroleum Corporation v. Hegar*. In that case, CITGO Petroleum Corporation seeks to recover a portion of the Texas franchise tax is paid on its report year 2008 and 2009 franchise tax reports. CITGO Petroleum Corporation refines crude oil and sells gasoline, diesel fuel, jet fuel, lubricants, petrochemicals, and other petroleum-based industrial products. Its affiliate, CITGO Trading Company, L.P. bought and sold commodity futures contracts and options on commodity futures contracts to mitigate the risks associated with potential price fluctuations in CITGO Petroleum Corporation’s inventory and the crude oil it refines to produce its inventory. CITGO Trading elected mark-to-market treatment under IRS § 475 which resulted in the sale of its securities receiving the same federal tax treatment as the sale of securities inventory. The Travis County District Court rendered a judgment against CITGO and CITGO has appealed to the Third Court of Appeals.³⁰ The Third Court of Appeals denied oral argument and set the case for submission on briefs.

²⁷ Comptroller Hearing Nos. 114,432; 114,433; 114,434; 114,435 (Aug. 15, 2019).

²⁸ D-1-GN-18-004006 (126th Dist. Ct., Travis County, filed Aug. 2, 2018).

²⁹ 34 Tex. Admin. Code § 3.591(e)(25).

³⁰ *Citgo Petroleum Corporation v. Hegar*, No. 03-21-00011-CV (Tex. App.—Austin filed Jan. 11, 2021).

Similar issues involving the apportionment of gains from the sale of securities that were treated as inventory for federal tax purposes have been raised in *Conagra Brands, Inc. v. Hegar*.³¹ Similar to *CITGO*, this case also involves using commodity hedges, some of which are agricultural and some of which are for crude oil which is a component of Conagra's plastic packaging.

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 produced its subscription content.³² 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.³³ 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.³⁴

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."³⁵ The Third Court observed Texas case law precedent, which found that a service is performed "where the act is done" to perform the service.³⁶ The Third Court accepted the Comptroller's position that the focus is on Sirius XM's "receipt-producing, end-product act."³⁷ The Third Court deferred to the Comptroller's interpretation of the franchise tax statute and applied the

³¹ *Conagra Brands, Inc. v. Hegar*, No. 03-21-00111-CV (Tex. App.—Austin, filed Mar. 9, 2021).

³² *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.

³³ *Hegar v. Sirius XM Radio, Inc.*, Cause No. 03-18-00573-CV (Tex. App.—Austin, May 1, 2020, pet. filed) (pending before the Texas Supreme Court, No. 20-0462).

³⁴ Tex. Tax Code § 171.103(a)(2).

³⁵ Slip op. at 5.

³⁶ Slip op. at 9 (quoting *Humble Oil & Refining Co. v. Calvert*, 414 S.W.2d 172, 180 (Tex. 1967) (embedded quotation and citation omitted)).

³⁷ Slip op. at 10.

“end-product act” analysis to source the receipt based upon the locations where the satellite radio signals were received, unscrambled, and played through the speakers in customers’ vehicles.³⁸

Amicus curiae briefs have been submitted by Tax Executives Institute (TEI), Texas Taxpayers and Research Association (TTARA), and Council on State Taxation (COST). The Texas Supreme Court has granted review, indicating it will evaluate whether the intermediate appellate court’s decision was correct. Oral argument is scheduled for November 30, 2021.

Rate

Finance Leases May Qualify for Lower Franchise Tax Rate. A Texas appeals court recently held that Xerox Corporation was entitled to compute its franchise tax based upon the lower Texas franchise tax rate, which resulted in a refund of half of the Texas franchise tax Xerox had paid during the relevant periods.³⁹

Xerox leases printers long-term to businesses under financing lease agreements. Xerox’s finance leases provide that its customers:

- Receive possession, but not title, to the equipment;
- Were responsible for insuring the equipment against loss;
- Were required to make all payments under the lease, even if the contract was terminated; and
- Could purchase the equipment at the end of the lease but typically did not because the lease was designed to last for the useful life of the equipment.

Wholesale Sales Qualify for Lower Texas Franchise Tax Rate. Generally, taxpayers pay Texas franchise tax at the rate of 0.75%.⁴⁰ Retailers and wholesalers (collectively hereinafter “Retailers”) pay Texas franchise tax at half that rate, or 0.375%.⁴¹ Retailers may qualify for the reduced Texas franchise tax rate when they derive more than half of their revenues from sales at retail or wholesale. Products sold under installment contracts qualify as retail sales, just like cash sales. Products leased or rented, however, are generally not treated as retail sales.

Despite Being Called “Leases,” Finance Leases Are Really Sales. Certain businesses, like Xerox, offer deferred payment plans that function like installment contracts, but are labeled as “finance” leases. In the Xerox case, the appellate court found that Xerox’s finance leases were more like sales than traditional leases because:

- The lease term was at least 75% of the useful life of the equipment;
- The present value of the lease payments was at least 90% of the fair value of the equipment; and
- The customer was required to make the lease payments, even if the contract was cancelled.

³⁸ Slip op. at 12–14.

³⁹ *Xerox Corporation v. Hegar*, 14-19-00358-CV (Tex. App.—Houston [14th Dist.], Aug. 31, 2021, no pet. h.).

⁴⁰ Tex. Tax Code § 171.002(a).

⁴¹ Tex. Tax Code § 171.002(b).

In other words, the leases were structured such that Xerox's customers had to pay for the equipment throughout its entire useful life (which would be the same as if Xerox had sold the equipment to the customer to be paid in installments). As a result, Xerox was entitled to the lower Texas franchise tax rate and a refund of half of the franchise tax it had paid during the affected report years.

While the Xerox decision reflects current law, the Comptroller has signaled he plans to ask the Texas Supreme Court to review the case by filing a motion with the Fourteenth Court of Appeals to reconsider its decision. In the meantime, taxpayers in similar circumstances may wish to consult with their tax advisors to determine whether to file protective refund claims while the final appeal of *Xerox Corporation v. Hegar* is pending. Furthermore, since the Xerox case treats certain financing leases as sales, taxpayers might consider claiming the cost-of-goods-sold (COGS) subtraction from revenue related to goods or equipment leased in a similar manner when determining taxable margin for Texas franchise tax purposes. In similar contexts, the Comptroller has endorsed using the same guidelines for both rate and COGS determinations.⁴²

Research & Development Credit

Research & Development Franchise Tax Credit and Sales Tax Exemption. Texas' laws designed to encourage research and development conducted in Texas allow a person engaged in qualified research to claim either (a) a sales tax exemption on the purchase, lease, rental, storage, or use of depreciable tangible personal property directly used in qualified research or (b) a franchise tax credit based on qualified research expenses.

On April 16, 2021, the Texas Comptroller proposed amendments to his research and development rules for both the sales tax exemption and the franchise tax credit.⁴³

The proposed amendments adopt a federal four-part test for research activities to constitute qualified research. The proposed rule describes the four parts of the test:

- (a) The IRC Section 174 Test;
- (b) The Discovering Technological Information Test;
- (c) The Business Component Test; and
- (d) The Process of Experimentation Test.

The proposed amendments clarify that federal regulations adopted after December 31, 2011 only apply if they require a taxpayer to apply that regulation to the 2011 federal income tax year. The amendments provide that each member of a combined group calculates its credit separately, and then the credits are aggregated on the combined report. It requires taxpayers to provide their entitlement to the credit by clear and convincing evidence supported by contemporaneous records.

⁴² See Comptroller Amendments to Rule 3.584 (proposed at 44 Tex. Reg. 3081, adopted at 44 Tex. Reg. 4741) (noting that the Comptroller adopted franchise tax rate and COGS provisions in the same legislative act and therefore "the [C]omptroller interprets these sections in the same manner").

⁴³ 46 Tex. Reg. 2565.

It also provides that the Comptroller may audit records outside the statute of limitations in order to verify that a credit was properly claimed in order for the taxpayer to claim a credit carryforward. The rule provides that items for which the taxpayer claimed another exemption, such as the manufacturing exemption, are not eligible to be included in the definition of in-house research expenses.

The Comptroller simultaneously proposed amendments to the parallel Texas sales tax exemption. These also contain the federal four-part test and limit post-2011 regulations to those which apply to the 2011 federal income tax year. The amendments clarify that property must be subject to depreciation in order to qualify, but the taxpayer need not actually depreciate the property.⁴⁴

⁴⁴ 46 Tex. Reg. 2555.

II. Sales Tax

Local Sales Tax Rule Revised

The Texas Comptroller has changed his local tax rule to undermine economic development agreements.⁴⁵ 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."⁴⁶

⁴⁵ 34 Tex. Admin. Code § 3.334.

⁴⁶ 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 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 Texas Legislature's 2021 regular session.⁴⁷ Although several bills were filed proposing various local tax rules, none passed during the regular session.

The Dallas Morning News Editorial Board then published its own article calling Comptroller Hegar's approach "an overreach of his authority" and noting that it stands to harm business-friendly cities that are home to online sellers.⁴⁸ The article notes that cities invest heavily in things like wider roads for trucks or upgraded fire department equipment for warehouses and count on increased sales tax revenue to pay for it.

Just before the rules were set to go into effect, several cities with these seller facilities sued the Comptroller to protect their local tax revenues.⁴⁹ These cities challenged the rule amendments under the Administrative Procedure Act, claiming the rule amendments are facially invalid, conflict with Texas law and deny them the local taxes they are legally entitled to receive.

On August 31, 2021, the parties to this litigation announced an agreement to delay implementation of the new sourcing provision, and the Travis County District Court issued an injunction prohibiting the Comptroller from enforcing Rule 3.334(b)(5) until a final hearing on the merits or further orders from the court. Trial is set for the week of June 13, 2022.

The Texas courts will likely have to decide if the rule exceeds the Comptroller's authority. In the meantime, these online shoppers' purchases will continue to be sourced to the business location of the seller.

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

⁴⁸ Dallas Morning News Editorial Board, *Stop Glenn Hegar's Sales Tax Switcheroo*, DALLAS MORNING NEWS, Aug. 22, 2021, available at <https://www.dallasnews.com/opinion/editorials/2021/08/22/stop-glenn-hegars-sales-tax-switcheroo/>.

⁴⁹ *City of Coppell et al. v. Hegar*, No. D-1-GN-21-003198 (Travis County Dist. Ct., filed July 12, 2021); *City of Round Rock v. Hegar*, No. D-1-GN-21-003203 (Travis County Dist. Ct., filed July 12, 2021).

Surveying

Surveying services are one type of “real property service,” which is listed as a taxable service under Texas law.⁵⁰ In general, surveying services are only taxable if they relate to the boundary lines for real property.

Proposed New Comptroller Rule 3.276. On September 24, 2021, the Comptroller proposed a new Comptroller Rule 3.276 covering the Texas sales and use tax treatment of surveying services.⁵¹

According to the Comptroller, the proposed adoption this new rule “memorialize[s] existing comptroller policy,” implements 2007 legislation, and defines used terms in the Texas Tax Code.⁵²

The Comptroller’s prior rules for surveying services were in Rule 3.356, the Comptroller’s rule for the broader category of “real property services.” The Comptroller intends for the two rules to be consistent, but to the extent the rules differ, the Comptroller intends for taxpayers to follow new Rule 3.276.

The Comptroller proposes the following definition of surveying: “An activity performed on land, from the air, under water or remotely that uses relevant elements of law, research, measurement analysis, computation, mapping and land description to determine or confirm the boundaries of real property or to determine or confirm the location of an improvement in relation to the boundaries of real property.”⁵³ Professional surveying subject to regulation under Texas Occupations Code Chapter 1071 (Land Surveyors) is presumed to be a surveying service.

Subsection (b) identifies taxable types of surveying and provides the following examples (generally related to real property boundary lines):

- as-built survey
- boundary survey
- easement survey
- land title survey
- right-of-way survey
- subdivision plat
- title survey
- staking and placement services⁵⁴

⁵⁰ Tex. Tax Code §§ 151.0101, 151.0048.

⁵¹ 34 Tex. Admin. Code § 3.276 (proposed new rule in 46 Tex. Reg. 6377).

⁵² Tex. Tax Code § 151.0048 (real property service).

⁵³ 34 Tex. Admin. Code § 3.276(a)(5).

⁵⁴ 34 Tex. Admin. Code § 3.276(b).

Subsection (c) provides the following examples of nontaxable surveying services (generally unrelated to boundary lines):

- as-built verification survey
- construction survey
- design survey
- existing O&G well ties survey
- geodetic/control survey
- hydrographic survey
- monitoring deformation survey
- O&G drilling unit, proration unit, and pooled unit plats
- seismic survey
- topographic survey
- tree survey
- building elevation survey
- archaeological or historic significance survey
- staking and placement services⁵⁵

The Comptroller's rule excludes surveying services if (1) a contractor purchases the service as part of constructing new improvements to residential real property or (2) a landman performs them to negotiate an O&G lease.⁵⁶

Surveyors have various responsibilities, including obtaining permits, collecting and remitting sales tax, and obtaining documentation from contractors and landmen claiming the exclusions in subsection (d).⁵⁷ The rule provides guidelines for surveyors issuing and receiving resale and exemption certificates.⁵⁸

The Comptroller also provides guidance for unrelated services (e.g., applying the 5% rule when unrelated nontaxable services and taxable surveying services are purchased for a single charge).⁵⁹

Accounting Methods & Bad Debts

Proposed Amendments to Comptroller Rule 3.302. On September 24, 2021, the Comptroller proposed amendments to Comptroller Rule 3.302 covering sales tax accounting methods, credit sales, bad debts, and related topics.

Per the Comptroller, the proposed amendments to Rule 3.302 incorporate longstanding agency policy on bad debts, revise agency requirements for taking credits on sales tax reports and requesting refunds, and define key terms left undefined by the Texas Tax Code. The Comptroller has extensively reorganized the rule, added new headings to existing sections, and moved many of the

⁵⁵ 34 Tex. Admin. Code § 3.276(c).

⁵⁶ 34 Tex. Admin. Code § 3.276(d).

⁵⁷ 34 Tex. Admin. Code § 3.276(e).

⁵⁸ 34 Tex. Admin. Code § 3.276(f).

⁵⁹ 34 Tex. Admin. Code § 3.276(g).

existing provisions to new subsections within the rule. The Comptroller has also made many minor non-substantive changes.

A retailer must obtain prior written approval to report its sales and use tax using an accounting method that is not a generally recognized accounting system (except for rentals and leases, for which Comptroller Rule 3.294 applies instead).⁶⁰

Retailers whose regular books are kept on an accrual basis may elect to use the cash basis for sales and use tax reporting.⁶¹ Only a retailer, private label credit provider, or assignee or affiliate of either may claim a credit or refund for sales tax paid on a bad debt or unpaid portion of the sales price of a taxable item repossessed under a conditional sales contract.⁶² Only one person is entitled to a credit or refund for sales tax paid on bad debt or repossession.⁶³

The Comptroller provides the following guidance for calculating the amount of a bad debt or unpaid portion of a sales price for a repossessed item:

- The amount is the sales price of the taxable item less all payments and recoveries, including those applied to interest, fees, and other expenses relating to the sales price, and including proceeds from selling the debt to a third party.
- The sales price does not include nontaxable separately stated charges such as finance, carrying, insurance, or service charges, interest from credit extended on sales of taxable items under a conditional sales contract or other contract providing for the deferred payment of the sales price.
- For a worthless account that includes charges for taxable and nontaxable items, payments on the account are applied to the charges occurring first in time and prorated between taxable and nontaxable charges occurring at the same time.⁶⁴

A claim for a credit or refund must be submitted within four years of the date the bad debt is charged off for federal income tax purposes or the date the item is repossessed.⁶⁵ If the seller claims the sales tax credit or refund for a bad debt, but later collects on the account, the creditor must report the total amount collected as a taxable sale in the reporting period when collection occurs.⁶⁶

The Comptroller provide these rules for claiming credits or refunds depending on whether or not the person holds a Texas Sales and Use Tax Permit:

⁶⁰ 34 Tex. Admin. Code § 3.302(b).

⁶¹ 34 Tex. Admin. Code § 3.302(c)(2)(D).

⁶² 34 Tex. Admin. Code § 3.302(d)(2)(A).

⁶³ 34 Tex. Admin. Code § 3.302(d)(2)(B).

⁶⁴ 34 Tex. Admin. Code § 3.302(d)(3).

⁶⁵ 34 Tex. Admin. Code § 3.302(d)(5).

⁶⁶ 34 Tex. Admin. Code § 3.302(d)(6).

- A person may claim a credit if they currently hold, or held at the time of the sale, a valid sales tax permit. They must claim the credit via an electronic report in the period in which the books reflect the bad debt or subsequent reporting periods.
- A non-permitted person must request a refund in writing from the Comptroller.⁶⁷

The Comptroller provides extensive recordkeeping requirements for those claiming bad debt credits or refunds. Purchasers or assignees of bad debt accounts must maintain additional records. Persons may request approval from the Comptroller for alternative recordkeeping and tax calculation methods if their volume or character of uncollectible accounts warrant alternative recordkeeping or calculation.⁶⁸

The Comptroller's rule amendments largely retain the existing provisions for interest on sales tax and trade-ins (e.g., cash basis sellers who charge interest on credit extended for sales tax must remit a portion of the interest as sales tax).⁶⁹ The Comptroller also provides that tax paid on an account that is later determined to be uncollectible and written off as a bad debt for federal tax purposes is not tax paid in error and does not accrue interest.⁷⁰

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 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.⁷¹ 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.⁷² 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.⁷³

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, "[m]edical billing services that occur before a claim is

⁶⁷ 34 Tex. Admin. Code § 3.302(d)(7)(A)-(B).

⁶⁸ 34 Tex. Admin. Code § 3.302(d)(7)(C).

⁶⁹ 34 Tex. Admin. Code § 3.302(e)-(f).

⁷⁰ 34 Tex. Admin. Code § 3.302(g).

⁷¹ Tex. Tax Code § 151.0101(a)(9).

⁷² 34 Tex. Admin. Code § 3.355(a)(8), (b).

⁷³ Comptroller Letter No. 201911003L (Nov. 22, 2019).

submitted do not fall under ‘insurance claims adjustment or claims processing’ and are not taxable as insurance services.”⁷⁴ During the Texas Legislature’s 2021 regular session, the Legislature passed HB 1445, which excludes medical or dental billing services from taxable insurance services if they are performed prior to the original submission of a medical or dental insurance claim, or prior to a claim related to health or dental coverage made to a medical assistance program funded by the federal or state government.

Manufacturing Exemption

Court Allows Manufacturing Exemption for Excavators Used to Mine Lignite Coal. The Third Court of Appeals has found that a taxpayer who extracts and processes coal for ultimate sale is entitled to the manufacturing exemption from Texas’ sales and use tax.⁷⁵ During the period at issue, Texas Westmoreland Coal Company owned and operated a lignite coal mine in Texas, using different types of heavy equipment to produce lignite coal that it sold to NRG Energy Corporation. After removing the dirt over the coal formation, Texas Westmoreland used excavators to break apart and reduce the size of the lignite coal. In “one seamless process,” its excavators dragged large buckets with teeth through the exposed lignite coal formation to crack, break and rip apart the coal formation and dumped the pieces of lignite coal into trucks, causing them to further break. NRG required that Texas Westmoreland provide the coal in appropriately-sized chunks no larger than a soccer ball so that NRG’s equipment could handle it.⁷⁶

Texas Westmoreland sought a Texas sales tax refund under the manufacturing exemption for the excavators, asserting that the excavators were directly used in processing of tangible personal property for ultimate sale. Texas’ manufacturing exemption statute provides:

(a) The following items are exempted from the taxes imposed by this chapter if sold, leased, or rented to, or stored, used, or consumed by a manufacturer:

...

(2) tangible personal property directly used or consumed in or during the actual manufacturing, processing, or fabrication of tangible personal property for ultimate sale if the use or consumption of the property is necessary or essential to the manufacturing, processing, or fabrication operation and directly makes or causes a chemical or physical change to:

(A) the product being manufactured, processed, or fabricated for ultimate sale . . .⁷⁷

The Third Court of Appeals noted that Texas Westmoreland satisfied each of the statutory requirements

⁷⁴ Comptroller Letter No. 202003007L (Mar. 19, 2020).

⁷⁵ *Hegar v. Texas Westmoreland Coal Co.*, No. 03-20-00406-CV (Tex. App.—Austin Oct. 7, 2021, no pet. h.).

⁷⁶ *Texas Westmoreland*, slip op. at 2.

⁷⁷ Tex. Tax Code § 151.318(a)(2)(A).

- (1) the Product that Westmoreland sold to NRG was tangible personal property,
- (2) the excavators directly used to process the Product (and for which Westmoreland paid sales and use taxes) were tangible personal property, and (3) the excavators caused physical changes to the lignite coal during the production process.⁷⁸

The Comptroller argued that, to qualify for the exemption, a taxpayer's manufacturing or processing process must relate to property which constitutes tangible personal property when the process begins. Under Texas law, minerals such as lignite coal, oil and gas constitute real property until they are severed or extracted from the earth.⁷⁹ The Third Court of Appeals "observ[ed] that the statute imposes no express requirement concerning the legal character of inputs or raw materials and, in fact, does not mention inputs or raw materials at all."⁸⁰ The court noted that the statute's language "manufacturing, processing, or fabrication of tangible personal property" used the preposition "of" only in reference to the state of the property at the end of the process, not the beginning. The court found that the exemption "expressly applies to the manufacturing of, the processing of, or the fabrication of a particular product for ultimate sale, and the essence of those three related processes is that the output at the end of the process is different from the one or more inputs along the way."⁸¹ As a result, the court refused to adopt an extra-statutory requirement that the inputs also constitute tangible personal property.

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.⁸²

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."

⁷⁸ *Texas Westmoreland*, slip op. at 4-5.

⁷⁹ *Cage Bros. v. Whiteman*, 163 S.W.2d 638, 641 (Tex. 1942); *In re Estate of Ethridge*, 594 S.W.3d 611, 616 (Tex. App.—Eastland 2019, no pet.).

⁸⁰ *Texas Westmoreland*, slip op. at 6.

⁸¹ *Texas Westmoreland*, slip op. at 7.

⁸² *HB Aviation, LLC v. Hegar*, No. 03-19-00414-CV (Tex. App.—Austin Nov. 11, 2020, pet. denied).

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 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.⁸³ HB Aviation filed a Motion for Rehearing asking the three-justice panel to reconsider the fraud penalty on January 21, 2021 and the Third Court denied the Motion for Rehearing on March 2, 2021. On June 1, 2021, HB Aviation filed a Petition for Review with the Texas Supreme Court, seeking the occasional sales exemption and reversal of the fraud penalty.⁸⁴ HB Aviation argues that the Third Court erroneously applied a heightened standard of review against HB Aviation by indulging every inference in favor of the State, taking the State’s evidence as true, disregarding HB Aviation’s evidence, and ignoring a genuine issue of material fact raised. At the Texas Supreme Court’s request, the Comptroller filed a response arguing that any decision would be of little precedential value because Tex. Tax Code Chapter 163, adopted in 2015, rendered the occasional sale exemption effectively inapplicable to aircraft. The Texas Supreme Court denied review on September 24, 2021.

⁸³ *HB Aviation, LLC v. Hegar*, No. 03-19-00414-CV (Tex. App.—Austin Nov. 11, 2020, pet. denied).

⁸⁴ *HB Aviation, LLC v. Hegar*, No. 21-0338 (Tex. filed Apr. 14, 2021).

III. Legislation

Texas Legislature's 87th Regular Session Laws Take Effect

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 and adjourned sine die (i.e., without reconvening) on May 31, 2021.⁸⁵ Much of the legislation passed during the regular session went into effect on September 1, 2021.

Although the Legislature adopted some substantive changes to the tax laws, the most significant developments appear to be changes to the procedures taxpayers may use to bring lawsuits against the Comptroller.

Below are brief descriptions of relevant substantive and procedural new tax law 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 review the bill text by clicking one of the three icons on the "Text" tab under the word "Bill." Select the "Enrolled" bill icons to view the final language of each bill that passed into law.

New Sales Tax Laws

[SB 153](#) – This law excludes certain payment processing services from the definition of "data processing service." The law excludes from taxable data processing "services exclusively to encrypt electronic payment information for acceptance onto a payment card network." It also excludes from taxation the "settling of an electronic payment transaction" by specified entities. The law takes effect October 1, 2021 and explicitly does not apply to any tax liability accruing prior to that date.

[SB 296](#) – This law extends the date by which taxpayers under audit may provide resale and exemption certificates to the auditor. Prior law required certificates to be submitted up until 60 days after written notice, which occurs after the audit concludes and the taxpayer petitions for redetermination. The final version of this law extended the deadline to 90 days after written notice and provides that the Comptroller and the taxpayer audit may extend that date by agreement. This law took effect immediately on June 7, 2021.

[SB 833](#) – This law allows taxpayers without sales tax permits who file severance tax reports to file sales tax refund claims for tax paid in error to vendors. Generally, a taxpayer must have a sales tax permit (or a vendor assignment) to obtain a refund from the Comptroller of taxes paid in error to vendors. This law took effect on September 1, 2021. It's unclear whether a severance taxpayer may file its sales tax refund claim for tax periods prior to the effective date.

[SB 477](#) – This law continues implementation of the 2019 marketplace provider legislation concerning use tax collection by out of state sellers in response to the U.S. Supreme Court's decision

⁸⁵ Tex. Const. Art III, Section 24(b).

in *South Dakota v. Wayfair*.⁸⁶ The law provides for marketplace sellers who sell admission tickets on marketplaces to indicate to the marketplace provider whether sales taxes were paid on the original purchase of the ticket. A marketplace provider who in good faith accepts a marketplace seller's certification may deduct from taxable sales reported the adjusted value of the ticket or admission document. The law also requires marketplace providers to collect the lead acid battery fee and the prepaid 9-1-1 service fee. Portions of this law are delayed until October 1, 2022. The remainder goes into effect October 1, 2021.

New Franchise Tax Laws

HB 3777 – This law is intended to close a loophole which allowed the franchise tax credit for rehabilitation of historic structures to be used by taxing entities such as school districts, counties, and municipalities. The law provides that expenditures by an exempt entity to rehabilitate a structure that is leased to a tax-exempt entity in a disqualified lease are not eligible costs and expenses. This law takes effect January 1, 2022.

SB 938 – This law creates a five-year franchise tax exemption for a new veteran-owned business. Each owner must be a natural person who served in and was honorably discharged from a branch of the U.S. armed forces and obtains a verification of their status from the Texas Veterans Commission to provide to the Comptroller. The business must be formed in Texas and first begin doing business after January 1, 2022.

HB 1195 – This law provides that Payroll Protection Program (PPP) loan forgiveness is not included in total revenue and that qualifying expenses paid with PPP loan proceeds may nevertheless be included in determining compensation or cost of goods sold, provided that the expenses otherwise meet the requirements to qualify for the compensation or cost of goods sold subtraction. The final version of the bill extends the same treatment to shuttered venue operator grants, microloan program recovery assistance, and restaurant revitalization grants. This law took effect immediately and applies to franchise tax report year 2021 and subsequent report years.

Procedural & Miscellaneous New Tax Laws

HB 1258 – This law requires financial institutions to share customer data with the Comptroller to identify the accounts of delinquent taxpayers. Each calendar quarter, financial institutions must exchange data with the Comptroller to facilitate matching the names of delinquent taxpayers with the names of account holders by one of two methods. Under the first method, the financial institution sends the Comptroller a list of all open accounts and account holder records which the Comptroller compares with the Comptroller's records of delinquent taxpayers. Under the second method, the Comptroller sends an "inquiry file" to the financial institution containing names of delinquent taxpayers, and the financial institution responds with a listing of all account owner

⁸⁶ 504 U.S. 298 (2018).

records that match the inquiry file. Financial institutions are prohibited from notifying account holders when the data is matched. This law took effect September 1, 2021.

HB 1445 – This law excludes certain medical and dental billing performed prior to the original submission of an insurance claim from taxable insurance services. Under the new law, taxable insurance services do not include medical or dental billing services performed before the original submission of (a) a medical or dental insurance claim related to health or dental coverage or (b) a claim related to health or dental coverage made to a medical assistance program funded by the federal or state government. “Medical or dental billing service” is defined to mean “assigning codes for the preparation of a medical or dental claim, verifying medical or dental insurance eligibility, preparing a medical or dental claim form for filing, and filing a medical or dental claim.” This change takes effect on January 1, 2022 and does not affect any liability accruing before January 1, 2022.

HB 1658 – This law allows the Comptroller to send deficiency determinations and jeopardy determinations by email and deems service to be completed when the email is transmitted. Governor Abbott took executive action to allow this during the COVID-19 pandemic, and this legislation makes the option to deliver deficiency and jeopardy determinations via email permanent. This law takes effect September 1, 2021.

HB 2080 – This law creates a new procedural option for taxpayers seeking to challenge an audit assessment to access the courts without first pre-paying the entire amount the state claims is due. Previously, a taxpayer generally had to pay the full audit assessment “under protest” before filing suit. Taxpayers now have two options to bring a suit against the Comptroller to challenge the Comptroller’s tax assessment. Both are tried “de novo” in district court:

1. A taxpayer may bring a “suit after redetermination.” In a suit after redetermination, the taxpayer must exhaust its administrative remedies by pursuing a redetermination proceeding to its conclusion and file a “motion for rehearing” which the Comptroller denies. The grounds in the taxpayer’s lawsuit are limited to those grounds which were raised in its motion for rehearing. The taxpayer must pay any portion of the assessment that is not disputed in the motion for rehearing. Failing to pay the undisputed amount, however, does not affect the jurisdiction of a court to consider the suit. Any unpaid amounts which the courts ultimately find are due accrue penalties and interest. Once the Comptroller is served with the lawsuit, the Comptroller is prohibited from collecting the disputed amounts but may still assert tax liens. The suit is barred if it is not brought within 90 days after the denial of the taxpayer’s motion for rehearing.
2. A taxpayer may still bring a “suit after protest payment.” In a protest payment suit, the taxpayer need not exhaust its administrative remedies but may simply pay the entire amount the state claims is due under protest and then bring a suit to recover the protest payment within 90 days after submitting its protest payment. The taxpayer must include with its protest payment a written protest setting forth the grounds it will raise in court.

HB 2080 also makes several other changes to tax procedures. The law repeals Texas Tax Code Chapter 112 Subchapter C, which allowed taxpayers to seek restraining orders or injunctions to prevent the Comptroller from collecting a tax or fee. The law also prohibits collection of attorney's fees in most tax cases and repeals a provision that allowed taxpayers to submit extended franchise tax reports and make their tax payments under protest.

This law applies to a suit to dispute an amount of tax, penalty, or interest that becomes due and payable on or after its September 1, 2021 effective date. Taxpayers with lawsuits for tax, penalty or interest that became due and payable prior to the effective date may achieve a similar result with the Comptroller's written agreement.

SB 903 - This law creates a new procedural option for taxpayers seeking a refund of tax previously paid. Taxpayers were previously required to exhaust their administrative remedies by pursuing their refund proceeding to its conclusion through the State Office of Administrative Hearings (SOAH). While that option is still available, under the new procedure a taxpayer may file suit after the Comptroller informally reviews and denies the taxpayer's refund claim, the taxpayer may skip going to SOAH and may instead file a Notice of Intent to Bypass Hearing. The notice must be filed within 60 days after the Comptroller issues a letter denying the refund claim and must contain the material facts and each specific legal basis on which a refund claimed. After receiving the notice, the Comptroller may require the taxpayer to attend a conference to "clarify any fact or legal issue in dispute regarding the refund claim and to discuss the availability of additional documentation that may assist in resolving outstanding issues regarding the claim." A taxpayer may amend its material fact or legal basis following the conference only if the Comptroller agrees in writing. A taxpayer must file its refund suit within 60 days of the date of the conference, or within 90 days of filing its notice if no conference was required by the Comptroller.

This law applies to a claim for refund that is pending or filed on or after the law's September 1, 2021 effective date.

HB 2857 - This law requires the Comptroller to wait 14 days after mailing an audit notice to a taxpayer before including that taxpayer's information on the list of taxpayers under audit available under the Texas Open Records Act. This replaces a former provision which required taxpayers to wait six days after a new taxpayer was added to this audit list. This law took effect September 1, 2021 and the Comptroller's audit lists now comply with HB 2857. See TEXAS COMPTROLLER, SECURE FILE TRANSFER, <https://data-secure.comptroller.texas.gov/main/public-files> (last visited October 5, 2021).

SB 873 - This law provides an exception to the confidentiality of tax information for the Comptroller to issue a certificate to the purchaser of a business stating that no tax is due. It also provides that a request for a Certificate of No Tax Due must be on an affidavit or other form prescribed by the Comptroller. This law took effect September 1, 2021.

Links:

Separate lists of all bills filed in each chamber in the regular session 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>

Texas 87th Legislature: First, Second and Third Special Sessions

After the Texas Legislature's 87th Regular Session, Governor Abbott called the same legislature back for three special called sessions, where the Legislature has focused primarily on items outside the scope of this presentation. The following legislation is currently pending in the Texas Legislature's third called special session:

HB 117 – This bill would create a new value-added tax on any person in Texas who supplies any service or property in the ordinary course of a trade or business. The rate would be 6.72% of the taxpayer's taxable receipts from the supply of services or property. The tax due would be the amount by which a taxpayer's "output tax" exceeds the taxpayer's "input tax" (hence only taxing value added). The bill would replace local sales tax with local value added tax. The new value added tax would make up for lost revenue resulting from a prohibition on school district maintenance and operations tax.

IV. Jurisdiction & Procedure

The Ongoing Jurisdictional Saga of *El Paso Electric Company v. Hegar*

Quoting Refund Statute and Providing Supporting Schedules Sufficient to Maintain Jurisdiction.

After a two-justice majority of the Third Court of Appeals sided with the Comptroller and dismissed El Paso Electric Company's sales tax refund suit, a majority of the full Third Court reversed and found the taxpayer adequately raised 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.⁸⁷ El Paso Electric filed an administrative sales tax refund claim for a variety of different types of equipment under a 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.⁸⁸ After the Comptroller denied El Paso's administrative refund claim, El Paso filed a district court lawsuit.⁸⁹ 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.⁹⁰

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:⁹¹

⁸⁷ *Hegar v. El Paso Electric Company*, No. 03-18-00790-CV (Tex. App.—Austin Aug. 13, 2020, no pet. h.) (majority opinion).

⁸⁸ Tex. Tax Code § 151.318(a)(4).

⁸⁹ *Hegar v. El Paso Electric Company*, slip op. at 2.

⁹⁰ 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).

⁹¹ Slip op. at 9.

(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. Two justices on the initial panel that heard the appeal 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.”⁹²

The third member of the three-justice panel issued a dissenting opinion.⁹³ 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 . . .”⁹⁴ Amicus briefs and letters were 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 asked the Third Court to re-hear the case en banc (i.e., with all justices in lieu of a three-justice panel) or to adopt the dissenting opinion in favor of the taxpayer.

On March 5, 2021, four of the six justices sitting on the Third Court of Appeals reversed the three-justice panel and rendered an en banc opinion in favor of the taxpayer. The Court concluded that El Paso Electric had adequately invoked the court’s jurisdiction over its refund claim for telemetry units by quoting the entire manufacturing exemption statutory subsection at issue and by listing the meters (which constituted exempt telemetry units) in its schedules of transactions submitted with its administrative filings. Two justices joined in a dissenting opinion, arguing that merely quoting the

⁹² Slip op. at 11.

⁹³ *Hegar v. El Paso Electric Company*, No. 03-18-00790-CV (Tex. App.—Austin Mar. 5, 2021, no pet. h.) (Kelly, J., dissenting)) (pending subsequent Motion for En Banc Reconsideration before the Third Court of Appeals).

⁹⁴ Slip op. at 4–5 (Goodwin, J., dissenting).

statute and listing the transactions on supporting schedules was insufficient to adequately put the Comptroller on notice of the nature of the taxpayer's claim.

On March 22, 2021, the Comptroller filed a Motion for En Banc Reconsideration, arguing that the Court's opinion will enable taxpayers to escape meaningful agency review of their refund claims and imploring the court to replace the en banc opinion with a new opinion in the Comptroller's favor. At the Third Court's request, the taxpayer filed a response on May 13, 2021 and the Comptroller filed a reply on May 28, 2021. In briefing, the Comptroller argues repeatedly that allowing El Paso Electric Company's claims to proceed will undermine the importance of airing all issues in an administrative proceeding, while the taxpayer contends that recent legislation allowing taxpayers to bypass the administrative process entirely undermines this notion.

Deadline Extension for Sales Tax Reports for Hurricane Nicholas

In response to Governor Abbott's disaster declaration regarding Hurricane Nicholas, taxpayers in the following declared counties that were affected by severe weather and flooding may request a 30-day extension for sales and use tax reports originally due on September 20, 2021:

- Aransas
- Brazoria
- Calhoun
- Chambers
- Galveston
- Harris
- Jackson
- Jasper
- Jefferson
- Liberty
- Matagorda
- Montgomery
- Newton
- Nueces
- Orange
- Refugio
- San Patricio
- Victoria
- Wharton

To request the extension, send the following information to ExtensionRequests@cpa.texas.gov:

- Taxpayer Name
- Taxpayer Number
- Tax Type(s) for which the extension is requested
- Affected filing period(s)
- Name and phone # of the person making the request