Texas Taxes Quarterly Update

2nd Quarter 2022

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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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Doug Sigel has 30 years of experience litigating and settling disputes in hearings and courts across the country. His practice focuses on state and local taxation, with an emphasis on litigation at the administrative, trial, and appellate levels. Examples of the types of matters Doug handles include sales and use tax, state corporate income tax (including the Texas margin tax), Texas property tax, motor vehicle sales tax, oil and gas severance tax, insurance tax, motor fuels tax, mixed beverage tax, unclaimed property, tax credits/incentives, nexus disputes, audits, hearings, trials and appeals, tax collection cases, voluntary disclosure agreements, letter rulings, and open records requests.

Doug handles his docket of administrative, district court, and appellate cases in an aggressive yet efficient manner and always seeks the best outcome possible for his clients. Doug strives to streamline the resolution of his cases through innovative approaches tailored for each individual case. Doug creates innovative and unique strategies for each of his cases by first gaining a thorough understanding of the issues, personalities, and facts early in a dispute. With this foundation, Doug crafts a strategy to achieve an expedited settlement of the dispute through a collaborative interaction with counsel for the taxing authority. If necessary, Doug will take the case to trial as quickly as possible and leverage the strengths of the taxpayer's position and evidence to present the taxpayer's argument in a focused and creative manner.

Doug has spoken on a variety of sales and use and income tax topics at seminars sponsored by IPT, COST, TEI, The Hartman Forum, the Texas Society of CPAs, the Tulane Tax Institute, the State Bar of Texas, the National Association of State Bar Tax Sections, and the ABA Tax Section. He is also a frequent author on state and local tax topics. For example, Doug has authored a chapter for the IPT Income Tax Deskbook published in 2012.

Doug is on the executive board of the state and local tax committee of the ABA tax section. He is IPT's overall chair for sales tax. He was the chair of the 2014 IPT Sales and Use Tax Symposium and is on the planning committee for the 2015 ABA/IPT Sales Tax Seminar. He has also served as chair of the National Association of State Bar Tax Sections.

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Each quarter, Gordon discusses recent developments in the Texas sales tax, Texas franchise tax, and tax administration in live webcasts sponsored by the Texas Society of CPAs. He also presents 4-hour CPE courses covering various Texas tax topics, including specific courses for the construction, technology, and energy industries.

Gordon is a member of the State Bar of Texas Tax Section and the Louisiana State Bar Association. He earned his bachelor's degree from The University of Texas at Austin, with honors. He earned his J.D. degree from the University of Houston Law Center with highest honors.

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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 second quarter of 2022. They include recent developments in Texas tax cases, the Comptroller's recent rule amendments, 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
Second Quarter 2022	July 14, 2022	Click Here to Register
Third Quarter 2022	October 22, 2022	Registration TBD
Fourth Quarter 2022	January 12, 2023	Registration TBD

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

I. Sales Tax

Local Sales Tax Sourcing for Online Sales

The Texas Comptroller has changed his local tax rule to undermine economic development agreements.[1] 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.

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1 34 Tex. Admin. Code § 3.334.

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."[2]

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

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[2] 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/.

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.[3] 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.[4] 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.[5] 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. In the case *City of Coppell et al. v. Hegar*, in which the injunction was issued, trial is set for the week of September 26, 2022.

Trial is scheduled in a similar case, *City of Round Rock v. Hegar*, the week of November 7, 2022.

The parties to these cases have filed motions for summary judgment, which are set for hearing July 19, 2022.

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3 45 Tex. Reg. 3505 (". . . giving interested parties an opportunity to seek a legislative change.").

4 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/.

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

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.

Surveying

Surveying services are one type of "real property service," which is listed as a taxable service under Texas law.[6] In general, surveying services are only taxable if they relate to the boundary lines for real property.

Adopted New Comptroller Rule 3.276. On April 8, 2022, the Comptroller adopted a new Comptroller Rule 3.276 covering the Texas sales and use tax treatment of surveying services.[7]

According to the Comptroller, the adoption of this new rule "memorialize[s] existing comptroller policy," implements 2007 legislation, and defines terms used in the Texas Tax Code.[8]

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 adopted 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."[9] 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

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6 Tex. Tax Code §§ 151.0101, 151.0048.

7 34 Tex. Admin. Code § 3.276 (adopted new rule in 47 Tex. Reg. 1888) (proposed new rule in 46 Tex. Reg. 6377).

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

9 34 Tex. Admin. Code § 3.276(a)(5).

- boundary survey
- easement survey
- land title survey
- right-of-way survey
- subdivision plat
- title survey
- staking and placement services[10]

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
- location services[11]

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.[12]

Surveyors have various responsibilities, including obtaining permits, collecting and remitting sales tax, and obtaining documentation from contractors and landmen claiming

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10 34 Tex. Admin. Code § 3.276(b).

11 34 Tex. Admin. Code § 3.276(c).

12 34 Tex. Admin. Code § 3.276(d).

the exclusions in subsection (d).[13] The rule provides guidelines for surveyors issuing and receiving resale and exemption certificates.[14]

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).[15]

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.[16] 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.[17]

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[13] 34 Tex. Admin. Code § 3.276(e).

[14] 34 Tex. Admin. Code § 3.276(f).

[15] 34 Tex. Admin. Code § 3.276(g).

[16] *Hegar v. Texas Westmoreland Coal Co.*, No. 03-20-00406-CV (Tex. App.—Austin Oct. 7, 2021, pet. filed).

[17] *Texas Westmoreland*, slip op. at 2.

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 . . . [18]

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

> (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.[19]

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.[20] 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

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18 Tex. Tax Code § 151.318(a)(2)(A).

19 *Texas Westmoreland*, slip op. at 4–5.

20 *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.).

materials at all."[21] 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."[22] As a result, the court refused to adopt an extra-statutory requirement that the inputs also constitute tangible personal property.

On November 22, 2021, the Comptroller filed a Petition for Review with the Texas Supreme Court.[23] After the filing of the taxpayer's Response and the Comptroller's Reply, the Texas Supreme Court requested briefing on the merits on March 11, 2022. The Comptroller filed his merits brief on June 10, 2022.

Court Allows Manufacturing Exemption for Electricity Used to Produce Ads on Receipt Paper. The Seventh Court of Appeals has ruled that a taxpayer who produces cash register tapes qualifies for the manufacturing exemption for electricity used to print advertisements on the cash register tapes.[24] RTU manufactures cash register tapes. When it was founded, it was a marketing company that sold advertising and outsourced the printing and production of register tapes. Later, it began printing in-house, producing register tapes and selling them to grocery and retail stores for use in point-of-sale machines.[25]

RTU sought the manufacturing exemption for electricity used in its plant in Houston to print and cut register tapes. RTU purchased jumbo rolls of blank paper, printed advertisements on the reverse side, then cut it into thousands of individual register tapes. These tapes contained both customer-specific advertising and third-party advertising.[26]

Texas provides a manufacturing exemption for natural gas and electricity used in powering equipment, as long as that equipment qualifies for the manufacturing exemption.[27] Equipment qualifies for the manufacturing equipment if it is directly used or consumed in the manufacturing of property for ultimate sale, and its use is necessary or essential to the

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

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

23 Hegar v. Texas Westmoreland Coal Co., No. 21-1007 (Tex. ____).

24 *RTU, Inc. v. Hegar*, No. 07-20-00301-CV (Tex. App.—Amarillo Jan 3, 2022, pet. denied).

25 *RTU*, slip op. at 2.

26 *RTU*, slip op. at 4.

27 Tex. Tax Code § 151.317(a).

manufacturing operation.[28] Under Texas law, a taxpayer must conduct a "predominant use study" to determine whether at least 50% of the electricity flowing through a single electric meter is exempt or taxable.[29] RTU Conducted a predominant use study and determined that its plant qualified for the exemption. The Comptroller challenged the exemption, arguing that:

(1) Printing advertisements on receipt paper is a pre-production activity that does not fall within the manufacturing exemption;
(2) Printing is not manufacturing; and
(3) The equipment used to print advertisements on the back of receipt paper is not necessary or essential to produce the receipt paper for sale to customers.[30]

The court rejected each of these arguments. It found that printing on receipt-paper was not pre-production, because Texas law recognizes that the printing process is a form of advertising by exemption "pre-press machinery, equipment, [etc.] that are necessary and essential to and used in connection with the printing process if they are purchased for "printing or imprinting tangible personal property for sale."[31] Rejecting the Comptroller's argument that customers did not contract to purchase the reverse side of the receipt paper, the court noted that "RTU's agreements with each customer include bargained-for provisions regarding the sale of the register tapes, and each had provisions giving RTU the right to place advertisements but also gave the customers the right to exclude certain advertisements (e.g., for competitors).[32]

On March 21, 2022, the Comptroller filed a Petition for Review with the Texas Supreme Court.[33] The Texas Supreme Court denied review on April 29, 2022.

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[28] Tex. Tax Code § 151.318(a).

[29] Tex. Tax Code § 151.317(e)

[30] *RTU*, slip op. at 10.

[31] Tex. Tax Code § 151.317; *RTU*, slip op. at 11.

[32] *RTU*, slip op. at 9–12.

[33] *RTU, Inc. v. Hegar*, No. 22-0098 (Tex. ____).

Data Processing

Mortgage Document Preparation Treated as Taxable Data Processing. The Third Court of Appeals has found that a law firm specializing in preparing mortgage documents purchased taxable data processing services.[34]

Black, Mann & Graham, L.L.P. ("BMG") is a Texas law firm employed by lending institutions to prepare loan documents. BMG hired vendors to prepare loan packages. These vendors employed programmers which created interfaces between the lenders' loan origination systems (LOS) and the vendors' document-generation software. The vendors' software interfaced with each lender's LOS, taking data files from the LOS and mapping the data onto all the documents that make up a loan package (promissory notes, deeds of trust, disclosures, etc.). Under the supervision of an attorney, paralegals for BMG would review each loan package for compliance with applicable laws and each lender's requirements.

The Comptroller audited BMG and assessed sales tax on its payments to these vendors, treating the vendors' services as taxable data processing. BMG paid the audit assessment under protest and brought suit challenging the Comptroller's assessment.

The State of Texas imposes sales tax on data processing services, which are defined as "word processing, data entry, data retrieval, data search, information compilation, payroll and business accounting data production, and other computerized data and information storage or manipulation."[35]

Data processing services do not include

> the use of a computer by a provider of other services when the computer is used to facilitate the performance of the service or the application of . . . accounting principles, and tax laws, e.g., . . . the use of a computer by a CPA firm, enrolled agent, or bookkeeping firm to produce a financial report, prepare federal income tax, state franchise or sales tax returns . . .[36]

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34 *Black, Mann & Graham, L.L.P v. Hegar*, No. 03-20-00391-CV (Tex. App.—Austin Feb. 25, 2022, no pet. h.).

35 Tex. Tax Code § 151.0035(a)(1).

36 34 Tex. Admin. Code § 3.330(a)(1).

BMG argued that the services it purchased were akin to outsourced paralegal services, noting that legal compliance and mortgage experts working for the vendors assisted programmers with creating legally-compliant loan packages. The Third Court of Appeals rejected this argument, noting that language in BMG's contracts with its vendors provided that BMG was solely responsible for the legal content and compliance of each document with Texas state laws. Furthermore, the court found that BMG could not have purchased "legal services" from the vendors, because if the vendors were providing legal services, they would be engaged in the unauthorized practice of law and the contracts would be void for public policy reasons.

II. Franchise Tax

Cost of Goods Sold (COGS)

Comptroller Published Guidance on Cost of Goods Sold Frequently Asked Questions (FAQs). On February 4, 2022, the Texas Comptroller provided guidance clarifying several Texas franchise tax cost-of-goods-sold ("COGS") issues for Texas taxpayers. The Comptroller issued the guidance as responses to Frequently Asked Questions ("FAQs"). The FAQs discuss several topics, including the proper calculation of COGS and whether labor and other expenses across certain industries qualify for subtraction, which components of mixed transactions qualify for a COGS subtraction, how to determine Internal Revenue Code ("IRC") Section 179 expense limitations and federal bonus depreciation for Texas COGS purposes, and information on capitalizing versus expensing costs.

Texas COGS is calculated separately from federal reporting and industry calculations. Subtractable costs must be expressly listed in Texas Tax Code Section 171.1012.

IRC Section 179 expense limitations and federal bonus depreciation amounts are based on the IRC in effect for the federal tax year beginning on January 1, 2007. As a result, the Section 179 expense is limited to $25,000 and the property acquisition threshold is $200,000 in effect for the 2007 tax year under federal law. Federal bonus depreciation may not be included in COGS because it was added to the federal tax laws after the franchise tax's fixed conformity date of January 1, 2007.

Entities generally must capitalize all allowable costs and may change from capitalizing costs to expensing—and vice versa—on an annual basis. An entity that elects to capitalize must capitalize all allowable subtractable costs that it capitalized for federal tax purposes, except the entity must exclude from COGS those costs not allowed pursuant to Texas Tax Code Section 171.1012. Moreover, the decision to capitalize or expense costs is made on an annual basis. An entity that switches from capitalizing costs to expensing them may not subtract any costs incurred before the first day of the report period, including ending inventory from a previous report. An entity that switches from expensing costs to capitalizing them may not capitalize costs incurred before the first day of the report period.

A limited partnership may not elect to amortize intangible drilling costs ("IDCs") over 60 months instead of expensing the IDCs. The election to amortize IDCs is not available to the partnership and must be made at the partner level. A taxable entity that elects to capitalize its allowable COGS under Texas Tax Code Section 171.1012(g) must capitalize those costs in the same manner and to the same extent they are capitalized on the taxable entity's (i.e., the partnership's) federal income tax return. Since the IDC amortization election is made at the partner level, the partnership must deduct its IDCs in the year incurred for the COGS subtraction.

A "mixed transaction" involves the sale of tangible personal property and the provision of a service. Only the allowable costs related to the sale of tangible personal property may be subtracted. Conversely, labor and other costs related to the services performed may not be included in the COGS subtraction.

Several additional industry-specific COGS subtractions covered by the FAQS include:

Expense	Included in COGS Calculation?
Contractor's payments to subcontractors	**Yes**, if the expenses relate to real property construction, improvement, remodeling, repair or industrial maintenance.
Costs to drill for oil and gas	**Yes**, because oil and gas extraction falls under the definition of production in TEX. TAX CODE § 171.1012(a).
Flow-through funds excluded from total revenue	**No**
Cost of labor for retailer store stocker	**Yes**, until the point that goods are displayed for sale; **No** after that point, unless they qualify as "additional" costs under TEX. TAX CODE § 171.1012(d).
Cost of labor for restaurant cooks	**Yes**
Cost of labor for restaurant waitstaff	**No**
Cost of labor for fulfillment center stocker	**Yes**, until the point that goods are available to fulfill specific orders; **No**, after that point, unless they qualify as "additional" costs under TEX. TAX CODE § 171.1012(d).
Cost of labor to install tangible personal property	**No**, unless they are part of construction, improvement, remodeling, repair, or industrial maintenance of real property.
Compensation and benefits of salespersons	**No**

Expense	Included in COGS Calculation?
Motor vehicle sales finance company interest expenses	**Yes**, in an amount equal to interest expense, so long as it qualifies as a lending institution.
Partnership or S corporation depletion	**Yes**, to the extent oil and gas depletion is related to production and reported to its owners for federal tax purposes, but the owners may not also include the depletion in their COGS.

Link: Click here to view the text of the Comptroller's Cost of Goods Sold FAQs.

Satellite Radio Service Not Engaged in Sale of Goods. In *Hegar v. Sirius XM Radio, Inc.* the Third Court of Appeals found that Sirius was not engaged in the sale of goods and was therefore ineligible to claim the cost of goods sold subtraction.[37] 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.[38]

To claim the cost of goods sold subtraction, a taxable entity must sell "goods," which are real or tangible personal property.[39] 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."[40] This includes "films, sound recordings, videotapes, live and prerecorded television and radio programs, books, and other similar property embodying words, ideas,

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37 *Hegar v. Sirius XM Radio, Inc.*, Cause No. 03-18-00573-CV (Tex. App.—Austin, May 1, 2020), *reversed on other issues*, No. 20-0462 (Tex. 2022). 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 and broadcast its content, but the Texas Supreme Court reversed. See **Apportionment** below**.**

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

39 Tex. Tax Code § 171.1012(a)(1).

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

concepts, images, or sound."[41] 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.[42]

The Third Court of Appeals 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.[43] 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."[44] 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.[45] 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.[46] 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 did not review the cost-of-goods-sold determination, but reversed the Third Court of Appeals on separate apportionment issues. The Texas Supreme Court held oral argument on November 30, 2021 and issued its opinion on March 25, 2022.

Compensation

Comptroller Adopts Compensation Rule Amendments. On April 15, 2022, the Comptroller adopted amendments to Rule 3.589 governing the franchise tax compensation subtraction**.**

Texas franchise tax law limits the amount of wages and cash compensation paid to a taxable entity's officers, directors, owners, partners, and employees per year, adjusted based

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

42 Tex. Tax Code § 171.1012(c).

43 Slip op. at 18–19.

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

45 Appellant's Supplemental Brief at 1, *Sirius XM Radio, Inc.*, Cause No. 03-18-00573-CV (Tex. App.—Austin, May 1, 2020), *reversed on other issues*, No. 20-0462 (Tex. 2022).

46 Slip op. at 20.

on the Consumer Price Index.[47] The adopted rule contains annual compensation caps (now referred to as "thresholds") through Report Year 2023. For Report Years 2020 through 2021, the maximum amount of compensation that may be subtracted for any one person is $380K in any 12-month period. For Report Years 2022 through 2023 the compensation cap is $400,000.

The rule no longer has restrictions that were held invalid in *Winstead PC v. Combs*. Per *Winstead*, benefits that are deductible for federal purposes are included in the franchise tax compensation subtraction. Employee discounts and working condition benefits (use of a company car, job related education, travel reimbursement) are subtractable.

New subsection (j) addresses expenses paid with qualifying loan and grant proceeds received for COVID-19 relief pursuant to HB 1195. It provides that a taxable entity may include in the compensation subtraction expenses paid with qualifying grant or loan proceeds (e.g., forgiven PPP loan proceeds), if otherwise allowed, even if the entity excluded the qualifying loan or grant proceeds from total revenue.

The rule now addresses wages and cash compensation paid to employees in foreign countries. Foreign employees' wages and cash compensation are included in the subtraction to the extent they are reported on a form substantially equivalent to Form W-2.

The rule updates definitions for professional employer organizations and includes various other minor policy changes.

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.[48]

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47 Tex. Tax Code §§ 171.1013(c) (providing compensation cap), 171.006 (requiring Comptroller to adjust caps based on Consumer Price Index every two years).

48 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:[49]

- 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.[50]

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.[51]

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 Hearing[52] and was recently employed by the Third Court of Appeals in *Hegar v. Sirius XM Radio, Inc.*[53] The Texas Supreme Court reversed the Third Court of Appeals and did not employ this test, which casts considerable doubt over the test.

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[49] 34 Tex. Admin. Code § 3.591(b)(3).

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

[51] Tax Policy News, Texas Comptroller (June 2009).

[52] Comptroller Hearing 10,028 (1980).

[53] *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 Comptroller intends to apply the adopted rule retroactively except for a few provisions which he concedes are changes in policy.

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."[54]

Receipts-Producing, End-Product Act. The Comptroller may be forced to revise his recently-adopted apportionment rule, which expressly provides that services not covered by specific subsections of the rule are to be sourced to the location of the "receipts-producing, end-product act."[55]

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 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

54 45 Tex. Reg. 8104, 8107.

55 34 Tex. Admin. Code § 3.591(e)(26)(A).

performed. The Texas Legislature, however, did not pass any laws providing for market-based sourcing.

The Comptroller justified 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."[56] 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."[57]

The Comptroller's rule provides that "[i]f there is not a receipts-producing end-product act, the location of all essential acts may be considered."[58] For example, receipts from sales of admissions to live or pre-recorded events are sourced to the location where 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.[59]

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.

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56 34 Tex. Admin. Code § 3.591(e)(26)(A).

57 45 Tex. Reg. 8107 (quoting Comptroller Decision No. 10,028).

58 34 Tex. Admin. Code § 3.591(e)(26)(A).

59 34 Tex. Admin. Code § 3.591(e)(26)(A)(i).

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 Opinion reversing the appellate court in *Hegar v. Sirius XM Radio, Inc.* calls into question the continuing validity of that test.[60]

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.[61] 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) *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.[62] 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).

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60 See **Satellite Radio Subscription Service Receipts** below.

61 34 Tex. Admin. Code § 3.591(e)(2)(A), (C).

62 34 Tex. Admin. Code § 3.591(e)(33).

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.[63]

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)

63 34 Tex. Admin. Code § 3.591(e)(1), (25).

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	Gross proceeds from sales of loans and securities treated as inventory of the seller for federal income tax purposes are included in gross receipts for apportionment.	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)

<u>Vocabulary Changes</u>

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.[64]

A similar issue is pending before the Travis County District Court in *Equistar Chemicals, LP v. Hegar*.[65] 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.[66] Equistar's district court case was stayed pending a final appellate decision in *CITGO Petroleum Corporation v. Hegar*.

***CITGO Petroleum Corporation v. Hegar*.** 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-

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

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

66 34 Tex. Admin. Code § 3.591(e)(25).

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 appealed to the Third Court of Appeals.[67] The Third Court of Appeals denied oral argument and set the case for submission on briefs.

On October 14, 2021, the Third Court of Appeals issued its Opinion affirming the trial court's denial of CITGO's apportionment argument. The court found that the legislature intended Tex. Tax Code § 106(f) to permit using the gross receipts for apportionment only for the sale of certain types of securities, noting that "the distinction turns not on whether the net gains or losses attributable to the securities are ultimately recognized as ordinary income, the 'tax treatment' Citgo relies on, which is not a characteristic unique to inventory securities, but on how the securities were handled as part of the seller's business. That is, whether the securities were sold to customers in the ordinary course of the seller's business (inventory securities) or whether they were held for other purposes (non-inventory securities)." The court determined that the Texas legislature intended to permit the inclusion of gross proceeds from securities which the Internal Revenue Code classifies as inventory of the seller, not for all securities which might receive similar federal treatment to inventory through an election of the taxpayer.[68]

On December 29, 2021, CITGO filed a Petition for Review in the Texas Supreme Court, challenging the Third Court of Appeals' decision.[69] Although the Comptroller initially waived its response, on February 18, 2022, the Texas Supreme Court requested that the Comptroller file a response. The Comptroller filed his response on April 20, 2022 and CITGO filed a reply to the Comptroller's response on June 3, 2022.

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*.[70] Similar to *CITGO*, this case also involves using commodity hedges, some of which

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67 *Citgo Petroleum Corporation v. Hegar*, No. 03-21-00011-CV (Tex. App.—Austin Oct. 14, 2021, pet. filed).

68 *Citgo Petroleum Corporation v. Hegar*, No. 03-21-00011-CV (Tex. App.—Austin Oct. 14, 2021, pet. filed).

69 *Citgo Petroleum Corporation v. Hegar*, No. 03-21-00011-CV (Tex. App.—Austin Oct. 14, 2021, pet. filed) (Texas Supreme Court Case No. 21-0997).

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

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 Texas Supreme Court reversed the Third Court of Appeals, rejecting the Comptroller's argument that receipts from services should be apportioned based on the "receipt-producing, end-product act" test.[71] Instead, the Texas Supreme Court found that Sirius' services should be apportioned based upon the locations of the employees and equipment providing the service.

Sirius XM Radio performs its satellite radio subscription services through an extensive network of equipment located around the globe. While roughly 8–9% of Sirius' customers are in Texas, virtually none of its equipment, employees, or operations are located in Texas. Sirius broadcasts over 150 satellite channels, produced primarily from studios in New York City and Washington, D.C. Only one Sirius radio channel has ever been produced in Texas. Sirius transmits signals to satellites using uplink facilities in New Jersey, Washington D.C., and Georgia. These satellites are launched from Kazakhstan and orbit 22,000 miles above the earth. They transmit signals back to Earth, where they are received either (1) directly by radios in customer vehicles or (2) indirectly after being received by a terrestrial repeater. Further, Sirius controls these satellites through facilities in Panama, Ecuador, and Georgia. Finally, the radios receiving the signals are owned by the customers, not Sirius.

Under the Texas franchise tax statute, a service is apportioned to Texas only if the service is "performed in this state."[72] As the Texas Supreme Court recognized, this is a form of "origin-based" sourcing. Disregarding its extensive out-of-state operations, the Comptroller convinced the Third Court of Appeals that Sirius' services were nevertheless performed in Texas because its customers could only receive the service if Sirius decrypts the satellite radio signal, which occurs in the radio set in each customer's vehicle.

The Texas Supreme Court cited its own prior precedent for the principle that "[i]n tax cases, courts must not disregard the economic realities underlying the transactions in

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71 *Hegar v. Sirius XM Radio, Inc.*, Cause No. 03-18-00573-CV (Tex. App.—Austin, May 1, 2020), *reversed*, No. 20-0462 (Tex. 2022). The Third Court of Appeals 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. The Texas Supreme Court did not review the cost-of-goods-sold determination. See **Cost of Goods Sold** above.

72 Tex. Tax Code § 171.103(a)(2).

issue."[73] Here, according to the Court, the "economic reality "is that Sirius is a radio production and broadcasting company operating dozens of satellite radio channels from location's outside Texas."[74] The Court noted that "[c]haracterizing the services Sirius performs as "decryption" elevates the technicalities of the transaction over the economic reality of the service performed and likened it to referring to The Wall Street Journal Online as a "paywall-removal service" rather than a news publication.[75]

The Texas Supreme Court agreed with Sirius that its services were performed where its employees and equipment were located using the "everyday words of the statute."[76] As it often does, the Court pointed out that:

> The focus should be on the statutory words themselves, not on extraneous concepts like "receipt-producing" or "end-product act," which do not appear in the statute and, when applied, may or may not yield the same result as a straightforward application of the words chosen by the Legislature.[77]

Although the Texas Supreme Court's Opinion did not reference the Comptroller's apportionment rule amendments—adopted while the case was still pending—some of the rule amendments now appear invalid because they conflict with the Texas Supreme Court's plain reading of the statute.[78]

After ruling that Sirius's services should be apportioned to the location of its employees and equipment, the Texas Supreme Court remanded the case to the Third Court of Appeals. In the Third Court of Appeals, the Comptroller submitted a supplemental brief pressing his argument that "Sirius XM presented legally insufficient evidence to support its refund claim" by relying on its costs of performance to establish the fair value of its services."[79]

Link: Click here to see a recording of the oral argument.

Link: Click here to see the Texas Supreme Court's Opinion on apportionment issues.

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73 Combs v. Roark Amusement & Vending, L.P., 422 S.W.3d 632, 637 (Tex. 2013) (internal quotations omitted) (represented by Martens, Todd & Leonard).

74 *Hegar v. Sirius XM Radio, Inc.*, No. 20-0462, slip op. at 16 (Tex. 2022).

75 Slip op. at 16–17.

76 Slip op. at 10.

77 Slip op. at 11–12.

78 34 Tex. Admin. Code § 3.599(e)(26) (requiring services to generally be apportioned to the location of the "receipts-producing, end-product act").

79 *Hegar v. Sirius XM Radio, Inc.*, Comptroller's Supplemental Brief (Tex. App.—Austin June 22, 2022).

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.[80]

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%.[81] Retailers and wholesalers (collectively hereinafter "Retailers") pay Texas franchise tax at half that rate, or 0.375%.[82] 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

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80 *Xerox Corporation v. Hegar*, 14-19-00358-CV (Tex. App.—Houston [14th Dist.], Aug. 31, 2021, pet. filed).

81 Tex. Tax Code § 171.002(a).

82 Tex. Tax Code § 171.002(b).

- The customer was required to make the lease payments, even if the contract was cancelled.

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 filed a Petition for Review, asking the Texas Supreme Court to exercise their discretionary review and reverse the court of appeals' decision.[83] On June 3, 2022, the Texas Supreme Court requested merits briefing.

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.[84]

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 of (b) a franchise tax credit based on qualified research expenses.

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83 *Xerox Corporation v. Hegar*, 14-19-00358-CV (Tex. App.—Houston [14th Dist.], Aug. 31, 2021, pet. filed) (pending before the Texas Supreme Court, No. 21-1011).

84 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").

2021 Research & Development Rule Amendments. On October 15, 2021, the Texas Comptroller adopted amendments to his research and development rules for both the sales tax exemption and the franchise tax credit.[85]

The amendments adopt a federal four-part test for research activies 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 adopted amendments provided 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 required that each member of a combined group calculates its credit separately, and then the credits are aggregated on the combined report. They requires taxpayers to provide their entitlement to the credit by clear and convincing evidence supported by contemporaneous records. They also provide 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 amendments provide that items for which the taxpayer claimed another exemption, such as the sales tax manufacturing exemption, are not eligible to be included in the definition of in-house research expenses.

The Comptroller simultaneously adopted 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.[86]

Taxpayers made a varity of public comments in response the proposed rule. The Comptroller consistently declined to make the changes requested by the taxpayers.

The tax services firm Ryan LLC filed a lawsuit on October 20, 2021 challenging the Comptroller's adoption of these R&D rules.[87] Ryan asserts that the rules harm and interfere with its tax services business because Ryan routinely files refund claims involving

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85 46 Tex. Reg. 2565.

86 46 Tex. Reg. 2555.

87 *Ryan LLC, v. Hegar*, D-1-GN-21-006290 (pending in Travis County District Court).

the research and development sales tax exemptions and franchise tax credits. Ryan seeks a declaratory judgment under Texas' Administrative Procedures Act[88] that various subsections of the Rules 3.340 and 3.599 are invalid as amended.

Fiserv, Inc., a software product company, also filed a lawsuit challenging the Comptroller's research and development rule amendments for its development of software for various business units.[89]

2022 Research & Development Rule Amendments. On June 10, 2022, the Comptroller published further amendments to his sales tax and franchise tax R&D rules. These amendments reverse some of the aggressive policies on internal use software and combined group membership changes that the Comptroller enacted with the 2021 R&D rule amendments.

<u>Both Rule 3.340 (Sales Tax: Research & Development Exemption) and Rule 3.599 (Franchise Tax: Research & Development Credit)</u>

The Comptroller proposes to amend the definition of Internal Revenue Code to allow taxpayers to apply federal treasury regulations if the taxpayer could have elected to apply the treasury regulation for the 2011 federal tax year. The Comptroller provides examples of treasury regulations applicable to the 2011 federal income tax year, such as Treasury Regulation §1.41-4 (internal-use software). The Comptroller continues to deny taxpayers the right to take advantage of more favorable treatment for internal use software adopted in paragraph (c)(6), because the treasury regulation only applied after October 4, 2016.

<u>Rule 3.599 (Franchise Tax: Research & Development Credit)</u>

The Comptroller clarifies that the combined group is the taxable entity for purposes of calculating and reporting the R&D credit.

The Comptroller proposes removing text restricting credit carryforwards and explains how to determine the carryforward when the combined group membership changes.

Proposed language clarifies that a conveyance, assignment or transfer of an ownership interest in an entity is not a prohibited assignment of the R&D credit.

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88 Tex. Gov't Code § 2001.038.

89 *Fiserv Inc. v. Hegar*, D-1-GN-21-002781 (pending in Travis County District Court).

III. Jurisdiction & Procedure

Procedural Rule Updates for 90-Day Certificate Deadline

Rule Amendments Replacing 60-Day Letter with New 90-Day Deadline. The Comptroller has adopted various rule amendments to implement a recent statutory change in sales tax procedure. After submitting a petition for redetermination, the Comptroller will issue written demand for resale and exemption certificates, and a seller is generally barred from claiming an exemption if the seller does not obtain and provide to the Comptroller it's customer certificate before the deadline. The change in the law extended that period from 60 days after the written notice to 90 days after written notice. The law allows the Comptroller to extend that period in writing if it agrees to do so.[90]

Taxpayers' representatives have always referred to this written demand as a "60-day letter." The rule amendments do away with that term refer to the Comptroller's demand simply as "written notice."

The Comptroller adopted amendments to the following rules to implement the statutory change:

Rule 1.10 (Practice & Procedure: Requesting a Hearing)

Rule 1.11 (Practice & Procedure: Statement of Grounds)

Rule 3.282 (Sales and Use Tax: Auditing Taxpayer Records)

Rule 3.285 (Sales and Use Tax: Resale Certificates)

Rule 3.287 (Sales and Use Tax: Exemption Certificates)

The rule amendments also contain various minor policy changes, such as providing that a Statement of Grounds filed electronically by a taxpayer's representative need not contain a signature and updating the contact information for the Office of Special Counsel for Tax Hearings.

New Rule for Banks Sharing Delinquent Taxpayer Records.

New Rule for Financial Institutions Sharing Delinquent Taxpayer Financial Records. On June 24, 2022, the Comptroller proposed new Rule 3.340.[91] The proposed new rule implements HB 1258, which enacted Tex. Tax Code § 111.025. The new statute requires

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90 Tex. Tax Code §§ 151.054, 151.104. See SB 296, 87th Leg., R.S.

91 47 Tex. Reg. 3659.

financial institutions to exchange data with the Comptroller on a quarterly basis to facilitate identifying bank accounts of delinquent taxpayers.

Subsection (a) provides definitions for the terms “account,” “account owner record,” [C]omptroller’s agent,” “data match,” “delinquent taxpayer,” “financial institution,” and “inquiry file.”

Subsection (b) describes the exchange of information between the Comptroller and financial institutions, which by law may occur no more than once each calendar quarter.

- Subsection (b)(1) explains the “matched accounts method,” under which the Comptroller provides an “inquiry file” to the bank listing delinquent taxpayers, and within 45 days the bank must respond with a list of all account holder who are on the inquiry file.

- Subsection (b)(2) explains the “all accounts method,” under which the bank submits to the Comptroller a list of all account owners.

Subsection (c) provides that the financial institution may not notify the account holder when providing account information to the Comptroller.

Subsection (d) addresses confidentiality; limits the Comptroller’s use of the information to matching with delinquent taxpayer data; requires that account information must be routinely destroyed; and prohibits the Comptroller for using the information for any other debt collection activities on behalf of the State.

Subsection (e) provides that a financial institution is not liable for any good faith actions it takes to comply with the rule.

Subsection (f) provides that levies issued during a data match are made within the statutory framework in Tex. Tax Code Chapter 111.

Subsection (g) provides that a suit to enforce the statute must be brought by the Attorney General in the Travis County district courts.

The deadline to submit public comments is July 24, 2022. Comments should go to James D. Arbogast, Chief Counsel for Hearings and Tax Litigation, P.O. Box 13528, Austin, Texas 787113528 or to the email address: james.arbogast@cpa.texas.gov.

Adding Subsequent Tax Periods to Pending Litigation

Paying Taxes for Subsequent Periods Under Protest Sufficient to Maintain Jurisdiction. The Third Court of Appeals has found that a taxpayer properly preserved the court's jurisdiction over its claims related to a protest payment for periods subsequent to the audit period in its protest suit.[92]

Black, Mann & Graham, L.L.P. ("BMG") is a Texas law firm employed by lending institutions to prepare loan documents. The Comptroller audited BMG and assessed sales tax on its payments to certain vendors. BMG paid the audit assessment under protest and brought suit challenging the Comptroller's assessment. While the suit was pending, BMG self-assessed Texas sales and use tax for subsequent periods, paid the self-assessed taxes under protest, along with a protest letter, and amended its pleadings to include the subsequent periods.

The Comptroller filed a plea to the jurisdiction, arguing that BMG's claim for the subsequent period failed to satisfy the statutory requirement for a "protest payment" because the amount was self-assessed, and the Comptroller "never claimed a specific amount of taxes" for the subsequent period. The Court rejected this argument, finding that a taxpayer need not wait for the Comptroller's tax assessment to add subsequent periods to a pending suit via a protest payment.

The 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. The Texas Supreme Court has now denied review, leaving the full Third Court's decision as the law of the land.

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.[93] 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

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92 *Black, Mann & Graham, L.L.P v. Hegar*, No. 03-20-00391-CV (Tex. App.—Austin Feb. 25, 2022, no pet. h.).

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

$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.[94] After the Comptroller denied El Paso's administrative refund claim, El Paso filed a district court lawsuit.[95] 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.[96]

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:[97]

> (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

94 Tex. Tax Code § 151.318(a)(4).

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

96 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).

97 Slip op. at 9.

not suffice to put the Comptroller on notice of the legal basis of a refund claim for telemetry units related to step-down transformers."[98]

The third member of the three-justice panel issued a dissenting opinion.[99] 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 . . ."[100] 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 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 motions for rehearing and 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

98 Slip op. at 11.

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

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

an administrative proceeding, while the taxpayer contends that recent legislation allowing taxpayers to bypass the administrative process entirely undermines this notion.

On November 9, 2021, the Third Court of Appeals denied the Comptroller's motions for rehearing and for en banc reconsideration.

On February 3, 2022, the Comptroller filed a Petition for Review with the Texas Supreme Court.[101] On June 17, 2022, the Texas Supreme Court denied the Petition for Review.

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101 *Hegar v. El Paso Electric Company*, No. 21-1062 (Tex. ___).