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Texas Comptroller Initiates Defensive And Offensive Strategy Against Perceived Abuses Of Administrative Procedure

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Texas taxpayers need to be prepared because the Texas Comptroller is well-armed for procedural battles over refund claims. The Texas Comptroller is attacking refund and audit strategies that the Comptroller views as abusive. Unfortunately, unsuspecting taxpayers may be caught in the cross-fire.

Strategies that the Comptroller finds offensive often attempt to extend the period during which refunds or audit offsets can be claimed and raise refund claims that arguably lack factual basis. One Comptroller complaint involves repeated filings of refund claims for the same tax type and period, attempting to toll the statute of limitations in hopes of discovering a legitimate refund claim. Some of these refund claims assert every conceivable basis for non-taxability (*e.g.,* every statutory exemption). Similarly, the Comptroller complains that taxpayers are extending audits in perpetuity hoping to discover an offsetting refund claim for the audited period.

In reaction to these types of strategies, the Comptroller previously sought and obtained legislation providing "swords" with which to combat these perceived abuses. With those additional weapons in the arsenal, the Comptroller is now taking the fight to taxpayers, both at the administrative level and in court.

Prior Preparations For Battle

In the last several legislative sessions, the Comptroller convinced the legislature to provide more weaponry for use in combating perceived abuses by taxpayers. Those prior legislative armaments generally included:

- requiring refund claims to be more detailed; [1]
- clarifying the deadline for filing a formal refund claim following the denial of an informal refund claim; [2]
- codifying the final deadline for producing documents in support of a refund claim; [3]

[1] Tex. Tax Code § 111.104(c) (eff. for refund claims filed on or after June 20, 2003).

[2] Tex. Tax Code § 111.105(a) (eff. for refund claims filed on or after June 20, 2003).

- expressly prohibiting duplicative or so-called "second" refund claims; [4]
- extending the period for the Comptroller to assess additional tax as a result of a federal determination; [5]
- mandating that the statute of limitations is not tolled during the pendency of an informal refund claim unless the taxpayer subsequently and timely requests a formal refund hearing; [6]
- providing that a protest payment does not toll limitations unless the taxpayer subsequently files a protest lawsuit; [7] and
- specifying that the limitations period is tolled during the pendency of an administrative redetermination or refund hearing (as opposed to a mere "administrative proceeding," which some argued included an informal refund claim), but only for the issues actually contested. [8]

Armed And More Dangerous

Armed with more procedural landmines, the Comptroller's Audit and Tax Divisions have shown a greater tendency to combat the claims of taxpayers by asserting procedural defects.

Hearing No. 45,369 – Refund in Redetermination Hearing May Not Be Raised Again As A Formal Refund Claim[9]

The Comptroller's Tax Division has become much more vigilant in arguing to prohibit a "second refund claim." Hearing No. 45,369 is a good example. The taxpayer was assessed following a franchise tax audit. The taxpayer filed a petition for redetermination protesting the assessment. During the redetermination hearing, the taxpayer alleged that the assessment should be offset by a refund (based on valuing assets at historical cost) unrelated to the original assessment. The Comptroller ultimately rejected the refund claim and the redetermination hearing became final.

The taxpayer then paid the audit assessment in full and filed a refund claim related to the valuation of assets at historical cost issue. The Comptroller's Revenue Accounting Division rejected the refund claim as a prohibited second refund claim, and the taxpayer requested a formal refund hearing. The taxpayer argued that the refund claim was not a prohibited second refund claim because it had previously been raised in the context of

(continued…)

[3] Tex. Tax Code § 111.105(e) (eff. for refund claims filed on or after June 20, 2003).

[4] Tex. Tax Code § 111.107(b) (eff. for refund claims filed on or after June 20, 2003).

[5] Tex. Tax Code § 111.206(b) (as amended eff. June 20, 2003).

[6] Tex. Tax Code § 111.1042(d) (eff. for refund claims filed on or after June 20, 2003).

[7] Tex. Tax Code § 111.207(a)(1) (eff. June 20, 2003).

[8] Tex. Tax Code § 111.207(a)(3), (b) (eff. June 20, 2003).

[9] Hearing No. 45,369, STAR No. 200510468H (Oct. 7, 2005).

a redetermination hearing and was unrelated to the audit adjustments. The Comptroller disagreed.

Noting that the Comptroller has on occasion converted a refund claim raised in a redetermination hearing into a stand alone, formal refund hearing, the Comptroller nevertheless held that the prohibition on second refund claims applies in this situation. In reaction to the taxpayer's argument that it had effectively been denied the opportunity to present its refund claim in court, the Comptroller pointed out that the taxpayer should have filed a refund suit within 30 days after having paid the contested refund amount to the Comptroller, rather than filing the duplicative refund claim with the Comptroller.

Observation: The procedural requirements for perfecting a tax lawsuit against the State, especially a refund suit, can be quite complex, especially in today's environment. Taxpayers proceeding without experienced Texas tax litigation counsel do so at their own peril.

Hearing No. 45,947 – Again, Duplicative Refund Claims Are Not Allowed[10]

Hearing No. 45,947 is yet another example of a taxpayer running head first into the prohibited second refund claim policy (which is now supported by the amended statute). This taxpayer was audited for sales tax compliance and the audit resulted in a net credit or refund. In addition to the agreed refunds, the taxpayer claimed the right to a refund of tax paid on charges to repair a plant damaged in an explosion. The Comptroller had previously denied that claim in a prior redetermination hearing. Rather than filing suit in district court on that claim, the taxpayer filed another refund claim with the Comptroller for that transaction. Instead of dismissing that refund hearing at the onset, the Comptroller explained why "do over" refund claims are not allowed.

Observation: Again, this area can be tricky. Once the Comptroller finally denies a refund claim, the remedy is to file a refund suit in Travis County district court, not to re-file the refund claim with the Comptroller.

Hearing No. 44,383 – Pending Sales Tax Redetermination Hearing Did Not Toll Limitations For Use Tax Paid Under Direct Pay Permit Because They Were Not The Same "Type Of Tax"[11]

The Comptroller's Tax Division recently flexed its muscles rejecting a refund claim for use taxes paid under a direct pay permit on the basis that limitations had expired. The taxpayer was audited for sales and use tax compliance (under its sales and use tax permit) for the period 1992-1996. The audit resulted in a deficiency that the taxpayer timely protested. The redetermination hearing was finalized in March 2003.

The taxpayer was separately audited for use tax compliance under its direct pay permit for the period December 1993 through June 1996. That audit resulted in a net credit. The taxpayer protested the audit claiming additional credits were owed. Based on the

[10] Hearing No. 45,947, STAR No. 200602609H (Feb. 1, 2006).

[11] Hearing No. 44,383, STAR No. 200605683H (May 4, 2006).

protest, the direct pay audit was amended, and the taxpayer did not request a hearing on the amended audit. The amended audit became final in June 2001.

During October 2002, the taxpayer filed a sales and use tax refund claim covering the period January 1992 through June 1996. The refund claim was docketed as a formal refund rehearing (No. 42,946), separate from the corresponding sales and use tax redetermination hearing for that period. That refund claim was within limitations under the law applicable at that time because limitations had been tolled by the pending redetermination hearing "for the same period and type of tax." *See* Tex. Tax Code § 111.207(d) (repealed eff. June 20, 2003).

During March 2003, the taxpayer submitted documents supporting its claim of overpaid taxes under both its sales and use tax permit and its direct pay permit. The documents related to the sales and use tax permit were considered in refund Hearing No. 42,946 and a refund was subsequently issued. The auditor rejected the documents related to the direct pay permit, leading to Hearing No. 44,383.

The Comptroller ruled against the taxpayer on the direct pay permit refund claim on the basis that limitations had expired. The Comptroller rejected the taxpayer's argument that the pending redetermination hearing on sales and use taxes for the period tolled the statute of limitations for the direct pay permit. Under the statute in effect at that time, in determining the expiration date for filing a refund claim, the period during which an administrative proceeding is pending before the Comptroller for the same period "and type of tax is not considered . . ." (i.e., the period for filing the refund claim related to the direct pay permit would be extended by the sales and use tax redetermination hearing if they both involved the same type of tax). *See* Tex. Tax Code § 111.207(d) (repealed eff. June 20, 2003). The Comptroller reasoned that the tax paid under the direct pay permit is a different tax type than the tax paid under the sales and use tax permit. Thus, the redetermination hearing related to the sales and use tax permit did not toll limitations for filing a refund claim for tax paid under the direct pay permit.

Note: Even though the subsection of the statute leading to this result was repealed in 2003, it is not clear that the outcome would be different under current law. Under current law, the expiration date for a refund claim is extended during the pendency of a redetermination hearing, but only for the "issues that were contested" in the redetermination hearing. *See* Tex. Tax Code § 111.207(a)(3), (b). Thus, under current law the outcome hinges not on whether the taxes were of the same type (sales tax permit taxes and direct pay permit taxes), but on whether the issues contested in the redetermination hearing were the same issues contested in the refund claimed for tax paid under the direct pay permit.

In a recent hearing, the Comptroller held that "issues that were contested" include the specific reason or ground advanced in the hearing and "all issues inherently inclusive within that specific reason or ground."[12] For example, in Hearing No. 45,190A, the Comptroller held that a refund claim for franchise tax attributable to receipts erroneously

[12] *See* Hearing No. 45,190A, STAR No. 200604611H (April 11, 2006).

sourced to Texas in violation of the "necessary delay in transit" requirement under the Commerce Clause would be "inherently inclusive" of a refund claim for franchise tax attributable to receipts thrownback to Texas in violation of the holding in *Home Interiors & Gifts v. Strayhorn*, 175 S.W.3d 856 (Tex. App.—Austin 2005, pet. filed) (holding throwback rule unconstitutional under the Commerce Clause as applied). The Comptroller reasoned that both involved Commerce Clause challenges to the franchise tax.

Observation: Hearing No. 44,383 was a situation in which the taxpayer submitted no less than 76 separate contentions for why it was due a refund. Apparently, the taxpayer believed it had overpaid tax under virtually every conceivable exemption under the Tax Code and Comptroller Rules (*e.g.,* for tax-exempt purchases of water, newspapers, manufacturing equipment, prototyping services, fuel for trains, medical devices, etc., etc., etc.).

This hearing highlights the "chicken and egg" problem resulting from battles between the Comptroller and taxpayers. Faced with perceived abusive refund claims, the Comptroller sought and obtained legislation substantially tightening the requirements for refund claims. The legislation requires that a refund claim state "fully and in detail each reason or ground on which the claim is founded" and that the limitations period is tolled during the pendency of a redetermination or refund hearing only for the "issues that were contested." Because of that legislation, some taxpayers felt compelled to file refund claims asserting every conceivable reason or ground for why a refund is due, in order to toll limitations for as many "issues" as possible. The Comptroller may view those protective claims as abusive (and thus push to expedite the discovery and production of documents supporting such refund claims—see below). When the battle dust finally settles at the end of the day, hopefully the road to victory is somewhere in the middle—neither rewarding taxpayers who overstate claims nor penalizing taxpayers who provide general notice of the issues raised.

The Comptroller Takes Procedural Fight To Court—Franchise Tax Refund Claim Barred By Limitations

The Comptroller's heightened enforcement of procedural issues is not limited to the administrative level. In *El Paso Natural Gas Co. v. Strayhorn*,[13] the Texarkana Court of Appeals recently sustained the Comptroller's denial of a refund claim as time barred. The taxpayer sought a refund of franchise taxes overpaid on its 1989 and 1990 returns. The taxpayer had filed a petition for unrelated franchise tax issues in Hearing No. 34,943. On January 12, 1998, the Comptroller's administrative law judge dismissed Hearing No. 34,943 based on the agreement of the parties, including the waiver of the right to file a motion for rehearing.

Sixteen days later, on January 28, 1998, the taxpayer filed a petition involving other issues and initiating Hearing No. 37,477. On July 16, 1998, the taxpayer's right to amend its petition in Hearing No. 34,477 to add a refund claim lapsed (as a matter of

[13] *El Paso Natural Gas Co. v. Strayhorn*, No. 06-05-00059-CV (Tex.App.—Texarkana Oct. 18, 2006, no pet. h.).

Comptroller policy). The taxpayer subsequently sought permission to reopen the record in Hearing No. 34,477 in order to raise the refund issue, but the motion was denied. Shortly thereafter, the taxpayer filed the refund claim in another petition resulting in Hearing No. 43,135. Thereafter, the taxpayer filed a refund suit in district court leading to the *El Paso Natural Gas* decision.

The Comptroller argued that the refund claim in Hearing No. 43,135 was barred by limitations, and the court agreed. The court reasoned that while the limitations period was tolled during the pendency of Hearing No. 34,943, such that the taxpayer could have raised the issue in that hearing, Hearing No. 34,493 became final, and the refund claim became time-barred on January 12, 1988 when Hearing No. 34,493 was dismissed and the parties waived the right to file a motion for rehearing. Because limitations had already expired, filing the petition resulting in Hearing No. 37,477 could not revive the limitations period for the refund claim. As the court held, the 6-month extension of the normal statute of limitations "after a jeopardy or deficiency determination becomes final" applies only to a jeopardy or deficiency determination on the same issues as the refund claims for which the extension is claimed. Because the determination resulting in Hearing No. 34,943 did not involve the same issue as the refund claim, the extension did not apply.

Observation: The procedural hoops necessary to get to the court's ruling are complex, mind-boggling – and based on former law. In these types of situations in the future, the Comptroller may simply point to a new statutory weapon: "the suspension of a period of limitation under Subsection (a) is limited to the issues that were contested under Subdivision (1), (2), or (3) [*i.e.*, the period during which an administrative redetermination or refund hearing is pending before the Comptroller]." *See* Tex. Tax Code § 111.207(b) (eff. June 20, 2003).

On Audit, You Get One Free Shot, But No More

Not to be out-gunned by the Comptroller's Tax Division, the Audit Division has similarly become more aggressive on issues of process and procedure. At a recent conference, Audit announced plans to substantially shorten the time to process a refund claim or finalize an audit. According to the plan, taxpayers will get one extension of time to respond to a document or information request. Second extensions will not be granted unless the taxpayer can show "substantial progress." Perhaps this may be an attempt to "weed out" refund claims that are essentially protecting unknown turf (*i.e.*, filed without a specific, provable, ground).

Audit also advised that it increasingly sees petitions for redetermination filed after the due date. According to Audit, absent extraordinary circumstances (such as where the taxpayer died with the petition in her hands while trying to file it), no relief will be granted. For taxpayers lacking extraordinary circumstances, the most direct remedy is to pay the amount alleged due, in full, and file a refund claim.

Conclusion

Texas state tax procedure has become incredibly complex, confusing, and rife with a host of hidden landmines for the unwary. Be on guard.■

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