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WINNING AN “ESSENCE OF THE TRANSACTION” CASE IN TEXAS

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Jones Day recently won a significant “essence of the transaction” sales tax redetermination hearing against the Texas Comptroller of Public Accounts before the State Office of Administrative Hearings. At issue was whether Taxpayer, a major automobile retail customer lead-generation company, was liable for Texas sales tax on its customer referral services involving direct-mail advertising.

Following a contested hearing, the SOAH administrative law judge agreed with our contention that the “essence of the transaction” was a nontaxable customer referral service rather than a taxable direct-mail advertising service. The ALJ ruled in favor of Taxpayer on all contested issues, and the Comptroller adopted the ALJ’s opinion. The entire contested assessment was subsequently reduced to zero. See Texas Comptroller Hearing No. 46,579, SOAH Docket No. 304-10-1028-26 (2010).

Background

Automobile dealers often hire the Taxpayer at issue to solicit referrals of potential automobile purchasers meeting certain credit criteria, using internet, television, and direct-mail advertising packages. The hearing challenged the treatment of the Taxpayer’s referral method that involved the Taxpayer’s use of targeted direct-mail advertising to solicit leads.

Based on credit criteria, location, and number of direct-mail letters selected by automobile dealers, the Taxpayer acquires a targeted mailing list from a credit-reporting agency and contracts with a direct-mail vendor to print and mail letters to Taxpayer’s designated recipients. The dealers do not take possession of the letters and do not know the names of the letter recipients. In most, if not all, instances, the dealers are not mentioned in the letters. The letters direct the recipients to call the Taxpayer if they are interested in purchasing a vehicle. If a potential automobile purchaser meets a dealer’s criteria, the Taxpayer refers the recipient to the respective dealer. The Taxpayer charges dealers for the referral service according to the number of direct-mail letters selected—the number of referrals is not guaranteed.

The Texas Comptroller maintained that the Taxpayer provides a taxable direct-mailing/printing service to dealers, and it assessed the Taxpayer for uncollected Texas sales tax. The ALJ rejected the Texas Comptroller's position and agreed with the Taxpayer's contention that the essence of the transaction was a nontaxable customer referral service. The ALJ reached his decision in part because the direct-mail letters were never in the possession or control of dealers and the letters directed potential automobile customers to call the Taxpayer (not the dealers). In reaching his decision, the ALJ held that the evidence presented by Jones Day was "compelling" that the essence of the service provided was not direct-mail advertising.

Analysis

The Taxpayer had a compelling story—dealers did not purchase a direct-mailing service; they purchased qualified customer referrals. Winning this "essence of the transaction" case turned in large part on how the facts and evidence were presented to support the story.

As in most cases, not all facts were helpful to the Taxpayer's case. The contracts were unclear. Limited materials were available from the audit period. The dealer order forms and invoices stated the number of letters ordered and the charges per letter, which led the auditor to conclude that the Taxpayer was providing a direct-mailing service.

There were important facts in the Taxpayer's favor, however. The Taxpayer used an external vendor to print and mail the letters. The customers were not simply buying direct mail services. The Taxpayer charged its customers substantially more than the printing and mailing costs to the Taxpayer. The letters themselves did not mention a dealer's name, but rather directed the recipient to call the Taxpayer if he or she was in the market to purchase a car. These facts all indicated that the Taxpayer was not simply providing a direct-mailing service to the dealers.

To support the Taxpayer's position that it provides a nontaxable lead-generation service to dealers, the Taxpayer produced samples of the advertising materials it sends to the dealers. Although the advertising materials were dated after the audit period, they showed the intent of the parties and supported the position that the essence of the transaction was the generation of qualified referrals, not the production of direct mailers. The Taxpayer also produced an affidavit by an employee who walked through Taxpayer's services and the evidence produced in detail.

While the limited amount of evidence may have discouraged some from contesting the issue, we are happy to report that the Taxpayer was ultimately rewarded for standing its ground. The ALJ, swayed by the story and evidence that the Taxpayer presented, granted a 100 percent victory on the contested issues.

The hearing shows what some hard work and creative thinking can do. Who says taxpayers cannot win at SOAH? Sometimes the argument just needs to be "compelling."



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