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TEXAS TAX DEVELOPMENTS – 2011 MARGIN TAX AND SALE/USE TAX UPDATE

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There were a number of important developments in the State of Texas during 2011. The legislature met in both a regular session and a special session, resulting in legislative changes to both the Texas margin tax and the Texas sales tax. The Texas courts heard and decided a number of important cases. And the Texas Comptroller issued a wealth of policy. Some of the more interesting developments are noted below.

Margin Tax

1. Small Business Franchise Tax Exemption (Senate Bill 1, Article 37).

This legislation extends the $1 million small business franchise tax exemption through 2013. A $600,000 no-tax-due threshold takes effect January 1, 2014. Effective September 28, 2011.

2. Franchise Tax Exclusions (Senate Bill 1, Article 45).

This legislation excludes payments made to artists by a qualified live-event promotion company from the company's total revenue for franchise tax purposes; it also excludes from the franchise tax unincorporated entities organized as political committees under the Election Code of the Federal Election Campaign Act and pass-through charges paid by courier and logistics companies to nonemployee agents. Effective January 1, 2012.

3. Apparel-Rental Activities (Senate Bill 1, Article 51).

This legislation classifies apparel-rental activities as retail trade for purposes of the franchise tax rate (½ percent). Effective January 1, 2012.

4. Research and Development Incentives Study.

The Texas Legislative Budget Board (LBB) is required to study the costs and benefits of reenacting the credit for research and development activities. The LBB is also required to study similar incentives offered by other states. House Bill 2383.

5. *TGS-NOPEC Geophysical Co. v. Combs*, 340 S.W.3d 432 (Tex. 2011). **Receipts from licensing the use of data are apportioned to the location of the payor, not to the location of use.**

The issue in this case is the proper method for apportioning receipts from the licensing of geological and seismic data. The Texas statute includes as Texas receipts "the use of a patent, copyright, trademark, franchise, or license in [Texas]." The court of appeals held that the receipts in question were from the use of a license within the meaning of the statute and that the Comptroller's methodology for determining the location of "use" was reasonable. The Texas Supreme Court reversed, holding that receipts for licensing an intangible (in this instance, the data) are not receipts for a "license," but instead are receipts from licensing the use of an intangible. Because the data was not specifically listed in the statute, the "location of use" sourcing rule did not apply. Instead, the court applied the default rule for sourcing intangibles other than those specifically listed in the statute. Under the default "location of payor" rule, such receipts were properly sourced to the legal domicile of the payor (which in this case was not Texas).

6. *AllCat Claims Service, L.P. v. Combs*, No. 11-0589 (Tex. Nov. 28, 2011). **Texas margin tax does not violate the Texas prohibition on taxing the income of individuals because the tax is imposed on legal entities and not on individual partners.**

In this case, the taxpayer claimed that the Texas margin tax is a tax on the income of natural persons, which if true would violate the Texas Constitution absent voter approval.[1] The prohibition does include a tax on "a person's share of partnership and unincorporated association income." The individual limited partner of the partnership/taxpayer argued that the tax applies to the net income of natural persons because it: (1) reduces the distributive share paid to the individual partners and (2) reduces the value of the partnership interest itself. The Comptroller claimed that the tax is imposed on the partnership itself, not on the individual partners, and that the Texas Constitution does not prohibit an income tax on legal entities merely because the entities happen to be owned by individuals.

In enacting the margin tax, the legislature specified that such challenges shall be heard by the Supreme Court of Texas and that the court must issue a decision within 120 days of the filing of the challenge.

The Texas Supreme Court ruled in favor of the Comptroller. The court held that the Texas margin tax is imposed on legal entities, not on their shareholders or owners. For example, a limited partnership is a taxable entity. And taxing the limited partnership does not amount to

[1] The Texas Constitution, Article VIII, Section 24, provides: "A general law enacted by the legislature that imposes a tax on the net incomes of natural persons, including a person's share of partnership and unincorporated association income, must provide that the portion of the law imposing the tax not take effect until approved by a majority of the registered voters voting in a statewide referendum held on the question of imposing the tax. The referendum must specify the rate of the tax that will apply to taxable income as defined by law."

taxing an individual partner's share of partnership income. There is no option to appeal the substantive holding.

7. *Taylor & Hill, Inc. v. Combs*, No. D-1-GN-10-004429 (Tex. Dist. Ct. 2011).

A registered professional engineering firm temporarily assigning its employees to its clients to supplement its clients' workforce in special situations was a staff leasing company qualifying for the revenue exclusion.

8. Comptroller Hearing Nos. 103,786 (2011); 104,092 (2011).

For purposes of qualifying for the ½ percent tax rate, if a company provides services and sells tangible personal property, only the stand-alone sales of tangible personal property qualify as retail or wholesale trade. For example, if the company sells tangible personal property and provides related services, those receipts are not from a retail or wholesale trade.

9. Comptroller Letter No. 201109204L (Sept. 30, 2011).

An insurance company may be excluded from the Texas unitary group if it pays gross premiums taxes in Texas. An insurance company paying gross premiums taxes to other states is not (by that fact alone) excluded from the Texas unitary group of its affiliates.

10. Comptroller Letter No. 201108182L (Aug. 30, 2011).

For purposes of cost of goods sold (COGS), direct labor includes only the labor of those who physically produce or acquire a good. Supervisory labor does not qualify as a deductible direct cost.

11. Comptroller Letter No. 201005184L (May 5, 2010).

A series of an LLC as a whole is a taxable entity and must file a single margin tax report. One series of a series LLC cannot file a margin tax report separate from the LLC.

12. Comptroller Taxability Memo No. 201108166L (Aug. 1, 2011).

For purposes of COGS, a company selling software will be considered to be selling tangible personal property even though the company is merely providing a license to use software.

13. Comptroller Taxability Memo No. 201108165L (Aug. 9, 2011).

If, upon audit, two or more entities or groups of entities are found to be unitary (required to file a single combined return), the resulting combined group may elect to compute margin using any method (COGS or compensation) used by any member on the returns as originally filed.

14. Comptroller Letter No. 201101133L (Jan. 2011).

While lending institutions are allowed to deduct interest as COGS, a lending institution making loans only to customers purchasing products does not qualify because it does not offer loans to the public.

15. Comptroller Hearing No. 103,083, STAR No. 2010201007874H (July 28, 2010).[2] **Taxpayer may not amend its franchise tax report to change the method used to calculate taxable margin from the 70 percent of revenue method to COGS.**

The taxpayer filed an amended franchise tax report for 2008 in which it sought to change the method it used to calculate taxable margin from the 70 percent of revenue method to deducting COGS. The Comptroller denied the refund, citing Rule 3.584, which the Comptroller claimed precludes a taxable entity from amending its report to change its election to the COGS or compensation deduction after the due date of the report. The taxpayer requested a refund hearing on the grounds that the original report was prepared using the best information available and that a later review of its business and a redesign of its accounting system produced an accurate COGS calculation.

The decision of the administrative law judge (ALJ) turned on the construction of Texas Tax Code § 171.101(a) and (d) and Rule 3.584(f), which control the election for computing margin. The Tax Code provides that, as an alternative to the 70 percent of revenue margin calculation, taxable margin may be calculated by subtracting COGS or compensation from total revenue. The election to use the COGS or compensation deduction must be made by the due date of the report. Rule 3.584 explicitly prohibits an entity from amending its report to change to a COGS or compensation deduction after the due date of the report.

The ALJ agreed with the Comptroller and affirmed the denial of the refund claim. The ALJ stated that the 70 percent of revenue method of computing margin is not an election, but rather operates as a base line or default for computing margin and that, for this reason, it is not inconsistent for the Comptroller to allow amendments to change from COGS or compensation to the 70 percent method but not allow the reverse change. The ALJ also found that the Comptroller's position was supported by the legislative history of Texas Tax Code § 171.101(d).

[2] See also Comptroller Hearing No. 104,076, SOAH 304-11-1254.13, STAR 201102012K (Feb. 2011); Comptroller Hearing No. 103,083, SOAH 304-10-3742.13, STAR 201007874H (July 2010) (taxpayer not entitled to change from 70 percent deduction to COGS on amended report); Comptroller Hearing No. 103,807, SOAH 304-10-5541.13, STAR 20101197H (Nov. 2010) (taxpayer not entitled to change from 70 percent deduction to compensation on amended report); Comptroller Hearing No. 103,450, SOAH 304-10-4202.13, STAR 201008923H (Aug. 2010) (taxpayer not entitled to change from E-Z Computation to COGS on amended report).

16. **No Exclusion for 1099 Labor for Non-COGS Companies** – Comptroller Taxability Memo No. 201104031L (April 19, 2011).

In this taxability memo, Comptroller franchise tax policy explained to Comptroller audit that a transportation company that contracts with independent owner/operators to perform transportation services on its behalf could not deduct the 1099 payments from its total revenue. The taxpayer elected COGS on its returns, but that was disallowed on audit. The taxpayer then amended its federal income tax returns by netting the 1099 payments from its total revenue. Franchise tax policy explained that if the taxpayer was responsible for the transportation (as opposed to finding someone else to transport the goods), then the taxpayer cannot net the 1099 payments from its total revenue, even if the taxpayer files amended federal income tax returns. Citing the IRC § 61 definition of "gross income," policy concluded that there is no federal basis for removing 1099 payments to independent contractors from revenue on a federal tax return.

Note: Companies that qualify for COGS can generally deduct 1099 labor.

17. Comptroller Hearing No. 103,340, SOAH 304-10-5539.13, STAR 2011010074H (Jan. 2011).

The taxpayer did not qualify for the ½ percent rate where more than 50 percent of revenue was attributable to products produced by the taxpayer's 100 percent related parent, even though the parent was in turn owned by 10 individuals whose ownership interests ranged from 42.6 percent to 0.65 percent. The parent and the taxpayer were still considered members of the same affiliated group.

18. **Access Fees for Social-Networking Site Sourced to Location of Payor** – Comptroller Letter Ruling No. 201102989L (Feb. 2, 2011).

Comptroller franchise tax policy held that a social-networking web site's revenues from its access fees should be sourced to the location of the payor.

Sales Tax

1. Restricted Sale-for-Resale Exemption.

Effective October 1, 2011, the sale-for-resale exemption is restricted to items that will be resold as or with a taxable item. The intent is that items purchased for use in performing a nontaxable service will not qualify for the exemption. In reaction to the *Blue Cross* case, the exemption is further amended to clarify when purchases of items for use in performing contracts with the federal government qualify for the exemption. Senate Bill 1 (2011).

2. Definition of "Retailer" Amended.

The sales tax was amended to provide that the terms "seller" and "retailer" include a person who, by agreement with an owner of tangible personal property, has been entrusted with possession of, and authority to sell, lease, or rent, the property, without additional action on the part of the owner.

The term "retailer engaged in business in this state" was also amended to include a retailer who:

> (1) holds a substantial ownership in, or is owned in whole or substantial part by, a person who maintains a business location in this state if the retailer sells substantially the same product line and does so under substantially the same business name as the related retailer or if the facilities or employees of the related person in this state are used to advertise, promote, or facilitate sales by the retailer or are used to maintain a marketplace in this state for the retailer, exchanging returned merchandise; or
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> (2) holds a substantial ownership in, or is owned in whole or substantial part by, a person that maintains a distribution center, warehouse, or similar location in this state that delivers property sold by the retailer.

The term "substantial ownership" generally means 50 percent. Senate Bill 1 (2011).

3. New $50 Late-Filing Penalty.

Beginning with reports originally due on or after October 1, 2011, the Comptroller will assess a penalty of $50 when certain tax reports are filed late. The penalty applies to late-filed sales tax, margin tax, hotel occupancy tax, mixed beverage gross receipts tax, and certain other taxes. Previously, penalty did not attach until the third late-filed report. Senate Bill 1.

4. Recordkeeping/Contemporaneous Documents.

Senate Bill 1 requires taxpayers to keep records open for inspection for at least four years (which is the normal statute of limitations) and, with respect to records related to a taxpayer's claim, longer than four years during any period when tax, penalty, or interest may be assessed, collected, or refunded by the Comptroller or while an administrative hearing or judicial proceeding is pending.

The bill also requires taxpayers to produce contemporaneous records and supporting documentation for transactions in question, in order to enable verification of claims related to the amounts of tax, penalty, or interest to be assessed, collected, or refunded in an administrative hearing or judicial proceeding.

5. Tax Exemption Number for Agricultural Exemption.

Beginning January 1, 2012, a person claiming an exemption from sales tax on the purchase of certain items used in the production of agricultural and timber products must provide a registration number issued by the Comptroller on the exemption certificate issued to the seller. The Comptroller's office has developed a new system for use in obtaining an agricultural exemption number. House Bill 268.

6. Internet Hosting Does Not Create Nexus.

Effective 2011, contracting with an internet web host in Texas does not create nexus with Texas. House Bill 1841.

7. *Combs v. Health Care Services Corp.* (a.k.a. Blue Cross), No. D-1-GN-04-001955 (Travis Co., Tex., Dist. Ct. July 2009), *affirmed*, No. 03-09-00617-CV (Tex. App.—Austin March 16, 2011, no pet. hist.) (slip op. at http://www.3rdcoa.courts.state.tx.us/opinions/pdfOpinion.asp?OpinionID=20044). **Items purchased for use in performing service contracts for the federal government qualify for sale-for-resale exemption.**

In *Combs v. Health Care Services Corp.* (a.k.a. Blue Cross), the taxpayer obtained a *$4.8 million* judgment[3] against the State of Texas for Texas sales tax paid on items purchased for use in performing "cost-plus" service contracts for the federal government. Blue Cross originally paid Texas sales tax when it purchased the items.[4] Blue Cross claimed, and the district court and the Austin Court of Appeals held, that the purchase of the items was exempt from the Texas sales tax because the items were resold to the federal government by virtue of the title-passage provisions in the Federal Acquisition Regulations (48 C.F.R. 52.245-5 and 52.245-2). The courts held that Blue Cross was entitled to a refund of the Texas sales tax paid when it purchased the items. In Senate Bill 1, discussed above, the legislature subsequently amended the sale-for-resale-exemption statute, effective October 1, 2011. in an effort to limit this decision.

8. *Khan v. Texas*, No. 03-09-00708-CV (Tex. App.—Austin Aug. 31, 2011, no pet. hist.).

The owner of a number of convenience stores was held personally liable for the Comptroller's estimated sales tax assessment issued against the stores.

9. *Austin Engineering Co., Inc. v. Combs*, No. 03-10-00323-CV (Tex. App.—Austin Aug. 5, 2011, no pet. hist.).

The taxpayer was liable for sales tax on construction-related erosion-control measures and services. According to the court, the essence of the transaction was not the performance of erosion-control services, but the sale of tangible personal property used to prevent erosion. The case was remanded to trial for consideration of the taxpayer's alternative-exemption claims.

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[3] The issue has been touted as the "billion-dollar" refund when applied to other, similarly situated companies.

[4] The items included office supplies, furniture, telephone equipment, utilities, capitalized assets, services (telephone, laundry, printing, landscaping, and janitorial services), leased assets, and software and maintenance on software.

10. *Roark Amusement & Vending, L.P. v. Combs*, No. 03-10-00105-CV (Tex. App.—Austin Jan. 26, 2011). **Tangible personal property purchased for use in performing a taxable albeit exempt amusement service qualified for the sale-for-resale exemption.**

In *Roark Amusement & Vending, L.P. v. Combs*, the Austin Court of Appeals held that toys purchased for use in performing a taxable albeit exempt amusement service qualified for the sale-for-resale exemption. Roark owned and leased coin-operated amusement crane machines, which it placed at various grocery stores, restaurants, and shopping malls in Texas and other states. Roark held a license issued by the Comptroller's office for amusement machines. It paid Texas sales tax on its lease payments for the machines and an annual occupation tax for each machine it owned in Texas.

Roark sought a refund of the sales tax it paid on the plush toys used to stock the machines, arguing that the toys were subject to the sale-for-resale exemption because they were transferred as an integral part of Roark's taxable amusement services. *See* Tex. Tax Code Ann. § 151.006(a)(3) (defining "sale for resale" to include sale of "tangible personal property to a purchaser who acquires the property for the purpose of transferring it . . . as an integral part of a taxable service"); *id.* § 151.0101(a)(1) (including "amusement services" within the definition of "taxable services"). The Comptroller countered that the integral-transfer exemption does not apply, arguing that Roark's services are not "taxable" for purposes of the sale-for-resale exemption because the Tax Code specifically exempts coin-operated amusement services from sales and use tax. *See id.* § 151.335 ("Amusement and personal services provided through coin-operated machines that are operated by the consumer are exempt from the taxes imposed by this chapter."). Thus, in the state's view, Roark is the ultimate consumer of any tangible personal property—including the plush toys—used to perform its nontaxable amusement services.

The Austin Court of Appeals ruled in favor of Roark. The court held that the purchase of the toys qualified for the sale-for-resale exemption, notwithstanding the fact that the toys were used in performing an exempt service. In so holding, the court distinguished between nontaxable services and those services that, like the amusement services in question, are taxable but qualify for an exemption.

11. Comptroller Hearing No. 47,782, SOAH 304-09-0632.26, STAR 200908044H (Aug. 2009) – **Taxpayer was liable for use tax on aircraft because the aircraft was hangared in Texas.**

An aircraft not hangared in Texas is subject to Texas use tax only if the Texas use is 50 percent or greater. The Comptroller ruled that once it is shown that an aircraft was hangared in this state, use tax is due on that basis, and taxability does not depend upon the percentage of Texas use.

12. Comptroller Letter Ruling No. 201104034L (April 2011) – **Title company may not purchase survey services for resale. Purchase of survey services by a title company does not qualify for exemption afforded to contractors.**

13. Comptroller Hearing No. 101,650, SOAH 304-10-5471.26, STAR 201103022H (March 2011) – **Refund was denied for tax paid on purchases of cryogenic plants that are part of a gas manufacturing plant.**

While Tax Code Section 151.318 does not state explicit rules for determining what constitutes an item of manufacturing equipment, the Comptroller ruled that the exemption does not apply broadly to plants or segments of plants, but rather to specific items within the plant that directly make or cause a chemical or physical change to the product being manufactured or processed.

14. Comptroller Hearing No. 46,579, SOAH 304-10-1028-26, STAR 201006866H (2010) – **Essence of direct-mail transactions was a nontaxable referral service.**

The taxpayer is hired by automobile dealers to solicit referrals, using internet, television, and direct-mail advertising packages, of potential automobile purchasers meeting certain credit criteria. At issue in the hearing was the taxpayer's use of targeted direct-mail advertising to solicit leads. On the basis of credit criteria, location, and the number of direct-mail letters selected by the 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 the taxpayer's designated recipients. 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 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 Comptroller Tax Division maintained that the taxpayer provides a taxable direct-mailing/printing service to dealers and assessed the taxpayer for uncollected Texas sales tax. The ALJ rejected the Tax Division'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 the dealers and the letters directed potential automobile customers to call the taxpayer (not the dealers). The ALJ held that our case was "compelling."

15. Comptroller Hearing No. 102,623, SOAH 304-10-2491.26, STAR 201008903H (Aug. 2010) – **Sales tax applies to purchase of packaging items by entities other than the manufacturers.**

The taxpayer sold collectible coins. The taxpayer purchased coin cases and holders to package its coins for sale and shipment to its customers, without paying sales tax. The Comptroller assessed tax on the purchases of the cases and holders as taxable packaging supplies. In the ensuing

redetermination hearing, the taxpayer claimed that the coin cases and holders become an integral part of the coins and that the cases and holders are necessary to preserve the value of the coins. The Tax Division argued that the taxpayer was a retailer and that the coin holders and cases it purchased were taxable packaging supplies under Texas Tax Code Section 151.302(c). This section does not allow a resale exemption for packing and wrapping supplies purchased in the furtherance of a sale of tangible personal property. Additionally, Tax Code Section 151.302(c) provides that packaging supplies used in wrapping or packing tangible personal property for the purpose of furthering the sale of tangible personal property may not be purchased for resale. The ALJ determined that the taxpayer was a retailer, not a manufacturer, and that as such, the taxpayer was not eligible to claim an exemption for packaging and wrapping supplies.

16. Refunds & Statutes of Limitations – 34 TAC 3.325 & 3.339.

The Texas Comptroller recently amended the administrative rules governing refund claims. These proposed rules reflect a number of changes in the refund procedures in Texas during the last several years. These rules illustrate a number of traps of which to be mindful in considering refund claims in Texas, such as procedural remedies, pleading requirements, exclusive remedy (jurisdictional) issues, statute-of-limitation issues, and the "prior collection" rule, to name a few. Effective July 19, 2011.

17. Exempt Organizations – 34 TAC 3.322.

The Comptroller amended Rule 3.322 regarding exempt organizations in part in reaction to legislation, but also to express agency policy concerning who is responsible for remitting sales tax when an exempt organization contracts with a private entity to sell taxable items belonging to the private entity during fundraising events. The latter change was prompted by the Austin Court of Appeals' decision in *Combs v. Entertainment Publications, Inc.*, 292 S.W.3d 712 (Tex. App.—Austin 2009, no pet.). Effective August 2011.

18. Security Services – 34 TAC § 3.333.

The Comptroller modified the regulation concerning security services to conform with legislation changing the definition of "security service" to "any service for which a license is required." The amended regulation changes the licensing authority to Occupations Code Chapter 1702, adds a new license required under Section 1702.1025, and adds electronic access control device companies, locksmith companies, and private security consultant companies to those requiring a license. Certain persons who provide telematics services, certain persons who provide personal emergency-response systems, accountants, and persons selling alarm systems through e-commerce are now excepted from the licensing requirements. Finally, services involving the use of a slim jim or similar device to unlock a vehicle are now exempt from sales tax. Effective February 24, 2010.

19. Seller's and Purchaser's Responsibilities – 34 TAC § 3.286.

The Comptroller modified the regulation regarding sales and use tax permit and collection requirements for entities that engage in business in the state. In addition to entities previously listed, the amendments indicate that the following are engaged in business in the state and are required to obtain a tax permit for each place of business operated in the state: (1) promoters of

arts and crafts shows or festivals, (2) kiosk operators, (3) itinerant vendors, and (4) sellers that own or use computer servers or software or other tangible personal property in the state.

The amendments also provide that a tax-exempt entity which runs a fundraiser and sells taxable items, other than amusement services, provided by a for-profit entity is considered the for-profit entity's representative, and the for-profit entity is considered the seller. As a result, the for-profit entity must obtain a permit and is responsible for proper tax collection and remittance. Furthermore, such a fundraiser would not qualify as a tax-free sale.

The amendments also add related definitions, provide due dates for electronic payments, and make additional clarifications. Effective July 11, 2010.