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TEXAS USE TAX APPLICABLE TO MATERIALS TEMPORARILY AFFIXED IN TEXAS FOR ULTIMATE TRANSFER AND USE OUTSIDE TEXAS

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In *Combs v. Chapal*,[1] the Austin Court of Appeals held that the Texas use tax applied to materials purchased outside Texas, affixed to other property in Texas, and then shipped outside Texas, notwithstanding the exception in the use tax statute for property attached to other property. The taxpayer bought marketing materials[2] suitable for use in selling jewelry outside Texas and had the materials shipped to Texas. Once the materials were in Texas, the taxpayer affixed the materials to jewelry purchased from outside Texas. The taxpayer then shipped the combined materials and jewelry by common carrier to Chapal's customers outside Texas. Chapal's customers used the combined materials and jewelry in making sales to ultimate consumers.

The Comptroller assessed Texas use tax against Chapal attributable to the materials. Chapal challenged the assessment, arguing that it did not make a taxable "use" of the materials in Texas. In relevant part, the applicable statute provides that:

> (f) Neither "use" nor "storage" includes the exercise of a right or power over or the keeping or retaining of tangible personal property for the purpose of:
>
> (1) transporting the property outside the state for use solely outside the state; or
>
> (2) processing, fabricating, or manufacturing the property into other property or *attaching the property to or incorporating the property into other property* to be transported outside the state for use solely outside the state.[3]

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[1] *Combs v. Chapal Zenray, Inc.*, No. 03-10-00646-CV (Tex. App.—Austin Nov. 18, 2011).

[2] Display cards, jewelry boxes, labels, elastic strings, twist ties, and foam ring pads.

[3] Texas Tax Code § 151.011(f) (emphasis added).

The taxpayer claimed that under the plain meaning of the statute, it attached the materials to other property to be transported outside the state for use solely outside the state. The Austin Court of Appeals held that the taxpayer's reading of the statute was at least reasonable because the "materials at issue are obviously 'annexed,' 'bound,' or 'fastened' in one way or another to the jewelry."[4] Nevertheless, the court ultimately ruled against the taxpayer. The court was persuaded by the Comptroller's arguments that: (1) the term "attaching" must mean some degree of permanent attachment (as opposed to packaging materials that are easily and actually discarded);[5] and (2) "permanent" attaching must be adjudged from the standpoint of the ultimate consumer (as opposed to Chapal's customers).[6] As to the first point, the court held that:

> it is not unreasonable to believe the legislature intended to exclude from taxation only property that, after being attached to other property, serves as a component of a finished product—an integration of components that provides a sustained functionality, aesthetic appeal, or usefulness that is greater than that which the components possess individually.[7]

As to the second point, while the court acknowledged that the taxpayer's reading of the terms actually used was reasonable, the court nevertheless held that the Comptroller's reading did not contradict the plain language of the statute. The court reached these conclusions even though the underlying administrative hearing was the Comptroller's only relevant formal interpretation.

Observation: It is difficult to square the court's decision with earlier cases holding that if the terms of a tax statute are clear, a court must apply the plain meaning of those terms and not resort to construction.[8] It is equally difficult to square the court's decision with earlier cases holding that a Comptroller "policy" is void unless it has been duly promulgated into a formal Comptroller rule (which was not the case here).[9]

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[4] *Chapal*, slip. op. at 12.

[5] The materials in question might have qualified for the manufacturing exemption, but that ground was not timely raised and was thus waived.

[6] Even if the statute required some degree of permanent attachment, that test would seem to have also been met if applied from the standpoint of Chapal's customers, because they generally kept the materials attached to the jewelry. Only Chapal's customers' customers would generally discard the materials.

[7] *Chapal*, slip. op. at 14.

[8] *See, e.g.*, *Fleming Foods of Texas, Inc. v. Rylander*, 6 S.W.3d 278 (Tex. 1999) ("These specific, unambiguous statutes are the current law and should not be construed by a court to mean something other than the plain words say unless there is an obvious error such as a typographical one that resulted in the omission of a word.").

[9] *Combs v. Entertainment Publications, Inc.*, 292 S.W.3d 712 (Tex. App.—Austin 2009, no pet.).