TEXAS STATE TAX DEVELOPMENTS

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I. FRANCHISE TAX

A. Judicial Developments

1. Apportionment: "Receipt-Producing, End-Product" Test for Service Receipts

Hegar v. Sirius XM Radio, Inc., 604 S.W.3d 125 (Tex. Ct. App. 2020) concerns the proper apportionment of receipts from satellite radio services. Under Tax Code § 171.103, Texas receipts include the receipts from "each service performed in this state." By rule, the Comptroller clarified "[i]f services are performed both inside and outside Texas, then such receipts are Texas receipts on the basis of the fair value of the services that are rendered in Texas." Thus, the questions before the court were (1) where Sirius XM performed the service and, (2) if an allocation was necessary, how to determine the fair value of services rendered inside and outside of Texas.

The vast majority of Sirius XM's operations occurred outside of Texas. Sirius XM's headquarters, transmission equipment, and production studios were almost exclusively outside of Texas and its satellites were in outer space. Sirius XM's Texas production was limited to one of its more than 150 channels, for which the host transmitted the programming from his Texas home.

Sirius XM apportioned its subscription receipts based on the locations where it produced its programming for broadcast, using the relative costs of those activities inside and outside of Texas. Sirius XM's approach was consistent with *Westcott Communications*, which rejected a taxpayer's attempt to source receipts from satellite training programs to the locations at which subscribers received the programs and required the receipts to be sourced to the company's Texas headquarters, which created and broadcasted the programming.

The Comptroller took the position that *Westcott Communications* was either distinguishable or wrongly-decided, and that Sirius XM's service receipts should be sourced using the receipts-producing, end-product act test set forth in a 1980 Comptroller hearing decision. According to the Comptroller, Sirius XM's receipt-producing, end-product act was not the "production and distribution of" satellite programming. Those were non-receipt-producing, albeit essential, support activities. Instead, the receipt-producing, end-product act was the actual performance of audible radio service for the customer.

In May 2020, the Third Court of Appeals ultimately agreed that the receipt-producing, end-product act test was a proper means of determining where performance of a service occurs, and sourced 100% of Sirius XM's receipts from Texas subscribers as Texas receipts. Sirius XM appealed the court of appeals' decision.

On March 25, 2022, the Texas Supreme Court issued its opinion. Looking to "straightforward understandings of the everyday words the statute uses," the Court held that a service is performed in Texas if the labor for the benefit of another is done in the state. Given the statute's focus on the location where the service is *performed* (not *received*), the "most natural reading of 'service performed in this state' supports locating the performance of the service at the place where the taxpayer's personnel or equipment is physically doing useful work for the customer."

The Court rejected the Comptroller's receipt-producing, end-product act test as "atextual and unhelpful," and noted that prior court opinions (*e.g., Westcott Communications*) and the Comptroller's own authority was inconsistent with his position advanced in *Sirius XM*. Notably, the Court never adopted the "cost of performance" language heavily referenced in Sirius's and *amici* briefing. Instead, the Court recognized Texas "uses an origin-based system" that has "long looked to where the service is performed rather than where it is received."

The Court also rejected the Comptroller's characterization of Sirius XM's service as 'decryption' because it "elevates the technicalities of the transaction over the economic reality of the service performed." Moreover, "the decryption service—even if it mattered—is performed outside of Texas, at the point of transmission." The Court ultimately concluded that "Sirius has little personnel or equipment in Texas that performs the radio production and transmission services for which its customers pay monthly subscription fees." Thus, the Court held "the court of appeals' decision apportioning to Texas all of Sirius's receipts from Texas subscribers must be reversed" and the case remanded to that court to review the sufficiency of Sirius' fair value allocation evidence.

On remand before the Third Court of Appeals, the parties have filed supplemental briefs addressing the sufficiency of Sirius XM's fair value allocation evidence. The case is currently is awaiting judgment.

2. **<u>Apportionment: Loans/Securities Treated as Inventory</u>**
Citgo Petro. Corp. v. Hegar, 636 S.W.3d 281 (Tex. Ct. App. 2021) concerns whether a company's gross proceeds from the sale of commodity futures are included in the apportionment formula for Texas franchise tax purposes. Tax Code § 171.106(f) provides that "notwithstanding section 171.1055, 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."

CITGO filed combined group Texas franchise tax returns for 2008 and 2009 for an affiliated group. The group included CITGO Trading Co. LP, which bought and sold commodity futures contracts and options to manage risks associated with fluctuations in valuation of CITGO's inventory of fuel, lubricants, petrochemicals, and other petroleum-based products, and the crude oil it refines to produce the inventory.

CITGO Trading made a federal election to apply mark-to-market accounting to the securities and "ensured that the Internal Revenue Service would account for any gains or losses resulting from the sale of the non-inventory securities as ordinary income or loss rather than as capital gain or loss," the court added.

CITGO included gross proceeds of roughly $10 billion from CITGO Trading's sale of the securities when calculating the denominator of the apportionment factor on its 2008 Texas franchise tax return and roughly $12 billion on its 2009 return, with none of the proceeds included in the numerator because the payor was not located in Texas.

In December 2020, the trial court ruled for the Comptroller, determining that net proceeds should have been used in the apportionment calculation, and denied CITGO's refund request.

In January 2021, CITGO appealed the trial court's decision, and the appellate court affirmed. The appellate court stated that the purchases and sales of the contracts and options were not held as inventory because they were not purchased or sold in the ordinary course of CITGO's business. The appellate court focused on the fact that the proceeds from the purchase and sale of CITGO's hedges were included on line 9 of the IRS Form 1120, and not line 1.

The appellate court noted that CITGO conceded that the securities did not constitute "inventory of the seller" for federal income tax purposes and rejected CITGO's contention that it fell within the scope of section 171.106(f) because it made the election for mark-to-market accounting and because IRC section 475(f) permits it to apply mark-to-market accounting to the securities at issue.

On September 30, 2022, the Texas Supreme Court denied CITGO's petition for review.

3. **Apportionment: Loans/Securities Treated as Inventory**
Conagra v. Hegar (Court of Appeals Case No. 03-21-00111-CV) concerns whether a company, which enters into hedging transactions for commodities used in its manufacturing process, can include the gross proceeds of those commodity hedges in its apportionment factor. Tax Code § 171.106(f) provides that "notwithstanding section 171.1055, 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."

At trial, Conagra presented evidence that Conagra uses many different raw materials, the bulk of which are commodities, as inputs in manufacturing its products. The commodities include both agricultural (corn, wheat, and soybean) and nonagricultural (crude oil used as a component of plastic tray packaging) raw materials.

The price Conagra pays for its commodities can rise or fall based upon a variety of factors (weather, market fluctuations, currency fluctuations, tariffs, the effects of governmental agricultural programs, etc.). Commodity price increases increase the costs of raw materials and manufacturing. Conagra may not be able to increase its product prices and achieve cost savings that fully offset these increased costs because increasing prices may result in reduced sales volume and profitability. To protect against this inventory price risk, Conagra entered into the commodity hedges. By hedging the cost of its commodity inputs, Conagra offset changes in the price of its inventory, regardless of whether the commodity hedge transactions resulted in a profit or loss. In short, the hedges were inventory substitutes treated as inventory for federal income tax purposes.

The trial court ruled that Conagra could not include the gross proceeds of its commodity hedges in its apportionment factor, and instead, is only permitted to include the net proceeds. Conagra appealed. In August 2022, the Third Court of Appeals affirmed the trial court's judgment. The court pointed out that Conagra did not dispute the trial court's finding that the securities were "not merchandise, stock in trade, raw materials, works in process, finished products, or supplies that are physically a part of the food products" sold to customers. "This unchallenged finding forecloses any argument that they are 'in substance' a 'substitute' for the raw materials that do constitute Conagra's inventory for federal income tax purposes," the court stated.

The court also distinguished the case upon which Conagra relied, a 1955 U.S. Supreme Court case, *Corn Products Refining Co. v. Commissioner*, stating that the U.S. Supreme Court did not conclude that corn futures were inventory, but instead held that "purchases and sales of corn futures were not capital-asset transactions for purposes of the Internal Revenue Code ("IRC") and Corn Products was required to report its gains and losses as ordinary, like gains and losses from inventory sales." The court of appeals explained: "The narrow holding that inventory hedges should not receive capital-asset tax treatment because they fall within the ambit of the inventory exclusion of IRC 1221 does not constitute a broader holding by the Court that inventory hedges *are*, actually or 'in substance,' a seller's inventory or a substitute therefor." The court also noted that Congress amended IRC section 1221 in 1999 to expressly exclude hedging transactions from the definition of "capital asset," which it interpreted to supplant the *Corn Products* rationale for treating hedging transactions as ordinary through the inventory exclusion, notwithstanding Conagra's expert testimony to the contrary.

Conagra intends to petition the Texas Supreme Court for review.

4. **<u>Reduced Tax Rate and COGS Subtraction for Leasing Operations</u>**
Hegar v. Xerox Corp., 633 S.W.3d 298 (Tex. Ct. App. 2021) concerns two Texas franchise tax issues: whether a company who almost exclusively enters into sales-type leases for the goods it sells can (1) avail itself of the reduced franchise tax rate for retailers and wholesalers and (2) include costs related to the leased equipment in its cost of goods sold ("COGS") subtraction.

Xerox was primarily engaged in distribution of high-end printing and publishing systems, as well as supplies (*e.g.*, toner, paper, and ink). Xerox offered a variety of distribution agreements to fit customer needs, including finance and operating leases. Most customers chose to enter into a finance lease (sales-type lease), given the financial commitment required for the equipment and how quickly printing systems can become obsolete. Xerox evaluated the terms of the sales-type leases and determined that it was primarily engaged in wholesale trade under the Tax Code and SIC Manual and, therefore, entitled to use the reduced franchise tax rate. Xerox also included in its COGS subtraction the costs related to the equipment sold to customers through sales-type leases.

The Comptroller took issue with both components of Xerox's franchise tax calculation. However, the trial court ruled for Xerox on both issues, and the court of appeals affirmed.

In evaluating the sales-type leases, the appellate court focused on the essence of the transaction, reviewing the substance of the leases, rather than the form of the agreement being simply titled a "lease." The court held that "the substance of Xerox's sales-type leases falls within the scope of Division F and thus constitutes wholesale trade under the Tax Code."

The court also rejected the Comptroller's COGS argument that Xerox's sales-type leases could not be considered sales and the property subject to those leases could not be considered "sold" because there was no transfer or passing of title. As the court noted, for purposes of the COGS subtraction, goods are "real or tangible personal property sold in the ordinary course of business of a taxable entity," and lawmakers have not provided a definition of "sold." Thus, the ordinary meaning of the term applied. After careful consideration, the court concluded that ordinary meaning of "sold" or "sale" does not require the transfer or passage of title, though it does require the transfer of the item being sold. Therefore, Xerox had sales for which associated costs qualified as COGS.

The court also rejected the state's position that the only lease transactions that qualify for the COGS subtraction are found in Tax Code § 171.1012(k-1). Lawmakers "did not state that an entity other than one of the three entities listed in subsection (k-1) may not make a COGS subtraction based on costs relating to property leased under sales-type leases that fall within the common meaning of 'sold.'"

Further, the court found no error in the district court's ruling that Xerox could include costs related to sales-type leases in its COGS subtraction during the relevant time period. Noting that "courts give effect to the substance of the transactions," the court concluded that "property leased under a sales-type lease may be considered to be 'sold' under the ordinary meaning of sold as used in Tax Code section 171.1012(a)(1)." Importantly, the appellate court also rejected the state's argument that the COGS statute should be strictly construed against Xerox because the statute is tantamount to a tax exemption.

The Comptroller petitioned the Texas Supreme Court for review. The Court has not yet decided whether to grant review, but it has requested briefing on the merits, which signals some interest.

5. **<u>R&D Credit</u>**

Ryan v. Hegar (Trial Court Case No. D-1-GN-21-006290) is a declaratory judgment challenge to the Comptroller's amendments to Comptroller Rule 3.599 regarding the Texas franchise tax exemption for certain R&D expenses.

In its petition, Ryan has challenged a number of subsections within Comptroller Rule 3.599, most notably the definitions of Internal Revenue Code, Qualified Research and its exclusion of internal use software, and Qualified Research Expenses; the burden of proof required to establish the entitlement to the credit; the contemporaneous business records requirement; retroactivity of the amended rule's application; and exclusion of supplies for which a sales tax exemption was claimed.

In July 2022, the trial court heard the parties' cross-motions for summary judgment.

In August 2022, the Comptroller adopted further amendments to Comptroller Rule 3.599. Notably, the Comptroller now recognizes any federal regulation adopted after 2011 that *could have applied* to the 2011 tax year (e.g., the 2021 final federal IRS regulations concerning internal use software). Additionally, the amendments to Comptroller Rule 3.599 also modify the definition of computer software, with respect to internal use software, specifically removing some of the restrictive language added by 2021 amendments. Lastly, the amendments to Comptroller Rule 3.599 remove restrictions on credit carryforwards and describe how to determine a credit carryforward when there is a change to the membership of the combined reporting group. As discussed herein, despite these amendments, several of the 2021 rule amendments remain the subject of pending litigation.

In September 2022, the trial court held that the clear and convincing evidence standard in the amended rule contravenes specific statutory language; is counter to the statutes' general objectives; or imposes additional burdens, conditions, and restrictions in excess of or inconsistent with the relevant statutory provisions and are, therefore, invalid and illegal. Furthermore, the trial court held that the retroactivity of the amended rule's application was invalid, as it violates Article 1, § 16 of the Texas Constitution and due process rights under the Federal Constitution. However, the court upheld the validity of various other rule sections. The court also ruled that Ryan's challenges to the internal use software sections of the rule were moot, presumably due the Comptroller's 2022 amendment of the rule to revise the challenged sections.

6. **R&D Credit**
   In *Fiserv v. Hegar* (Trial Court Case No. D-1-GN-21-002781), the taxpayer, a financial software company, has challenged the Comptroller's audit adjustment of the R&D credit. The crux of the dispute centers on whether Fiserv's software activities are properly characterized as internal use and, if so, whether such activities are excluded from Texas qualified research. Fiserv's suit also challenges the validity of certain recent amendments to Comptroller Rule 3.599.

   In July 2022, the trial court heard the parties' cross-motions for summary judgment. In September 2022, the trial court held that the clear and convincing evidence standard in the amended rule contravenes specific statutory language; is counter to the statutes' general objectives; or imposes additional burdens, conditions, and restrictions in excess of or inconsistent with the relevant statutory provisions and are, therefore, invalid and illegal. Furthermore, the trial court held that the retroactivity of the amended rule's application was invalid, as it violates Article 1, § 16 of the Texas Constitution and due process rights under the Federal Constitution. However, the court upheld the validity of various other rule sections. The court also ruled that Fiserv's challenges to the internal use software sections of the rule were moot, presumably due the Comptroller's 2022 amendment of the rule to revise the challenged sections.

B. Administrative Developments

1. **Combined Reporting.** A recent Comptroller hearing decision addressed the proper members of a combined group. In Texas, taxable entities that are part of an affiliated group engaged in a unitary business must file as a combined group for Texas franchise tax purposes in lieu of individual reports based on the combined group's business. Taxpayer was a subsidiary of an insurance products and services provider. Taxpayer served as the centralized purchasing unit for the parent and sister companies, as well as the reporting entity for the group. Taxpayer contended that it did not operate as a unitary business with the affiliates of the parent company. In ruling that all of the entities included in the combined report were unitary, the Comptroller concluded that the evidence showed that the subsidiary and its affiliates were in the same general line of business; carried out activities that constitute steps in a vertically structured enterprise; and were controlled by the same centralized management. Hearing Nos. 116,854, 117,455, and 117,900 (March 14, 2022), STAR Document No. 202205009H.

2. **Federal Income Tax Reporting and Total Revenue.** A Comptroller hearing decision held that a construction company that reported net income from long-term contracts as "other income" on Line 10 of

federal Form 1120 did not comply with federal income tax law, so its total revenue was not properly calculated on amended Texas franchise tax returns for report years 2014 through 2016. The taxpayer reported net revenue from the contracts on Line 10, instead of reporting the receipts on Line 1 and the cost of goods sold on Line 2. The taxpayer's reporting method had passed IRS examination muster. This net revenue method produced a lower franchise tax bill when coupled with the 30% of revenue deduction.

Texas franchise tax liability is determined by calculating an entity's taxable margin, which first includes determining the entity's revenue. Total revenue is computed by adding the amounts entered as reportable income on the federal income tax return "to the extent the amount entered complies with federal income tax law." The Comptroller determined that instructions for Line 1 of federal Form 1120 support a conclusion that income derived from long-term contracts is calculated in accordance with Internal Revenue Code ("IRC") § 460 and Treas. Reg. § 1.460-4 and reported on Line 1a of federal Form 1120. Instructions for Line 1a of the federal Form 1120 state that line is to include "gross receipts or sales from all business operations, except for amounts that must be reported on lines 4 through 10." None of the federal Form 1120 instructions for Lines 4 through 10 refer to a requirement of including income from long-term contracts, or otherwise address such contracts. The instructions for Line 10 "other income" direct a taxpayer to "enter any other taxable income not reported on lines 1 through 9," giving examples of specific income items, but making no reference to income derived from long-term contracts. Further, the instructions for Line 1 direct corporations reporting income from long-term contracts refer to IRC § 460.

Because the instructions for Line 1 of federal Form 1120 indicate that income from long-term contracts is reported on Line 1 and the construction company failed to demonstrate that its reporting of income from long-term contracts on its federal returns for the tax years at issue complied with federal tax law, the Comptroller determined that the company failed to prove the total revenue included in its amended franchise tax returns for each report year (and the resulting amended taxable margin) was properly calculated, thus, he denied the refunds. Hearing Nos. 117,954-956 (May 3, 2022), STAR Document No. 202205024H.

3. **Revenue Exclusion for Flow-Through Funds.** Taxpayer provided audiovisual equipment and services to hotel customers. Taxpayer contracted with hotels to provide the equipment and services to customers who use the hotels' facilities (ballrooms, conference rooms, and event spaces). Taxpayer paid the hotels commissions to be the

exclusive provider of audiovisual equipment and services. Customers either paid Taxpayer directly (with the Taxpayer paying the hotels' commission after receiving payment); or, customers paid the hotel and the hotel remitted the payment to Taxpayer after subtracting its commission. Taxpayer filed a refund claim seeking to exclude the commissions paid to the hotels from gross revenue as flow-through sales commissions. *See* Tex. Tax Code § 171.1011(g)(1).

The Tax Code defines "sales commission" to mean any form of compensation paid to a person for engaging in an act for which a license is required by Chapter 1101, Occupations Code; or compensation paid to a sales representative by a principal in an amount that is based on the amount or level of certain orders for or sales of the principal's product and that the principal is required to report on Internal Revenue Service Form 1099-MISC. *See id*. Taxpayer did not issue Forms 1099-MISC to the hotels because the form does not require the inclusion of payments made to corporations. Therefore, the Comptroller held the payments to hotels organized as corporations would not meet the definition of "sales commissions" that may be excluded from total revenue. The Comptroller rejected Taxpayer's arguments that defining "sales commission" to include a requirement that it be reported on Form 1099-MISC was arbitrary, resulted in gross receipts being taxed twice, failed to reflect legislative intent, and led to disparate treatment of taxpayers based on organizational structure. Hearing No. 117,091 (Nov. 9. 2021), STAR Document No. 202201011H.

4. **<u>COGS: Labor Costs.</u>** Taxpayer was Federal Aviation Administration certified aircraft repair station which sought to subtract its labor costs for installing parts in aircraft engines as COGS. The Comptroller rejected the Taxpayer's arguments, relying on *Hegar v. Autohaus LP,* 514 S.W.3d 897 (2017), which held that COGS subtraction does not include labor costs arising from installation of parts on vehicles. In *Autohaus*, the appellate court held that the auto dealership "did not, in any way, modify, make, or complete the automotive part to 'produce' it." The Comptroller noted that the same reasoning applies to customer-owned aircrafts. Hearing No. 110,947 (June 23, 2022), STAR Document No. 202206017H.

5. **<u>COGS: Retirement Benefit Expenses.</u>** Taxpayer was the reporting entity for a combined group which consisted of commonly controlled affiliates primarily engaged in worldwide manufacturing. Here, the subsidiary was a manufacturer until its operating assets were sold, but continued to maintain benefit obligations for retired employees. The combined group argued the expenses of this subsidiary remained eligible COGS deductions after the sale because the reporting entity and other subsidiaries continued to produce goods. For franchise tax purposes, the

COGS deduction includes labor costs, other than service costs, that are properly allocable to the acquisition or production of goods and are of the type subject to capitalization or allocation under Treas. Reg. § 1.263A-1(e) or Treas. Reg. § 1.460-5 as direct labor costs, indirect labor costs, employee benefit expenses, or pension and other related costs, without regard to whether the taxable entity is required to or actually capitalizes such costs for federal income tax purposes. In ruling that combined group primarily was not entitled to the COGS subtraction for the retirement benefit expenses of one of its subsidiaries, the Comptroller concluded because the subsidiary is no longer acquiring or producing goods, the retirement costs eligible for capitalization is zero and, therefore, are not the type subject to capitalization or allocation under the Treasury Regulations. Therefore, these expenses were not eligible for the COGS subtraction for the combined group. Hearing Nos. 116,701-704 (February 18, 2022), STAR Document No. 202204023H.

6. **<u>Retailer's Rate.</u>** Taxpayer had agreements with retail stores to provide lease purchase options to consumers and sought to use the retailer's rate based on *Rent-A-Center, Inc. v. Hegar*, 468 S.W.3d 220 (Tex. App.—Austin 2015, no pet.). The Comptroller rejected Taxpayer's arguments, distinguishing the structure of Taxpayer's agreements from those considered in *Rent-A-Center* and other Comptroller hearing decisions. In determining that Taxpayer was not engaged in retail trade, the Comptroller noted that Taxpayer did not offer merchandise for sale or have mechanisms to attract individuals to buy merchandise (*e.g.*, physical storefronts, radio, online, or newspaper) for most of the agreements from which it generated its revenue. Rather, the substance of Taxpayer's business was generating revenue through the discounted prices for which it purchased merchandise from retail stores and the amount over the cash price reflected in the agreements it receives from the individual customer through extended rental payments. Taxpayer's activities were more accurately described as financing, which fell outside the SIC codes qualifying as retail trade. Hearing No. 117,226 (Aug. 31, 2021), STAR Document No. 202110018H.

7. **<u>Credits: Business Loss Carryforward.</u>** When the Texas franchise tax moved from a tax based on earned surplus or capital stock to a tax based on taxable margin, effective January 1, 2008, the legislature provided for a credit against the margin-based tax based on any unused business loss carryforwards of the business entity from period before January 1, 2008. The Comptroller issued a private letter ruling that discusses whether the credit was available for use by a combined group after a transaction that was treated as a merger of the subsidiary that generated the credit into another member of the combined group for federal income tax purposes. The reporting entity is a publicly traded holding company that is the parent of the liquidating subsidiary and a sister subsidiary. The plan of

liquidation for the subsidiary involved as transfer of the stock of the liquidating subsidiary in exchange for cash. The parent and the subsidiary elected to treat this sale of stock as a disposition of the subsidiary assets for federal income tax purposes by making an election under IRC § 336(e). Following the deemed sale of assets, any remaining assets of the subsidiary were transferred to the sister subsidiary in a tax-free reorganization under IRC § 368(a)(1)(C). The reporting entity argued that the combined group was entitled to the credit originally generated by the subsidiary because Texas regulations allow the credit to remain with the combined group after a member merges with another member of the group. In deciding that the combined group cannot use the temporary credit for business loss carryforward of its liquidated subsidiary, the Comptroller highlighted that the omission of the aforementioned IRC sections from Texas law indicates that the Texas franchise tax does not recognize such elections. In summary, the Comptroller disallowed the credit because: (1) Texas statutory law prohibits the credit from being conveyed, assigned, or transferred (i.e., the credit cannot be transferred from the liquidating subsidiary to the sister subsidiary); and (2) Texas regulations prohibit the inclusion of the credit with the combined group if a member of the group changes combined groups (i.e., for Texas franchise tax purposes, all of the liquidating subsidiary's stock was sold to the unrelated third-party's combined group). STAR Document No. 202204015L (April 4, 2022).

C. Rulemaking

1. **34 Tex. Admin. Code § 3.591 (Apportionment).** In early 2021, the Comptroller adopted sweeping amendments to his apportionment rule. The changes incorporated statutory amendments, defined new terms, modified existing definitions, incorporated current Comptroller policy, and changed various sourcing provisions. In short, a thorough and detailed review of the new rule is warranted. The Comptroller adopted these changes despite objections from a wide range of stakeholders, many of whom voiced concerns about retroactivity because not all changes were given a prospective effective date.

   Perhaps most notably, the Comptroller amended the rule to define “location of performance” for the sourcing of service receipts as the location of the “receipt-producing, end-product act or acts,” consistent with his litigation position in *Sirius XM* discussed herein.

   In March 2022, the Texas Supreme Court reversed the court of appeals’ decision in *Sirius XM*, invalidating the Comptroller’s rule amendments adopting the receipt-producing, end-product act test. The Comptroller is presently working to amend his rule in accordance therewith.

2. **<u>34 Tex. Admin. Code § 3.599 (R&D Credit)</u>.** In late 2021, and over significant objection, the Comptroller adopted significant amendments to the rule governing the Texas franchise tax research & development credit. Notable changes include incorporating the four-part test for "for "qualified research" in IRC § 41(d), clarifying which federal regulations apply to the Texas credit, identifying activities that do not constitute qualified research (*e.g.*, a blanket disallowance of internal use software), imposing a clear and convincing evidence burden of proof and documentation standards, providing combined group guidance, and authorizing verification of credit carryforwards even if the statute of limitations has expired for the year creating the credit. Several lawsuits challenged the validity of the amended rule, with a specific focus on the Comptroller's internal use software policy.

   In August 2022, the Comptroller adopted further amendments to Comptroller Rule 3.599. Notably, the Comptroller now recognizes any federal regulation adopted after 2011 that *could have applied* to the 2011 tax year (e.g., the 2021 final federal IRS regulations concerning internal use software). Additionally, the amendments to Comptroller Rule 3.599 also modify the definition of computer software, with respect to internal use software, specifically removing some of the restrictive language added by 2021 amendments. Lastly, the amendments to Comptroller Rule 3.599 remove restrictions on credit carryforwards and describe how to determine a credit carryforward when there is a change to the membership of the combined reporting group.

   As discussed herein, despite the recent amendments to Comptroller Rule 3.599, several of the 2021 rule amendments remain the subject of pending litigation.

D. Legislative Developments

1. **<u>Franchise Tax Treatment of Federal COVID-Relief Measures</u>.** The 2021 legislature added Tax Code § 171.10131 (for reports due on or after January 1, 2021) to exclude loan proceeds and grants from qualifying COVID-related federal programs from Texas franchise tax revenue. This includes the Paycheck Protection Program. The law also provides that taxpayers may include, as cost of goods sold or compensation, expenses paid using qualifying loan or grant proceeds to the extent the expenses would otherwise qualify for subtraction.

E. Trends and Outlook for 2022/2023

1. Given the aforementioned cases, we predict apportionment and the R&D credit to dominate the Texas franchise tax discussion for the foreseeable future.

2. Whether the Texas Supreme Court's opinion in *Sirius XM* will prevent further apportionment litigation regarding service receipts is unclear. Members of the Comptroller's office previously cautioned taxpayers against wishing for a taxpayer victory in *Sirius XM*, warning it would likely lead to battles concerning fair value allocation. We now see that playing out on remand.

II. SALES AND USE TAXES

A. Judicial Developments

1. **<u>Manufacturing Exemption: Coal Extraction</u>**
Hegar v. Texas Westmoreland Coal Co., 636 S.W.3d 61 (Tex. Ct. App. 2021) concerns the scope of the manufacturing exemption applicable to coal mining.

Texas Westmoreland sought a refund of sales and use tax paid on excavators used to extract lignite coal from a mine and break it down into saleable pieces. Texas Westmoreland argued that it used the excavators to process tangible personal property within the meaning of the manufacturing exemption. The trial court granted the refund. The Comptroller appealed and the court of appeals affirmed.

On appeal, the Comptroller argued that equipment used in excavating and processing lignite coal could not qualify for the manufacturing exemption because the input to the manufacturing process was real property, not tangible personal property. The appeals court disagreed, holding that both the statute's grammar and structure indicate that the manufacturing exemption's focus is on the end product, not the inputs, so the equipment qualified for the manufacturing exemption if it was used to process tangible personal property for sale. The court of appeals also noted that the Texas Supreme Court had declined to adopt the Comptroller's argument previously advanced in *Southwest Royalties*, and that the Comptroller's litigating position was inconsistent with his own prior hearing decision.

On September 30, 2022, the Texas Supreme Court denied the Comptroller's petition for review.

2. **<u>Manufacturing Exemption: Electricity Used in Manufacturing Process</u>**

RTU, Inc. v. Hegar, No. 07-20-00301-CV, 2022 Tex. App. LEXIS 9 (Tex. Ct. App. Jan. 3, 2022) concerns a cash register tape manufacturing company and whether it is entitled to a sales tax exemption for electricity used in manufacturing. RTU is a manufacturer of cash register tapes for grocery stores, restaurants, and retail stores to use in their point-of-sale machines. RTU conducted a predominant use study of its manufacturing plant's electricity usage. The study concluded that 66.74% of the electricity consumed at the plant was used to power exempt manufacturing equipment and to light, heat, or cool the manufacturing area. RTU sought a refund for the sales tax paid on the electricity purchased and consumed at the manufacturing plant under the manufacturing exemption.

At trial, the Comptroller argued that RTU failed to meet its burden of proof because the predominant use study was flawed as a result of RTU including register tapes which had third-party advertising printed on the back.

The trial court agreed with the Comptroller.

In October 2020, RTU appealed. The court of appeals' analysis focused on the contractual agreements with the manufacturer's customers, as well as the manufacturing exemption statute. To fulfill the agreements, the advertising printing and equipment used for it was necessary and essential to the manufacturing of the register tapes it sold.

The manufacturing exemption does not make a distinction about the type of content that may, or may not be, printed on the tangible personal property in order to qualify for the exemption. Therefore, RTU was entitled to a refund for sales tax paid on electricity purchased and consumed in the manufacturing process.

The Texas Supreme Court denied the Comptroller's Petition for Review.

3. **<u>Taxable Data Processing: Loan Documents</u>**

Hegar v. Black, Mann, & Graham, L.L.P., No. 03-20-00391-CV, 2022 Tex. App. LEXIS 1311 (Tex. Ct. App. Feb. 25, 2022) concerns whether a law firm's purchases of loan document packages were purchases of data processing services that are subject to Texas sales tax.

Black, Mann, and Graham ("BMG") offers services in connection with residential mortgages and is employed by lending institutions to prepare loan packages that typically include a promissory note, deed of trust, and required federal and state disclosures. BMG either (1) generated the loan packages itself or (2) outsourced the work to vendors who compiled loan packages for review and approval by BMG. The vendors employ programmers that create software to map the data onto all the documents that make up the loan package. During this process, the vendors' programmers work with legal-compliance experts to ensure the software chooses all the legally required forms and enters all the necessary information in the correct places on the forms.

The Comptroller audited BMG for sales tax on the vendors' services as taxable data processing. The Comptroller defines data processing as "the processing of information for the purpose of compiling and producing records of transactions, maintaining information, and entering and retrieving information." BMG paid the assessment under protest and filed suit.

At trial, BMG argued that the vendors' services were not taxable data processing, but instead, nontaxable professional services based on *CheckFree* and several private letter rulings. The Comptroller argued that the essential component of the vendors' service was data entry and retrieval, and therefore, should be classified as taxable data processing. The trial court ruled for BMG.

The Comptroller appealed the case. The court rejected BMG's argument that the purchased services were nontaxable professional legal services, finding that the relevant administrative rule did not limit data processing to specific enumerated services. The court agreed with the Comptroller that BMG contracts with the vendors show that the intent of the transactions was to purchase data processing services and that BMG was responsible for ensuring that the documents were legally compliant. The court held that the vendors' services could not be professional legal services because that would result in the unauthorized practice of law.

4. **Taxable Data Processing: Digital Services**

Apple v. Hegar (Trial Court Case No. D-1-GN-20-004108) concerns whether Apple's iCloud and iTunes Match services are subject to Texas sales tax as data processing. Apple alleges that the iCloud and iTunes Match services are not taxable data processing. Apple further alleges that, even if iCloud and iTunes Match are data processing, the Internet Tax Freedom Act preempts state and local taxation of these services.

In late 2021, the parties filed cross-motions for summary judgment, and September 2021, the trial court held a hearing on the motions. Interestingly, in June 2022, the trial court denied both parties' motions for summary judgment. As is custom for summary judgment orders, no explanation was given. There is currently no trial set for this case.

5. <u>Sourcing Sales for Local Tax Purposes</u>

City of Round Rock v. Hegar (Trial Court Case No. D-1-GN-21-003203), and *City of Coppell, Texas; City of Humble, Texas; City of Desoto, Texas v. Hegar*, challenge the Comptroller's 2020 adoption of various local sales and use tax regulations.

Most notably, Comptroller Rule 3.334 shifted the state from "origin sourcing" to "destination sourcing" for online retail sales. Pre-amendment, online retailers' in-state order-processing facilities are treated as the "place of business" where an online order is received and generally where the orders are consummated. Because sales tax is allocated to the local government where a sale is consummated, local governments that host those facilities receive sales tax for all Texas online sales they process, regardless of buyers' locations in the state. Local governments have made deals with retailers to site those facilities within their jurisdictions to capture that revenue, providing sales tax rebates to retailers in return. Round Rock has such an agreement with Dell.

However, the amended rule establishes that servers, software, and internet protocol addresses are not a "place of business," and that online orders are therefore not received at a place of business. It will establish that online orders are consummated at the seller's place of business in the state where they're fulfilled or, if they're not fulfilled at a location that qualifies as a seller's place of business, at the location where they're delivered or taken possession of, with sales tax calculated for and allocated to the local governments at those locations. The regulation's provisions effectively establish that cities with online order-processing facilities will no longer receive the revenue from all the online sales those facilities process — instead, the tax revenue will go to the jurisdictions where buyers live.

Round Rock's suit argues that the amended rule will "drastically" reduce some municipalities' sales tax revenue and that such a change "should be effectuated only by state law" enacted by the legislature. The cities argue that the comptroller's office has exceeded its statutory authority and established a de facto destination-sourcing rule for online sales without any change in the governing statute. The cities say the amended rule contradicts existing law and the state's long-standing use of origin sourcing for sales.

The Comptroller has agreed not to enforce the amended rule while litigation is pending. However, that does not impact its effective date if the amended rule is upheld by the courts.

In July 2022, the trial court held a hearing on the parties' cross-motions for partial summary judgment, as to whether the Comptroller complied with the requirements of the Administrative Procedures Act in promulgating Comptroller Rule 3.334. In August 2022, the trial court held that the Comptroller failed to substantially comply with one or more of the procedural requirements of Section 2001.024 (Content of Notice) of the Texas Government Code in adopting amendments to Comptroller Rule 3.334(b)(5). In response, the Comptroller is re-promulgating Comptroller Rule 3.334. The revised notice of proposed rule contains an expanded 19-page Preamble that includes a much more detailed explanation of why, and the authority for, the proposed rule amendments, including numerous examples of sourcing different types of transactions.

Round Rock v. Hegar is currently set for trial the week of January 16, 2023 to address the validity of Comptroller Rule 3.334. It is yet to be determined if this current trial setting will remain.

B. Administrative Developments

1. **Cloud-Based Online Platform Is Non-Taxable Education Service.** Taxpayer delivered digital clinical experiences to nursing and other professional healthcare students via a cloud-based online platform. In deciding that the sale of access to the platform was not subject to sales tax, the Comptroller stated that the digital clinical experiences constituted an educational service, and not merely the sale of information or data processing services. The educational simulations instructed students on interactions with patients and provided feedback to the students based on their performance. STAR Document No. 202206008L (June 10, 2022).

2. **Cloud-Based Online Platform Is Taxable Data Processing / Information Service.** Taxpayer operated an online learning platform where students learned from thousands of on-demand digital courses. The courses streamed video lessons teaching academic subjects, professional topics, and vocational licensure preparation. In deciding that the sale of subscriptions to the platform were subject to sales tax as data processing or an information service, the Comptroller highlighted that the platform did not resemble the types of nontaxable information services outlined in the Comptroller's rule. Additionally, the Comptroller stated that the functionality of one of the platform's products satisfied the elements of data processing (i.e., storage, retrieval, and compilation of data). STAR Document No. 202206014L (June 10, 2022).

3. **Card Management Program Is Non-Taxable Electronic Payment Processing.** Taxpayer provides a payment card management program that allows services, such as food delivery services, the ability to apply customized spending limits and other controls on debit and prepaid cards used in their business. In deciding that the taxpayer's service was a nontaxable electronic payment processing service, the Comptroller

highlighted that the taxpayer does not issue cards, but works with issuing banks and payment networks to authorize, process, and settle its customers' transactions. STAR Document No. 202204028L (April 29, 2022).

4. **Taxability of Outsourced Information Technology Services.** Taxpayer operates an information technology company, providing network design, installation, infrastructure, and management services. Taxpayer contended that its sales of equipment, software, and Google apps were taxable, and that its sales of information technology and consulting services were nontaxable. This hearing decision provides a comprehensive overview of the Comptroller's positions regarding the taxability of various information technology services. Hearing No. 117,239 (October 28, 2021), STAR Document No. 202202025H.

5. **Remote Seller Guidance Update**d. In early 2022, the Comptroller issued updated guidance addressing out-of-state sellers whose only activity in Texas is the remote solicitation of sales. The guidance addresses the sales tax and franchise tax obligations of these remote sellers and links to various forms and additional resources. STAR Document No. 202201002L (Jan. 5. 2022).

6. **Taxability of Social Media Management Services.** The October 2021 issue of the Comptroller's Tax Policy News discusses the taxability of various social media management services, including written content creation, advertising, website management, and finished art and photography. The guidance identifies which items are taxable and instructs taxpayers how to tax the sale of commingled taxable and non-taxable services. STAR Document No. 202110017L (Oct. 29, 2021).

7. **Contests, Giveaways, and Discounts.** The November 2021 issue of the Comptroller's Tax Policy News discusses the sales and use tax implications for transactions made during contests, in which the taxpayers award prizes, provide discounts on retail purchases of taxable items, or giveaway items as samples or business advertisements. STAR Document No. 202111004L (Nov. 1, 2021).

8. **Online Lead Generating Service Is Taxable Information Service.** A recent private letter ruling held that online lead generating services were taxable information services. Taxpayer was a marketing service provider that assisted higher education institutions with recruitment, enrollment, and retaining of students through targeted personalized searches and predictive modeling. Taxpayer claimed that its services constituted nontaxable proprietary information services. However, Taxpayer's clients had no enforceable, proprietary rights to the student data Taxpayer sold. Taxpayer could sell the same personal information about prospective

students to multiple clients. Despite determining that the service was taxable, the Comptroller noted that Taxpayer's sales may qualify as exempt if sold to a governmental entity or a religious, educational, or public service organization. PLR20201012121830, STAR Document No. 202109061L (Sept. 30, 2021).

C. Rulemaking

1. **34 Tex. Admin. Code § 3.334 (Local Tax Sourcing).** In May 2020, the Comptroller amended the local sales and use tax rule to implement local tax sourcing changes. As stated in the July 2021 issue of the Comptroller's Tax Policy News, the amendment clarified the definition of a place of business and made clear that sales personnel must be present for a location to be considered a place of business. STAR Document No. 202107002L (July 28, 2021). Thus, a place of business does not include a computer server, IP address, domain name, website or software application. *Id.* Under the revised rule, orders received by a shopping website or shopping application will be sourced to the Texas customer's location unless fulfilled by the seller's Texas place of business. The Comptroller originally delayed implementation of the change until October 1, 2021, to give taxpayers time to prepare. However, taxpayers subsequently challenged the portion of the rule changing the sourcing of internet orders in multiple suits, and the agency has agreed not to enforce the provision while suit is pending. The Comptroller has made clear on his website that this agreement does not change the effective date of the rule.

   In August 2022, the trial court held that the Comptroller failed to substantially comply with one or more of the procedural requirements of Section 2001.024 (Content of Notice) of the Texas Government Code in adopting amendments to Comptroller Rule 3.334(b)(5). In response, the Comptroller is re-promulgating Comptroller Rule 3.334. The revised notice of proposed rule contains an expanded 19-page Preamble that includes a much more detailed explanation of why, and the authority for, the proposed rule amendments, including numerous examples of sourcing different types of transactions. However, no substantive changes were made in the challenged rule itself. It remains to be seen if the revisions to Comptroller Rule 3.334 will be adopted as proposed.

   With no substantive changes being made to the rule itself, the Comptroller is likely to maintain his position that there is no change to the effective date of the rule. So, if the courts ultimately determine that the rule follows the statute, taxpayers as well as the agency will be bound by that determination. Presumably, this means taxpayers will face retroactive exposure from the effective date of the rule.

2. **<u>34 Tex. Admin. Code § 3.340 (R&D Exemption).</u>** In late 2021, the Comptroller adopted significant amendments to the rule governing the Texas sales and use tax exemption for depreciable tangible personal property used in qualified research. Notable changes include incorporating the four-part test for qualified research in IRC § 41(d), clarifying which federal regulations apply to the Texas exemption, identifying activities that do not constitute qualified research (*e.g.*, a blanket disallowance of internal use software), and imposing a clear and convincing evidence burden of proof and documentation standards.

   In August 2022, the Comptroller adopted further amendments to Comptroller Rule 3.340. Notably, the Comptroller now recognizes any federal regulation adopted after 2011 that *could have applied* to the 2011 tax year. Additionally, the amendments to Comptroller Rule 3.340 also modify the definition of computer software, with respect to internal use software, specifically removing some of the restrictive language added by 2021 amendments. As discussed herein, despite the recent amendments to Comptroller Rule 3.340, several of the 2021 rule amendments remain the subject of pending litigation.

3. **<u>34 Tex. Admin. Code § 3.302 (Credit Sales & Bad Debts).</u>** Effective January 6, 2022, the Comptroller adopted amendments to his rule concerning accounting methods, credit sales, bad debt deductions, repossessions, interest on sales tax, and trade-ins. The Comptroller stated the changes incorporate longstanding agency guidance on bad debts, revise agency requirements with respect to taking credits on sales and use tax reports and requesting refunds, and define key terms used in the Tax Code and the rule.

D. Legislative Developments

1. **<u>Marketplace Clarifications.</u>** The 2021 Legislature enacted various provisions to clarify the marketplace provider legislation enacted in 2019. For example, a marketplace provider that sells lead-acid batteries now must collect the lead acid battery fee and the prepaid 9-1-1 service fee associated with that sale. The amendment also requires a marketplace seller who places a ticket or other admission document for sale through a marketplace to certify to the marketplace provider that the sales taxes imposed on the original purchase of the ticket or admission document was paid. Then, a marketplace provider who in good faith accepts that certification may take the deduction provided by Tax Code § 151.432 on behalf of the marketplace seller.

2. **<u>Payment Processing Excluded from Taxable Data Processing.</u>** The 2021 Legislature amended the statutory definition of taxable data processing in Tax Code § 151.0035 to exclude certain electronic payment processing services. Data processing does not include certain electronic

payment encryption services, the settling of an electronic payment transaction by certain downstream payment processors or point of sale payment processors routing electronic payment information, persons engaged in the business of money transmission and required to obtain certain licenses, certain federally insured financial institutions, persons who have entered into certain sponsorship agreements for the purpose of settling that entity's electronic payment transactions through a payment card network, or a payment card network that allows a person to accept a specific brand of debit or credit card by routing information and data to settle an electronic payment transaction. The Comptroller has indicated an intent to narrowly construe this exclusion from the definition of data processing.

3. **Medical and Dental Billing Excluded from Insurance Services.** The 2021 Legislature amended the statutory definition of taxable insurance services in Tex. Tax Code § 151.0039 to exclude medical or dental billing services. "Medical or dental billing service" is defined to mean "assigning codes for the preparation of a medical or dental claim, verifying medical or dental insurance eligibility, preparing a medical or dental claim form for filing, and filing a medical or dental claim."

4. **Extension of Time to Provide Resale and Exemption Certificates.** The 2021 Legislature amended Tex. Tax Code §§ 151.054 and 151.104 to allow taxpayers additional time to provide exemption and resale certificates to support claims of exemption. Taxpayers now have 90 days (previously 60) from the date the Comptroller gives written notice that the certificates are due to provide certificates. The amended law also allows taxpayers and the Comptroller to further extend that time by agreement. However, the Comptroller may verify the reason or basis for the exemption claimed for certificates offered during the 90-day (or extended) period.

5. **Direct Refund Claims for Oil & Gas Producers.** The 2021 Legislature authorized oil and gas producers who file severance tax returns but do not hold sales tax permits to file refund claims directly with the Texas Comptroller for sales and use tax paid in error to vendors. Previously, these purchasers would have needed a refund assignment from their vendors to obtain a refund directly from the Comptroller.

E. Trends and Outlook for 2022/2023

1. The scope of taxable data processing and other various exemptions will likely continue to be defined through litigation.

2. Whether local tax sourcing will be overhauled remains to be seen.

III. PROCEDURAL UPDATES AND OTHER MATTERS OF INTEREST

A. Judicial Developments

1. Refund Claim: Assignment of Right to Refund

Piazza et al. v. Hegar, (Court of Appeals Case No. 03-19-00246-CV), addressed whether the trial court properly dismissed the tax refund suit by class representatives and assignees of Best Buy.

Best Buy operated a rebate program between 1998 and 2007. But while it partially refunded the retail price to customers that submitted rebate forms, it did not refund any of the sales tax.

Rockey Piazza, Linda Piazza, and Paul Denucci filed a class action suit in 2002 seeking a refund of the tax directly from Best Buy and later sought an assignment from Best Buy of the right to request a refund directly from the Comptroller. The suit was settled, with the parties agreeing that Best Buy would assign its right to bring a tax refund claim to the Piazzas and Denucci and individual class members.

The plaintiffs, through class counsel, filed a tax refund claim with the Comptroller for more than $11 million on behalf of the class members in 2008. The Comptroller denied the claim, and the trial court dismissed the lawsuit, finding that the class counsel lacked the authority to file individual refund claims on behalf of each individual putative class member.

In a separate proceeding brought by Best Buy, the Comptroller denied the refund on the grounds that Best Buy had not refunded the sales tax in question and the claim had already been assigned. Best Buy executed an assignment of its right to a refund in 2017 to the Piazzas, Denucci, Tara Levy, and Robert Tycast as part of an agreement to be dismissed from the suit.

In November 2017, an administrative law judge recommended that the refund be denied because the Tax Code did not authorize a class action refund claim. In March 2018, the Comptroller adopted the recommendation, as changed, and the assignees filed the tax refund lawsuit.

In its April 2021 opinion, the appellate court affirmed the dismissal of the tax refund suit, and the assignees filed a motion for reconsideration. Several amici parties filed briefs raising concern over the perceived invalidation of the refund assignment procedure. In its substitute opinion issued in August 2022, the appellate court held that the trial court properly dismissed the tax refund suit by class representatives and assignees of Best Buy, finding that Best Buy had already assigned its right to a tax refund before the administrative refund claim was brought. The appellate court considered only whether Best Buy had already assigned its right to bring the refund claim in 2008, making the 2017 assignment invalid. The plaintiffs conceded that Best Buy and the class had attempted to assign Best Buy's claims to a group of individuals in 2008 but argued that the 2008 assignment was void. The court concluded that its decision that class counsel could not represent the individual assignees in their individual refund claims "did not address or expressly void any assignment," adding that such lack of authority did not affect the validity of the assignment.

The plaintiffs' deadline to file a motion for rehearing and motion for rehearing en banc is currently September 30, 2022.

2. **Refund Claim: "State Fully and In Detail"**
Hegar v. El Paso Electric Co., (Court of Appeals Case No. 03-18-00790-CV), addressed whether the taxpayer had satisfied Tax Code § 111.104(c)(2)'s requirement that its refund claim "state fully and in detail each reason or ground on which the claim is founded." The Comptroller argued that taxpayer's refund request failed to satisfy the refund claim statute because the Comptroller was not put on notice with the approximately thirty generic claims. The Comptroller also argued that the taxpayer failed to exhaust its administrative remedies on its manufacturing exemption claim under the Comptroller's rules.

The trial court denied the Comptroller's jurisdictional challenge.

The Comptroller appealed. In August 2020, the court of appeals held that the taxpayer's refund claim and supporting schedules did not put the Comptroller on notice of the legal basis of its claim. The taxpayer moved for reconsideration en banc. In March 2021, the court of appeals vacated its prior holding and affirmed the trial court's denial of the Comptroller's jurisdictional challenge. The court of appeals held that the Comptroller did not dispute that he was on notice of the taxpayer's manufacturing exemption claim (1) when the claim was filed and (2) throughout the administrative proceedings. Additionally, the court of appeals held that the Comptroller, in raising his exhaustion of administrative remedies argument, conflated his own procedural rules with the statute's jurisdictional requirements.

The Texas Supreme Court denied the Comptroller's Petition for Review.

3. **Protest Suit: "Amount Claimed by the State"**
1st Global, Inc. v. Hegar, No. 03-19-00740-CV, 2021 Tex. App. LEXIS 8760 (Tex. Ct. App. Oct. 29, 2021) addressed whether a protest suit's "amount claimed by the state" includes taxes self-assessed by taxpayer in accordance with the Comptroller's known position the Taxpayer wishes to contest.

1st Global Inc. is the reporting entity of a combined group of investment advisers. It has a Dallas office, but not all its advisers live and work in Texas. It disagreed with a Comptroller administrative ruling concluding that all the company's gross receipts — not just its Texas receipts — should be apportioned to Texas for franchise tax purposes. 1st Global submitted that amount of tax to the Comptroller, along with its annual report and a protest letter, initiating a tax protest suit.

The Comptroller argued that 1st Global had not met the requirements for bringing a tax protest suit because the state had not claimed that the company owed any specific amount of tax. The district court agreed and granted the Comptroller's motion to dismiss.

1st Global appealed the trial court's ruling. 1st Global argued that a taxpayer need only pay a tax in order to file a protest, and pointed out that it had followed the Comptroller's guidance in performing its self-assessment. The Third Court of Appeals ultimately affirmed the lower court's dismissal of the taxpayer's remittance of a self-assessed amount of franchise tax, concluding that a tax protest suit can be initiated only after the state makes a claim for a specific amount of tax that is due.

According to the appellate court, the crux of the issue rested on a narrow reading of Tax Code § 112.051(a), which requires that a taxpayer "pay the amount claimed by the state" when initiating a tax protest suit. The court explained that the meaning of the phrase "the amount claimed by the state" does not include a taxpayer's self-assessment, but would have to be the amount that the state actually claimed the taxpayer owed. The court held that "the phrase 'the amount claimed by the state' can reasonably be read to require some sort of affirmative claim by the state for a specific amount of franchise taxes."

The appellate court acknowledged that 1st Global had followed the Comptroller's "previously announced general legal position regarding apportionment," and that its argument was appealing, but concluded that this did not clearly and unambiguously meet the tax protest suit statutory requirements.

4. **Tax Suits: Inability-to-Pay Exception (Post-*EBS Solutions*)**
Texas courts continue to apply *EBS Solutions v. Hegar*, 601 S.W.3d 744 (Tex. 2020) by allowing taxpayers to seek judicial review of a tax assessment without full prepayment of taxes, so long as the taxpayer satisfies the jurisdictional requirements of the inability-to-pay provision found in Tax Code § 112.108. *See Jai Dining Servs. v. Hegar*, No. 03-19-00750-CV (Tex. Ct. App. Oct. 27, 2021); *see also 13335 Duluth Restaurant & Bar, L.L.C. v. Hegar*, No. 14-20-00098-CV (Tex. Ct. App. Sep. 23, 2021); *see also Hegar v. Alam, Inc.,* No. 03-18-00044-CV (Tex.

Ct. App. Mar. 18, 2021); *see also Hegar v. Zertuche Constr., LLC*, No. 03-19-00238-CV (Tex. Ct. App. Jan. 22, 2021).

B. Legislative Developments

1. **Playing Without Paying.** The 2021 Legislature passed HB 2080, which permits taxpayers who have exhausted their administrative remedy to challenge a deficiency determination in district court without having to pay the disputed amounts under protest. The issues in the district court suit are limited to the grounds of error contained in the taxpayer's motion for rehearing, but they would be subject to de novo review. During the pendency of the suit, the Comptroller is enjoined from collecting disputed amounts, but may assert tax liens. Any disputed amount upheld in a final judgment will accrue penalty and interest, and the Comptroller is entitled to damages if the court determines that all or part of the enjoined collection amounts were disputed solely for delay. This new "no pay-to-play" path to district court applies to suits disputing amounts that become due and payable after September 1, 2021.

   Many taxpayers had hoped for a path to challenge audit assessments in district court that did not require a protest payment or completion of the administrative hearing process. Texas was not willing to go that far. Instead, under HB 2080, taxpayers who could not previously afford to pay an assessment under protest now have a path to de novo court review that is not dependent upon their financial health (arguably an open courts violation). And, taxpayers who can afford to pay under protest may seek judicial relief without having their funds deposited into the state's coffers to accrue minimal interest during litigation. The bill's legislative history stated a desire to provide an alternative to Texas's traditional protest suit, which requires pre-payment of the assessment in full and is "onerous for both taxpayers and the state." HB 2080 sought "to ease the burden on taxpayers and ensure that all Texans, regardless of means, are able to access the taxpayer suit processes by establishing a new type of taxpayer protest suit that does not require prior payment of the amount in protest." HB 2080, Bill Analysis, Ways & Means Committee Report (Substituted).

2. **Taking Refund Claims Straight to Court**. The 2021 Legislature enacted SB 903, which improves the jurisdictional path for refund claims pending or filed on or after September 1, 2021. The law permits taxpayers to bypass the administrative hearing process presently required for a refund suit.

   Under the new statute, taxpayers claiming a refund may file a notice of intent to bypass the administrative hearing process within 60 days of the Comptroller's denial of its refund claim and proceed to district court. The notice of hearing must be in writing and assert the material facts and specific legal bases on which a refund is claimed. In response, the

Comptroller may require a conference with the taxpayer to clarify any factual or legal issue in dispute and to discuss the availability of additional documentation that may assist in resolving outstanding issues. Following the conference (or the Comptroller's waiver of the conference), the taxpayer may file suit in district court. The statute requires a taxpayer to pick a path (administrative hearing or district court) early in the refund process because a notice of intent to bypass waives the taxpayer's right to an administrative hearing.

The bill's legislative history attributed the need for an administrative bypass to taxpayer claims that a refund claim "often involves issues that ultimately must be determined by a court (i.e., challenging the constitutionality of a statute, seeking to reverse comptroller policy or precedent)" and that "the hearings process at SOAH overwhelmingly finds in favor of the state." Thus, "[f]or many taxpayers, a mandatory administrative hearing prior to being able to file in a district court is unnecessary, expensive, and unreasonably delays the opportunity to resolve their tax case." HB 2080, Bill Analysis, Ways & Means Committee Report (Substituted). Taxpayer complaints were undoubtedly strengthened by the Texas Taxpayers and Research Association's report, released in January 2021, finding that taxpayers prevailed in less than five percent of SOAH administrative hearings and obtained partial relief in only ten percent of hearings. HB 2080, Bill Analysis, Ways & Means Committee Report (Substituted).

As recognized by the legislature, allowing taxpayers to bypass the administrative process shortens the time period in which a refund claim is pending—an important consideration given the state's low refund interest rate, which fails to keep pace with inflation and, over time, can reduce the value of the claim. The bypass feature also reduces litigation expense by permitting taxpayers to skip the administrative level when the Comptroller has staked out a position on the issue(s) in dispute, thereby making the outcome almost certainly unfavorable.

IV. BIOGRAPHIES

A. Danielle V. Ahlrich

Danielle is a partner in Reed Smith's State Tax Group, based in the Austin office. She focuses her practice on Texas tax matters, specializing in Texas sales and use tax and Texas franchise tax. Danielle represents taxpayers in a variety of industries—including construction, oil and gas, and tech—and assists them with all phases of Texas tax issues. While Danielle loves to help clients minimize audit exposure through front-end planning, she also maintains a robust tax controversy practice in which she represents Texas taxpayers during audit and in challenging tax assessments and pursuing tax refunds before the State Office of Administrative Hearings, in state district court, and on appeal.

B. Rich W. Moore

Rich is an associate in Reed Smith's State Tax Group, based in the Austin office. Rich's practice focuses on state and local tax controversies, including corporate franchise/income tax and sales and use tax. Rich resolves these state and local tax controversies at all stages, including audit, administrative appeals, and judicial proceedings.