Texas Tax: The Comptroller, Legislature and the Ox, Oh My!

SPEAKER

David E. Colmenero
Partner

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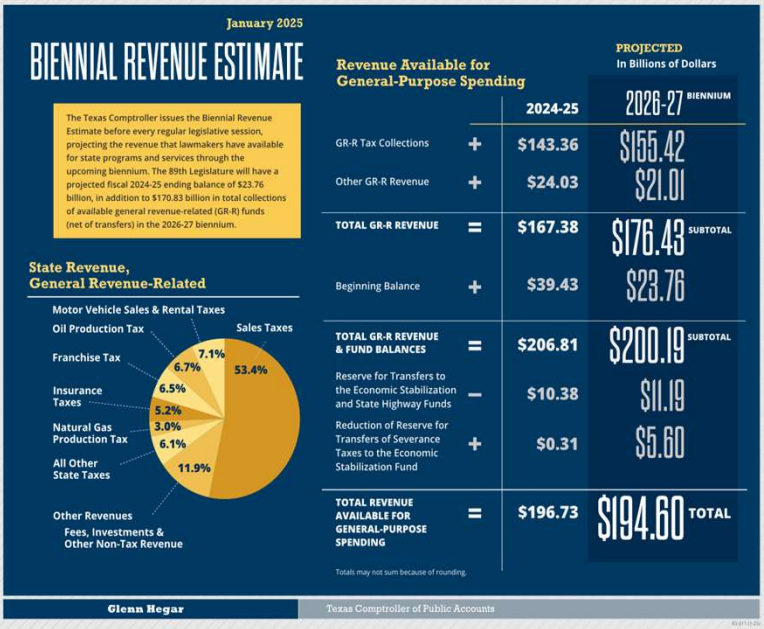
Meadows Collier
901 Main Street, Suite 3700, Dallas, TX 75202
Phone: 214.744.3700 | 800.451.0093 | Fax: 214.747.3732
MeadowsCollier.com

Texas 89th Legislature

- November 12, 2024: Bill filing began.
- January 13, 2025: Texas Comptroller Releases Revenue Estimate.
- January 14, 2025: Legislative Session Convened.
- March 14, 2025: Deadline to file bills.
- June 2, 2025: Last day of Session.



Overview of Pending Tax Bills

- Property Tax:
  - Governor Abbott declared property tax relief an emergency item: "Last session, we slashed your property taxes. But for many Texans, those cuts were wiped out by local taxing authorities that hiked your property taxes even more. That must end this session. I want at least $10 billion in new property tax relief. But that will only work if local authorities cannot use loopholes to jack up your property taxes like Haris County did. They increased property taxes more than 10% last year. Loopholes that increase your property taxes must be banned. No taxing entity should be able to raise your property taxes without a two-thirds approval by voters. No approval, no new taxes." Gov. Abbott State of the State Address (Feb. 2, 2025).
  - Several property tax bills are under consideration.
- Franchise Tax Bills Pending:
  - Credit Related to Payment of Property Tax on Inventory
  - R&D Credit Revisions
  - Reduced Tax Rate for Rental of Industrial Uniforms, Garments and Linen
  - Radio and Television Broadcasting COGS
  - Spaceport Operator Exemption
  - Repeal of Franchise Tax?

Overview of Pending Tax Bills

- Sales Tax Bills Pending:
  - ❖ Local Tax Sourcing
  - ❖ Data Processing
    - ➢ Homeowners Association Documentation
    - ➢ Internet Access Service
    - ➢ Marketplace Providers
  - ❖ Non-residential Real Property Repair and Remodeling
  - ❖ Exotic Animals
- Tax Procedures Bill Pending
- Others?

Franchise Tax Bills

- SB 32: Credit Related to Payment of Property Tax on Inventory
  - ❖ Would increase exemption for property tax on tangible personal property from $2,500.00 to $25,000.00;
  - ❖ Would allow a credit against franchise tax equal to 20% of property tax paid on inventory, as defined;
  - ❖ The total amount of credit for all reports in any given year would be capped at $500 million which would be allocated prorata to taxpayers claiming the credit under a formula provided for in the statute;
  - ❖ The Texas Comptroller could require taxpayers to pay the full amount of Texas franchise tax and request a refund for this credit.
  - ❖ The credit would not be assignable.
  - ❖ The effective date would be January 1, 2026
- Status: Passed by Senate; pending at House Ways and Means Committee.

Franchise Tax Bills

- The Current R&D Credit in Texas:
  - ❖ Has a franchise tax and sales tax component.
  - ❖ Is generally based on newly incurred or increases in Qualified Research Expenditures, which are not necessarily equal to the federal tax QRE amounts according to the Texas Comptroller.
  - ❖ Has become very complex to compute and administer.
  - ❖ Are heavily audited by the Texas Comptroller.

Note: Texas Comptroller audits have been substantially delayed in many cases.

Franchise Tax Bills

- SB 2206 (Bettencourt/Huffman)/HB 4393(Geren): R&D Franchise Tax Credit/Exemption
  - ❖ Would tie the Qualified Research Expense amount to QRE amounts reported on IRS From 6765.
  - ❖ Would allow statistical sampling for determining QRE amounts.
  - ❖ Would allow use of QRE amounts reported on financial statements in some instances.
  - ❖ Would increase the general credit from 5% to 8.722%. For QREs incurred under a contract with institutions of higher education, the rate would increase from 6.25% to 10.903%.
  - ❖ Would make the R&D Credit refundable for years for which no franchise tax is owed.
  - ❖ Would eliminate the alternate sales tax R&D exemption.
  - ❖ Unused R&D credits could continue to be used as provided for under existing law.
- Status: SB 2206 was approved by Senate Finance Committee and is pending at the Senate. HB 4393 is pending at the House Ways and Means Committee.

Franchise Tax Bills

- SB 2774 (Campbell): Rental of Industrial Uniforms, Garments and Linen
  - Would amend Tex. Tax Code §171.0001(12) to state that "retail trade" for purposes of the reduced Texas franchise tax available to certain "retailers" and "wholesalers" includes the following:

    "activities involving the rental of industrial uniforms, industrial garments, and industrial linen supplies that are classified as Industry 7213 or 7218 of the 1987 Standard Industrial Classification Manual published by the federal Office of Management and Budget."
  - The Bill analysis explains, "Many companies engaged in the business of renting work uniforms are not properly classified for franchise tax purposes because the industry groups under which they operate are not expressly listed in the definition of "retail trade" in the Tax Code. This has resulted in an inequity, where businesses that functionally operate like retailers are excluded from the lower retail franchise tax rate simply because they rent, rather than sell, their goods."
  - Note: The bill would take effect January 1, 2027.
- Status: Passed by Senate. Transferred to House on April 24, 2025.

Franchise Tax Bills

- SB 1058(Parker): Texas Stock Exchange?
  - Would allow a registered securities market operator to exclude from total revenue "transaction rebate payments", which is defined as "amount[s] paid to incentivize a broker or dealer to provide liquidity to the market."
  - Bill analysis: "[F]or entities engaged in securities markets, revenue often includes pass-through payments that do not reflect true income, particularly transaction rebate payments made to brokers or dealers as part of securities trades. S.B. 1058 seeks to address this issue and secure accurate tax treatment for entities operating in the securities market by excluding from an entity's total revenue, for purposes of the franchise tax, rebate payments made to brokers or dealers that do not represent retained income."
  - Status: Passed by both House and Senate.

Franchise Tax Bills

- SB 263 (Perry): Television and Radio Broadcasting COGS Deduction
  - ❖ Would amend Section 171.1012(o) to permit a cost of goods sold deduction to entities whose principal business activity is television or radio broadcasting under a license issued by the FCC.
  - ❖ Passed by Senate; Pending at House Ways and Means Committee
- HB 3045 (Gerdes,Curry,Capriglione)
  - ❖ Would create exemption for an operator of a "spaceport" authorized by the FAA and has a contract with the US. DOD to provide spaceflight or launch services to that department.
  - ❖ Status: Pending in House
- HB 1508(Metcalf): Repeal of tax?
  - ❖ Would repeal the franchise tax
  - ❖ Status: Pending at House Ways and Means Committee

Sales and Use Tax

- ❖ Current statute Re Sourcing:
  - ➢ Chapter 321, generally sources sales to seller's place of business. *See, e.g.*, Tex. Tax Code § 321.203(b)(" (b) If a retailer has only one place of business in this state, all of the retailer's retail sales of taxable items are consummated at that place of business except as provided by Subsection (e).")
  - ➢ Pre-*Wayfair*: If seller had no physical presence in Texas, it had no duty to collect sales or use tax. If it had only one place of business, all sales were sourced to that location. If it had multiple places of business in Texas, certain ordering rules would apply, generally based on seller's place of business. These rules have generally been applied equally to Internet sales.

Sales and Use Tax

Cont'd.

- Current statute Re Sourcing:
  - Following *Wayfair*: (i) new marketplace provider rules source all sales made by a marketplace seller through a marketplace to destination, *see* Tex. Tax Code §321.203(e-1); and (ii) sellers can opt to collect a single local use tax (currently 1.75%) instead of determining the actual local tax rates, *see* Tex. Tax Code §151.0595.
  - ***Note***: According to the Texas Comptroller, the single local use tax rate is not available to marketplace providers. *See* Texas Comptroller, *Remote Sellers and Marketplace Frequently Asked Questions available at* https://comptroller.texas.gov/taxes/sales/remote-sellers-marketplace-faq.php.

Sales and Use Tax

Cont'd.

- Sourcing of Sales
  - Recent Comptroller Rule Amendments to Rule 3.334, Local Sales and Use Tax
    - The Comptroller has amended Rule 3.334 four times since 2020.
    - Generally, the amendments provide that online sales that are not fulfilled from a "place of business" in Texas should be sourced to the place of delivery/destination, even if the seller maintains a place of business in Texas. 34 Tex. Admin. Code §3.334(c)(2)(B).
    - Amended Rule 3.334(b)(5) reads: "A facility without sales personnel is usually not a 'place of business of the seller.'…A computer that operates an automated shopping cart software program is not ['an established outlet, office, or location,' and does not constitute a 'place of business of the seller.' A computer that operates an automated telephone ordering system is not 'an established outlet, office, or location,' and does not constitute a 'place of business of the seller.'" 34 Tex. Admin. Code §3.334(b)(5).
  - *Note*: The apparent intent of this amendment was to source online sales based on destination rather than a seller's place of business.

Sales and Use Tax

- Sourcing of Sales
  - ❖ Pending Litigation Re: Amendments to Rule 3.334
    - ➢ *City of Coppell, Texas et al. v. Hegar*, Cause No. D-1-GN-21-003198 (D.Ct. Travis County, filed July 12, 2021): The Cities of Coppell, Humble, DeSoto, Texas and Round Rock challenge the validity of the Comptroller's amended Rule 3.334 relating to the sourcing of Internet orders.
    - ➢ Following a non-jury trial the week of October 14, 2024, the Court issued a final judgment on December 3, 2024.

Sales and Use Tax

City of Coppell, Texas et al. v. Hegar, Cause No. D-1-GN-21-003198 (D.Ct. Travis County) Final Judgment:

- Fulfillment Centers: The Court found that Section 321.002(a)(3)(A) of the Tax Code requires a determination of whether at least three orders were received by the retailer during the calendar year and therefore it could not prospectively declare Fulfillment Centers as places of business. Accordingly, the Court denied Coppell Plaintiffs' request to declare Fulfillment Centers receiving only Website Orders places of business under the 2016 version of 34 TAC § 3.334.
- Rule 3.334: The Court also found that Comptroller Rule 3.334(a)(9), (18); (b)(5) and (c) contravene Texas Tax Code §§ 321.002 (a)(3)(A), 321.203 and 323.203 and permanently enjoined the Texas Comptroller from enforcing these provisions.
- APA: The Court additionally found that the Texas Comptroller did not substantially comply with the notice and "reasoned justification" requirements of Administrative Procedures Act.

Sales and Use Tax

City of Coppell, Texas et al. v. Hegar, Cause No. D-1-GN-21-003198 (D.Ct. Travis County) Final Judgment:

- Notice of Appeal Filed by Plaintiffs: "Even though the Coppell Plaintiffs believe they received all the relief necessary to declare that the rules they challenged contravene the Tax Code, the Coppell Plaintiffs file this notice because counsel for the Comptroller of Public Accounts insists that the Coppell Plaintiffs did not receive that relief and has advised that the Comptroller of Public Accounts intends to propose rules in response to the December 3, 2024, judgment that the Coppell Plaintiffs believe would directly contravene their understanding of that judgment."

Sales and Use Tax Bills

HB 134 (Meyer): Sourcing for Local Tax

- Would amend Section 321.203 regarding sourcing for municipal sales and use tax to provide that the following sales would be consummated (*i.e.*, sourced) as follows:
  - For items sold by a "small business" (as defined), at the seller's "principal business location";
  - For items sold by other businesses, at the retailer's place of business where the retailer receives the order, provided that the order is placed in person at the retailer's place of business in Texas where the retailer receives the order;
  - For other sales, at the location in Texas to which the item is shipped or delivered at at which possession is taken by the purchaser.
  - For these purposes, a place of business would not include a computer server, Internet protocol address, domain name, website, or software application.
- Status: Approved by House Ways and Means Committee; pending at the House.

Sales and Use Tax Bills

- HB 3646 (Capriglione): Homeowners Association
  - Would exclude from taxable services for sales and use tax purposes the provision of certain information by or on behalf of a homeowners' association to a member or their representative or agent, lender or title company including:
    - A resale certificate;
    - A condominium information statement;
    - Financial information or other record about a homeowners' association or member property;
    - Certain organizational documentation regarding the homeowner's association; or
    - Other similar information.
  - Status: Pending at House Ways and Means Committee

Sales and Use Tax Bills

- SB 1405(Nichols, Hagenbuch): Internet Access Service
  - Internet Access Service: Would amend Tex. Tax Code §151.0101(a) to remove "Internet access service" from the list of taxable services for Texas sales and use tax purposes.
  - *Note*: SB does not delete the language in Tex. Tax Code §151.00394(c) which excludes Internet access service from data processing.

Sales and Use Tax Bills

- SB 265 (Perry)/HB 1681(Button): Marketplace Providers
  - ❖ Would add to the list of items excluded from "data processing service" "services provided by a marketplace provider in relation to the processing of a sale or payment for a marketplace seller, as those terms are defined by Section 151.0242."
  - ❖ Status: SB 265 filed Nov 12, 2024; HB 1681filed Dec. 19, 2024.
  - ❖ Status: SB 265 referred to Senate Finance Committee. HB 1681 pending in House Ways and Means Committee.
- *Note*: Texas Comptroller Rule 3.330(b)(5) states, "(5) Effective October 1, 2025, marketplace provider services may be included in taxable data processing services when they involve the computerized entry, retrieval, search, compilation, manipulation, or storage of data or information provided by the purchaser or the purchaser's designee. For example, services provided by a marketplace provider to its marketplace seller that store product listings and photographs, maintain records of transactions, and compile analytics are taxable data processing services."

Sales and Use Tax Bills

- ❖ SB 2020 (Campbell): Non-residential Real Property Repair and Remodeling
  - ➢ Would amend Tex. Tax Code §151.0101(a) to remove "real property repair and remodeling" services from the list of taxable services and would also make corresponding changes to other portions of Chapter 151. This amendment would effectively eliminate the Texas sales/use tax that currently applies to non-residential repair and remodeling work.
  - ➢ The Bill Analysis explains, "Eliminating the tax would level the playing field between new construction and renovation projects, giving businesses the flexibility to choose the most cost-effective and practical solution for their needs. Without the added tax burden, commercial property owners can more easily modernize buildings, enhance safety and energy efficiency, and contribute to the economic revitalization of communities across Texas."
  - ➢ Status: Pending at Senate Finance Committee.

Sales and Use Tax Bills

- HB 135 (Campbell)
  - Would exempt exotic animals and game animals as defined from tax.
  - Status: Passed by House; Pending in Senate.

Tax Procedure Bill

HB 1937(Craddick)/SB 266(Perry):

- Would amend the Texas Tax Code as follows:
  - Documentation Requirements: Would amend various sections of the Tax Code to require "sufficient" records to substantiate the amount of tax, penalty or interest to be assessed, collected, or refunded in an administrative or judicial proceeding, rather than "contemporaneous" records as the Tax Code currently states.
  - Abatement of Penalty for Pending Lawsuits: Would amend Section 111.0081(d) of the Tax Code to state that the additional 10% penalty that applies to an unpaid assessment 20 days after it becomes final would be abated if a lawsuit challenging the assessment is timely filed in district court until 20 days after a judgment in the lawsuit becomes final.

Tax Procedure Bill

HB 1937(Craddick)/SB 266(Perry):

- Would amend the Texas Tax Code as follows:
  - Security in Lieu of Liens for Pending Lawsuits: As an alternative to issuing liens while a lawsuit is pending, would amend the Tax Code to permit the Texas Comptroller to require a security from the taxpayer sufficient to secure payment of the entire disputed amount.
  - Managed Audit Lawsuits: Would amend the Tax Code to permit taxpayers who underwent a managed audit and who dispute an assessment to file a lawsuit without paying the disputed amount by first filing a notice of intent to bypass the redetermination process. Several deadlines would apply and procedures similar to those that apply to notices of intent to bypass the administrative hearings process for refund claim denials would apply.
- Status: HB 1937 Approved by HWM Committee; SB 266 approved by Senate and currently pending at HWM Committee.

Tax Procedure Bill

HB 1937(Craddick)/SB 266(Perry):

Note: These bills appear likely to pass.

Query: Should the Texas Legislature amend the Tex. Tax Code to make notices of intent to bypass the redetermination hearings process available for all assessments?

Data Processing

- Data Processing is considered taxable in Texas. However…,
  - ❖ What constitutes taxable data processing has become highly controversial with many key issues arising.
  - ❖ The Texas Comptroller has taken aggressive positions recently in classifying transactions as taxable data processing.
  - ❖ Several cases are pending in court challenging Texas Comptroller assessments.
  - ❖ As a result, there is considerable uncertainty as to what should be classified as taxable data processing.

Data Processing

- Section 151.0035:
  - ❖ (a) "Data Processing Services" includes:
    - ➢ (1) word processing, data entry, data retrieval, data search, information compilation, payroll and business accounting data production, and other computerized data and information storage or manipulation;
    - ➢ (2) the performance of a totalisator service with the use of computational equipment required by Subtitle A-1, Title 13, Occupations Code (Texas Racing Act); and
    - ➢ (3) the use of a computer or computer time for data processing whether the processing is performed by the provider of the computer or computer time or by the purchaser or other beneficiary of the service.
  - ❖ (d) " 'Data storage' … does not include a classified advertisement, banner advertisement, vertical advertisement, or link when the item is displayed on an Internet website owned by another person."

Data Processing

- Section 151.00394(a),(c):
  - ❖ "Data Processing Services" does not include "Internet access service."
  - ❖ " 'Internet access service' means a service that enables users to access content, information, electronic mail, or other services offered over the Internet and may also include access to proprietary content, information, and other services as part of a package of services offered to consumers. The term does not include telecommunications services."

Data Processing

- Texas Comptroller Rule 3.330 (before April 2, 2025)
  - ❖ (a)(1) "Data processing services - *the processing of information* for the purpose of compiling and producing records of transactions, maintaining information, and entering and retrieving information. It specifically includes word processing, payroll and business accounting, and computerized data and information storage or manipulation. The charge for data processing services is taxable regardless of the ownership of the computer. Examples of data processing services include entering inventory control data for a company, maintaining records of employee work time, filing payroll tax returns, preparing W-2 forms, and computing and preparing payroll checks. *Data processing does not include the use of a computer by a provider of other services when the computer is used to facilitate the performance of the service* or the application of the knowledge of the physical sciences, accounting principles, and tax laws, e.g., the use of a computer to provide interpretive or enhancement geophysical services or the use of a computer by a CPA firm, enrolled agent, or bookkeeping firm to produce a financial report, prepare federal income tax, state franchise or sales tax returns, or charges for temporary secretarial personnel who as part of their function use word processing equipment. *Data processing services does not include Internet access services or data processing services provided in conjunction with and incidental to the provision of Internet access service when billed as a single charge."* (emphasis added)

Key Issues Re Data Processing

- What Constitutes Data Processing?
  - Can online services be taxed as data processing?
  - When a nontaxable service becomes fully or partially automated, does it become a taxable data processing service?
  - Should nontaxable services that include and/or require some level of data processing be treated as taxable data processing?
  - Should website development or HTML coding be considered taxable data processing?
  - Should all data storage be viewed as taxable data processing?

Pending Litigation Re Data Processing

- Currently Pending Court Cases Re Data Processing:
  - *Apple, Inv. v. Hegar*, D-1-GN-20-004108: Whether personal electronic storage is taxable as data processing.
  - *Scorpion Design, LLC v. Hegar*, D-1-GN-24-003011: Whether internet marketing and digital advertising is taxable as data processing.
  - *West Publishing Corporation v. Hegar*, D-1-GN-25-00594: Whether internet marketing is taxable as data processing.
  - *Katalyst Data Management, LLC v. Hegar*, D-1-GN-20-001539: Whether certain services related to the management, interpretation, enhancement and transformation of geological and geophysical data are taxable data processing.

Data Processing versus Nontaxable Services

Hegar v. CheckFree Services v. Corp., 2016 Tex. App. LEXIS 4039 (Tex. Civ. App.—Houston, April 19, 2016, no pet.) Online Bill Pay Services

- Facts: Taxpayer contracted with several banks to provide bill pay services through the banks' online banking services to bank customers. The Comptroller claimed that these services were taxable data processing services. The trial court held that the services at issue were "bill pay services" and not data processing services and therefore not taxable. Specifically, the trial court held, "CheckFree has thousands of skilled and/or certified professionals who collaborate in the performance of these professional services centered around bill payment."
- Held: The Houston Court of Appeals agreed with the Trial Court that the services were not taxable. "[T]o the extent that CheckFree provided [data processing services], they were ancillary to the professional bill pay services provided by CheckFree for the bank's customers-the electronic commerce services that the bank purchased from CheckFree."

Recent Revisions to Rule 3.330

- Rule 3.330, Data Processing Revisions:
  - ❖ On Sept 13, 2024, the Texas Comptroller's office published proposed revisions to it's Data Processing Rule in the Texas Register.
  - ❖ Comments were received by the October 13, 2024 deadline.
  - ❖ On December 6, 2024, the Comptroller held a hearing on the proposed revisions to Rule 3.330.
  - ❖ The proposed amendments were adopted on April 2, 2025.

Revisions to Rule 3.330

Amendment to Rule 3.330 Revises Definition of Data Processing

- Subject to several specific inclusions and exclusions, subsection (a)(1) defines "data processing" as follows:

"Data processing service--the computerized entry, retrieval, search, compilation, manipulation, or storage of data or information."

Revisions to Rule 3.330

Recent Amendment to Rule 3.330 Rejects Essence of Transaction:

- *Preamble*: "The test for determining whether a data processing service is 'ancillary' to a nontaxable service is not an essence of the transaction test. The essence of the transaction test attempts to determine what the buyer ultimately wants. *Combs v. Chevron, Inc.,* 319 S.W.3d 836, 843 (Tex. App.--Austin 2010, pet. denied) ("underlying goal"). *The buyer will never want the manipulation of data for its own sake. The buyer will always want the manipulation of data as the means to achieve an end. Therefore, the identification of the 'underlying goal' of the buyer, or the essence of the transaction, is not the appropriate test for data processing services. See also,* Hellerstein & Hellerstein, State Taxation §12.08 (3rd ed. 2020) (the primary purpose test is 'folly'). [emphasis added]
- "In determining whether a data processing service is "ancillary" to a nontaxable service, the comptroller will focus on what the seller is doing, and not what the buyer wants. The repetitive or routine manipulation of data by the seller is a factor suggesting that the activity is not ancillary and should be taxable as a data processing service, while the manipulation of data that depends on the external knowledge and discretionary judgment of the service provider suggests that the activity is ancillary and should not be taxable as a data processing service."
- ***Query***: Can the Texas Comptroller overrule the judicially created "essence of the transaction" test?

Revisions to Rule 3.330

Amendment to Rule 3.330 Focuses on Whether Data Processing Has "Separate Value":

- ***Newly Adopted Standard focuses on existence of "separate value":*** (a)(1)(C):"Under its exclusive jurisdiction to interpret taxable services, the comptroller excludes from the definition of 'data processing service' data processing that is sold for a single charge with another service if the data processing service *does not have a separate value, and the data processing service is ancillary to the other service*. The burden is on the taxpayer to demonstrate that the data processing service does not have a separate value and is ancillary to the other service. [emphasis added]"
- ***If no separate value, taxability depends on which service is "ancillary" to the other*:** (a)(1)(C)(iii): "In determining whether the data processing service and the other service have separate values, the comptroller will consider *whether the services are distinct and identifiable and whether each service is of a type that is commonly provided on a stand-alone basis or commonly provided as an additional service for a greater single charge*. [emphasis added]"
  - ***Meaning of "Ancillary" if No Separate Value:*** (a)(1)(C)(iv): "In determining whether the data processing service is ancillary to another service, or conversely, whether the other service is ancillary to the data processing service, the comptroller may consider the extent to which the service provider exercises discretion or judgment in individual applications of the processed data based on knowledge of the physical sciences, accounting principles, law, or other fields of study. The repetitive or routine manipulation of data by the seller is a factor suggesting that the data processing activity is not ancillary to another service and should be taxable as a data processing service. The manipulation of data that depends on the external knowledge and discretionary judgment of the service provider in individual applications suggests that the data processing activity is ancillary to another service and should not be taxable as a data processing service. The provider's skill, experience, or expertise, in processing data or information is not a factor. Other factors may be considered, and the weight of the factors may vary from case to case. The evaluation is based on what the service provider is doing, not on what the customer wants."

Revisions to Rule 3.330

Amendment to Rule 3.330 Relies on 5% Rule for DP Services Having Separate Value:

- ***If separate value exists, 5% rule applies*:** (e)(2):"Where nontaxable related [unrelated] services and taxable services are sold or purchased for a single charge and the portion relating to taxable services represents more than 5.0% of the total charge, the total charge is presumed to be taxable. The presumption may be overcome by the data processing service provider at the time the transaction occurs by separately stating to the customer a reasonable charge for the taxable services. However, if the charge for the taxable portion of the services is not separately stated at the time of the transaction, the service provider or the purchaser may later establish for the comptroller, through documentary evidence, the percentage of the total charge that relates to nontaxable related [unrelated] services. The service provider's books must support the apportionment between exempt and nonexempt activities based on the cost of providing the service or on a comparison to the normal charge for each service when [if] provided alone. If the charge for exempt services is unreasonable when the overall transaction is reviewed considering the cost of providing the service or a comparable charge made in the industry for each service, the comptroller will adjust the charges and assess additional tax, penalty, and interest on the taxable services."
- ***Query***: Does the Texas Comptroller have the authority to overrule the "essence of the transaction" standard created by the judiciary?

Recent Texas Supreme Court Decision

GEO Grp., Inc. v. Hegar, No. 23-0149, 2025 WL 852414 (Tex. Mar. 14, 2025): Evidentiary Standard in Court

•**Facts**: The taxpayer ("GEO Group") owns and operates correctional facilities throughout the United States for detaining federal and state inmates. It argued that it could purchase various supplies deemed necessary to operate those facilities tax free because it qualified as an "agent" or "instrumentality" of the government under Texas Tax Code §151.309 and Texas Comptroller Rule 3.322(c). It also argued that the Texas Comptroller had erroneously denied its exemption by applying the heightened "clear and convincing evidence" standard rather than applying a "preponderance of the evidence" standard.

•**Holding Re Standard of Proof**: The Court agreed with GEO Group that it was only required to prove by a preponderance of the evidence its eligibility for exemption, noting that the Texas Comptroller's authority "does not extend to dictating the standard of proof to be applied in court." The Court also stated that it recognized the "oddity" created by the Texas Comptroller's Rule which applies a heightened "clear and convincing evidence" standard to administrative matters.

Recent Texas Supreme Court Decision

GEO Grp., Inc. v. Hegar, No. 23-0149, 2025 WL 852414 (Tex. Mar. 14, 2025): Evidentiary Standard in Court

- **Holding Re Exemption**: The Court ruled that GEO Group did not qualify for exemption as an agent or instrumentality of the federal or state government. Citing the rule of statutory construction *noscitur a sociis*, the Court held that the Comptroller's rule referencing agencies or instrumentalities of a government intends to cover entities "that have either been 'explicitly and unequivocally' declared to be a qualifying agency or instrumentality by the government (whether by statute or by contract) or those that could reasonably be viewed as an arm of the government as opposed to merely performing a governmental function." The Court noted that GEO Group's contracts with its government clients included language specifically stating that it acted as an independent contractor and that no principal-agent relationship was created. It also noted that those same contracts stated that GEO Group would be responsible for any taxes imposed on the facilities and related property.
- Query: What relevance might this case have on the Texas Comptroller's attempt to overrule the "essence of the transaction" standard?

Manufacturing Exemption

- The Texas Comptroller is considering revising its treatment of sand, dirt, gravel, rock and other solid materials in light of recent case law.
- *Hegar v. Texas Westmoreland Coal Co.*, 636 S.W.3d 61 (Tex. App. — Austin 2021, pet. denied): Equipment Used to Extract Lignite Coal Held Exempt
  - ❖ Facts: Taxpayer extracts and processes lignite coal for sale. It uses large equipment that cracks, breaks or rips apart exposed lignite formations in real property. Taxpayer then sold the coal to a third party.
  - ❖ Issue: Taxpayer filed a refund claim for tax paid on the equipment claiming it qualifies for the manufacturing exemption. The Comptroller denied the exemption claiming that, because the formation constituted real property when the equipment first dug into it, the equipment was processing real property, not processing tangible personal property for sale. The District Court ruled in favor of the taxpayer. The Comptroller appealed.

Manufacturing Exemption

Following *Texas Westmoreland Coal Co.:*

- The Texas Comptroller circulated a proposed Audit Memorandum Re Taxability of Sand, Dirt, Gravel, rock and Other Solid Materials to certain industry groups for comment, dated Dec 20, 2024.
- Under the proposed memo:
  - ❖ Extraction: Sand, gravel and other solid materials would be treated as processed materials when extracted from the earth in a way that causes a chemical or physical change to those materials.
  - ❖ Washing/Separating/etc: Activities such as washing, drying, and separating materials would be considered processing when the activities cause a chemical or physical change. *E.g.*, equipment used to separate individual sand grains and remove to remove impurities attached to the sand grains would be considered processing.
  - ❖ Gathering: Gathering loose sand and other materials from the ground would not be considered processing/manufacturing.
- *Note:* This proposed memo is still in draft form and has not been finalized or formally adopted by the Texas Comptroller.

Manufacturing Exemption

Following *Texas Westmoreland Coal Co.:*

- ***Query***: How may this policy affect other industries? For example, should cutting timber for production now be viewed as part of the manufacturing process? Texas Comptroller Rule 3.300 currently states,

> *"Manufacturing--Each operation beginning with the first stage in the production of tangible personal property and ending with the completion of tangible personal property. The first production stage means the first act of production, and it shall not include those acts in preparation for production. For example, a lumber company that cuts trees or a manufacturer that gathers, arranges, or sorts raw materials or inventory is preparing for production."* 34 Tex. Admin. Code §3.300(a)(9).

Manufacturing Exemption

Compressors Used In Oil and Gas Operations: Are they exempt?

- On December 20, 2024, the Texas Comptroller issued a letter to the Texas Oil and Gas Association addressing the exemption addressing the situation where compressors are used for both exempt and non-exempt purposes which reads in part:

> *"When used for an exempt purpose, such as supplying manufacturing equipment, compressors create differences in pressure which cause gas to move. The differences in pressure are also necessary for taxable transportation purposes such as moving gas into a pipeline or on to the next processing facility. This dual-purpose nature of compressors creates a tension in the manufacturing exemption/exclusion statutes and a challenge for taxpayers and the agency in determining the taxability of compressors because they are often used in both a taxable and nontaxable manner at the same time."*

Manufacturing Exemption

The Texas Comptroller December 20, 2024 letter regarding compressors continues as follows:

"The agency proposes to allow the following safe harbor percentages:

1. Compressors at a wellhead or prior to a compressor station will be treated as 100 percent taxable.

2. Compressors at compressor stations that process gas and cause it to move on to a natural gas processing facility will be allowed a 70 percent exemption. This percentage will apply to all compressors located along a pipeline between an initial compressor station and a natural gas processing facility.

3. Other than the final or outlet compressor at a natural gas processing facility, all compressors in the natural gas processing facility will be allowed a 100 percent exemption.

4. Beginning with the final or outlet compressor at a natural gas processing facility, all compressors distributing natural gas will be treated as 100 percent taxable. ....

Manufacturing Exemption

The Texas Comptroller December 20, 2024 letter regarding compressors continues as follows:

"Taxpayers may [alternatively] choose to calculate divergent use of compressors based on pressure or another appropriate measure of output. ... However, taxpayers must choose to either calculate divergent use or to apply the safe harbor percentages for all compressors before the outlet compressor at a natural gas processing facility. This safe harbor may be added as an alternative way of applying divergent use in future proposed"

***Note**:* The Texas Comptroller requested feedback about this proposed administrative solution for a safe harbor by January 31, 2025 before moving forward. As a result, this safe-harbor has not been adopted yet.

Query: Should compressors at a wellhead be treated as 100 percent taxable?

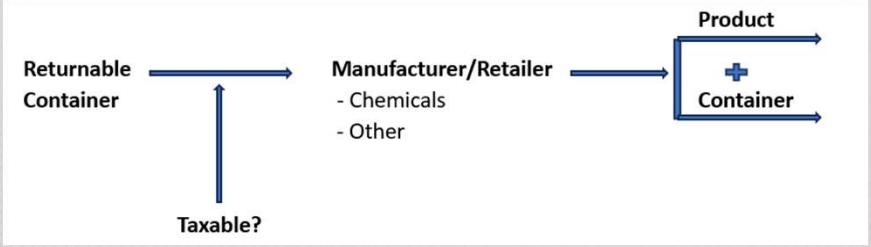
Manufacturing Exemption

Tetra Production Testing Services, LLC v. Hegar, Cause No. D-1-GN-20-006888 (Travis County D. Ct., pending): Equipment Used in Flowback Services

- Facts: Taxpayer provides flowback services. It paid tax under protest related to the purchase of oil and gas separators and replacement parts used to perform the flowback services.
- Issue: Taxpayer claims that its purchases of equipment qualify for the manufacturing exemption. In an Internal Memo dated Sept. 20, 2020, Access. No. 202009002L, the Comptroller argues that the equipment does not qualify because the flowback process occurs "prior to completion of the well and [being] put into production."
- Status: Discovery period ended Jan. 19, 2024.

Returnable Containers

Key Issue: Do Returnable Containers Qualify for the Resale or Manufacturing Exemption When Purchased to be Sold With Product?



Returnable Containers

Key Issue: Do Returnable Containers Qualify for the Resale Exemption?

- Sale for Resale Exemption:
  - Tex. Tax Code §151.006(a)(1): "Sale for resale" means a sale of …. tangible personal property or a taxable service to a purchaser who acquires the property or service for the purpose of reselling it as a taxable item as defined by Section 151.010 (Taxable Item) in the United States of America or a possession or territory of the United States of America or in the United Mexican States in the normal course of business in the form or condition in which it is acquired or as an attachment to or integral part of other tangible personal property or taxable service …."
- Manufacturing Exemption:
  - Tex. Tax Code §151.318(a)(1): "The following items are exempted from the taxes imposed by this chapter if sold, leased, or rented to, or stored, used, or consumed by a manufacturer: (1) tangible personal property that will become an ingredient or component part of tangible personal property manufactured, processed, or fabricated for ultimate sale …."
  - Tex. Tax Code §151.318(d): "In this section, 'manufacturing' includes each operation beginning with the first stage in the production of tangible personal property and ending with the completion of tangible personal property having the physical properties (including packaging, if any) that it has when transferred by the manufacturer to another. "

Returnable Containers

Key Issue: Do Returnable Containers Qualify for the Resale Exemption?

East Texas Oxygen, Co. v. State of Texas, 681 S.W.2d 741 (Tex. App.– Austin, 1984, no writ)

- Facts: Taxpayer sold oxygen in returnable cylinder tanks to customers. It charged separately for the tanks as "lease" charges to its customers and collected tax on those charges. It purchased the tanks tax free as exempt sales for resale. The Comptroller assessed tax on the purchase of the tanks claiming they did not qualify for the resale exemption.

Returnable Containers

East Texas Oxygen, Co. v. State of Texas, 681 S.W.2d 741 (Tex. App.– Austin, 1984, no writ)

- Issue: At issue was Tex. Tax Code §151.322 which reads as follows:

"(a) The following are exempted from the taxes imposed by this chapter:

(1) a container sold with its contents if the sales price of the contents is not taxed under this chapter;

(2) a nonreturnable container sold without contents to a person who fills the container and sells the contents and the container together; and

(3) a returnable container sold with its contents or resold for refilling."

Returnable Containers

East Texas Oxygen, Co. v. State of Texas, 681 S.W.2d 741 (Tex. App.– Austin, 1984, no writ)

- Held: Although Taxpayer's purchase of returnable containers is a "'sale for resale' under the literal statutory definition of that term", it could not claim the exemption because doing so would (1) mean that no one would tax on the containers; and (2) would render the language in Section 151.322, which exempts the sale of nonreturnable containers to one who sells goods in the container and the resale of returnable containers for refilling meaningless because these would already be exempt.

Returnable Containers

Combs v. Health Care Services Corp, 401 S.W.3d 623 (Tex. 2013)

Held: In construing and allowing a taxpayer to claim the resale exemption for Texas sales tax purposes on purchases of equipment where the subsequent sale of that equipment was also exempt, the Court stated,

> "If a statute is worded clearly, we must honor its plain language, unless that interpretation would lead to absurd results…. We recognize that statutes, framed in general terms, can often work peculiar outcomes, including over or under-inclusiveness, but such minor deviations do not detract from the statute's clear import. If an as written statute leads to patently nonsensical results, the "absurdity doctrine" comes into play, but the bar for reworking the words our Legislature passed into law is high, and should be. The absurdity safety valve is reserved for truly exceptional cases, and mere oddity does not equal absurdity."

Query: How does the Texas Supreme Court's holding in *Health Care Services Corp*. reconcile with the Texas Court of Appeals' earlier holding in *East Texas Oxygen Co*.?

Returnable Containers

Championx, LLC v. Hegar, D-1-GN-20-000139 (Travis Co. Dist. Ct., pending) and *Championx, LLC v. Hegar*, D-1-GN-21-000699 (Travis Co. Dist. Ct., pending) (consolidated on July 21, 2021): Returnable Containers Held Exempt

- Facts: Taxpayer manufactures various types of chemicals for the energy and water industries. Taxpayer packaged the chemicals it sells into returnable containers. After a customer finishes using the product, Taxpayer retrieves the container, reconditions and cleans them. Damaged containers are repaired or discarded. The average life span of a container is 20 to 30 years. Taxpayer sought a refund of sales tax paid on the purchases of:
  - ❖ the returnable containers, and
  - ❖ related cleaning services claiming the manufacturing exemption.
- Status: On March 20, 2024, the District Court judge issued an order granting Plaintiff's motion for summary judgment and denying Defendants' MSJ. Notice of Appeal flied on October 10, 2024. Briefing is currently underway at the 15th Court of Appeals.

Questions?

DISCLAIMER

The information included in these slides is for discussion purposes only, is not legal advice, and should not be relied on without seeking individual legal advice.

David E. Colmenero, J.D., LL.M., CPA
PARTNER

phone: 214.744.3700
toll-free: 800.451.0093
fax: 214.747.3732
dcolmenero@meadowscollier.com

Mr. Colmenero has experience in litigation and practices primarily in the State Tax Controversy and Litigation and State Tax Planning areas. He represents individuals, closely held businesses, and large corporations in all forums for Texas tax litigation, including the Texas State Office of Administrative Hearings, Texas District Court, the Texas Courts of Appeals, and the Texas Supreme Court. He has also represented clients in IRS audits, appeals, and litigation in the United States Tax Court, Federal District Courts and the United States Court of Federal Claims, U.S. Courts of Appeals, and the United States Supreme Court.

Mr. Colmenero was previously a sales tax auditor for the State of Texas and, as a lawyer, has successfully represented taxpayers in contested proceedings involving sales and use tax, franchise tax, motor fuels tax, motor vehicle tax, mixed beverage taxes, employment tax and others. Mr. Colmenero represents taxpayers through contested Texas tax proceedings including audits, Independent Audit Review Conferences, administrative proceedings before the Texas Comptroller, Texas State Office of Administrative Hearings, Texas Workforce Commission and in State court litigation.

Mr. Colmenero is a Certified Public Accountant and maintains active involvement in various professional legal and accounting organizations. He previously served as Chair of the Tax Section of the State Bar of Texas and was a member of the Board of Directors for the Texas Society of CPAs. He is the immediate past chair of the Federal Tax Policy Committee of the Texas Society of CPAs and is a member of the Texas Comptroller's Taxpayer Advisory Group. Mr. Colmenero received the TXCPA Outstanding Committee Chair Award for 2023-2024 in recognition for his outstanding leadership of the TXCPA Federal Tax Policy Committee. He is a member of the 2024-2025 Comments Subcommittee of the Federal Tax Policy Committee. He is a past chair of the Dallas CPA Society and past chair of both the State and Local Tax Committee and the Tax Controversy Committee of the Tax Section of the State Bar of Texas. He helped form the Leadership Academy for the Tax Section of the State Bar of Texas and served as its Program Director for several years. He frequently speaks on substantive and procedural tax issues involving both federal and state tax matters.

Mr. Colmenero was admitted to practice in Texas in 1997.

MEADOWS COLLIER
ATTORNEYS AT LAW