Texas Sales Tax Update

August 9, 2013

Texas sales and use taxes have been impacted by several events over the past six months: Governor Perry signed seven sales tax bills, the Comptroller revised several rules affecting sales tax, and the Texas Supreme Court issued two opinions and Third Court of Appeals issued one opinion relating to the resale exemption.

Legislative Amendments to Texas Sales and Use Tax Statutes

HB 1133: Refund/Exemption for Items Used by Cable, Internet, and Telecom Providers[1]

HB 1133 establishes Tex. Tax Code § 151.3186, effective September 1, 2013, which provides a sales and use tax refund for items used by cable television, Internet access, and telecommunications service companies in the provision of their services. The refund is available for:[2]

1. property sold, leased, or rented to or stored, used, or consumed by a provider or a subsidiary of a provider; and
2. the property is directly used or consumed by the provider or subsidiary in or during:
   a. the distribution of cable television service;
   b. the provision of Internet access service; or
   c. the transmission, conveyance, routing, or reception of telecommunications services.

The total annual refund available for all qualifying purchases by all qualifying taxpayers is *limited* to $50 million. In the event that claims from all taxpayers exceed $50 million in a year (they will), each taxpayer will be entitled to a refund equaling its pro rata share of the $50 million maximum refund.[3]

HB 800: Exemption for Equipment Used in Research Activities

HB 800 establishes Tex. Tax Code § 151.3182, which provides an exemption for depreciable equipment used in qualified research activities. Effective January 1, 2014, the sale, storage, or use of depreciable tangible personal property (TPP) by taxpayers engaged in qualified research under I.R.C. § 41 is eligible for exemption. The TPP must be directly used in qualified research[4], and the taxpayer must not claim the corresponding franchise tax credit for the depreciation expenses relating to the TPP.[5] Taxpayers will need to compare the relative values of the sales tax exemption and franchise tax credit in deciding which they should apply in a specific year.

HB 1223: Exemption for Property Used in Data Centers

Effective September 1, 2013, HB 1223 adds a temporary exemption under Tex. Tax Code § 151.359 for property used in the construction of new data centers. The exemption applies to the construction or expansion of a data center with at least 100,000 square feet of space in a single building or portion therein used by a single qualifying occupant.[6] To qualify for the exemption, the data center must contain certain power interruption, fire suppression, and security systems,[7] and must not be primarily used for telecommunications services.[8] In addition, the data center operator must create 20 qualifying jobs in the county in which the data center is located[9] and make a capital investment of at least $200 million in the data center.[10]

The items exempted under Tex. Tax Code § 151.359 include electricity, electrical and cooling systems, computers and related systems, software, and supporting mechanical, electrical, and plumbing systems.[11] The exemption will expire for each qualifying taxpayer either (i) ten years from the date that the Comptroller certifies that the data center qualifies for exemption if the taxpayer makes a total investment in the data center greater than $200 million, but less than $250 million[12] or (ii) 15 years from the date that the Comptroller certifies that the data center qualifies for exemption if the taxpayer makes

a total investment in the data center greater than $250 million. [13]

HB 1712: Exemption for Offshore Spill Response Containment Systems

HB 1712 establishes an exemption under Tex. Tax Code § 151.356 for the purchase, lease, storage, or use of TPP used in offshore spill response activities[14] by an entity primarily formed to engage in offshore spill response activities.[15] Tex. Tax Code § 151.356 likewise exempts services performed on TPP used in offshore spill response activities.

HB 3169: Amendments Affecting Exemptions for Medical Devices, Newspapers, and Destination Management Companies

HB 3169 amends several sales tax statutes to provide clarifications that both expand and limit the application of sales tax to certain transactions. First, Tex. Tax Code § 151.313 is amended to clarify the definition of intravenous system. The amendment effectively reins in the Comptroller's narrowing interpretation of which items qualify as exempt intravenous systems/items. Effective September 1, 2013, the exemption for medical devices applies to "intravenous systems, supplies, and replacement parts *designed or intended to be* used in the *diagnosis or* treatment of humans."[16] The exemption is thus expanded to include intravenous systems designed or intended to be used on humans—arguably regardless of whether they actually are used on humans. The definition also now includes items serving a diagnostic function, not just a treatment function. More significant, subsection (e) is added to Tex. Tax Code § 151.313, which provides:

> A product is an intravenous system for purposes of this section if, regardless of whether the product is designed or intended to be inserted subcutaneously into any part of the body, the product is designed or intended to be used to administer fluids, electrolytes, blood and blood products, or drugs to patients or to withdraw blood or fluids from patients. The term includes access ports, adapters, bags and bottles, cannulae, cassettes, catheters, clamps, connectors, drip chambers, extension sets, filters, in-line ports, luer locks, needles, poles, pumps and batteries, spikes, tubing, valves, volumetric chambers, and items designed or intended to connect qualifying products to one another or secure qualifying products to a patient. The term does not include a wound drain.[17]

The Comptroller had previously maintained that only items inserted into human veins (not arteries or other locations) qualified as exempt intravenous systems, and the health care industry had consistently battled the Comptroller over its narrow and restrictive interpretation. Tex. Tax Code § 151.313(e) effectively settles the debate in favor of taxpayers.

HB 3169 likewise amends Tex. Tax Code § 151.313 to clarify the definition of hospital beds as beds "specially designed for the comfort and well-being of patients and the convenience of health care workers, with special features that may include wheels, adjustable height, adjustable side rails, and electronic buttons to operate both the bed and other nearby devices." [18] The 83rd Legislature also amended the statute to include specific examples of hospital beds, including mattresses for qualifying beds, devices built into the bed or designed for use *with* the bed, infant warmers, incubators or other beds for neonatal and pediatric patients, and beds specifically designed and marketed for use in the rest, recuperation, and treatment of obese patients, obstetric patients, and burn patients.[19]

Second, HB 3169 amends Tex. Tax Code § 151.0565 to clarify the definition of "destination management services." The amendments include both expansions and limitations relative to the prior statute. For instance, the definition of destination management services is expanded to include shuttle system services[20] and airport meet-and-greet services.[21] However, the definition of destination management company is amended in a manner that both expands and limits the definition.[22]

Third, Tex. Tax Code § 151.319(f) is amended to expand the sales tax exemption for newspapers to those selling for an average price of $3.00 or less. The exemption was previously limited to newspapers with an average sales price of $1.50 or less.

SB 1151: Expansion of Food Item Exemption to Include Certain Snack Items

SB 1151 amends the definition of exempt food items to include "snack items."[23] Snack items include breakfast, granola, yogurt, and various nutrition bars (unless labeled and marketed as candy), snack and trail mix, nuts not including candy coatings, popcorn, chips, crackers, and hard pretzels.[24] The exemption for snack items does not apply to snack items sold through vending machines or sold as individual portions (labeled as one serving or, if no portion is indicated, containing less than 2.5 ounces).[25]

SB 1533: Amendment Relating to Activities of Purchasing Companies

SB 1533 amends Tex. Tax Code § 321.002 to clarify the changes to that section made during the 82nd Legislative Session. Effective September 1, 2013, a retailer's purchasing facility will not be considered a "place of business of the retailer" if the Comptroller determines that that facility exists to avoid the local sales and use tax legally due or exists solely to rebate a portion of such tax. Although the statute seems to continue granting significant powers to the Comptroller to determine whether the retail location exists for a valid business reason (i.e., not to simply minimize local sales tax burden), the statute now provides guidelines that would restrict the Comptroller's interpretation. Tex. Tax Code § 321.003(a)(3)(B) now provides:

> An outlet, office, facility, or location does not exist to avoid the tax legally due under this chapter or solely to rebate a portion of the tax imposed by this chapter if the outlet, office, facility, or location provides significant business services, beyond processing invoices, to the contracting business, including logistics management, purchasing, inventory control, or other vital business services.

A retailer's purchasing outlet will now be considered a place of business if that retailer can demonstrate that the outlet serves the retailer by providing logistics management, purchasing, inventory control, or other vital business services. Of course, these purchasing outlets have always served to offer purchasing services, so the inclusion of that language appears liberal. However, the Comptroller will likely continue its attack on certain operations based on its skepticism that they are merely local tax shifting schemes.

Recent Revisions to Comptroller Rules

Rule 3.1—Prior Rule 3.1, *Request for Extensions of Time in Which to File Report* was repealed and replaced with the new Rule 3.1, *Private Letter Rulings and General Information Letters*. The new rule adopts specific guidelines relating to taxpayers' requests for, and the Comptroller's issuance of, private letter rulings and general information letters. Taxpayers will no longer be able to rely on letter rulings that are requested on an anonymous basis. A taxpayer must now provide information fully disclosing its identity, as well as specific documentation for the Comptroller to consider the ruling request, as a prerequisite to obtaining a letter ruling upon which the taxpayer could prospectively rely. The new rule thus imposes conditions that will significantly impact the number of letter rulings issued by the Comptroller because taxpayers will be reluctant to disclose such information based on concerns of potential exposure.

Rule 3.324—*Oil, Gas, and Related Well Service*. The Comptroller amended Rule 3.324 in an attempt to clarify the differences between taxable services to TPP and exempt resales pertaining to chemicals, brine water, potassium chloride, and CO_2. Following are the relevant amendments to Rule 3.324(h):

> Chemicals, brine water, potassium chloride (KCl), CO_2—sales versus service.
>
> (3) Excluding that which may be purchased to provide nontaxable well services identified in subsection (b) of this section, CO_2 used to stimulate production may be purchased, exempt from tax, by the well operator for injection provided the well operator issues a properly completed exemption certificate in lieu of paying the tax.

Rule 3.325—Adoption of amendments to Refunds and Payments Under Protest. In July 2011, the Comptroller repealed Rule 3.325 in favor of a new rule imposing far greater burdens on taxpayers requesting refunds of sales tax paid in error. The July 2011 version of Rule 3.325 required taxpayers to submit an exhaustive list of information to support their refund claims. The Comptroller began denying refund claims that were filed without the information listed in the rule. Worse, the Comptroller treated those refund claims as procedurally defective, which resulted in the statute of limitations' not being tolled.

The Comptroller amended Rule 3.325, effective January 7, 2013, in response to widespread pushback from taxpayers and practitioners that material portions of the July 2011 rule were unsupported and contradicted by the underlying statutes—specifically Tex. Tax Code § 111.104. The current rule provides that the filing of a refund claim that does not contain the information required under the rule will still toll the statute of limitations if it is later cured. However, many taxpayers and practitioners feel that the current rule does not afford taxpayers sufficient protection to maintain their rights to refunds for tax that was erroneously paid. To that end, one tax consulting firm filed a declaratory judgment action against the Comptroller over the 2011 and 2013 rules, and the presiding district court judge issued a declaratory judgment deeming subsections (a)(4), (b)(10), and (e) of current Rule 3.325 invalid and illegal. The Comptroller filed a Notice of Appeal with the Third Court of Appeals on June 6, 2013. As of August 9, 2013, the court had set neither a briefing schedule nor oral argument.

Texas Sales and Use Tax Litigation Update

DTWC Corporation v. Combs, et. al, Texas Third Court of Appeals – Austin, No. 03-10-00801-CV (appealed from Travis Co. 250th District Court D-1-GN-06-004267 [Judge Hurley presiding])

The Third Court of Appeals reversed a lower court ruling and rendered judgment in favor of DTWC in its action to recover sales tax paid in error on certain hotel amenities (e.g., soap, shampoo, conditioner, mouthwash, shower caps, pens, and notepads) provided to hotel guests. Justice Rose wrote that the amenities qualified for the sale for resale exemption provided in Tex. Tax Code § 151.302 because the amenities were transferred to the hotel guests "in the form or condition in which [DTWC] acquired them", the amenities were transferred to the hotel guests in the normal course of business, and the hotel guests paid consideration (i.e., the room rate) for the amenities.

The opinion highlighted several key issues, which may apply to other taxpayers claiming the resale exemption:

- The plain language of the statute supported the exemption—even though the end consumers did not pay sales tax on their purchases of the amenities;
- DTWC's guests paid consideration for the amenities because the value of the amenities was included in the all-encompassing room charge;
- DTWC did not need to be in the business of selling hotel amenities in order to qualify for the resale exemption; rather, DTWC must simply buy and resell the amenities in the normal course of providing lodging to its customers, which it did.
- DTWC made no taxable use of the amenities, which were merely stored on its premise until provided to hotel guests.

The Third Court's Opinion is final because the Comptroller did not file a Petition for Review with the Texas Supreme Court.

Combs v. Roark Amusement & Vending, LP, Texas Supreme Court No. 11-0261 (March 8, 2013).

The Texas Supreme Court ruled that Roark's purchases of "plush toys" used in coin-operated amusement machines qualified for the resale exemption provided in Tex. Tax Code § 151.302. Roark deployed certain coin-operated machines whereby customers paid money to operate a mechanical claw that was used to retrieve toys from inside the machine. Sometimes the customers succeeded and obtained a toy, and other times the customers were unsuccessful and the toys stayed in the machine.

Based on a plain-meaning review of the relevant statutes, the Court found that Roark acquired the plush toys for the purpose of transferring the toys as an integral part of a taxable service and therefore qualified for the exemption. The Comptroller presented two main arguments:

1. Roark did not provide a taxable amusement service because coin-operated machines are exempted from sales tax pursuant to Tex. Tax Code § 151.335; and
2. The toys were not integral to the service because a toy wasn't transferred to a customer every time the customer operated the machine.

The Court dismissed the Comptroller's arguments explaining that the exemption in Tex. Tax Code § 151.335 did not change the statutory definition in Tex. Tax Code § 151.0101, which expressly identifies amusement services as taxable, whether the services are provided by amusement machines or otherwise. Moreover, the Court explained that the toys were integral to the services because no one would play the game if there weren't the possibility of obtaining a plush toy prize.

Roark could have broad applicability to other taxpayers, both in terms of the sale for resale exemption and the Comptroller's power to administer Texas taxes too far. It is noteworthy that the Court sternly warned that, "the Comptroller cannot through rulemaking impose taxes that are not due under the Tax Code."

Combs v. Health Care Services Corporation, Texas Supreme Court No. 11-0283 & 11-0652 (June 7, 2013).

Health Care Services Corporation (HCSC) was a government contractor that provided administration services for federal health insurance programs (e.g., Medicare). HCSC sought a refund of Texas sales taxes paid on certain items used in the performance of its services. The Texas Supreme Court ruled that HCSC's purchases of tangible personal property and services used in the administration of federal health insurance programs qualified for the resale exemption provided in Tex. Tax Code § 151.302. However, the Court ruled that the resale exemption did not apply to items leased by HCSC and used in

the performance of the government contracts.

With respect to the tangible property purchased by HCSC, the Court determined that the items were resold in the normal course of HCSC's business, which was to fulfill service contracts with the federal government. The items were resold to the federal government through automatic title-passage clauses expressed in the applicable contracts. With respect to the services purchased by HCSC and used to perform the federal government contracts, the Court determined that the services were resold to the federal government because the services were performed on behalf of the federal government and transferred to the government in the form or condition in which the services were acquired.

The Court harmonized its decision with *Day v. Zimmerman*, another Texas sales tax case involving government contracts and the resale exemption. The Court further addressed the Comptroller's arguments for denial of the exemption:

- The Comptroller argued for application of an essence of the transaction test in which HCSC must prove that its primary purpose was to resell the property to the federal government. The Comptroller further argued that HCSC could not meet this standard because its primary purpose was to consume the items in the performance of the service. The Court dismissed the argument because the statute did not prescribe such a test.
- Despite the Comptroller's arguments otherwise, HCSC was not required to transfer care, custody, and control of the tangible property to the government because HCSC provided a nontaxable service. The requirement in Tex. Tax Code § 151.302(b) applies only to property transferred in the performance of taxable services.
- Deference to agency interpretation only applies when the statute is ambiguous. The Court will apply the plain language meaning of a statute (regardless of the unintended consequences) unless that plain meaning leads to an absurd result.
- HCSC was not required to prove that the federal government had not already reimbursed it for the taxes paid on the items at issue. Tex. Tax Code § 111.104(f) applies to taxes collected in error, not reimbursements for taxes paid in error.

The direct impact of HCSC is limited by the revisions to Tex. Tax Code § 151.006(c) (definition of "sale for resale"), which was effective October 1, 2011. However, the Court's analysis could have a longstanding impact on Texas taxpayers and the Comptroller's interpretative authority in administering Texas taxes.

Pending Court Cases

Buckhorn Aviation, Inc. v. Combs, et. al. – Buckhorn seeks a refund for taxes paid under protest on its purchase of an airplane. Buckhorn asserts that the airplane purchase qualifies for the resale exemption. Buckhorn further contends that the Comptroller adopted and applied an economic substance policy without proper notice and comment, as required under the Administrative Procedure Act (Texas Government Code, Chapter 2001).

Checkfree Services Corporation v. Combs, et. al. – Whether Checkfree provided nontaxable financial and consulting services or taxable data processing services. Since there is limited judicial authority on the definition of taxable data processing services, the decision in this case could impact various taxpayers and industries.

Del Monte Fresh Produce (Texas), Inc. v. Combs, et. al. – Whether Del Monte qualifies for the manufacturing exemption on its purchases of equipment, electricity, packaging, and other items used to process vegetables—specifically, potatoes and tomatoes. The case could potentially impact other taxpayers/manufacturers depending on how the court(s) analyzes and reconciles prior manufacturing cases such as *Haber Fabrics*.

Rackspace US Inc. v. Combs, et al. – Whether the resale exemption applies to software licensed by Rackspace and used by its customers as part of Rackspace's web hosting services. This case could provide guidance with respect to the meaning and application of Tex. Tax Code § 151.302(b). The trial is set for November 12, 2013.

Southwest Royalties, Inc. v. Combs, et al. – This is the lead case involving the application of the manufacturing exemption to down-hole equipment (i.e., casing, tubing, pumps, etc.) used in the production of oil and gas. The case is set for oral argument before the Third Court of Appeals in Austin, Texas on September 25, 2013.

For more information about these changes to Texas tax law, please contact the authors of this alert—**Kevin Oldham** at koldham@dykema.com or 512-494-4155 and **Drew McEwen** at dmcewen@dykema.com or 512-494-4078—or any of the Dykema Tax attorneys listed to the left or your Dykema relationship lawyer.

[1] Tex. Tax Code § 151.3186 is effectively an exemption for items used by cable television, Internet access, and telecommunication service providers. However, tax is still due at the time of the original transaction, and taxpayers must file annual refund claims for their purchases. This procedural requirement ensures that the total annual exemption is limited to $50 million.

[2] Tex. Tax Code § 151.3186(b).

[3] Tex. Tax Code § 151.3186(d)(2).

[4] Tex. Tax Code § 151.3182(b)(1).

[5] Tex. Tax Code § 151.3182(b)(2).

[6] Tex. Tax Code § 151.359(a)(2).

[7] Tex. Tax Code § 151.359(a)(2)(E).

[8] Tex. Tax Code § 151.359(a)(2)(D).

[9] Tex. Tax Code § 151.359(d)(2)(A).

[10] Tex. Tax Code § 151.359(d)(2)(B).

[11] Tex. Tax Code § 151.359(b).

[12] Tex. Tax Code § 151.359(f)(1).

[13] Tex. Tax Code § 151.359(f)(2).

[14] As defined under Tex. Tax Code § 11.271(c).

[15] As defined under Tex. Tax Code § 11.271(f).

[16] Tex. Tax Code § 151.313(a)(15).

[17] Tex. Tax Code § 151.313(e).

[18] Tex. Tax Code § 151.313(f).

[19] Tex. Tax Code § 151.313(f)(1)-(6).

[20] Tex. Tax Code § 151.0565(1)(h).

[21] Tex. Tax Code § 151. 0565(1)(i).

[22] Tex. Tax Code § 151.0565(2).

[23] Tex. Tax Code § 151.314(b).

[24] Tex. Tax Code § 151.314(b-1).

[25] Tex. Tax Code § 151.314(h).

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Practice Areas

Taxation