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Texas Tax Cases to Watch in 2017

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The past year saw some landmark tax cases issued by the Texas Supreme Court in the area of state and location taxation. First, the Court held that the imposition of a tax on cigarette manufacturers that were not part of the late-1990s settlement agreement with the major tobacco companies did not violate the Equal and Uniform Clause of the Texas Constitution.[3] Later, in *Hallmark*, the Court held that in computing the apportionment factor for franchise tax, a taxpayer is not required to reduce the denominator to the extent total net losses exceed net gains on the sale of an investment or capital asset.[4] Additionally, in a case that affects almost all Texans, the Court described Texas' school finance system as "Byzantine" and noted there was immense room for improvement, but ultimately upheld it as constitutional.[5] Finally, in *Southwest Royalties*, much to the dismay of taxpayers in the oil & gas industry, the Texas Supreme Court held that equipment used in extracting, separating, and bringing hydrocarbons to the surface did not qualify for the manufacturing exemption.[6]

2017 is shaping up to be another interesting year for state taxation issues and is already off to a quick start. On January 6, the Third Court of Appeals issued its much-anticipated substitute opinion in *American Multi-Cinema, Inc. v. Hegar*.[7] While the Court still ruled in favor of the taxpayer in its substitute opinion, it held that the movie theatre's product falls within the definition of "tangible personal property" under § 171.1012(a)(3)(A)(ii)[8] and expressly avoided the issue of whether it also falls within the definition of § 171.2012(a)(3)(A)(i)[9] since the previous determination was dispositive. Thus, the Court significantly narrowed the potentially expansive application of its original opinion.

This article seeks to highlight several of the important cases currently pending before the Texas Supreme Court that may be decided later this year.

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[3] *Hegar v. Tex. Small Tobacco Coal.*, No. 14-0747, 59 Tex. Sup. Ct. J. 534, 2016 Tex. LEXIS 228 (Tex. Apr. 1, 2016).

[4] *Hallmark Mktg. Co., LLC v. Hegar*, 488 S.W.3d 795, 796 (Tex. April 15, 2016).

[5] *Morath v. Tex. Taxpayer & Student Fairness Coal.*, 490 S.W.3d 826, 833 (Tex. May 13, 2016).

[6] *Sw. Royalties, Inc. v. Hegar*, No. 14-0743, 59 Tex. Sup. Ct. J. 1316, 2016 Tex. LEXIS 508 (Tex. June 17, 2016).

[7] *Am. Multi–Cinema, Inc. v. Hegar*, 03-14-00397-CV, 2017 Tex. App. LEXIS 85 (Tex. App.—Austin Jan. 6, 2017, no. pet. h.).

[8] All § references are to the Texas Tax Code.

[9] Defining "tangible personal property" to mean "personal property that can be seen, weighed, measured, felt, or touched or that is perceptible to the senses in any other manner."

***Graphic Packaging, Inc. v. Hegar*[10]**

At issue in *Graphic Packaging* is whether a taxpayer may use the three-factor apportionment formula provided for under the Multi-State Tax Compact in computing its Texas franchise tax rather than the single-factor formula set forth in the § 171.106.

The trial court ruled in favor of the Comptroller, and was affirmed by the Third Court of Appeals. The Court of Appeals held that the franchise tax is not an income tax and thus the three-factor apportionment formula under the Compact is not applicable. In deciding the franchise tax is not an income tax, the Court stated that none of the alternative ways of computing the franchise tax result in taxing net income.

A decision in favor of the taxpayer would have a dramatic impact on franchise tax for many taxpayers, particularly those with a multistate presence. Additionally, a large number of taxpayer have already filed refund claims on the basis of this case.

The Texas Supreme Court has ordered briefing on the merits. Briefing should conclude in the early part of this year.

***ETC Marketing Ltd. v. Harris County Appraisal District*[11]**

ETC Marketing is an important property tax case with Commerce Clause implications. At issue is whether natural gas in an interstate pipeline system becomes subject to property tax if stored for some period of time in an underground reservoir in Texas, or whether it retains its interstate commerce exemption.

The trial court granted summary judgment for the Appraisal District, and the First Court of Appeals affirmed. The Court held that the natural gas was stored in Harris County for more than a temporary period of time, and Harris County's imposition of property taxes satisfied the four prongs of *Complete Auto*.[12]

In its briefings to the Supreme Court of Texas, ETC argues that it has no control over its natural gas once it enters interstate pipeline system—a system managed by a third party. Because it has no control, ETC does not decide whether the gas is stored in the underground reservoir. Further, ETC argues that any storage is strictly temporary while the gas awaits delivery to customers.

The Appraisal District responds that the natural gas is not in transit to customers; rather, it is stored indefinitely until ETC determines when and where to sell it.

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[10] 471 S.W.3d 138 (Tex. App.—Austin, 2015, pet. filed). This matter is pending before the Texas Supreme Court as Cause No. 15-0696.

[11] 476 S.W.3d 501 (Tex. App.—Houston [1st Dist.] 2015, pet. granted). This matter is pending before the Texas Supreme Court as Cause No. 15-0687.

[12] *See Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274 (1977).

In oral arguments, the Supreme Court Justices focused their questions on the reasons for storage—more specifically, whether storage was (i) a necessary and essential component of interstate transport, or (ii) for more than a temporary period with a business purpose beyond merely enabling transport.

The Court granted review on September 2, 2016 and heard oral arguments on Dec 6, 2016. An opinion is anticipated later this year.

EXLP Leasing LLC & EES Leasing LLC v. Ward County Appraisal District[13]

Primarily at issue in *EXLP Leasing* is whether the Texas Legislature can constitutionally separate types of property into different classes when prescribing special appraisal methods for property tax valuation. While the majority of tangible personal property is appraised in Texas on the basis of its January 1 market value, Texas utilizes special appraisal methods for certain types of property. The statute at issue in *EXLP Leasing*, § 23.1241, requires heavy-equipment inventories (here, natural-gas compressors) to be appraised on the basis of prior-year sales. This issue concerns numerous taxpayers and appraisal districts across Texas, as there are hundreds of current lawsuits on-hold—each awaiting the Supreme Court's decision in this case.

Two Courts of Appeals have issued opinions on this issue. The Eighth Court of Appeals ruled in favor of EXLP, reversing "[t]he portion of the trial court's judgment declaring Sections 23.1241 and 23.1242 to be unconstitutional," and rendering judgment "that these two statutes are not unconstitutional as applied."[14] The Fourteenth Court of Appeals reversed the trial court judgment that the statute was unconstitutional, but, instead of rendering judgment for EXLP, remanded the case to the district court to determine whether the statute "create[s] a reasonable method of appraising the market value of" the inventory.[15]

EXLP cites the Texas Constitution, which states, "All real property and tangible personal property in this State... shall be taxed in proportion to its value, *which shall be ascertained as may be provided by law*."[16] EXLP argues that this broad grant of power to the Legislature explains why the Supreme Court of Texas has never invalidated a valuation statute. EXLP argues for deference to the Legislature, which has refined § 23.1241 over the years in order to solve administrative and compliance problems that have arisen in attempting to value heavy-equipment inventories.

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[13] 476 S.W.3d 752 (Tex. App.—El Paso 2015, pet. filed); *EXLP Leasing LLC v. Loving County Appraisal Dist.*, 478 S.W.3d 790 (Tex. App.—El Paso 2015, pet. filed); *EXLP Leasing, LLC v. Galveston Cent. Appraisal Dist.*, 475 S.W.3d 421 (Tex. App.—Houston [14th Dist.] 2015, pet. filed); *Midcon Compression, L.L.C. v. Reeves County Appraisal Dist.*, 478 S.W.3d 804 (Tex. App.—El Paso 2015, pet. filed); *Valerus Compression Servs v. Reeves County Appraisal Dist.*, 478 S.W.3d 20 (Tex. App.—El Paso 2015, pet. filed).

The Supreme Court of Texas has consolidated these five cases on appeal. These matters are pending before the Texas Supreme Court as Cause Nos. 15-0683, 15-0965, 15-0969, 15-0970, and 15-0971.

[14] 476 S.W.3d at 763.

[15] 475 S.W.3d at 428.

[16] Tex. Const. art. VIII, § 1(b) (emphasis added).

The Appraisal District argues that Texas courts have interpreted the Constitution's mandate—that property "be taxed in proportion to its value"—to require a willing-buyer, willing-seller standard for all property. The Appraisal District further alleges that § 23.1241 is unconstitutional because it does not achieve equal and uniform taxation.[17]

Heavy-equipment dealers are not the only taxpayers potentially impacted by this case. A victory for the Appraisal District could result in the invalidation of several other special appraisal methods.[18]

The Texas Supreme Court has ordered consolidated briefing on the merits. The initial briefs were filed on November 1, 2016. Response briefs were filed on December 22, 2016, and briefing is set to conclude with Reply briefs currently due on February 6, 2017.

Valero Refining v. Galveston Central Appraisal District[19]

Valero Refining concerns whether Valero, in comparing its facilities to others in an equal and uniform analysis, can exclude the value of pollution control equipment, which is largely non-taxable in Texas.[20]

Valero's position is that because the Appraisal District separated its facility into different account numbers, Valero should be able to contest some of those accounts but not others. In other words, Valero sought to apply equal and uniform analysis to certain portions of its refinery as compared to the corresponding portions of nearby BP and Marathon refineries. Valero's experts compared the facilities using valuation metrics based on the capacity and complexity of each refinery as compared to their valuations (after excluding the pollution control equipment of each refinery).

The Appraisal District argues that an equal and uniform comparison must consider each facility in its entirety—including all account numbers associated with the facility.

The trial court ruled in favor of Valero, reducing the equal and uniform value by nearly $200 million. But the Fourteenth Court of Appeals reversed and remanded, ruling that whether pollution-control equipment should be excluded is a question of fact, and the evidence was legally insufficient to support exclusion.

The primary issue on appeal thus appears to be whether this is an issue of fact or law. Valero argues that as a practical matter, when an appraisal district separates property into several different account numbers, taxpayers are not required to guess which accounts must be bundled together—especially in light of the fact that these accounts may pertain to large, complex industrial facilities

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[17] *See id.* § 1(a).

[18] TEX. TAX CODE, Title 1, Chapter 23, Subchapter B requires special appraisal methods for several different classes of property, including motor vehicle inventories, temporary production aircraft, and vessel inventory.

[19] 463 S.W.3d 177 (Tex. App.—Houston [14th Dist.] 2015, pet. granted). This matter is pending before the Texas Supreme Court as Cause No. 15-0492.

[20] There are also important evidentiary disputes at issue that are beyond the scope of this article.

that contain property owned by third parties. And as a legal matter, it cites several cases that appear to support partitioning larger facilities for purposes of valuation.

The Appraisal District responds that pollution-control equipment is integral to the refinery, would assuredly be included in any sale of the refinery, and therefore should be included in an equal and uniform valuation.

Briefing on the merits concluded in April 2016. The Court granted the Petitions for Review on September 2, 2016. The Court heard oral arguments on November 9, 2016.

Allstate Insurance Co. v. Hegar[21]

Allstate concerns whether and under what circumstances temporary staffing services are excluded from Texas sales tax as temporary employee services under § 151.057(2). Allstate Insurance subcontracted with a third party, Pilot Catastrophe Services, Inc., to supplement Allstate's existing staff of claims adjusters, commonly following a weather event that generated a large volume of claims.

Allstate argued these staffing services were excluded from Texas sales tax under § 151.057(2). This section excludes from sales tax, services performed by employees of temporary employment services for an employer to temporarily supplement their existing work force. This provision requires (i) the service to be normally performed by the employer's own employees, (ii) the employer to provide all supplies and equipment necessary, and (iii) the temporary employees to be under the supervision of the employer.

The Comptroller took issue with whether these adjusters were "temporary," claiming the adjusters did not qualify as temporary employees since they were provided by Pilot to Allstate on a continuous and ongoing basis. In support of this argument, the Comptroller noted that there was at least one Pilot employee, and usually more, providing adjusting services to Allstate on any given day throughout the period at issue.

The Court disagreed with the Comptroller's "holistic" view regarding whether the services were temporary in nature and held that the exclusion must be analyzed on an individual employee basis. Applying this standard, the Court determined that Pilot provided each individual adjuster to Allstate on a temporary basis.

While the Court held that several of the adjusters qualified for the exclusion, the Court ruled against Allstate regarding other adjusters for which Allstate did not provide all necessary equipment. A requirement of the § 151.057(2) exclusion is that the employer must provide "all supplies and equipment necessary." Allstate's agreement with Pilot required Pilot's adjusters to have "electronic voice mail, cellular telephones and laptop computers at the time they arrive at a site to provide Adjusting Services to Allstate." Since the contract required the provision of these items, the Court determined them to be "necessary" to the performance of the adjusting services.

[21] 484 S.W.3d 611 (Tex. App.—Austin 2016, pet. filed).

Allstate conceded that it did not provide this equipment to these adjusters. Therefore, the Court denied the exclusion for such adjusters.

This case has significant implications not only for the insurance industry but also for other industries that utilize temporary employment services to supplement their existing workforce. The Court's method of determining the temporary nature on an individual-employee basis is a departure from the Comptroller's historically "holistic" approach and certainly more favorable to taxpayers.

The Texas Supreme Court has ordered briefing on the merits. Briefing is expected to conclude in the early part of this year.

Fitness International, LLC v. Hegar[22]

At issue in *Fitness International* is whether purchases by health clubs of tangible personal property for use by club members qualifies for the sale-for-resale exemption. The taxpayer, Fitness International, owns and operates health clubs in Texas. It grants access to use its facilities and amenities through the sales of memberships.

The trial court granted Fitness' claim in part and denied it in part. The claim was granted as to purchases of towels, basketballs, and personal sanitation consumables; but denied with respect to exercise machines, weight racks, scales, and promotional flyers. The Comptroller withdrew his appeal with respect to the items that were deemed exempt; however, he noted that he disagreed with the trial court's determination. Thus, only the denied items were at issue on appeal.

Fitness argued that its purchases met the exemption's requirements because members paid the membership fee to "rent" the items, and such rental is a sale under § 151.005(2), or the items were "transferred" to members. Fitness also claimed that it did not need to show that it transferred care, custody, and control to the guests because it did not use the items to "perform" services.

The Court rejected Fitness' arguments and held that the equipment was not purchased for the purpose of reselling it, transferring it, or offering it for lease or rental. The Court also noted that the membership agreements could not be reasonably construed as leases or rental agreements and that making the equipment available to members while at the gym did not equate to transferring possession. The Court did not address Fitness' arguments that it was not required to show care, custody, and control was transferred, since it concluded that Fitness did not acquire the items for the purpose of reselling or transferring them.

If Fitness prevails in this matter, it would broaden the application of the sale-for-resale exemption. This could especially affect taxpayers who purchase equipment for use in connection with the provision of taxable services.

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[22] 03-15-00534-CV, 2016 Tex. App. LEXIS 6337 (Tex. App.—Austin June 16, 2016, pet. filed). This matter is pending before the Texas Supreme Court as Cause No. 16-0237.

Fitness' filed its Petition for Review on August 31, 2016. The Court has not ordered full briefing or agreed to hear the case on its merits.