

SALES AND USE TAXES

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INTRODUCTION

COURSE OBJECTIVE

To explain how sales taxes work, what the rules are and the many areas where there are no rules.

These taxes were first adopted in the 1930s and have not changed very much. Unlike the federal income tax, the state statutes and regulations are very general. There are few rulings or cases to fill in the gaps.

AUDITS

“Guilty Until Proven Innocent”

The auditor’s determination is presumed to be correct unless it is overruled by superiors within the Department or by the courts.

HOW AUDITS ARE DONE

How the auditor audits sales and purchases

Audit sampling techniques--the “gross-up”

The gross-up is very important because it can magnify the tax due from a failure to pay the proper tax on any particular transaction.

GENERAL STEPS IN ANY SALES TAX ANALYSIS

1. Is there a potentially-taxable transaction?
2. Where is the “retail sale”? Everything before that is a sale for resale.
3. For a retail sale, is an exemption available?
4. What should be included or excluded from the price of the retail sale?
5. Consider if the sale can be restructured to avoid or minimize the tax.
6. Document all sales for resale and exemptions/deductions from retail sales.

Do this analysis for each state in which the property is physically present.

I. GENERAL PRINCIPLES

A. Terminology

1. Both a *sales tax* and a *use tax* are taxes on the sales price of a transaction. Sales tax is often used generically to include use tax as well as sales tax. Actually, use tax complements the sales tax if for some reason the sales tax does not apply.
2. *Sales tax* is a tax on the seller's gross receipts from the sale of tangible personal property or a taxable service. It usually applies if title passes within the state or the seller accepts orders in the state.
3. *Use tax* complements the sales tax. When sales tax has not been collected on a particular transaction, the purchaser is liable for use tax and must pay it directly to the State Department of Revenue.

B. Analogous Taxes

1. Gross receipts tax (Indiana gross income tax)
2. Excise Tax
3. Business license tax (many California cities)
4. Business and occupation tax (Washington State B&O tax)
5. Retailers' occupation tax (Illinois)

All of these taxes generally work the same way. There are many more similarities than differences in the various taxes. In addition, the differences are in how the state treats specific areas. Thus, working with a specific state's tax becomes more a matter of issue spotting than learning a totally new methodology. Also, certain states have protected "pet" industries that may be exempt from tax such as tobacco in North Carolina and oil and gas in Texas.

C. Why We Should Care about Sales Tax

1. *Lost sales tax* is an out-of-pocket cost to your company. Sellers are liable for any uncollected tax, even if they did not know it was due. Thus, collecting tax from customers at the time of the sale is very important; it is extremely difficult to collect it later (practical and legal considerations).
2. *Undercollecting sales tax* can also cause problems. If the customer has a fixed budget, paying tax means that there is less money for the seller since the seller must reduce its quoted price to cover the tax. Also, customers may rebel at paying the tax in addition to the quoted price. That harms customer goodwill and the seller may end up “eating” the tax anyway.
3. *Overpaying use tax* on your company’s purchases goes straight to its bottom line.

Examine every type of revenue or charge. If you are not charging tax, confirm the basis for the exemption. If you are paying tax, is there a way to reclassify or restructure the charge to minimize the tax?

D. Transaction-by-Transaction Analysis

Each sale stands on its own merits and is considered separately. Auditors are extremely literal in interpreting transactions and documents.

E. Liability for the Tax

Most sales taxes are nominally imposed on the seller who is then legally authorized to collect them from the purchaser at the time of the transaction.

F. Statement of Tax

The seller should always separately state the amount of tax on its invoice to the purchaser. That enables the purchaser to prove that the tax was paid if the purchaser is ever audited for use tax.

It also lowers the amount of revenue on which the seller must pay sales tax. States are reluctant to allow sellers to “back out” the tax

from the total received (fair advertising, consumer protection concerns).

However, the seller is still liable if the purchaser refuses to pay the tax.

G. Taxable Use

A *taxable* use is the ownership of tangible personal property in a state for only a moment.

1. Examples of transactions subject to use tax:

- a) The purchaser buys from an out-of-state seller.
- b) A seller takes items out of its resale inventory for its own use.

or

- c) A company brings property into the state.

2. It is very easy to have a taxable use for the same property occur in more than one state! Thus, it is also possible for more than one state to try to tax that property.

3. In most states, the use tax has the same rules as the sales tax; however, there may be additional exemptions for the use tax.

4. There is usually a line on the standard sales tax return for the purchaser to report and pay use tax. Some companies may be liable for sales tax only, for use tax only or for both.

5. Pennsylvania “use tax election.”

This statute is a trap for companies bringing depreciable property into the state. The current fair market value of the equipment can be listed as the tax base only if the taxpayer files a use tax return one year from the original due date. Otherwise, sales tax is due on the original purchase price.

Moral: The states intentionally make the rules of the game unfair to taxpayers. Regulations like the one above are **policy** decisions made by the managements of the state departments of revenue, not the auditors in the field.

6. Exxon Corp. v. Wyoming, 783 P.2d. 685

(1989), cert. denied, 110 S.Ct. 1937 (1990), is a classic horror story of double taxation. The company had to pay \$400,000 Colorado use tax, \$500,000 Wyoming use tax, plus *years* of attorneys' fees!

Exxon bought pipe for \$13 million, had it modified in Colorado and permanently installed in a pipeline in Wyoming. Wyoming would not allow a credit for its use tax against the Colorado use tax. The U.S. Supreme Court was not outraged enough to take the case.

Moral: the importance of issue-spotting and self-help (vs. hoping for justice in the courts).

How could this transaction have been restructured to prevent one of the two use taxes?

One example: a wholly-owned purchasing subsidiary could have purchased the pipe, owned it while it was in Colorado and then sold it to Exxon when it was installed in Wyoming. That would have avoided Colorado use tax because the property would have been held for resale in the state.

II. IDENTIFYING POTENTIALLY TAXABLE TRANSACTIONS

A. Taxes and Personal Property

1. Any transfer of tangible personal property or a taxable service is potentially subject to sales tax.
2. Sales taxes don't apply to transfers of intangibles or real estate.

B. The True Object Test

Is the purchaser's primary intent to obtain the service or the property produced by the service?

Easy example: A lawyer prepares a Will for a client. While the paper is tangible personal property, this transaction is a sale of professional services.

But the purchaser has to have both. He cannot get the Will without the paper.

C. Problem Areas

1. Mailing lists and customer lists
2. Fixtures (attachments to real estate) vs. items that keep their status as tangible personal property
3. Computer software

D. Custom-Made Goods

Custom-made goods may be exempt from tax. States generally require that the product be usable only by the purchaser.

There could be a problem with off-the-shelf goods like those produced by a dressmaker.

E. Taxable Services

State sales taxes are gradually evolving to include services.

1. Services related to tangible personal property

- a) Installation or repair services
 - b) Fabricating/processing
 - c) Printing
 - d) Maintenance contracts
2. Specified or enumerated services. Very few states tax all or most services. If they do, their tax is usually labeled as a gross receipts tax.
3. Commonly-taxed services
- a) Data processing
 - b) Telecommunications
 - c) Information services
 - d) Management services
4. Problems with taxing services
- a) Definition—Statutes and regs are very brief. Where do you draw the line between a taxable computer service and a nontaxable service that utilizes computers? This determination is an extremely subjective area—taxability is in the eye of the beholder (the auditor).
 - b) Situs—Usually the service is taxed in the state where the customer is located.
 - c) Pyramiding—Greater likelihood of a “tax on a tax” because it is very difficult to identify a sale for resale.
5. Selected authorities
- a) AmTote provides computerized racetrack systems (tote boards). Texas viewed that as taxable data processing in Decision of the Comptroller of Public Accounts, Hearing No. 29,110 (12/7/92). Adding

insult to injury, the ruling taxed 100% of the charges under the 5% presumption contained in the regulations.

- b) Several Florida letter rulings, or “Technical Assistance Advisements” (TAAs) tax electronic transmissions of information as telecommunications.
- c) Florida was unsuccessful in taxing a computerized information service in *Dept. of Revenue v. Henley Holdings, Inc.*, 599 So. 2d 1282 (Fla. 1st. Dist. Ct. App. 1992). The state also lost in *First Federal Savings and Loan Ass’n of Putnam County v. Department of Revenue*, Div. of Admin. Hearings (6/6/93), CCH 202-547. There, a data processing company used a computer network to collect financial information from banks and S&Ls and then prepared financial reports. However, the only issue decided was whether the company provided a “private communication service.”
- d) The 6% City of Chicago Transactions Tax applies to leases of tangible personal property. The Ordinance defines the use of a computer on a “time sharing” basis as a rental of the computer itself, even if the user does not control the computer. The Department has further expanded a taxable rental to include the use of a computer database. See *Meites v. City of Chicago*, 184 Ill. App. 3d 887 (1989) (taxing the Lexis computer service).
- e) Chicago has ruled that a credit bureau is subject to Transaction Tax if the user obtains the information directly from the computer, *i.e.*, with no involvement of the credit bureau’s personnel. See Chicago Transaction Tax Ruling No. 13 (effective 9/28/92). Any taxable lease of a computer is deemed to occur where the user’s access terminal is located.
- f) The New York tax-on-information services are essentially the same as those taxes in Texas.

Information will not be taxable if it is sufficiently personalized or individualized; however, the New York determining whether information is personal or can be used again for another customer. For example, reports are taxable if they are generated by a database which is not confidential. Compare ADP Automotive Claims Services, Inc., New York Supreme Court, App. Div., CCH1 400-993 (3/4/93) (computerized estimates of automobile damage costs for insurance companies were taxable because the underlying cost data were not confidential), with Alan/Anthony, Inc., TSB-A-93 (16)S (Advisory Opinion 2/25/93) (computer database of the membership of a trade association was confidential, so reports drawn from it were exempt).

III. IDENTIFYING SALES- RETAIL SALE VS. SALE-FOR-RESALE

What is the *retail sale*? Everything else is a *sale-for-resale*.

A. A Sale from a Sales Tax Point-of-View

1. A sale usually occurs whenever:
 - a) An amount is *separately stated* for the taxable item;
or
 - b) A taxable item is a *substantial* portion of the transaction.

Most practitioners feel that “substantial” means 50% or more; 11 to 49 percent is questionable. Ten percent or under should not be “substantial.” Many states have no published authority on this point.

Exception: 5% is enough to make the entire charge taxable in Texas. That state’s regulations on data processing and information services state that the entire charge is “presumed” taxable if “taxable services represent more than 5% of the total charge.” The only way mentioned in the regs for overcoming the presumption is to unbundle the charge to the customer and separately state the taxable amount.

2. For sales tax purposes, a sale is any transfer of a taxable item for consideration. The amount of the consideration is also referred to as *the selling price*.
3. A transfer of title is needed to make deposits taxable. Deposits shouldn’t be taxable until the property itself is transferred.
4. Consideration means anything of value: cash, assumption of liabilities and other property.

B. When a Sale Occurs

1. Gifts are not sales.

A “gift” is any transaction that is not a sale for sales tax purposes. The “donor” *pays* tax when it purchases the property.

2. Expense reimbursements and intercompany, charges may be sales.
3. 2-for-1 sales are sales of the “free” item
4. Containers and packaging should qualify for resale exemption. In addition, many states have special exemptions for packaging.
5. Rental of tangible personal property: the rental payments are the retail sale in virtually all states.

Is it a true lease or conditional sale?

IV. RESALE CERTIFICATES

A. General Comments

1. The best, and sometimes the only, way to document a sale for resale is to get a resale certificate with an *in-state registration number*. Otherwise, the sales tax turns into a tax on missing documentation. State auditors have a very strict interpretation of the requirements for a valid certificate.
2. The certificate is not filed with the state; rather, the seller must keep it in its files and have it available if the seller is audited for sales taxes.
3. Getting resale certificates, keeping them on file and updating them periodically are especially important if the seller will not have the benefit of the statute of limitations because it isn't registered or filing tax returns.

B. Requirements for Valid Certificate

1. The names and addresses of the buyer and seller
2. A statement that the buyer is purchasing the goods for purposes of resale
3. The buyer's sales tax registration number in the destination state where the goods are to be delivered
4. The name and title of the individual signing the certificate on behalf of the buyer
5. The date the buyer signed the certificate

The most important requirement is the purchaser's sales tax registration. A state will typically accept a resale certificate only if the purchaser is registered to collect sales tax in that state.

Most states do not accept a sales tax registration number issued by another state. A resale certificate without the proper registration number is not a valid resale certificate.

C. Absolute-Requirement States

Some states have an absolute requirement that the purchaser must be registered to collect sales tax in that state. Otherwise, the purchaser cannot provide a valid resale certificate.

In those states, a resale certificate with the purchaser's in-state registration number is the only way to obtain a resale exemption. Without it, the sale is taxable even if the parties can later prove that the purchaser actually resold or leased the property.

States with this approach include:

1. District of Columbia
2. Kansas
3. Michigan
4. New Mexico
5. Oklahoma
6. Pennsylvania (law unclear)
7. Tennessee
8. Utah
9. Wisconsin
10. Wyoming

D. Model Resale Certificate

**Blanket [Name of State] Resale Certificate SELLER:
PURCHASER:**

[Name] _____ [Name] _____

[Address] _____ [Address] _____

Purchaser hereby certifies that it is engaged in the business of selling _____, and that all of the tangible personal property which it will purchase from Seller will be purchased for the purpose of resale in the regular course of business.

Purchaser holds a valid Registration No. _____ issued by the Department of Revenue [Name state].

In the event that any of the above-described property is used for any purpose other than resale in the regular course of business, Purchaser will report an applicable sales or use tax. Purchaser will furnish any further documentation required to establish that its purchases from Seller are exempt from state and local sales and use taxes. If the claimed exemption is denied by the taxing authorities, Purchaser agrees to reimburse Seller for any tax, interest and penalties for which the Seller is liable as a result of the denied exemption.

I swear or affirm that I have examined this certificate and that the information on it is true and correct.

DATE:

By: _____
[PRINT NAME]
[TITLE]

E. Other Proof for Resale Exemption

1. The rule in most states is that a seller can use other proof to establish that the sale was actually a sale for resale.
2. However, this proof may not be accepted at the audit level. Then, the audit must be appealed to the administrative hearings section of the State Department of Revenue.
3. Usually, the proof must relate to the specific sale in issue. It is usually difficult to obtain this information years after the sale took place.
4. The “XYZ Letter” is the best way to prove that a sale was really for resale. See form on following pages.

Note the difference in the level of proof between a resale certificate (general statement of intent to resell) and XYZ letter (each sale must have actually been resold).

Purchasers can also send XYZ letters to their sellers (or call them to see if they have already been audited).

5. Other examples of proof
 - a) Statements by the buyer (assuming that it is still doing business with the seller)
 - b) Statements by the seller’s salesmen **or** other employees with personal knowledge of the buyer’s business with the seller)

SAMPLE LETTER
REQUESTING PURCHASER'S STATEMENT

XYZ Company
112 East Pecan Street
San Antonio, Texas 78205

Auditors of the Texas State Comptroller's Office are currently examining our records in connection with the Texas Sales and Use Tax Law. They have questioned certain nontaxed sales made to you, as covered by the invoices listed on the attached sheet.

Would you please indicate the disposition of this property by checking the appropriate box and completing the statement. The Comptroller will not accept the statement if it is not filled out completely and signed by an authorized representative.

Please return the inquiry statement to us as soon as possible so that we may be in a position to support any claims for exemption that are in order.

Very truly yours,

**STATEMENT CONCERNING PROPERTY PURCHASED WITHOUT
PAYMENT OF THE TEXAS TAX**

In reference to your noted purchase(s) from:

Seller's Permit No. _____

<u>DATE</u>	<u>INVOICE</u>	<u>AMOUNT</u>	<u>DESCRIPTION</u>
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- a) The above property was purchased for resale and is presently in resale inventory. It has not been used for any purpose other than retention, demonstration, or display while being held for sale in the regular course of business.
- b) The above property was purchased for our own use and tax was paid directly to the Board with our sales tax return for the reporting period _____.
- c) The above property was purchased for leasing and tax measured by rental receipts has been paid directly to the Comptroller with our sales tax returns _____.
- d) PLEASE NOTE: If any of the above boxes are checked, your seller's permit number must be entered in the space below.
- e) The above property was purchased for our own use and not for resale.

COMMENTS:

*Purchaser's Permit No. _____

City

Signed _____

Date: _____

Title: _____

(Owner, Partner, Purchasing Agent,
Etc.)

Tel. No. _____

IMPORTANT: The Comptroller will not accept this statement if it is not filled out completely and signed by an authorized representative.

F. Drop Shipments. “The Bermuda Triangle of Sales and Use Tax”

1. The parties
 - a) Supplier—Sells to the Middleman.
 - b) Middleman—Buys from the Supplier and sells to the Customer
 - c) Customer—May be a manufacturer, a retailer or an end-user.
2. The Supplier bills the Middleman but ships the goods directly to the Customer. The Supplier does not have a contract with the Customer.
3. The Supplier’s problem: It ships the goods into a state where the Middleman is not registered for sales tax.
4. Factors in the analysis
 - a) Is the Supplier registered for sales tax in the Customer’s state?
 - b) Should it be? “How much” nexus does it have? (See next section)
 - c) In the Customer’s state, is a resale certificate with an in-state registration number the only way to obtain a resale exemption?
 - d) If not, will the Supplier be able to get an XYZ letter years later, when it gets audited?

Relationship with Middleman? Is it a major customer or is this a one-shot deal.
 - e) Can the Supplier charge tax to the Middleman? If it obtains an indemnity instead, will it be able to collect on that if necessary?

- f) Note indemnification language at end model resale certificate. But remember, a contract right is not the same as money in the bank.

V. EXEMPTIONS AVAILABLE FOR RETAIL SALES

A. Governments (Federal, State and Local)

B. Manufacturing Machinery and Equipment

C. Charitable Organizations

They are required to register with the state and obtain an exemption number or letter to confirm that they qualify for the exemption.

D. Isolated/Occasional Sale

In general, it is a sale by someone who is not a dealer. Each state has its own requirements, and may limit the exemption.

Some state statutes define the term “sale” to include certain transactions, such as a merger or corporate reorganization. Each state’s provisions should be analyzed before a transaction is finalized.

Note: A transaction is not automatically exempt from sales tax just because it’s exempt for federal income tax purposes. For example, a § 351 contribution to a subsidiary can be taxable in California and New York—in those states, the subsidiary must be newly formed in order to qualify.

Example: Beatrice (Cal. Court of Appeals, Feb. 10, 1993): A transfer of assets to an existing but inactive subsidiary was taxable. The court found that the assumption of liabilities was consideration.

E. Intercompany Transactions

May be exempt in some states if there is the specified level of common ownership and there is no profit component in the intercompany charge

F. Interstate Commerce

1. The goods must be transported outside the state, either by the seller’s own trucks or by carrier.
2. Shipping documentation is crucial.

3. Even if it leaves the state immediately, the purchaser cannot pick up the goods.
4. Some states distinguish between common carriers and contract carriers.
5. “Taxable moment” vs. Complete Auto

G. Temporary Storage.

H. Direct Pay Permits.

VI. ADDITIONS & DEDUCTIONS FROM THE PRICE OF A RETAIL SALE

A. Services

Services are usually exempt if they are *separately stated* on the contract or customer invoice.

(Rationale: two contracts)

B. Repair and Installation Charges

C. Freight/Delivery Charges

Freight/delivery charges are usually exempt if separately stated.

This means transportation to the customer. Freight in to the seller's location is not exempt because it is a *cost of doing business*.

D. Cash or Trade Discounts, Finance Charges (Interest)

Cash or trade discounts, finance charges (interest) are exempt.

E. Coupons

Coupons issued by the seller reduce the sales price; coupons issued by a manufacturer or a third party are taxable because they still represent gross receipts to the retailer.

F. Trade-Ins

Trade-ins are exempt in most states. Be careful with Section 1031 exchanges.

G. Use Tax

1. Credit for sales tax already paid to another state

Sometimes the state denies the credit because it feels that the other state's sales tax was improper.

Example: Missouri and Arkansas impose sales tax when title passes in their state even if the seller then ships it outside the state.

2. Problems with claiming credits against local taxes

For example, municipalities commonly allow a credit only for a municipal-level sales tax.

VII. DOCUMENTING EXEMPTIONS & DEDUCTIONS

A. “All sales are considered taxable in the absence of documentation to the contrary.”

You can have the greatest legal theory in the world but you'll still lose if you don't have the documentation to prove it.

B. The Hobson's Choice

Collect the proper documentation or bill sales tax. Explanation: This really isn't a choice. Hobson was an English stablekeeper. If someone wanted to rent a horse from him, they would have to take the one nearest the door.

C. Exemption Certificates

Exemption certificates generally follow the same rules as resale certificates.

VIII. NEXUS: WHEN MUST AN OUT-OF-STATE SELLER COLLECT TAX?

A. Nexus in General

1. Nexus means a contact with a state that is enough to give the state taxing jurisdiction.
2. “Nexus gets you noticed.” (Advertising slogan for Nexus hair products). A company probably has nexus wherever it has a significant amount of sales
3. Technically, the seller is collecting the use tax owed by the in-state purchasers. However, there are virtually no differences between paying sales tax or collecting use tax.

B. Activities That Constitute Nexus

1. A company is required to collect a state’s sales/use tax if it has any of the following in that state:
 - a) Owning or leasing real estate or tangible personal property
 - b) Maintaining a business location or inventory
 - c) Having resident or nonresident employees work in the state, regardless of how frequently or how long ago
 - d) Having the company incorporate in the state or qualify to do business there
 - e) Using the company’s own trucks and personnel to make deliveries into the state on a regular basis
 - f) Perhaps, even independent contractors or other agents soliciting orders on behalf of the company or performing services for it

Would the company have to send its own employees into the state if it didn’t use independent contractors?

2. Nexus is an all-or-nothing test. Once any of the above activities have occurred, the company is forever tainted.

C. Examples of Nexus

1. Company employees attend a trade show in the state.
2. The company owns paper which is located at an in-state printer.
3. The company owns molds or patterns that are used by unrelated suppliers to manufacture parts to its specifications, and/or company employees visit those suppliers.
4. The company owns a piece of raw land as an investment.
5. The only protected business is a pure mail order seller. It uses only mail, telephone and common carriers to communicate with its customers in the state.

D. Nexus and Corporate Divisions

Nexus is determined for an entity as a whole. Thus, one division of a corporation can create nexus for all of its other divisions, even if their activities are unrelated.

Separate corporations are usually respected for sales tax purposes, as long as:

1. Corporate formalities are followed.
2. Any intercompany transactions are priced and documented on an arm's length basis.
3. The in-state corporation does not act as an agent of the out-of-state corporation.

E. Example of Tax Planning

Many national retail chains have set up separate mail order subsidiaries so that they won't have to collect sales tax on the mail order sales.

However, states are trying to expand their taxing jurisdiction to bring in companies who systematically exploit their market. This theory is called *economic nexus*.

Example: Garbage Nexus: The mail order company burdens the state because its catalogs and junk mail end up in the state's landfills.

F. Major United States Supreme Court Cases (WayFair and Quill)

G. Nexus and Income Tax

There is a different test for income tax. A federal statute, Public Law, 86-272, protects a company from a state's income tax if:

1. Its activities in the state are limited to solicitation of orders.
2. All orders are accepted outside the state.
3. Orders are filled by shipment or delivery from outside the state.

H. Planning for *Nexus*

1. Collect resale or exemption certificates that meet the requirements of the destination state.
2. Consider registering in all states where the company has substantial sales in order to file returns and start a statute of limitations running.
3. Tax harvesting by the states.
4. Registration.

IX. SPECIAL INDUSTRIES

A. Manufacturing

1. Machinery and equipment exemption

The item must be used directly in manufacturing:

- a) What is manufacturing?
- b) When does the manufacturing process begin?
- c) When does it end?
- d) Do parts or replacement equipment qualify?

2. Resale exemption

This exemption covers *only* ingredients and components. The materials must be physically traceable in the finished product. It is not sufficient that the product cannot be made without them.

3. “Industrial processing” exemption

This exemption applies to items directly used or consumed in manufacturing. It is much broader than the resale exemption. However, not all states have this exemption.

4. Utilities and fuel

5. Taxable purchases (*e.g.*, office equipment and supplies)

6. Self-consumed goods, including by-products

7. Sales of fixed assets and scrap

B. Construction Contractors/Capital Improvements

1. Contractors are the end-users of the tangible personal property that is incorporated into the real estate. The

customer has no use tax exposure because it has not made taxable purchase for sales tax purposes.

2. Real vs. personal property, New Construction vs. Remodeling
3. Sometimes the type of contract is important (e.g., lump-sum vs. cost plus).
4. Often, the customer's exemption can flow-through to the contractor. That is an exception to the normal rule that each transaction in the chain is treated separately.

However, the contractor's tools and molds are taxable.

5. Materials bought for a job in another state

The temporary storage exemption usually applies only to use tax and not sales tax.

X. SALES TAX RETURNS, AUDITS & APPEALS

A. Audit Trail for Sales Tax Returns

1. Be able to tie the gross receipts reported on the sales tax return to:
 - a) Sales per the federal income tax return
 - b) Bank deposits
2. Be able to reconcile the sales/use tax payable accounts.
3. Wherever possible, use separate liability accounts for each jurisdiction. It is easier to see if they are zeroed out.

B. Record Retention

Record retention is crucial, especially for small businesses. “Good record retention can be the difference between major assessments and minor inconveniences.”

Often, whether a transaction is taxable turns entirely on how much documentation is available at the time of the audit.

C. Handling the Audit

D. Accounting Methods

1. Cash vs. accrual
2. Installment sales
3. Issues with accrual method
4. Returns and allowances
5. Bad debts
6. Repossessions
7. The Seller’s discount/collection fee usually lost if return or quarter monthly deposit is late.

E. Statute of Limitations

1. May be longer for deficiencies than for refunds
2. Waivers
3. A right of offset is always available

F. Refund Claims

G. Appeals and Litigation

1. General procedures
2. Factors in deciding whether to litigate:
 - a) Amount of deficiency
 - b) Is the audit issue a *continuing issue*? Can the company restructure its activities to avoid the tax in the future? Alternatively, can it collect the tax from its customers?
 - c) Is the audit issue common to the taxpayer's *industry*? Often, industry groups are willing to share litigation costs or work to amend the statute.
 - d) What are the realistic chances of success in the courts?

Very few taxpayers pay the deficiency and file for refunds unless the amount can be paid into a special escrow fund.

H. Emerging Legal Defenses

1. Due Process--Need for rulemaking
2. Equal protection--Similar businesses must be taxed the same way

I. Sales Tax Research

1. Tax department organization

2. Additional functions
 - a) Compare audit experiences with others—networking is crucial
 - b) Monitor proposed legislation
3. Sources of Assistance:
 - a) Trade Associations
 - b) Taxpayers federations
 - c) CPA Societies
 - d) Monitor proposed regulations
4. State rulemaking procedures
 - a) Notice and comment period after publication in State Register (like the Federal Register)
 - b) Public hearing
 - c) Review by legislative committee
5. Internal sales tax manuals and employee training
6. Tax research

XI. MORE SALES TAX PLANNING TECHNIQUES

- Unbundle a charge to separately state the service component.
- Create a sale for resale in multistate situations.
- Prevent double taxation where there is a taxable use in more than one state.

Solution: Create a resale situation.

- Restructure a transaction to have the property purchased directly by an exempt purchaser instead of a taxable middleman.

Example: Assume that a service provider is taxable if it purchases property but that its customer is exempt. Have the customer buy the property directly so that it will get the exemption. Such an idea may also work for construction contracts in states that don't allow a pass-through of the customer's exempt status.

Request a letter ruling from the state (when and how to do it).

XII. TEXAS SALES TAX ISSUES

A. **Definitions of Sales Tax and Use Tax.** The Limited Sales Excise and Use Tax Act imposes a tax on the sale, lease or rental of tangible personal (touchable movable) property and on certain specified services. Sales and Use taxes are complementary. Together, they are intended to tax transactions only once for the purpose of making purchases, whether in or out of Texas, subject to a uniform tax burden.

1. **Sales Tax.** This tax is imposed on retail sales of taxable items in Texas. The state rate is 6.25%. Various local sales taxes may be imposed in addition to this tax. The maximum combined tax rate for local taxes may not exceed 2% at any location. Therefore, the maximum possible sales tax rate is 8.25%.

Example. ABC Manufacturing purchases an office desk in Waco. This is a taxable sale. ABC Manufacturing is considered the consumer of the desk.

2. **Use Tax.** This tax applies when items are purchased out of state and brought into Texas. A Texas retailer would be required to collect the sales tax at the time of sale. Because a non-Texas retailer would be involved, the sales tax would not be collected at the time of sale. Without the use tax, persons could purchase items from out of state retailers and use the items in Texas, and thus, escape the Texas sales tax. The use tax is designed to prevent this abuse. The use tax applies to “any taxpayer who purchases tangible personal property from any retailer for storage, use or other consumption in Texas.”

Example. ABC Manufacturing purchases a office desk in Tulsa, Oklahoma, for use at its offices in Texas. Texas use tax is owed on the office desk if sales tax wasn't owed and paid in Oklahoma.

3. Joint Liability. The tax is a debt of the purchaser of the goods or services. The Seller or service provider is responsible for collecting and remitting the tax. The Comptroller may pursue either the buyer or seller for the unpaid tax.

B. Goods and Services Subject to Sales and Use Tax. In general, all retail sales or use of tangible personal property are presumed to be taxable transactions. This is contrasted with the performance of taxable services where this presumption does not lie. The sales tax is imposed on the “sales price” of each “sale” of a “taxable item” in Texas. The tax is not imposed when an exemption from the tax applies. The details of the various exemptions are discussed later in this presentation.

1. “Sales Price.” This is the amount for which the item is sold, leased or rented without a deduction for the cost of transportation. Certain charges, if separately stated, are not subject to the tax. These include discounts, refunds, returns, finance charges and trade-ins.
 - a. Title. Transferring title of tangible personal property is a sale. A sale still occurs if the seller keeps possession of the item sold, but passes title.
 - b. Possession. Transferring possession of tangible personal property may also be a sale.
 - (i) Mere Possession. However, mere possession does not constitute a sale unless it is in lieu of transferring title or constitutes a barter or exchange.
 - (ii) Segregation. However, if the seller merely segregates the property in contemplation of transferring title or possession, a sale has not yet occurred.
 - c. Exchanges. The exchange or barter of tangible personal property is a sale.

- (i) Trade-Ins. A trade-in to reduce the purchase price of a taxable item is a taxable barter, but only if the item traded by the buyer is not sold in the seller's regular course of business.
 - Example. Mr. Smith buys a new car from ABC Ford Dealer, which is in the business of selling new and used cars. The purchase price of the new car is \$20,000. Mr. Smith pays \$12,000 cash and trades his old car for \$8,000. Mr. Smith owes sales tax based upon the cash he paid (\$12,000) and not on the full purchase price (\$20,000) because ABC Ford Dealer will sell the trade-in in the ordinary course of its business.

- d. Lease or Rent. The lease or rental of tangible personal property is a sale.
 - (i) General. Leases or rentals of tangible personal property are subject to sales tax. There are two broad categories of leases, financing leases and operating leases.

- e. Service. Performance of a taxable service. This is discussed in more depth below.

- f. "Taxable Item" means tangible personal property and taxable services.
 - (i) Tangible Personal Property. Tangible Personal Property is property that can be weighed, measured, felt or touched or that is perceptible to the senses in any other manner and includes computer programs.

 - (ii) Taxable Services. These are the services specifically enumerated as taxable under the statute.

- C. Entity Concept.** Texas follows the separate entity concept. Each person or entity is treated as a separate taxpayer. Transactions between related taxpayers are generally subject to the sales or use tax.
1. Sales to Affiliates. Sales between two separate corporations, even if they are related as brother-sister or parent-subsiidiary, are subject to sales and use tax.
 2. Division Transfers. Sales or transfers between two divisions or agencies of the same corporation are not subject to sales tax, even though the two divisions may treat the transfer as a sale and purchase on their records.
- D. Distinction Between Non-taxable vs. Exempt Items.** Only certain enumerated services are subject to sales tax. Other services are simply not taxable. Compare this situation to the sale of a taxable item to a reseller. In this case, the sale, while taxable, is exempt in accordance with the statute and if the reseller produces an exemption certificate.
1. Non-Taxable Service. When a person performs a non-taxable service, such as legal services, the attorney becomes the consumer of the materials or taxable services that go into the non-taxable service. If these materials are taxable, the attorney pays the sales tax on them.
- E. Credit for Taxes Paid to Other States.** As a member of the Multi-State Tax Compact, Texas allows a credit against Texas use tax due in an amount equal to a tax paid on the same item to another state, if the other state would grant Texas taxpayers similar treatment.
- F. Registration, Permit and Reporting Requirements.**
1. Sales/Use Tax Permits. Sellers must obtain a sales tax permit for each place of business in Texas. Out-of-state sellers selling items for use in Texas must obtain a use tax permit. Sellers are set up as monthly, quarterly or yearly reporters, depending upon the amount of tax they expect to remit.

2. Sales and Use Tax Reports. These are generally due the 20th day of the month following the month of sales, except for quarterly and yearly filers.
 - a. Credit for Early Payment. Sellers may obtain a discount of 1.25% of the amount of sales tax by prepaying the tax.
3. Record Retention Guidelines. Sales records must be kept for 4 years. This applies to all sellers, users/consumers of taxable items, and taxable service providers.

G. Direct Payment Permits. Purchasers who purchase at least \$800,000 of taxable items for their own use may apply for a permit that allows the purchaser to pay sales tax on the purchased items directly to the Comptroller. This is in lieu of having the seller of items collect the sales tax from the purchaser and remit it to the Comptroller.

Requirements. The applicant must agree to accrue and pay use taxes that become due by the statutory due date, waive the permit discount, and file all applicable state, city and MTA returns.

H. Taxable Services in Texas. The Tax Code provides that amounts charged for labor and services are not taxable unless they are included within the definition of “taxable services” under the law.

I. General Rules for Taxable Services.

1. Sales Price of Taxable Services. The total amount charged for a taxable service is subject to tax, including charges for labor, materials, overhead and profit, regardless of whether such charges are separately identified to the purchaser of the service.
2. Intercorporate Services Exemption. There is an exemption for intercorporate services.

- a. The Statutory Language. The exemption is found in the Tax Code and reads as follows:
- (i) There are exempt from the taxes imposed by this chapter, service transactions among affiliated entities, at least one of which is a corporation that reports their income to the Internal Revenue Service on a single consolidated return for the tax year in which the transaction occurs.
 - (ii) For purposes of this section, “affiliated entity” includes an entity that would be classified as a member of an affiliated group under 26 U.S.C. Section 1504, but for the exclusions provided by that section.
 - (iii) An exemption authorized by this section does not apply to a service that would have been taxable under this chapter as it existed on September 1, 1987.
 - (iv) Services that are exempt under this section may not be purchased for resale by the providing company.
 - (v) Tangible personal property that is transferred as an integral part of a service exempted under this section may not be purchased for resale by the providing company.
- b. Interpretation. The Comptroller has interpreted this statute to apply to corporations which qualify to report their income to the IRS on a single consolidated return with other members of the affiliated group for the tax year in which the taxable service is provided.
- c. Partnerships. A partnership is not considered a member of an affiliated group for purposes of the intercorporate services exemptions.

3. Unrelated Services. A taxpayer will sometimes be charged for services that are both taxable and nontaxable. If a nontaxable service is involved along with a taxable service, the nontaxable service must be unrelated to the taxable service to be exempt from tax. A service is considered unrelated if (i) it is not a taxable service, (ii) it is a type of service which is commonly provided on a stand-alone basis, and (iii) the performance of the service is distinct and identifiable.
 - a. Five (5) Percent Rule. If the nontaxable unrelated service and the taxable service are purchased for a single charge, and the portion of the fee relating to the taxable service represents more than 5% of the total charge, the entire fee is *presumed* to be taxable.
 - (i) Separately Stated Charges. If the portion of the charge relating to the nontaxable unrelated service is separate stated, then only the taxable service is subject to tax. The charge for the taxable service and unrelated nontaxable service must be reasonable based on a comparison to the normal charge for each service if provided alone. The service provider's books must support the apportionment between the taxable and nontaxable services. More specific information regarding unrelated services is provided in the Administrative Rule for each taxable service when applicable. Under a new rule, the taxpayer may prove the portion of the charge that is nontaxable.

XIII. TEXAS COMPTROLLER CONTROVERSIES

A. Audits

1. General Rules Regarding Audits

- a. Purpose. The purpose of a tax audit is to confirm that the taxpayer has reported and paid the correct amount of tax to the State. Amounts reported by the taxpayer are analyzed and compared to the taxpayer's records and to other information available to the Texas Comptroller. The overall goal of a practitioner should be to have the documentation and information available at the commencement of a tax audit so that the audit can be completed quickly.

2. Authority to Conduct Audits

- a. Texas Comptroller. Most audits are conducted directly by the Texas Comptroller's team of auditors. Section 151.023(a) of the Texas Tax Code authorizes the Texas Comptroller to conduct sales and use tax audits. Section 171.211 of the Tax Code authorizes the Texas Comptroller to investigate or examine the records of a corporation to determine the franchise tax liability of a corporation. Some of the Texas Comptroller's auditors are cross-trained to conduct both sales and use tax and franchise tax audits.

B. Selection of Taxpayers for Audit

Most audits are selected at random, generally on a computer-generated basis. But a number of audits are selected in other ways including:

1. Repeat Audits. Taxpayers who are audited and assessed a tax can generally expect to be audited again. The Texas Comptroller will generally be back within four years to avoid losing any subsequent audit periods to the statute of limitations.

2. Priority I Audits. Some taxpayers are designated as “Priority I accounts.” These include taxpayers who cumulatively report the top 65% of tax under Tax Code, Chapter 151, recalculated annually. See Texas Comptroller Rule 3.368(a)(4). Priority I taxpayers are audited every four years to avoid losing any years to the statute of limitations.
3. Audit Leads. Some audits are generated through “audit leads.” Frequently, an auditor will audit one taxpayer and learn of another taxpayer who may not be in compliance. Other leads are obtained from “call-in” leads where someone simply calls the Texas Comptroller’s office to notify them of a non-compliant taxpayer.
4. Refund Audits. Some audits are triggered by refund claims. The Texas Comptroller will sometimes audit a taxpayer who has filed a refund claim with the Texas Comptroller to verify that the taxpayer is entitled to a refund claim.

C. Statute of Limitations

1. Section 111.201 of the Tax Code. The Tax Code states that no tax may be assessed after four years from the date that the tax becomes due and payable. See Tex. Tax Code §111.201.
2. Exceptions. The four-year limitations period does not apply, and the Texas Comptroller may assess tax at any time if:
 - a. with intent to evade the tax, the taxpayer files a false or fraudulent return;
 - b. no report for the tax has been filed; and
 - c. information contained in the report of the tax contains a gross error (usually not asserted). A “gross error” is defined to mean that, after correction of the error, the amount of tax due and payable

exceeds the amount initially reported by at least 25%.

D. Audit Procedures

1. Contact With Auditor

- a. Assignment to Audit Office and Auditor. The audit is assigned to the audit office with jurisdiction over the taxpayer's location. There are 18 audit offices throughout the State of Texas, and 3 audit offices located outside of the State. The audit offices outside of the state are located in Chicago, IL, New York, NY, and Tulsa, OK.
- b. Audit Questionnaire. After an audit is assigned to an auditor, the auditor will send the taxpayer an audit questionnaire asking for certain information to assist the auditor in the audit.
- c. Entrance Conference. Upon receipt of the completed Audit Questionnaire, the auditor will contact the taxpayer to schedule an entrance conference. At the entrance conference, the auditor will hold a preliminary discussion with the taxpayer about the business and the audit. The auditor may also use this opportunity to tour the taxpayer's facilities.

2. Location of Audit.

- a. Taxpayer's Location. Most audits are conducted at the taxpayer's location. However, even in situations where the audit is conducted elsewhere, the auditor will generally ask to visit the taxpayer's premises. The Texas Tax Code authorizes the Texas Comptroller's personnel to inspect at any time during business hours any business premises where a taxable event has occurred, and examine, copy, photograph, the books, returns, records, papers and equipment relating to the conduct in question. See Tex. Tax Code § 151.023(b)(1).

- b. Taxpayer's Representative. A taxpayer may prefer to have the audit conducted at the office of his or her representative. The Texas Comptroller's office will generally honor this request.
- c. Texas Comptroller's Office. Some audits are conducted at the Texas Comptroller's office. The taxpayer brings or sends its records to the Texas Comptroller's office for examination by the auditor. The Texas Comptroller's office is currently conducting some franchise tax audits using this method under its "Disk Audit" program.

Note: We generally recommend having field audit conducted somewhere other than at the taxpayer's location. An ideal place would be the CPA or attorney's office. Doing so provides greater control over the flow of information and documentation to the auditor.

- E. **Resale Certificates.** One of the most common areas of review by an auditor in a sales tax audit is resale certificates. This makes for an easy assessment where a taxpayer claims that sales were made for resale, but does not have a resale certificate to support those sales. The Texas Tax Code states that all gross receipts of a seller that are alleged to be exempt from tax on the basis of the resale exemption must be supported by properly completed resale certificates.
- F. **Exemption Certificates.** The Texas Comptroller's Regulations state that all gross receipts of a retailer are subject to sales or use tax unless a valid and properly completed exemption certificate is accepted by the seller.
- G. **Independent Audit Review Conferences.** The Texas Comptroller has implemented an informal process for taxpayer's to resolve disputes with an auditor's proposed adjustments, known as an "Independent Audit Review Conference." The process involves a conference with an "Independent Audit Reviewer" who considers the items at issue and renders an informal opinion. The process is available to

taxpayers before the audit is complete (*i.e.*, before the issuance of a Notice of Audit Results) is issued. This procedure can provide an effective and low-cost means for resolving or at least narrowing issues in an informal forum before initiating other appeals.

- H. **Tax Determinations/Notification of Audit Results.** Following the completion of an audit, the Texas Comptroller may issue a deficiency determination under Sections 151.501 and 111.008 of the Texas Tax Code (a/k/a “Notification of Audit Results”).
- I. **Authority.** Section 111.008 states that if the Texas Comptroller is not satisfied with a tax report or the amount of tax required to be paid to the state by a person, the Texas Comptroller may compute and determine the amount of tax to be paid from any information available to the Texas Comptroller. The Tax Code also authorizes the Texas Comptroller to estimate the tax liability of a person who did not file sales and use tax returns as required by the Tax Code. See Tex. Tax Code § 151.503(a).
- J. **Finality of Determination.** The Texas Comptroller’s determination becomes final on the expiration of 30 days after the day on which the determination was served by personal service or by mail, unless a petition for redetermination is filed before the determination becomes final. See Tex. Tax Code § 1,505. Once a determination becomes final, it may no longer be appealed and the only remaining issue becomes one of payment and collection. The taxpayer may still be able to appeal the adjustment in a claim for refund.
- K. **Appeals Options.** Taxpayers who receive a Notice of Audit Results from the Texas Comptroller generally have three options available to them.
 - 1. The first option includes filing a petition for redetermination with the Texas Comptroller within 60 days. This has the effect of initiating an administrative appeal with the Texas Comptroller. The appeal may be undertaken without first paying the tax at issue.

2. The second option is to pay the tax and file a claim for refund with the Texas Comptroller. Upon denial, the taxpayer may then seek a redetermination of the denial.
3. The third option is to pay the tax under protest and file a petition in District Court.

L. Redetermination Process

1. General. A taxpayer who receives a Notice of Additional Tax Due following the completion of an audit may seek an administrative redetermination of the assessment. A taxpayer is not required to prepay the tax prior to commencing the redetermination process.

M. The Chronology of the Redetermination Process

1. Initiation of Redetermination. A redetermination hearing is initiated by filing a request for redetermination and a statement of grounds with the Texas Comptroller.
 - a. Timing. A petition for redetermination must be filed with the Texas Comptroller within 60 days from the date of the deficiency determination or within 20 days from the date of a jeopardy determination. Failure to submit the redetermination on time results in the denial of a hearing, and the taxpayer must pay the tax due and request a refund before any objection to the determination will receive administrative reconsideration. (Rule 1.5(a))
 - b. Content. The Texas Comptroller's Rules state that the request must include a statement of grounds that sets out in detail the reasons the taxpayer does not agree with the determination. The taxpayer must list and number the items, individually or by category, with which he or she disagrees, and list and number the factual and legal grounds why the tax should not be assessed or should be refunded. Legal authority must be cited if the taxpayer disagrees with the agency's interpretation of the law. A case may be dismissed if the statement of

grounds does not comply with these requirements. If an item or transaction, or category thereof, is not listed in the Statement of Grounds, it may be barred from consideration in a hearing. A statement of grounds may be amended up to the time that a reply to the position letter is required. See Tex. Comptroller Rules 1.5 and 1.7.

- c. 60-Day Letter. Upon receiving a timely-filed petition for redetermination and statement of grounds, the Texas Comptroller will issue taxpayers a “60-day Letter” which notifies the taxpayer that their request for a hearing has been granted and gives the taxpayer 60 days to provide any additional documentation that the taxpayer would like for the auditor to review. This is generally the last opportunity to resolve the disputed assessment with the auditor before the audit is referred to the administrative hearings section. The 60-Day Letter also gives the taxpayer 60 days to provide any resale or exemption certificates to support tax-free sales. Resale or exemption certificates that are not submitted within this 60-day time limit will not be accepted as evidence to support a claim of tax-free sale. Taxpayers should be particularly aware that any sales for resale that are not supported by resale certificates are deemed *per se* taxable. See Tex. Comptroller Rule 3.285(b)(4).
2. Position Letter. The Texas Comptroller will respond to the taxpayer’s statement of grounds with a “Position Letter,” which will accept or reject, in whole or in part, each contention of the taxpayer and set forth what the assistant general counsel finds is properly subject to or exempt from tax. The Position Letter is filed by an attorney with the Texas Comptroller’s Administrative Hearings Section. See Tex. Comptroller Rule 1.8.
3. Response. The taxpayer must accept or reject, in whole or in part, the Position Letter within 45 days after the day

the Position Letter is dated. See Tex. Comptroller Rule 1.10.

- a. Failure to respond within this 45-day period will result in filing of a motion to dismiss the hearing and disposition of the case according to the position of the Administrative Hearings Section.
- b. A taxpayer must accept or reject the Texas Comptroller's Position Letter within 45 days from the date of the Position Letter, unless an extension is granted. The Position Letter will include a selection form that will offer the taxpayer two options:
 - (i) Agree with the Position Letter. If the taxpayer agrees with the Position Letter, the tax liability or refund will be calculated accordingly. An amended determination or final billing concludes the administrative proceeding. See Tex. Comptroller Rule 1.10(b)(1).
 - (ii) Disagree with the Position Letter. If the taxpayer disagrees with the Position Letter, the taxpayer must also submit a Reply to the Position Letter with the selection form. In the Reply, the taxpayer may present any additional acts, legal arguments, or documents for consideration. The Reply is essentially a legal brief in which all unresolved contentions are addressed with factual and legal support. All factual allegations must be supported by sworn affidavits, certified business records, or otherwise admissible evidence. See Texas Comptroller Rule 1.10(b)(2); 1.15. The Texas Comptroller's office has been fairly flexible about granting taxpayers an initial 45-day extension. Additional extensions may be more problematic for taxpayers.

4. Administrative Hearings Response. The AHS may file a response to the taxpayer's Reply to the Position Letter if the taxpayer presents additional acts or legal arguments in its Reply. The AHS response is due within 45 days from the date the taxpayer files its Reply. However, the AHS may grant itself an extension if it is unable to respond within that time period, in which case, the taxpayer will be notified of the delay and informed of the revised response date. See Tex. Comptroller Rule 1.16(a).
5. Oral Hearing. If the parties are unable to resolve or settle all contested matters, the Tax Division will, at a taxpayer's request, or on its own motion, file a Request to Docket Case form with the State Office of Administrative Hearings ("SOAH"). The Request must be filed within 30 days from the date of the taxpayer's Request unless the parties agree otherwise. The taxpayer is given the option of selecting:
 - a. A written submission hearing before a SOAH administrative law judge, or
 - b. An oral hearing before a SOAH administrative law judge.
6. Proposed Decision. The assigned administrative law judge will issue a proposal for decision ("PFD") in accordance with SOAH's Rules of Procedure. Both the taxpayer and the AHS may file exceptions and responses in accordance with those Rules.
7. Final Decision. After reviewing the PFD from SOAH any exceptions filed by the taxpayer and the assistant general counsel, the Texas Comptroller will issue a final decision. The Texas Comptroller's decision is final 20 days from the date the Texas Comptroller notifies the taxpayer of its final decision unless a motion for rehearing is filed within that 20-day period. See Texas Comptroller Rule 1.28(a).