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TAX SECTION
State Bar of Texas

January 29, 2015

Via email to Teresa.Bostick@cpa.state.tx.us

Ms. Teresa G. Bostick
Texas Comptroller of Public Accounts
Manager, Tax Policy Division
P. O. Box 13528, Capitol Station
Austin, TX 78711-3528

RE: Comments Pertaining to The Texas Comptroller's Proposed Rule 3.13 Relating to Timely Filing and Payment

Dear Ms. Bostick:

On behalf of the Tax Section of the State Bar of Texas, I am pleased to submit the enclosed comments pertaining to proposed Comptroller Rule 3.13, relating to postmarks, timely filing of reports, and timely payment of taxes and fees. The proposed rule was published in the January 2, 2015, edition of the Texas Register.

THE COMMENTS ENCLOSED WITH THIS LETTER ARE BEING PRESENTED ONLY ON BEHALF OF THE TAX SECTION OF THE STATE BAR OF TEXAS. THE COMMENTS SHOULD NOT BE CONSTRUED AS REPRESENTING THE POSITION OF THE BOARD OF DIRECTORS, THE EXECUTIVE COMMITTEE OR THE GENERAL MEMBERSHIP OF THE STATE BAR OF TEXAS. THE TAX SECTION OF THE STATE BAR OF TEXAS, WHICH HAS SUBMITTED THIS LETTER, IS A VOLUNTARY SECTION OF MEMBERS COMPOSED OF LAWYERS PRACTICING IN A SPECIFIED AREA OF LAW.

THE COMMENTS ARE SUBMITTED AS A RESULT OF THE APPROVAL OF THE COMMITTEE ON GOVERNMENT SUBMISSIONS OF THE STATE BAR OF TEXAS TAX SECTION AND PURSUANT TO THE PROCEDURES ADOPTED BY THE COUNCIL OF THE TAX SECTION, WHICH IS THE GOVERNING BODY OF THAT SECTION. NO APPROVAL OR DISAPPROVAL OF THE GENERAL MEMBERSHIP OF THIS SECTION HAS BEEN OBTAINED AND THE COMMENTS REPRESENT THE VIEWS OF THE TAX SECTION MEMBERS WHO PREPARED THEM.

We greatly appreciate the opportunity to work with your office on these significant tax issues and hope to provide relevant analysis for your review. Thank you for your consideration.

Respectfully submitted,

Andrius R. Kontrimas
Chair, Tax Section
The State Bar of Texas

COMMENTS ON THE TEXAS COMPTROLLER'S PROPOSED RULE 3.13

These comments, submitted in response to proposed Comptroller Rule 3.13, as published in the Texas Register on January 2, 2015, are presented on behalf of the Tax Section of the State Bar of Texas (the "Section"). The principal drafters of these comments include the Chair and Vice Chair of the Section's Committee on State and Local Tax, Charolette Noel and Sam Megally, and Section members Ira Lipstet, Kirk Lyda, and Sandi Farquharson. The Section's Committee on Government Submissions ("COGS") has approved these comments. Robert Probasco, Chair of COGS, reviewed these comments. Alyson Outenreath also reviewed these comments on behalf of COGS.

Although many of the persons who participated in preparing this letter have clients who would be affected by the state tax principles addressed by this letter or have advised clients on the application of such principles, no such person (or the firm or organization to which such member belongs) has been engaged by a client to make a government submission with respect to, or otherwise to influence the development or outcome of, the specific subject matter of this letter.

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Date: January 29, 2015

I. INTRODUCTION

This letter provides comments concerning the proposed adoption of 34 Tex. Admin. Code § 3.13, relating to postmarks, timely filing of reports, and timely payment of taxes and fees ("Proposed Rule 3.13").[1]

We recognize and appreciate the challenges facing the Texas Comptroller of Public Accounts (the "Comptroller") in establishing whether a report or payment submitted by mail is timely remitted. We also appreciate the time and efforts of the Comptroller to prepare new Rules to assist in efficient tax administration. These efforts are very helpful to taxpayers, practitioners, and Comptroller personnel. It is our intent to present comments for consideration that may help and support the Comptroller personnel.

II. PROPOSED RULE 3.13 COMMENTS

As an initial matter, we note that the preamble to Proposed Rule 3.13 states that this Proposed Rule does not apply to taxpayers required by statute or another section of this title to remit funds electronically. Thus, we understand this provision will apply primarily to smaller taxpayers, taxpayers located outside the state, and other taxpayers not required to remit funds electronically. Such taxpayers often have limited sales or operations in Texas. Particularly since these taxpayers may find identifying and understanding the procedural rules challenging, we recommend incorporating some of the explanatory language in the preamble into the text of the Proposed Rule and clarifying other ambiguities in Proposed Rule 3.13 to limit potential confusion, increase the likelihood of desired compliance, and reduce corresponding administrative burden on the Comptroller when confusion causes a filing or a payment to be treated untimely.

A. Clarification of the "Comptroller's Correct Address"

Proposed Rule 3.13(c)(1) appears to incorporate a "correct address" requirement in order for a report to be determined to be timely filed or a payment timely made. In particular, Subsection (c)(1) of Proposed Rule 3.13 provides:

> To determine whether a report has been timely filed or a payment timely made, the date of a United States Postal Service postmark or a receipt mark showing when a report or payment was delivered to a common carrier or contract carrier will be prima facie evidence of the date the filing or payment was made, so long as the envelope, or common carrier or contract carrier documentation, reflects *the comptroller's correct address*." (emphasis added).

[1] Hereinafter, all references to "Rule" or "Rules" (as appropriate) are to Title 34 of the Texas Administrative Code.

Proposed Rule 3.13 does not define or provide reference to determine "the comptroller's correct address." Instead, the guidance that is available is limited to language in the preamble, which with respect to Subsection (c) of Proposed Rule 3.13 provides, in relevant part:

> [A] postmark or receipt mark will serve as prima facie evidence of the date of filing a report or submitting a payment, so long as the postmarked or receipt-marked envelope of documentation reflects the comptroller's correct address. The correct post office box address for submitting reports and payments for individual tax and fee types can be found on the comptroller's website at http://www.window.state.tx.us/taxinfo/p_o_box.html. In addition, reports or payments may be submitted to the comptroller's physical address: 111 East 17th Street, Austin, Texas 78701.

The language of the preamble may be read to imply that the "correct address" may differ for particular tax and fee types. A recent review of the website shows nine addresses for filing reports. If any of those separate addresses represents the preferred address for a particular filing requirement, we recommend that Proposed Rule 3.13 be clarified to state such (in the text as opposed to the preamble). Further, the new Proposed Rule is not clear as to whether a particular address must be used because the explanation also provides the option of using the Comptroller's headquarters address: "111 East 17th Street, Austin, Texas, 78701." While availability of the Internet is common, it is not universal. Accordingly, we appreciate the safe-harbor option of being able to use the Comptroller's headquarters address. We would also recommend that Proposed Rule 3.13 be clarified to state that taxpayers are permitted to use addresses provided in relevant tax forms and instructions, including addresses appearing on correspondence the taxpayers have received from the Comptroller.

We propose the language in Subsection (c)(1) of Proposed Rule 3.13 be revised to permit any address of the Comptroller to be used, as long as the envelope or other document lists a *valid* Comptroller address found on the Comptroller's website or as indicated on the relevant form or instructions, so that it reads:

> To determine whether a report has been timely filed or a payment timely made, the date of a United States Postal Service postmark or a receipt mark showing when a report or payment was delivered to a common carrier or contract carrier will be prima facie evidence of the date the filing or payment was made, so long as the envelope, or common carrier or contract carrier documentation, reflects a *valid comptroller's address*." (emphasis added).

If Proposed Rule 3.13 intended that a particular address be used, we recommend such a requirement be reconsidered. The primary reason is that requiring a specific address would appear to be contrary to the various tax statutes, which do not require any specific address to be used. Also, requiring a specific address as determined by tax or fee type based on ambiguous language in the preamble of Proposed Rule 3.13 does not provide sufficient notice to a taxpayer or a tax practitioner – particularly those taxpayers or practitioners who do not deal with Comptroller tax matters on a regular basis. The vagueness inherent in having several alternate addresses creates a regrettable potential for error based upon a report or payment merely going to the "wrong" address, even if the Comptroller received the report or payment on a timely basis. The impact could be particularly severe if a filing to preserve important procedural rights, with a relatively short deadline (such as a 30 day period to contest an asserted tax deficiency or denial of a refund claim), is deemed to be untimely because the submission was sent to the "wrong" Comptroller address.

B. Definition of Postmark

The explanations in the preamble preceding the Proposed Rule include a clarification of what constitutes a postmark or receipt mark. We believe it would be useful to include the same language in the text of the rule itself. Specifically, we suggest that the Comptroller add a definition in Subsection (a) for *"United States Postal Service postmark or a receipt mark"* to clarify that they do not include dates on postage purchased over the Internet, purchased as pre-metered stamps, or from postage meters unless an actual postmark is generated.

C. Adhering to the Statutory Mailbox Rule

Finally, we are concerned that Proposed Rule 3.13(c)(2) is inconsistent with Texas Tax Code § 111.054. Tax Code § 111.054(a) establishes a so-called "mailbox" rule for determining that a payment or report is filed when such item is placed in a U.S. Post Office or in the hands of a common or contract carrier. In particular, Tax Code § 111.054(a) provides:

> Sec. 111.054. TIMELY FILING: MAIL DELIVERY. (a) *If a tax payment or a report is placed in a U.S. Post Office or in the hands of a common or contract carrier* properly addressed to the comptroller on or before the date the payment or report is required to be made or filed, *the payment or report is made or filed on time.* (emphasis added).

Tax Code § 111.054(b) further provides that the date of such filing may be evidenced by the receipt mark or postmark, but such evidence is rebuttable by either the taxpayer or the Comptroller if delivery to the U.S. Post Office or to a common or contract carrier (filing) differed from the date of the receipt mark or postmark:

> (b) The receipt mark of a contract or common carrier or the postmark on a tax payment or report is prima facie evidence of the date on which the payment or report was delivered to a carrier or the post office. The comptroller or the person making the payment or filing the report may show by competent evidence that the actual date of delivery to the carrier or post office differs from the receipt mark or postmark.

Proposed Rule 3.13(c)(2), however, provides a test that differs from the statutory test for determining when a report or payment is filed. Proposed Rule 3.13(c)(2) provides:

> (2) If a report or payment is received through the United States Postal Service and does not have a postmark, or is received

> through a common or contract carrier and does not have a receipt mark, the date the report or payment is physically received by the comptroller and a file stamp is affixed to the envelope containing the report or payment shall be the date of filing or payment.

Proposed Rule 3.13(c)(2) seems inconsistent with the statutory "mailbox" rule in three respects. First, under the rule of the statute, delivery to the U.S. Post Office or the carrier is the date of filing. Nothing in the statute indicates the filing date should be delayed if items are subsequently delivered by the carrier without a receipt mark or a postmark. Second, the statute does not suggest that filing is deemed to occur only when the item is physically received by the Comptroller. Certainly filing would have occurred at least as early as receipt by the Comptroller, but receipt by the Comptroller is not the statutory filing date. Third, nothing in the statute delays the deemed filing date to when the Comptroller affixes a stamp to the envelope after the item is physically received by the Comptroller.

Rule 1.32 acknowledges that some period of time occurs between the date mailed and the date received. We suggest incorporating presumptions similar to the concepts in Rule 1.32 to recognize that the filing date is based on the date mailed, not the date received. Thus, we suggest Proposed Rule 3.13(c)(2) be modified as follows:

> (2) If a report or payment is received through the United States Postal Service and does not have a postmark, or is received through a common or contract carrier and does not have a receipt mark, the date of the filing of the report or payment is presumed, in the absence of evidence supporting the assertion of a different filing date, to be:
>
> > (A) if received through the United States Postal Service, three days prior to the date on which the report or payment is physically received by the comptroller as evidenced by comptroller records; or
> >
> > (B) if received through a common or contract carrier, one day prior to the date on which the report or payment is physically received by the comptroller as evidenced by comptroller records.

III. <u>CONCLUSION</u>

For the reasons discussed above, we respectfully suggest that current Proposed Rule 3.13 should be modified as indicated.

We greatly appreciate the opportunity to work with your office on these tax issues and hope these comments provide relevant analysis for your review. Thank you for your consideration.

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TAX SECTION
State Bar of Texas

January 7, 2015

Via Electronic Mail
PEO@tdi.texas.gov.

Ms. Jamie Walker
Associate Commissioner for Licensing Services
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Austin, TX 78714-9104

Re: Comments for Rules Relating to Professional Employer Organizations Sponsoring Self-Funded Employee Health Benefit Plans

Dear Ms. Walker:

On behalf of the Tax Section of the State Bar of Texas, I am pleased to submit the enclosed response to two (2) requests of the Texas Department of Insurance ("TDI") published on TDI's website, for comments relating to an informal working draft of rules to implement Section 16 of Senate Bill 1286, relating to the regulation of professional employer organizations sponsoring self-funded employee health benefit plans (the "Notice"). We understand that the link to the Notice will be removed when the rule proposal is filed.

THE COMMENTS ENCLOSED WITH THIS LETTER ARE BEING PRESENTED ONLY ON BEHALF OF THE TAX SECTION OF THE STATE BAR OF TEXAS. THESE COMMENTS SHOULD NOT BE CONSTRUED AS REPRESENTING THE POSITION OF THE BOARD OF DIRECTORS, THE EXECUTIVE COMMITTEE OR THE GENERAL MEMBERSHIP OF THE STATE BAR OF TEXAS. THE TAX SECTION, WHICH HAS SUBMITTED THESE COMMENTS, IS A VOLUNTARY SECTION OF MEMBERS COMPOSED OF LAWYERS PRACTICING IN A SPECIFIED AREA OF LAW.

THE COMMENTS ARE SUBMITTED AS A RESULT OF THE APPROVAL OF THE COMMITTEE ON GOVERNMENT SUBMISSIONS OF THE TAX SECTION AND PURSUANT TO THE PROCEDURES ADOPTED BY THE COUNCIL OF THE TAX SECTION, WHICH IS THE GOVERNING BODY OF THAT SECTION. NO

APPROVAL OR DISAPPROVAL OF THE GENERAL MEMBERSHIP OF THIS SECTION HAS BEEN OBTAINED FOR THESE COMMENTS AND THESE COMMENTS REPRESENT THE VIEWS OF THE MEMBERS OF THE TAX SECTION WHO PREPARED THEM.

We commend the TDI for the time and thought that has been put into preparing the Notice, and we appreciate being extended the opportunity to participate in this process.

Respectfully submitted,

Andrius R. Kontrimas III

Andrius R. Kontrimas
Chair, Tax Section
The State Bar of Texas

COMMENTS ON RULES RELATING TO PROFESSIONAL EMPLOYER ORGANIZATIONS SPONSORING SELF-FUNDED EMPLOYEE HEALTH BENEFIT PLANS

These comments are submitted on behalf of the Tax Section of the State Bar of Texas. Principal responsibility for drafting these comments was exercised by Jim Griffin and Henry Talavera. The Committee on Government Submissions ("COGS") of the Tax Section of the State Bar of Texas has approved these comments. Robert Probasco, the Chair of COGS, reviewed these comments. Riva Johnson also reviewed these comments and made substantive suggestions on behalf of COGS.

Although members of the Tax Section who participated in preparing these comments have clients who would be affected by the principles addressed by these comments or have advised clients on the application of such principles, no such member (or the firm or organization to which such member belongs) has been engaged by a client to make a government submission with respect to, or otherwise to influence the development or outcome of, the specific subject matter of these comments.

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Date: January 7, 2015

These comments are provided in response to the request from the Texas Department of Insurance ("TDI') for comments on an informal working draft of rules ("Informal Working Draft") to implement Section 16 of Senate Bill 1286, relating to the regulation of professional employer organizations ("PEOs") sponsoring partially or fully self-funded/self-insured ("self-funded") employee health benefit plans ("Benefit Plans").

SUMMARY

We respectfully recommend that the TDI reconsider several aspects of the proposed rules contained in the Informal Working Draft. In finalizing the Informal Working Draft, we suggest that the TDI fully consider the impact of the Patient Protection and Affordable Care Act, as amended ("ACA") and ERISA, as well as the probable economic impact on PEOs and other employers who have entered into a co-employment relationship with respect to their workers. Without substantial accommodation from the TDI, such employers may at some point have no reasonable alternative to satisfy the requirements of ACA and the TDI, except for purchasing fully insured insurance products from an insurance company, or in the worst case, perhaps laying-off workers or ceasing operations.

We would, in particular, recommend that TDI consider specific rules for compliance for different types of entities depending upon perhaps, among other things, (A) the size of the entity in terms of numbers of total employees, (B) whether such entity is clearly a PEO, (C) the number of workers employed by such entity in a co-employment relationship or as independent contractors and (D) whether such employers employ long-term, temporary employees for periods longer than a fixed period of time (e.g., at least three (3) months, six (6) months, one (1) year, etc.). We would also like the opportunity to explore whether other criteria might be important and whether TDI might consider providing reasonable methods for various entities and Benefit Plans to become properly regulated by the TDI (or perhaps exempted from any rules by TDI).

Specifically, as outlined further below, we recommend that TDI remove (or at least more narrowly tailor) the dispute resolution provisions in the Informal Working Draft to be more clearly in conformance with ERISA's claims procedures.

Lastly, we suggest that the proposed rules in the Informal Working Draft appear to be so burdensome as to make the cost prohibitive with respect to any Benefit Plan sponsored by a PEO. We point to a couple of examples, but given the time frame for comments, we have not had a chance to provide all of your comments. We are hopeful that the TDI will consider having an additional comment period on the Informal Working Draft before finalizing such rules. The Tax Section of the State Bar of Texas is willing to consider providing further input to the TDI if requested.

Chapter 91 Self-Funded Employee Health Benefit Plans Are MEWAs

Benefit Plans provided by a professional employer organization ("PEO") for individuals who are co-employed by the PEO and its client employers, as authorized by Chapter 91 of the Texas Labor Code ("Chapter 91"), are known as multiple employer welfare arrangements (singularly "MEWA," and collectively, "MEWAs") for purposes of the Employee Retirement Income Security Act of 1974, as amended ("ERISA").

ACA and Benefit Plans

As background, many employers have entered into co-employment relationships with PEOs and other entities, particularly as it relates to temporary employment (singularly "Temp Agency," or collectively "Temp Agencies"). An employee may have more than one employer within the meaning of the Texas Workers' Compensation Act, and each employer who subscribes to workers' compensation insurance may raise the exclusive-remedy provision as a bar to claims about a work injury. *See Garza v. Exel Logistics, Inc.,* 161 S.W.3d 473, 475-76 (Tex. 2005) (stating that client company could assert exclusive-remedy defense to claims by temporary employee if it was covered by workers' compensation insurance); *Wingfoot Enters. v. Alvarado,* 111 S.W.3d 134, 143 (Tex. 2003) (holding that exclusive-remedy provision applied to both temporary staffing company and client company); *see also Port Elevator-Brownsville, L.L.C. v. Casados,* 358 S.W.3d 238, 242-243 (Tex. 2012).

Temp Agencies are clearly co-employers for purposes of the Texas Workers' Compensation Act, but their status is much less clear under other Texas laws, including but not limited to Chapter 91. A Temp Agency is generally exempt from any licensure requirements as a PEO, because such Temp Agency will qualify in many cases as, among other things, a "temporary common worker employer." Regardless, it is not clear that in all circumstances a Temp Agency will qualify as other than a PEO with respect to its employees. *See* Texas Labor Law § 92.002 (a "temporary common worker employer" includes certain persons who, among other requirements, provide "common workers to a user of common workers").

Under TDI rules, we generally understand workers employed by Temp Agencies and similar entities are arguably the employees of such Temp Agencies and no other entity, including, but not limited to, the customer of any such Temp Agencies. However, this answer is not free from doubt in all circumstances, particularly as it relates to properly classifying such workers as employees. While unrelated to the issue of co-employment, there is much litigation regarding whether individuals should be classified as employees compared to being independent contractors.

There is significant litigation in California and Missouri on these issues and as it relates to ERISA covered Benefit Plans. *See Alexander v. Fedex Ground Package System, Inc.*, 765 F.3d 981 (9th Cir. 2014) (independent contractors are employees under California law); *see also Gray v. Fedex Ground Package System, Inc., at* http://scholar.google.com/scholar_case?case=8497351377564157366&q=reginald+gray+fedex+ERISA&hl=en&as_sdt=6,44 (misclassified employees can possibly receive damages based upon the value of ERISA covered benefit plans). While such litigation is not directly related to PEOs and Temp Agencies, there is risk of litigation in the area of co-employment, particularly in light of the ACA requirements being shifted from the customer to the PEO and Temp Agencies.

Furthermore, under ACA, it is not certain when a temporary staffing firm, including a Temp Agency, might be a co-employer with its customer with respect to temporary workers. In the definition of "temporary" worker, under the final employer shared responsibility regulations under ACA ("Regulations") the Regulations discuss the concept of "short-term employees," meaning employees "who are reasonably expected to average at least 30 hours of service per week and are hired into positions expected to continue for 12 months" (not including seasonal employees, who are expected to have recurring employment on an annual basis). *See* Preamble to Shared Responsibility for

Employers Regarding Health Coverage; Final Rule ("ACA Preamble"), 79 Fed. Reg. 8533, 8562 (Feb. 12, 2104).

The Regulations specifically decline to treat short-term employees any differently from any other employees who are expected to be full time as of their dates of hire. However, the Regulations make clear that there should be no concerns regarding the application of any ACA penalty with respect to certain short-term employees whose employment lasts for less than 90 days, since the general employer shared responsibility rules give employers a pass on the application of ACA penalties for the first several months of full-time employees' employment. *Id.*

The Regulations also discuss the complications of applying certain ACA rules to the employees of temporary staffing firms, including but not limited to, Temp Agencies. As a result, there is not yet any specific guidance under ACA concerning when an employee might or might not be a temporary employee. However, the Regulations provide some preliminary guidance in the ACA Preamble. Specific factors to be used in determining whether an employee of a temporary staffing firm can be treated as other than a full-time employee include, but are not limited to:

> "whether other employees in the same position of employment with the temporary staffing firm, as part of their continuing employment, retain the right to reject temporary placements that the temporary staffing firm offers the employee; typically have periods during which no offer of temporary placement is made; typically are offered temporary placements for differing periods of time; ***and typically are offered temporary placements that do not extend beyond 13 weeks***."

ACA Preamble at 8557 (emphasis added).

Prior to the enactment of ACA, the distinction between a PEO and a Temp Agency was, with limited exception, not necessarily critical. Under ACA, Temp Agencies generally have faced the prospect of prohibitively expensive "fully insured" products, and many insurers in our experience have asked such Temp Agencies to represent that there is no co-employment relationship between the Temp Agencies and any other person. For these and other reasons, many Temp Agencies and similar employers have purchased self-insured medical insurance here in Texas (*i.e.*, the employers pay the first dollar of claims up to certain aggregate and other stop-loss limits, along with stop-loss insurance in favor of the employers). Such arrangements could potentially be classified as MEWAs. However, because the Informal Working Draft only applies to PEOs, such employers are potentially exposed under Texas law to regulation by the TDI without any meaningful method to comply with Texas law.

Because of the uncertainty and evolving nature of the law, including ACA, we respectfully request that the TDI consider issuing rules that would allow such Temp Agencies and others who have entered into either a co-employment and/or independent contractor relationship with workers to reasonably secure TDI approval with respect to Benefit Plans.

The penalties for operating an unregistered MEWA in Texas could be severe. An entity sponsoring a MEWA that is not registered under the state's registration process may be sued by the TDI for violating the prohibition against the unauthorized business of insurance in Texas Insurance Code Annotated Sections 101 and 102. In one case, TDI not only requested that an entity be ordered to cease practicing the business of insurance in Texas, it also requested assessment of a $2 million penalty relating to the prohibited behavior. *LHR Enterprises, Inc. v. Geeslin, Tex. Court of Appeals,* (3rd Dist 2007), *at http://scholar.google.com/scholar_case?case=4799541432513528716&q*

=lhr+enterprises+geeslin&hl=en&as_sdt=6,44 (Texas Court of Appeals approved a significant penalty under Texas law).

The PEO and its Client Employers Are Co-Employers

There are significant issues related to Benefit Plans of PEOs. Section 13.510 of the Informal Working Draft provides that a PEO that holds a license in good standing from the Texas Department of Licensing and Regulation may sponsor a self-funded employee health benefit plan in Texas only after it receives its certificate of approval from TDI under Chapter 91.

Chapter 91 provides that the relationship between a PEO and its client employers is a co-employment relationship, which Section 13.512(7) of the Informal Working Draft defines as a contractual relationship between a client employer and a PEO that involves the sharing of employment responsibilities with or allocation of employment responsibilities to covered employees in compliance with the professional employer services agreement and Chapter 91. Thus, any Benefit Plan that is provided by a PEO to its employees (who are also employees of its client employers) is likely established or maintained for the purpose of offering or providing health benefits to the employees of two or more employers, thereby arguably meeting the employee welfare benefit plan definition in Section 3(1) of ERISA and the MEWA definition in Section 3(40) of ERISA.

Chapter 91 and the Informal Working Draft arguably create special MEWA requirements that are applicable only to PEOs and their client employers, while at the same time arguably preventing any other employers in a co-employment relationship from securing TDI approval. This Informal Working Draft has been adopted outside of the existing statutory MEWA provisions in Chapter 846 of the Texas Insurance Code and rules adopted under the Texas Administrative Code.

Because of the importance and impact of the Informal Working Draft on Benefit Plans, we respectfully recommend that the TDI issue further guidance to assist various types of employers with co-employees and/or independent contractors in providing ACA compliant Benefit Plans that do not run afoul of TDI rules and regulations. Furthermore, because proper characterization of an entity is not always certain, we would respectfully request that the TDI establish different, less onerous TDI requirements for certain entities, such as Temp Agencies, that might employ long-term temporary employees or other entities that might employ just a few temporary employees and/or independent contractors.

***MDPhysicians* Does Not Apply**

The issues discussed above differ importantly from the questions involved in the litigation with the Texas State Board of Insurance ("State Board") in the early 1990s in *MDPhysicians & Associates, Inc. v. State Board of Insurance*, 957 F.2d 178 (5^{th} Cir. 1992). In that case, MDPhysicians asserted that ERISA preempted the attempts by the State Board to regulate a health benefits plan that was offered to over 100 unrelated employers. Siding with the State Board, the Fifth Circuit concluded that the promoter of the health benefit plan was not an "employer," and thus, the plan could not be an "employee welfare benefit plan" under ERISA. Accordingly, ERISA's preemption provision did not block regulation of the plan by the State of Texas.

The precedent in *MDPhysicians* is unlikely to apply to ERISA preemption involving Benefit Plans under Chapter 91 and the provisions in the Informal Working Draft. The critical distinction is that Chapter 91 expressly provides that the PEO is an employer of the employees who are assigned to the client employers. This fact alone is very likely sufficient by itself to cause a PEO's self-funded Benefit Plan to be considered an "employee welfare benefit plan" as defined in and subject to ERISA, including ERISA's MEWA and preemption provisions.

Section 13.557's Dispute Resolution Provisions

Section 13.557 of the Informal Working Draft ("Section 13.557") contains two provisions relating to disputes arising under the Benefit Plan and corresponding trust ("Plan and Trust"). Subsection (1) provides that all disputes arising under the Plan or Trust will be subject to the jurisdiction of Texas state courts. This is referred to below as the "exclusive jurisdiction provision." Subsection (2) provides that the approved PEO and the Plan and Trust waive any right to assert a claim or defense based on Federal statute or common law with respect to all disputes arising under the Plan or Trust. This is referred to below as the "federal claim waiver provision." An approved PEO must include in its Plan and Trust a statement addressing both the exclusive jurisdiction provision and the federal claim waiver provision.

We are aware of no provision in Chapter 91 that requires either the exclusive jurisdiction provision or the federal claim waiver provision for Benefit Plans. As a result, we respectfully recommend that Section 13.557 be revised to be consistent with ERISA claims under the Benefit Plans, as well as other federal laws that might apply such as federal privacy laws.

The Dispute Resolution Provisions Arguably Conflict With ERISA

It appears that the provisions of Section 13.557, if adopted by TDI, may represent a substantial intrusion into the field of federal interest that is occupied by the civil enforcement provisions of ERISA. The civil enforcement mechanism of ERISA Section 502 is one of the cornerstones of ERISA, reflecting Congress' desire to protect interstate commerce and the interests of participants in employee benefit plans and their beneficiaries by providing for appropriate remedies, sanctions, and ready access to the Federal courts. ERISA § 2(b).

The potential interference that Section 13.557 would have with the specific operation of ERISA exists in the following areas:

1. Section 13.557 provides that all disputes arising under the Plan and Trust would be subject to exclusive jurisdiction of the Texas state courts. ERISA, however, provides that state courts and Federal courts have concurrent jurisdiction in claims that are brought by a participant or beneficiary to recover benefits due under the terms of the plan, to enforce rights under the terms of the plan, or to clarify rights to future benefits under the terms of the plan. ERISA § 502(a)(1)(B). Federal courts have exclusive jurisdiction of all other civil actions under ERISA that are brought by the Department of Labor ("DOL") participants, beneficiaries, or fiduciaries. ERISA § 502(e)(1).

2. It appears that Section 13.557 may also interfere with a fundamental purpose of ERISA, by requiring the approved PEO and the Plan and Trust to waive any right to assert a claim or defense based on federal statute or common law with respect to all disputes arising under the Plan and Trust. The federal claim waiver provision would interfere with ERISA's objective of providing uniformity from state to state in the administration of employee benefit plans. 29 U.S.C. § 1001(b). Federal policy under ERISA is reflected in statutory provisions of ERISA as well as judicial doctrines that have been developed by the Federal courts since ERISA was established in 1974. Examples of the ERISA statutory provisions that could be displaced by the dispute resolution provisions include ERISA provisions dealing with fiduciary duties (ERISA Section 404), liability for breach of fiduciary duty (ERISA Section 409), claims procedures (ERISA Section 503), civil enforcement and limitations on actions (ERISA Section 502) and preemption of state law (ERISA Section 514).

ERISA's Preemption Provision

Although not free from doubt, Section 13.557 also arguably interferes with the preemption provision of ERISA with respect to the vast majority of all Benefit Plans that are offered by non-governmental employers and that are also considered employee welfare benefit plans within the meaning of Section 3(1) of ERISA. The preemption provision of ERISA is designed to promote the national uniformity of benefit plan administration by nullifying the enforcement of "any and all State laws insofar as they may now or hereafter relate to any employee benefit plan." ERISA § 514(a). ERISA also contains special rules that apply to State laws that regulate MEWAs, which are discussed below.

Special ERISA Preemption Rules for MEWAs

ERISA, like Texas law, recognizes that MEWAs may provide benefits that are fully insured or that are partially or wholly self-funded or self-insured by such employer. In the case of a MEWA that provides benefits that are fully insured, ERISA provides that any law of any State that regulates insurance may apply to the MEWA to the extent that the law provides:

1. standards, requiring the maintenance of specified levels of reserves and specified levels of contributions, which any such plan, or any trust established under such a plan, must meet in order to be considered under such law able to pay benefits in full when due; and

2. provisions to enforce such standards.

ERISA § 514(b)(6)(A)(i).

A different and narrower standard saving State laws from the scope of ERISA preemption applies, however, to Texas laws affecting self-funded MEWAs, like the Plan and Trust authorized to be adopted by PEOs pursuant to Chapter 91. ERISA provides as follows:

in the case of any other employee welfare benefit plan which is a multiple employer welfare arrangement, in addition to this title, any law of any State which regulates insurance may apply to the extent ***not inconsistent*** with the preceding sections of this title.

ERISA § 514(b)(6)(A)(ii) (emphasis added).

A State law that applies to self-funded MEWAs must satisfy two requirements to survive a preemption challenge under ERISA. First, the State law must be a law that regulates insurance. Second, the law must not be inconsistent with ERISA. Even assuming that the dispute resolution provisions of the Informal Working Draft could be construed as regulating insurance, it appears that the dispute resolution provisions may not meet the "not inconsistent" requirement.

The "Not Inconsistent" Exception for Self-Funded MEWAs

In 1990, the DOL provided its interpretation of ERISA's preemption exception for self-funded MEWAs. The DOL is the Federal agency charged by Congress with the responsibility for the interpretation and enforcement of ERISA. The DOL explained its position as follows:

> "[A] state law which regulates insurance would be inconsistent with the provisions of title I to the extent that compliance with such law would abolish or abridge an affirmative protection or safeguard otherwise available to plan participants and beneficiaries under title I of ERISA, or conflict with any provision of title I of ERISA. For example, state insurance law which would require an ERISA-covered MEWA to make imprudent investments would be deemed to be "inconsistent" with the provisions of title I of ERISA because compliance with such a law would "conflict" with the fiduciary responsibility provisions of ERISA section 404, and, as such, would be preempted pursuant to the provisions of ERISA section 514(b)(6)(A)(ii).
>
> However, a state insurance law will, generally, not be deemed "inconsistent" with the provisions of title I of ERISA if it requires ERISA-covered MEWAs to meet more stringent standards of conduct, or to provide more or greater protections to plan participants and beneficiaries, than required by ERISA. For example, state insurance laws which would require more informational disclosure to plan participants of an ERISA-covered MEWA will not be deemed by the Department to be "inconsistent" with the provisions of ERISA. Similarly, a state insurance law prohibiting a fiduciary of an ERISA-covered MEWA from availing himself of an ERISA statutory or administratively-granted exemption permitting certain behavior will not be deemed by the Department to be "inconsistent" with the provisions of ERISA.
>
> Finally, the Department also notes that, in its opinion, any state insurance law which sets standards requiring the maintenance of specified levels of reserves and specified levels of contributions to be met in order for a MEWA to be considered, under such law, able to pay benefits in full when due will generally not be considered to be

> "inconsistent" with the provisions of title I of ERISA pursuant to ERISA section 514(b)(6)(A)(ii).
>
> Thus, it is the opinion of the Department that a state law regulating insurance which requires the obtaining of a license or certificate of authority as a condition precedent or otherwise to transacting insurance business or which subjects persons who fail to comply with such requirements to taxation, fines, and other civil penalties, including injunctive relief, would not in and of itself adversely affect the protections and safeguards Congress intended to be available to participants and beneficiaries or conflict with any provision of title I of ERISA, and, therefore, would not, for purposes of section 514(b)(6)(A)(ii), be inconsistent with the provisions of title I. Moreover, given the clear intent of Congress to permit states to apply and enforce their insurance laws with respect to ERISA-covered MEWAs, as evidenced by the enactment of the MEWA provisions, it is the view of the Department that it would be contrary to Congressional intent to conclude that states, while having the authority to apply insurance laws to such plans, do not have the authority to require and enforce registration, licensing, reporting and similar requirements necessary to establish and monitor compliance with those laws."

ERISA Opinion Letter 90-18A (July 2, 1990) (footnotes omitted).

According to the DOL, ERISA will not permit any law that would abolish or abridge an affirmative protection or safeguard otherwise available to plan participants and beneficiaries under Title I of ERISA, or conflict with any provision of title I of ERISA.

In our view, there is a material risk that a Federal court may find that the dispute resolution provisions of the Informal Working Draft would abolish or abridge the protections and safeguards of ERISA and that the dispute resolution provisions of the Informal Working Draft are preempted by ERISA. At a minimum, it is not certain how such dispute resolution provisions can be reconciled with the provisions of ERISA for orderly administration of Benefit Plans. Accordingly, we respectfully recommend that TDI consider modifying the Informal Working Draft to provide that the dispute resolutions do not apply in litigation involving a PEO's self-funded Benefit Plan and its participants and beneficiaries.

Further Comments

We would welcome the opportunity to discuss the Informal Working Draft further with TDI or provide further input regarding the intersection between ERISA and other federal law that might apply. We would also welcome the opportunity to provide additional written comments to the Informal Working Draft, and we respectfully request that the TDI extend the deadline to provide further comments and/or suggested revisions to the Informal Working Draft.

It appears that the Informal Working Draft would be extremely onerous on employers. For example, Section 13.520 of the Informal Working Draft contains a list of eighty nine (89) requirements that apply to an approved PEO, or to a Plan and Trust to the same extent as the provisions apply to any entity that the TDI regulates. That section alone would effectively treat the self-funded Benefit Plan of a PEO as a fully insured plan, thereby eliminating many, if not most, of the advantages of a self-funded plan that were presumably envisioned by the Legislature when it enacted Chapter 91.

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Given the limited availability of affordable fully insured plans that will comply with ACA and the important economic role played by staffing and temporary agencies in Texas who will cease offering self-funded Benefit Plans or potentially be put of business for complying (or failing to comply) with the proposed rules set forth in the Informal Working Draft, we respectfully request the TDI to consider an additional comment period on the Informal Working Draft before finalizing such rules.

Finally, the Informal Working Draft contains a rule that requires PEO employers to transmit contributions within two (2) business days of receipt. *See* Section 13.542 of the Informal Working Draft. This seems particularly onerous, as very few employers could meet this requirement, and neither the DOL nor ERISA imposes such requirements even on employee contributions to tax qualified profit-sharing plans, commonly known as "401(k)" plans. At a minimum, we suggest that contributions be permitted when such contributions can reasonably be segregated from an employer's assets, but not more than 90 days after receipt. *See* DOL Technical Release 92-01, *found at,* http://www.dol.gov/ebsa/newsroom/tr92-01.html

TAX SECTION
State Bar of Texas

December 19, 2014

Via email to Teresa.Bostick@cpa.state.tx.us

Ms. Teresa G. Bostick
Texas Comptroller of Public Accounts
Manager, Tax Policy Division
P. O. Box 13528, Capitol Station
Austin, TX 78711-3528

RE: Comments Pertaining to The Texas Comptroller's Proposed Amended Rule 3.286, Relating to Seller's and Purchaser's Sales and Use Tax Responsibilities and Nexus

Dear Ms. Bostick:

The Tax Section of the State Bar of Texas is providing comments in response to solicitation of comments pertaining to proposed amended Comptroller Rule 3.286 relating to sales and use tax responsibilities and nexus. The proposed amended rule was published in the November 14, 2014 edition of the Texas Register. We appreciate your having agreed to extend the time within which to submit our comments.

THE COMMENTS ENCLOSED WITH THIS LETTER ARE BEING PRESENTED ONLY ON BEHALF OF THE TAX SECTION OF THE STATE BAR OF TEXAS. THE COMMENTS SHOULD NOT BE CONSTRUED AS REPRESENTING THE POSITION OF THE BOARD OF DIRECTORS, THE EXECUTIVE COMMITTEE OR THE GENERAL MEMBERSHIP OF THE STATE BAR OF TEXAS. THE TAX SECTION OF THE STATE BAR OF TEXAS, WHICH HAS SUBMITTED THIS LETTER, IS A VOLUNTARY SECTION OF MEMBERS COMPOSED OF LAWYERS PRACTICING IN A SPECIFIED AREA OF LAW.

THE COMMENTS ARE SUBMITTED AS A RESULT OF THE APPROVAL OF THE COMMITTEE ON GOVERNMENT SUBMISSIONS OF THE STATE BAR OF TEXAS TAX SECTION, WHICH IS THE GOVERNING BODY OF THAT SECTION. NO APPROVAL OR DISAPPROVAL OF THE GENERAL MEMBERSHIP OF THIS SECTION HAS BEEN OBTAINED AND THE COMMENTS REPRESENT THE VIEWS OF THE TAX SECTION MEMBERS WHO PREPARED THEM.

1414 Colorado Street, Austin, TX 78701
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We greatly appreciate the opportunity to work with your office on these significant tax issues and hope to provide relevant analysis for your review. Thank you for your consideration.

Respectfully submitted,

Andrius R. Kontrimas
Chair, Tax Section
The State Bar of Texas

COMMENTS PERTAINING TO THE TEXAS COMPTROLLER'S PROPOSED AMENDED RULE 3.286

These comments, submitted in response to proposed amended Comptroller Rule 3.286, as published in the Texas Register on November 14, 2014, are presented on behalf of the Tax Section of the State Bar of Texas (the "Section"). The principal drafters of these comments include the Chair and Vice Chair of the Section's Committee on State and Local Taxation, Charolette Noel and Sam Megally, and Section members Alyson Outenreath, Karen Currie and Kirk Lyda. The Section's Committee on Government Submissions ("COGS") has approved these comments. Robert Probasco, Chair of COGS, reviewed these comments. Ira Lipstet also reviewed these comments and made substantive suggestions on behalf of COGS.

Although many of the persons who participated in preparing this letter have clients who would be affected by the state tax principles addressed by this letter or have advised clients on the application of such principles, no such person (or the firm or organization to which such member belongs) has been engaged by a client to make a government submission with respect to, or otherwise to influence the development or outcome of, the specific subject matter of this letter.

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Date: December 19, 2014

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I. INTRODUCTION

This letter provides comments concerning the proposed adoption of 34 Tex. Admin. Code § 3.286, relating to Sales and Use Tax Responsibilities and Nexus ("Proposed Rule 3.286").[1]

We recognize and appreciate the time and thoughtful work invested by the Texas Comptroller of Public Accounts ("Comptroller") in preparing Proposed Rule 3.286 and the descriptions and context provided by the preamble. We also appreciate the efforts of the Comptroller to survey existing authority and update existing Rules, particularly as needed to reflect statutory changes. These efforts are extremely useful to taxpayers and practitioners. It is our intent to present items for consideration that may help and support Comptroller personnel in this endeavor.

While most of our comments focus on modifications in Proposed Rule 3.286 to provisions related to the definition of being engaged in business and the connection between that definition and the definition of having nexus in the state, we have also provided comments on the revised definition of a "taxable item." Following are our comments and suggestions addressing these issues.

II. PROPOSED RULE 3.286 COMMENTS

As an initial matter, we wish to reiterate our appreciation for the helpful descriptions of the proposed amendments provided by the preamble to Proposed Rule 3.286. Based on the initial paragraph of that preamble, we understand that the amendments reflected in Proposed Rule 3.286 are not intended to change longstanding policy, except to incorporate statutory changes made by the Texas Legislature in 2011 and 2013. In general, our comments recommend clarifications consistent with this stated intent.

A. Inconsistent Terminology Between the Tax Code and Proposed Rules

As a general matter, we have concerns that some provisions of Proposed Rule 3.286 incorporate terminology that varies from the terminology used in Chapter 151 of the Texas Tax Code,[2] particularly related to the use of the terms "retailer," "seller" and "person." These terms are sometimes used interchangeably although the terms appear to have distinct and sometimes inconsistent definitions. For example, Proposed Rule 3.286(a)(3) generally uses the term "person" where the corresponding statutory provision in Tax Code § 151.107(a) uses the term "retailer." Also, Proposed Rule 3.286(a)(11) appears to adopt a unique definition of "seller" that varies from the statutory use of the term "seller" as used in Tax Code § 151.008(a).

We suggest that Proposed Rule 3.286 incorporate consistent definitions of statutory terms to limit confusion and avoid potentially inconsistent interpretations of statutory provisions.

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[1] Hereinafter, all references to "Rule" or "Rules" (as appropriate) are to Chapter 34 of the Texas Administrative Code.

[2] Hereinafter, all references to "Tax Code" are to Chapter 151 of the Texas Tax Code.

B. Amendments to the Definition of "Engaged in Business"

According to the preamble:

> Renumbered paragraph (3) [of Proposed Rule 3.286(a)], which defines the term "engaged in business," is amended to more closely follow the language of Tax Code, § 151.107(a). The reference to the term "nexus" in this paragraph is deleted, as the definition of the term "nexus" is revised to state that a person has nexus with this state if the person is engaged in business in this state . . . .

We applaud the Comptroller's goal to more closely follow the language of the Texas Tax Code and understand that it may be helpful to cross reference the definition of "nexus" to clarify that a person has nexus with the state if the person is engaged in business in the state. As drafted, however, Proposed Rule 3.286(a)(3) appears to unintentionally deviate from the language of Tax Code § 151.107(a), which describes when a retailer is engaged in business in this state.

As written, some of the subsections of Proposed Rule 3.286(a)(3) appear to treat a person as doing business "in this state" simply because another affiliated person maintains a location or uses facilities or advertising in the state. The language in the Tax Code, on the other hand, describes the required in-state "nexus" by linking the representatives or affiliates to the retailer's sales. To clarify the terminology and more closely follow the statutory language of Tax Code § 151.107(a), we respectfully suggest that the Comptroller consider revising Proposed Rule 3.286(a)(3). Proposed changes are shown below, with strikethroughs for deleted text and underlines for added text:

> (3) Engaged in business--A person is engaged in business in this state if the person:
>
> (A) maintains, occupies, or uses in this state, permanently or temporarily, directly or indirectly, or through an agent by whatever name called, a kiosk, office, distribution center, sales or sample room or place, warehouse or storage place, or any other physical location where business is conducted;
>
> (B) has any representative, agent, salesperson, canvasser, or solicitor who operates under the authority of the person to conduct business in this state, including selling, delivering, or taking orders for taxable items;
>
> (C) promotes a flea market, arts and crafts show, trade day, festival, or other event in this state that involves sales of taxable items;

(D) uses independent salespersons, who may include, but are not limited to, distributors, representatives, or consultants, in this state <u>to conduct the person's</u> ~~in~~ direct sales of taxable items;

(E) derives receipts from the sale, lease, or rental of tangible personal property that is located in this state or owns or uses tangible personal property that is located in this state, including a computer server or software <u>to solicit orders for taxable items</u>, unless the person uses the software as a purchaser of an Internet hosting service;

(F) allows a franchisee or licensee to operate under its trade name in this state if the franchisee or licensee is required to collect sales or use tax in this state;

(G) otherwise conducts business in this state through employees, agents, or independent contractors;

(H) is formed, organized, or incorporated under the laws of this state and the person's internal affairs are governed by the laws of this state, notwithstanding the fact that the person may not be otherwise engaged in business in this state pursuant to this section; or

(I) holds a substantial ownership interest in, or is owned in whole or substantial part by, another person who:

(i) maintains a distribution center, warehouse, or similar location in this state and delivers property sold by the <u>aforementioned</u> person to purchasers in this state;

(ii) maintains a location in this state from which business is conducted, ~~if both persons sell~~ <u>and sells</u> the same or substantially similar lines of products <u>as the aforementioned out-of-state person (i.e., the person that has no connection with this state other than ownership of or by the in-state seller)</u>, <u>and sells such products under a business name that is the same as</u> ~~under the same~~ or substantially similar <u>to the</u> business name~~s~~ <u>of the aforementioned out-of-state person if the in-state seller:</u>

<u>(I) uses its facilities or employees to advertise, promote, or facilitate sales by the aforementioned person to purchasers; or</u>

<u>(II) otherwise performs any activity on behalf of the aforementioned person that is intended to establish or maintain a marketplace for the aforementioned person in this state, including receiving or exchanging returned merchandise</u>; or

(iii) maintains a location in this state from which business is conducted, if the <u>other</u> person with the location in this state:

(I) uses its facilities or employees to advertise, promote, or facilitate sales by the ~~other~~ <u>aforementioned</u> person to purchasers; or

(II) otherwise performs any activity on behalf of the ~~other~~ <u>aforementioned</u> person that is intended to establish or maintain a marketplace for the <u>aforementioned</u> person in this state, including receiving or exchanging returned merchandise.

C. Nexus

The term "nexus" is defined in Proposed Rule 3.286(a)(7). Proposed Rule 3.286(a)(7) begins by defining "nexus" to mean "[s]ufficient contact with or activity within this state, as determined by state and federal law, to require a person to collect and remit sales and use tax." Subpart (A) of Proposed Rule 3.286(a)(7) further provides that "[a] person has nexus with this state if the person is engaged in business in this state."

As described above, Proposed Rule 3.286(a)(3), provides the definition of "engaged in business" and enumerates a list of activities that constitute being engaged in business. The preamble explanation of certain changes to the definition of "engaged in business" seems to indicate an intention to tie "nexus" and "engaged in business" together. It states: "The reference to the term "nexus" in [paragraph (a)(3)] is deleted, as the definition of the term 'nexus' is revised to state that a person has nexus with this state if the person is engaged in business in this state." Because of how the Comptroller defines "nexus" to tie into the "engaged in business" definition, the "engaged in business" definition in Subsection (a)(3) seemingly provides the list of activities that create nexus for sales and use tax collection purposes.

Although not entirely clear, subpart (A) of Proposed Rule 3.286(a)(7) seems to limit "nexus" solely to the defined list of activities deemed to be "engaged in business" under Proposed Rule 3.286(a)(3). The "lead-in" sentence to the nexus definition in Proposed Rule 3.286(a)(7) appears to define nexus more broadly. Thus, Proposed Rule 3.286 might be interpreted as creating two nexus rules -- one based on federal and state law in Proposed Rule 3.286(a)(7) and the other based on the narrower enumerated "engaged in business" list in Proposed Rule 3.286(a)(3).

The narrower interpretation of nexus also seems to be supported by Proposed Rule 3.286(a)(7)(B), which provides that a person does *not* have nexus with this state if (i) the person's only activity in this state is conducted as an unrelated user of an Internet hosting service; or (ii) the person has no connection with this state except the possession of a certificate of authority to do business in this state issued by the Texas Secretary of State. Initially, we suggest that the Comptroller consider expanding this provision to address the statutory language of Tax Code 151.107(b). That language suggests that a person does not have nexus with this state if the person's only activity in this state is through the dissemination of national advertising that is not intended to be disseminated primarily to consumers in this state and does not appear exclusively in a Texas edition or section of a national publication. Also, similar to the analysis of subpart (A), we note that subpart (B) of Proposed Rule 3.286(a)(7) appears to create two rules, but this time for what does *not* create nexus.

In the end, as currently written, the two sets of nexus rules described above arguably create a disconnect because under the "narrower" rules of Proposed Rule 3.286(a)(3) nexus is deemed to exist only by state law, in defined enumerated situations, *and not also by federal law.* Moreover, some of the situations enumerated in Proposed Rule 3.286(a)(3), to the extent such contacts with the state are *de minimis*, would appear to conflict with the constitutional requirement of "substantial nexus" and the U.S. Supreme Court's rejection of a "slightest presence" standard. *See, e.g., Quill v. North Dakota*, 504 U.S. 298, 315 n.8 (1992) (company's ownership of a few floppy diskettes in the state was a "slender thread" of nexus that failed the "substantial nexus" requirement of the Constitution). Due to these perceived issues, we suggest that the relationship between "nexus" and being "engaged in business" be clarified so that Proposed Rule 3.286(a)(7), in conjunction with Proposed Rule 3.286(a)(3), does not unintentionally create nexus standards that do not comport with state and federal law

D. "Seller" for Sales and Use Tax Purposes

1. Definition of "Seller"

Proposed Rule 3.286(a)(11) begins by defining a "seller" to mean "[e]very retailer, wholesaler, distributor, manufacturer, or any other person *engaged in the business of selling taxable items in this state* who sells, leases, rents, or transfers ownership of tangible personal property or performs taxable services in this state for consideration" (emphasis added). We note that the definition of "seller" in Proposed Rule 3.286(a)(11) differs from the statutory definition in Tax Code § 151.008(b). In particular, the language of Tax Code § 151.008(b) generally does not limit "sellers" to those engaged in the business of selling taxable items *in this state*. We recommend that the definition of "seller" not be limited to someone who is "engaged in … business … in this state," so that the definition in Proposed Rule 3.286 of the term "seller" is consistent with that used in the statute. Applying a different, narrower, definition of "seller" in the Proposed Rule compared to the statute may lead to confusion where the statutory provisions refer to out-of-state sellers, such as in Tax Code § 151.007(b).

The term "seller" is further defined by a list of examples that describe certain types of persons to be "a seller responsible for . . . collection and remittance." The grammatical structure of the examples, which include one type of person who is "not considered a seller responsible for . . . collection and remittance" may prove confusing. We recommend providing numbered examples of sellers in a subpart (A) and describing any examples of non-sellers in a separate subpart (B). In addition, it may be helpful for the Comptroller to consider creating a new subpart to describe the responsibilities for collection and remittance separate from the definitional examples in subparts (A), (B), (C), and (D).

2. Permit Requirements

Proposed Rule 3.286(b)(1) provides: "Each seller who *has nexus with* this state must apply to the comptroller and obtain a sales and use tax permit for each place of business operated in this state" (emphasis added). Proposed Rule 3.286(b)(2) begins by stating: "Each out-of-state seller who is *engaged in business* in this state must apply to the comptroller and obtain a sales and use tax permit" (emphasis added).

As a general matter, it would seem appropriate to have a consistent standard for requiring in-state and out-of-state sellers to obtain a sales and use tax permit. Because of how Proposed Rule 3.286(a)(3) and (a)(7) attempt to create a connection between the definitions of "nexus" and "engaged in business," it is unclear whether the emphasized language above in Proposed Rule 3.286(b)(1) and (b)(2) was intended to establish two different standards. To clarify that one standard should apply, it may be appropriate to revise the emphasized language above in Proposed Rule 3.286(b)(2) to state: "Each out-of-state seller who ~~is engaged in business~~ has nexus in this state must apply to the comptroller and obtain a sales and use tax permit..." (strikethrough used for deleted text and underline used for added text.)

E. "Taxable Item" Definition

Proposed Rule 3.286(a)(12) would change the definition of "taxable item" so that it reads:

> Except as otherwise provided in Tax Code, Chapter 151, the term includes tangible personal property and taxable services transferred or used in any electronic form or media now in existence or which may be later devised instead of in or on physical media.

In contrast, Rule 3.286(a)(10), as it currently exists, defines the term "taxable item" to mean "tangible personal property and taxable services."

With respect to this definitional change, the preamble states that the reason for the amendment is to "conform more closely to the statutory definition of the term in Tax Code, § 151.010." Tax Code § 151.010 states:

> "Taxable item" means tangible personal property and taxable services. Except as otherwise provided by this chapter, the sale or use of a taxable item in electronic form instead of on physical media does not alter the item's tax status.

The amended definition in Proposed Rule 3.286(a)(12) appears to exceed the statutory language of Tax Code § 151.010 by use of the phrase "now in existence or which may be later devised instead of in or on physical media." Indeed, Tax Code § 151.010 provides that the sale or use of a taxable item in "electronic form instead of on physical media does not alter the item's tax status," but this is not the language used in Proposed Rule 3.286(a)(12). It is unclear what the phrase "now in existence or which may be later devised instead of in or on physical media" means. Further, the language could be interpreted to mean that a new, *additional* taxable item is created, upon which use tax would be due, if an item is converted in the future to a new medium by the owner or licensee. This result appears inconsistent with the direct language of Tax Code § 151.010.

Because the new definition of "taxable item" in Proposed Rule 3.286(a)(12) appears to be broader than what is statutorily contained in Texas Tax Code § 151.010, we recommend that the Comptroller revise the proposed new definition so that it reads:

> The term includes tangible personal property and taxable services. Except as otherwise provided in Tax Code, Chapter 151, the sale or use of a taxable item in electronic form instead of physical media does not alter the item's tax status.

F. Cessation of Out-of-State Sellers Responsibility

Similarly, because of how Proposed Rule 3.286(a)(3) and (a)(7) attempt to create a connection between the definitions of "nexus" and "engaged in business," it appears that Proposed Rule 3.286(b)(2) should be revised to delete the term "engaged in business" and replace such term with "nexus." Suggested changes are shown below (with underlines for added text and strikethroughs for deleted text, including language no longer needed when the term "nexus" is used instead of "engaged in business"):

> An out-of-state seller is responsible for the collection and remittance of sales and use tax on all sales of taxable items made in this state until the seller ceases to ~~be engaged in business~~ <u>have nexus</u> in this state. ~~An out-of-state seller ceases to be engaged in business in this state when the seller no longer has nexus with this state and no longer intends to engage in activities that would establish nexus with the state~~. For example, an out-of-state seller who enters the state each year to participate in an annual trade show does not cease to ~~be engaged in business~~ <u>have nexus</u> in this state between one trade show and the next. In contrast, an out-of-state seller who discontinues the product line that it marketed and sold in this state, and who does not anticipate entering the state to solicit new business, has ceased ~~to be engaged in business~~ <u>having nexus</u> in this state. An out-of-state seller is required to maintain, for at least four years after the out-of-state permit holder ceases to ~~be engaged in business~~ <u>have nexus</u> in this state, all records required by subsection (j) of this which the out-of-state permit holder ceased to ~~be engaged in business~~ <u>have nexus</u> in this state.

We also think the foregoing language in Proposed Rule 3.286(b)(2) would be more instructive if the same example were used to explain when an out-of-state seller would and would not continue to have nexus with Texas, as follows (with proposed changes in strikethroughs and underlines):

> For example, an out-of-state seller who enters the state each year to participate in an annual trade show does not cease to have nexus

in this state between one trade show and the next. In contrast, an out-of-state seller who discontinued entering Texas each year to participate in an annual trade show would cease to have nexus in this state beginning the day after the out-of-state seller was last in Texas. ~~s the product line that it marketed and sold in this state, and who does not anticipate entering the state to solicit new business, has ceased having nexus in this state.~~ An out-of-state seller is required to maintain, for at least four years after the out-of-state permit holder ceases to have nexus in this state, all records required by subsection (j) of this which the out-of-state permit holder ceased to have nexus in this state.

III. CONCLUSION

We greatly appreciate the opportunity to work with your office on these significant tax issues and hope these comments provide relevant analysis for your review. Thank you for your consideration.

TAX SECTION
State Bar of Texas

December 3, 2014

Via email to Teresa.Bostick@cpa.state.tx.us

Ms. Teresa G. Bostick
Texas Comptroller of Public Accounts
Manager, Tax Policy Division
P. O. Box 13528, Capitol Station
Austin, TX 78711-3528

RE: Comments of the Tax Section of the State Bar of Texas in Response to Texas Comptroller Request for Comments Pertaining to Proposed New Rule 3.280 Relating to Aircraft and Proposed New Rule 3.285 Relating to Sales for Resale

Dear Ms. Bostick:

The Tax Section of the State Bar of Texas is providing comments pertaining to proposed new Comptroller Rules 3.280 and 3.285 relating to aircraft and sales for resale, respectively. The proposed new rules were published in the October 31, 2014 edition of the Texas Register. We appreciate your having agreed to extend the time within which to submit our comments in light of the holidays.

THE COMMENTS ENCLOSED WITH THIS LETTER ARE BEING PRESENTED ONLY ON BEHALF OF THE TAX SECTION OF THE STATE BAR OF TEXAS. THE COMMENTS SHOULD NOT BE CONSTRUED AS REPRESENTING THE POSITION OF THE BOARD OF DIRECTORS, THE EXECUTIVE COMMITTEE OR THE GENERAL MEMBERSHIP OF THE STATE BAR OF TEXAS. THE TAX SECTION OF THE STATE BAR OF TEXAS, WHICH HAS SUBMITTED THIS LETTER, IS A VOLUNTARY SECTION OF MEMBERS COMPOSED OF LAWYERS PRACTICING IN A SPECIFIED AREA OF LAW.

THE COMMENTS ARE SUBMITTED AS A RESULT OF THE APPROVAL OF THE COMMITTEE ON GOVERNMENT SUBMISSIONS OF THE STATE BAR OF TEXAS TAX SECTION, WHICH IS THE GOVERNING BODY OF THAT SECTION. NO APPROVAL OR DISAPPROVAL OF THE GENERAL MEMBERSHIP OF THIS SECTION HAS BEEN OBTAINED AND THE COMMENTS REPRESENT THE VIEWS OF THE TAX SECTION MEMBERS WHO PREPARED THEM.

1414 Colorado Street, Austin, TX 78701
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We greatly appreciate the opportunity to work with your office on these significant tax issues and hope to provide relevant analysis for your review. Thank you for your consideration.

Respectfully submitted,

Andrius R. Kontrimas
Chair, Tax Section
The State Bar of Texas

COMMENTS PERTAINING TO THE TEXAS COMPTROLLER'S PROPOSED NEW RULES 3.280 AND 3.285 AS PUBLISHED IN THE TEXAS REGISTER ON OCTOBER 31, 2014

These comments, submitted in response to proposed new Comptroller Rules 3.280 and 3.285, as published in the Texas Register on October 31, 2014, are presented on behalf of the Tax Section of the State Bar of Texas (the "Section"). The principal drafters of these comments include the Chair and Vice Chair of the Section's Committee on State and Local Taxation, Charolette Noel and Sam Megally, and Section members Alyson Outenreath, David Cowling, Kirk Lyda, and Cindy Ohlenforst. The Section's Committee on Government Submissions ("COGS") has approved these comments. Robert Probasco, Chair of COGS, reviewed these comments.

Although many of the persons who participated in preparing this letter have clients who would be affected by the state tax principles addressed by this letter or have advised clients on the application of such principles, no such person (or the firm or organization to which such member belongs) has been engaged by a client to make a government submission with respect to, or otherwise to influence the development or outcome of, the specific subject matter of this letter.

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Date: December 3, 2014

I. INTRODUCTION

This letter provides comments concerning the proposed adoption of 34 Tex. Admin. Code § 3.280, relating to Aircraft ("Proposed Rule 3.280"), and proposed amendments to 34 Tex. Admin. Code § 3.285, relating to Resale Certificate; Sales for Resale ("Proposed Rule 3.285").[1]

We recognize and appreciate the tremendous amount of time and thoughtful work invested by the Comptroller in preparing these Proposed Rules and the descriptions and context provided by the preambles. We also appreciate the efforts of the Texas Comptroller of Public Accounts (the "Comptroller") to survey existing authority and update existing Rules and draft new Rules. These efforts are extremely useful to taxpayers and practitioners. We recognize and appreciate the challenges facing the Comptroller when balancing the task of providing a fair and transparent administrative policy related to aircraft and sale-for-resale issues against the Comptroller's need for an efficient administrative process to resolve related claims and controversies. It is our intent to present items for consideration that may help and support Comptroller personnel.

The focus of these comments is on the modification and/or addition of Proposed Rule provisions that dictate the policy on taxable transactions and non-taxable transactions involving aircraft, including circumstances under which a purchase may qualify for the sale-for-resale exemption. It is our understanding that the provisions in Proposed Rules 3.280 and 3.285 are not intended to narrow the interpretation of the specific statutory exemptions available for certificated or licensed carriers of persons or property, including under Texas Tax Code Section 151.328(a)(1), so our comments do not address changes that might otherwise be recommended to conform to statutory language. While most of our comments focus on Proposed Rule provisions regarding aircraft, we have also provided comments to Proposed Rule 3.285 relating to sales for resale that have broader application. Following are our comments and suggestions addressing these issues in the context of both Proposed Rules.

II. PROPOSED RULE 3.280 COMMENTS

As background to our comments, we note that the Texas Tax Code generally treats aircraft in a manner similar to other types of tangible personal property under Chapter 151 of the Texas Tax Code (the "Sales Tax Law"). For example, the sale-for-resale provisions of the Sales Tax Law enacted by the Texas Legislature (the "Legislature") generally do not draw a distinction between aircraft and other types of tangible personal property (sometimes referred to herein as "TPP").[2] Except where the Legislature has enacted a special rule for aircraft, we suggest the

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[1] Hereinafter, all references to "Rule" or "Rules" (as appropriate) are to Chapter 34 of the Texas Administrative Code.

[2] The Sales Tax Law does draw a distinction between certain types of TPP. For example, TPP used to perform a taxable service is not considered resold unless the care, custody, and control of the TPP is transferred to the purchaser of the services. Tex. Tax Code § 151.302(b). Internal or external wrapping, packing, and packaging supplies used by a person in wrapping, packing, or packaging TPP or in the performance of a service of furthering the sale of TPP or the service may not be purchased by the person for resale. Tex. Tax Code § 151.302(c).

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Comptroller consider conforming Proposed Rule 3.280 to the general Sales Tax Law and the Comptroller's longstanding policies interpreting the Sales Tax Law.

A. The Doctrine of Legislative Acquiescence

As a general matter, we have concerns that some provisions of Proposed Rule 3.280 appear designed to change longstanding policies that the Legislature has confirmed by acquiescence and on which taxpayers rely in working to comply with the Sales Tax Law. The doctrine of legislative acquiescence applies when a particular construction of a statute is of such longstanding significance that it should not be changed in the absence of clear statutory authorization. *Humble Oil & Ref. Co. v. Calvert*, 414 S.W.2d 172, 180 (Tex. 1967). The sale-for-resale exemption was adopted with the original Texas Sales Tax statutes in 1961 and enacted (in its current form) in 1981 during the recodification of the prior Texas Tax Code. For many years, the Comptroller applied the resale exemption to aircraft and other types of TPP in the same manner. During this time, the Legislature amended Sales Tax Law Section 151.302 (the sale-for-resale exemption) on two separate occasions, and Sales Tax Law Section 151.006 (the definition of sale for resale) on three separate occasions. None of these amendments impacted or limited the manner in which the sale-for-resale exemption applies to aircraft. When a statute that has been construed by the proper administrative officers is reenacted without any substantial change in verbiage, it will ordinarily receive the same construction. *Humble Oil*, 414 S.W.2d at 172.

In November 2006, the Comptroller announced a departure from her prior policy, stating that she would prospectively evaluate taxability of aircraft transactions based on subjective tests of economic substance and valid business purpose. *See* Comptroller Letter Ruling, STAR Accession No. 200611755L (Nov. 15, 2006). Notwithstanding this announcement, it appears that the Legislature has not adopted the Comptroller's new approach. Since this announced policy change, the Legislature has not amended Sales Tax Law Section 151.302. While Sales Tax Law Section 151.006 sale for resale was amended in 2011, such amendments were made during an Extraordinary Legislative Session and enacted in response to recent cases addressing the applicability of the exemption to purchases of property to be resold as an integral part of a service not subject to tax; the amendments did not address the applicability of the sale-for-resale exemption to aircraft. These 2011 amendments do not evidence that the Legislature has acquiesced in the Comptroller's 2006 change in policy. *Cf. Sharp v. House of Lloyd, Inc.*, 801 S.W.2d 245, 248 (Tex. 1991) (clarifying that the doctrine of legislative acquiescence applies only where there has been an affirmative longstanding administrative policy); *Sharp v. Park 'n Fly*, 696 S.W.2d 572 (Tex. App. 1998—Austin, pet. denied) (holding that the passage of only five years before the Comptroller asserted a contradictory construction does not rise to such a level as to be an affirmative longstanding departmental construction giving rise to the doctrine of legislative acquiescence). Rather, the doctrine of legislative acquiescence would more likely apply to the decades-long policy, prior to 2006, of respecting intercompany transactions and determining the sale-for-resale exemption based on satisfaction of the specified statutory exemption requirements. *Compare* Comptroller Letter Ruling, STAR Accession No. 7607L0026E10 (July 29, 1976) (resale certificates should be issued when aircraft is purchased for lease and subsequent lease payment subject to sales tax unless leased for an exempt purposes) (superseded without comment) *and* Comptroller Hearing No. 38,128, STAR Accession No. 200009860H (Sept. 14, 2000) (purchase of aircraft for lease to affiliate respected as sale for resale) (superseded on Nov. 22, 2011 for change of sale-for-resale policy with reference to Hearing No. 102,653, STAR Accession No. 201110276H, ruling on policy change to disregard the sale-for-resale if intercompany lease deemed below fair market value); *see also,* Comptroller Letter Ruling, STAR Accession No. 9004L1020A01 (Apr. 10, 1990) (transfer of aircraft as contribution to capital is not subject to Texas sales or use tax if no consideration is given by a wholly-owned subsidiary) (superseded Nov. 15, 2006 due to subsequent policy change with reference to Accession No. 200611755L); Comptroller Letter Ruling, STAR Accession No. 9502L1333G03 (Feb. 7, 1995) (Texas use tax not applicable to flight use in Texas after distribution of aircraft without consideration as a result of dissolution) (superseded Nov. 15, 2006 due to subsequent policy change with reference to Accession No. 200611755L); Comptroller Letter Ruling, STAR Accession No. 9803325L (Mar. 25, 1998) (Texas use tax not applicable when aircraft transferred to newly-formed subsidiary that hangars the airplane in Texas) (superseded on Nov. 15, 2006 due to subsequent policy clarification with reference to Accession No. 200611755L); Comptroller Letter Ruling, STAR Accession No. 200108953L (Aug. 20, 2001) (LLC that received aircraft for initial capitalization and took possession outside Texas was not subject to Texas sales or use tax where aircraft will be hangared in Texas flights both inside and outside the State) (superseded on Nov. 15, 2006 due to subsequent policy clarification with reference to Accession No. 200611755L).

B. Recharacterization of Intercompany Transactions

The Comptroller's economic substance principle is set forth in Proposed Rule 3.280(c)(5), relating to use tax, which provides:

> When a person purchases an aircraft outside this state and, within one year of the purchase, transfers title or possession of the aircraft to another person for hangaring or other use in this state by any means other than sale in the regular course of business, both the purchaser and the affiliated entity are considered to be storing, using, or consuming the aircraft in the state and the comptroller may recover use tax against either person . . . .

Our first concern with respect to Proposed Rule 3.280(c)(5) is that the Proposed Rule would permit imposition of use tax on certain aircraft transfers between affiliated entities. Thus, when one entity purchases an aircraft outside of Texas (such that no Texas sales tax would be due on the purchase) and later transfers such aircraft to an affiliated entity that then brings the aircraft into Texas, the Comptroller may ignore the separateness of the affiliated entities and collect tax as though the purchasing entity itself had brought the aircraft into Texas. The proposed language seems to create a new rule permitting the Comptroller to disregard the separate entity status of affiliated entities based solely on the timing of certain transactions. We have concerns that this provision of the Proposed Rule is inconsistent with longstanding statutory and judicial authority in Texas.

The preamble to Proposed Rule 3.280(c)(5) cites as support for the Comptroller's position a footnote in *Combs v. Roark Amusement & Vending, LP*, 422 S.W.3d 632 (Tex. 2013), which states that "The United States Supreme Court has long observed that statutory determinations in tax disputes should reflect the economic realities of the transactions in issue."

However, all but one of the cases cited in that footnote relate to federal income taxes. The one Texas case cited therein, *Bullock v. Statistical Tabulating Corp.*, 549 S.W.2d 166, 167–68 (Tex. 1977), involves the Sales Tax Law but articulates a doctrine applicable to transactions entirely different from the aircraft transactions targeted in the Proposed Rule. This "essence of the transaction" doctrine is used to characterize a sale of tangible items transferred along with non-taxable intangible items.

Unlike the Sales Tax Law, the Internal Revenue Code has long included provisions such as 26 U.S.C. § 482, which allows the Internal Revenue Service to "distribute, apportion, or allocate gross income, deductions, credits, or allowances between or among such organizations, trades, or businesses, if he determines that such distribution, apportionment, or allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of any of such organizations, trades, or businesses." Similarly, Treasury regulations such as 26 C.F.R § 301.7701-3, which allows organized legal entities to elect to be disregarded as separate entities for purposes of federal income taxation, have long supported administrative taxability determinations inconsistent with certain legal formalities. Further, in interpreting the Internal Revenue Code and Treasury regulations, courts have developed longstanding principles such as the step transaction doctrine, by which the courts may ignore the legal separateness of certain entities or the technical structure of certain transactions in order to reach conclusions that are inconsistent with certain legal formalities.

The Legislature has never enacted provisions similar to 26 U.S.C. § 482, and Texas case law has never supported interpretive principles such as the step transaction doctrine or the economic substance doctrine that Proposed Rule 3.280(c)(5) seeks now to adopt. Indeed, in the context of the pre-2008 Texas Franchise Tax Code, the Comptroller publicly admitted that Texas does not have an economic substance doctrine. *See* Comptroller Letter Ruling 9606338L, STAR Accession No. 9606L1417A11 ("Like all tax systems, the Texas franchise tax is not immune to tax avoidance strategies. Taxpayers can use legal yet artificial transactions to reduce their franchise tax liability. There are four commonly used methods. Two involve conversion from a corporate to a non-corporate, or 'pass-through' entity. Two others take advantage of the franchise tax apportionment rule for receipts from intangible assets. This rule is known as the 'location of payor' rule."). Without statutory amendments explicitly providing for such interpretations, it appears that Proposed Rule 3.280(c)(5) – by reversing longstanding Comptroller policy interpreting appropriately structured transactions consistent with the existing Texas statutory scheme – may exceed the Comptroller's rulemaking authority.

Additionally, to the extent Proposed Rule 3.280(c)(5) would disregard transfers between related entities, it is inconsistent with decades of cases in which the Comptroller has consistently required related companies to pay sales taxes on consideration paid in connection with inter-company sales, regardless of whether there were business reasons for the transactions. *See, e.g.*, Comptroller Hearing No. 6,843, STAR Accession No. 7702H0233C05 (Feb. 1977) (courts "have been reluctant to disregard the separate legal entities of the parties to grant relief from taxes at the expense of the State") (finding that, because "the Petitioner and its subsidiary are separate corporations[,]...a change of ownership [of certain property transferred from Petitioner to its subsidiary had] occurred.") If the Comptroller were to ignore transfers between related entities in the limited context of aircraft transactions, she could be faced with hundreds of claims for refund by taxpayers asserting that their asset transfers to related entities must also be ignored.

Further, to the extent Proposed Rule 3.280(c)(5) is intended to apply to aircraft transferred by merger or in an initial contribution to create an entity for no consideration, this provision conflicts with the underlying definition of "sale" in Sales Tax Law Section 151.005, which provides that, any "sale" or "purchase" upon which sales or use tax is imposed must be "done or performed for consideration." If a transfer of an aircraft to an affiliated entity does not occur for "consideration," then such transfer should not be subject to sales or use tax pursuant to this basic sales and use tax principle. *See, e.g.,* Comptroller Hearing No. 104,123, STAR Accession No. 201201361H (Jan. 2012) (aircraft contributed to corporation for no consideration is not taxable). Proposed Rule 3.280(c)(5) appears to be a special rule that would depart from the basic statutory principle but only for aircraft. We are not aware of anything in the statutory scheme of the Sales Tax Law that supports such a special rule for aircraft.

For the various reasons reflected above, we respectfully suggest that the Comptroller reconsider Subsection (c)(5) of Proposed Rule 3.280. To the extent she wishes to advance the interpretive scheme, we suggest it would be appropriate for the Comptroller to seek legislative amendments supporting such a material reversal of longstanding Texas statutory and judicial authority.

Further, if the Comptroller declines to strike Subsection (c)(5) from Proposed Rule 3.280, we would recommend the provision be clarified to limit the circumstances in which the form of a transaction -- and the separate existence of taxpayers – would be re-characterized. We suggest that such re-characterization should be apply, if at all, only when "a person . . . *for the purpose of avoiding the use tax*, transfers title or possession of aircraft to an affiliated entity for hangaring or other use in this state" (emphasis added).

Further, we note that this provision applies to a transfer "by any means other than a sale in the regular course of business." We believe that it would be more appropriate to refer to "any means other than a sale in the normal course of business." An activity that is in the regular course of business is part of the "day-to-day" operations of a business, according to the definition in Proposed Rule 3.285(a)(9). The "normal course of business" is defined as "usual or customary" in Proposed Rule 3.285(a)(8). Aircraft transfers, while they may be usual or customary, will likely never be part of the day-to-day operations of a business. We believe that an exception to re-characterization for a sale in the normal course of business would be appropriate, while an exception for an aircraft sale in the day-to-day operations of the business would be too narrow an exception.

C. "Sales Price" Exclusions for Cash Discount and Trade-in Value

Sales Tax Law Section 151.007, which defines "sales price" and provides statutory exclusions from the sales price, applies equally to aircraft and other types of tangible personal property. In pertinent part, Sales Tax Law Section 151.007(c) provides:

> "Sales price" or "receipts" does not include any of the following if separately identified to the customer by such means as an invoice, billing, sales slip or ticket, or contract:
>
> (1) a cash discount allowed on the sale;

[and]

(5) the value of tangible personal property that:

(A) is taken by a seller in trade as all or part of the consideration for a sale of a taxable item; and

(B) is of a type of property sold by the seller *in the regular course of business*; . . . .

Tex. Tax Code § 151.007(c) (emphasis added).

Proposed Rule 3.280(b)(2) provides, in part: "The total sales, lease, or rental price does not include separately stated cash discounts or the value of any tangible personal property taken as a trade-in by the seller in lieu of all or part of the price of the aircraft in the *normal course of business*." (emphasis added).

The terms "normal course of business" and "regular course of business" are defined in new Proposed Rule 3.285(a)(8) and Proposed Rule 3.285(a)(9), respectively. The preamble relating to those provisions states that "the comptroller intends that the terms 'normal course of business' and 'regular course of business' be given the same meaning for purposes of sales for resale and resale certificates only." Proposed Rule 3.280(b)(2) refers to the above-quoted Sales Tax Law Section 151.007 for information on determining the taxable sales price of an item of tangible personal property. Thus, use of the phrase "normal course of business" in Proposed Rule 3.280(b)(2) may be unintended.

We would recommend deleting the phrase "in the normal course of business" in Proposed Rule 3.280(b)(2) or, alternatively revising the quoted sentence in Proposed Rule 3.280(b)(2) to read, "The total sales, lease, or rental price does not include separately stated cash discounts or the value of any tangible personal property taken as a trade-in in the regular course of the seller's business." To the extent the Comptroller is seeking to apply a special rule only to aircraft, we are concerned that the provision may also violate the Equal and Uniform provision of the Texas Constitution.

D. A Service that Is Part of a Sale

Sales Tax Law Section 151.007(b) provides that the "total amount for which a taxable item is sold, leased, or rented *includes a service that is a part of the sale* and the amount of credit given to the purchaser by the seller." (emphasis added). Proposed Rule 3.280(b)(2) provides that "(2) Sales tax is due on the total sales, lease, or rental price of the aircraft, aircraft engine, or component part. The total sales, lease, or rental price *includes separately stated charges for any service or expense connected with the sale*, lease, or rental, including transportation or delivery charges." (emphasis added). Whether a service is *part of the sale* (the statutory test) appears to be a different -- and potentially broader and more subjective -- test than whether a service is *connected with the sale*. We respectfully suggest that the Comptroller consider revising the second sentence of Proposed Rule 3.280(b)(2) to conform to the statutory test.

E. Factors for Use Tax on Aircraft

Proposed Rule 3.280(c)(1) generally provides that use tax will apply to aircraft purchased or leased outside the state if the aircraft is "brought into this state to be hangared" or is "otherwise used in this state . . . as provided in this subsection." Subsection (c)(3) of Proposed Rule 3.280 further provides that "aircraft that is not hangared in this state is subject to use tax in Texas when it is used more than 50% of the time inside the state during the 12 months following the date that the owner or operator takes possession of the aircraft." To clarify the relationship of Subsection (c)(1) and Subsection (c)(3), we suggest that the first sentence of Subsection (c)(1) be revised to state, "Aircraft that is purchased, leased, or rented outside this state and brought into this state to be hangared or otherwise used as provided in subsection (c)(3) is subject to Texas use tax."

Further and more broadly, to the extent this special rule is intended to apply only to aircraft, we are concerned that the provision may also violate the Equal and Uniform provision of the Texas Constitution.

1. *Determining Whether an Aircraft is Hangared in Texas*

With respect to the evaluation of whether an aircraft is hangared in Texas, the introductory language of Proposed Rule 3.280(c)(2) includes language that creates ambiguity, including from a temporal standpoint, and also raises concerns under the general separation-of-powers doctrine. In particular, the second sentence of Proposed Rule 3.280(c)(2) provides that "[a]n aircraft is subject to use tax in Texas *when the comptroller determines* that the aircraft is stored in this state for longer than a temporary period during the 12 months ..." (emphasis added). Even assuming the "storage in this state for longer than a temporary period during the 12 months ..." test is appropriate, the Proposed Rule could be read as granting the Comptroller exclusive jurisdiction to determine if and "when" a use tax should be imposed in this situation. We recommend the Comptroller revise this sentence to delete the words "the comptroller determines that" and to provide more specific guidance for predicting what will be treated as "a temporary period."

Proposed Rule 3.280(c)(2)(D) provides that one factor the Comptroller "will consider" in determining whether an aircraft is stored in Texas for more than a temporary period is "whether the owner or operator of the aircraft is *a resident* of this state." (emphasis added). Proposed Rule 3.280(c)(2)(E) provides that another factor for determining whether an aircraft is stored in Texas for more than a temporary period is "whether the owner or operator of the aircraft is *engaged in business* in this state, as that term is defined by § 3.286 of this title" (emphasis added).

Neither the residence of the owner or operator nor whether the owner or operator is "engaged in business" in the state seems relevant to the determination of where an aircraft is stored and for how long. While, for convenience, the owner or operator may hangar its owned or leased aircraft in the owner's or operator's state of residence, we believe the state of residence should not be a controlling factor in determining whether a specific period of time is longer than a "temporary period." Whether the owner or operator is doing business in a state appears to be even less of a determinative factor, as the owner or operator may be conducting business in many states.

The preamble for Subsection (c)(2) of Proposed Rule 3.280 states that subparagraphs (D) and (E) were "added pursuant to Comptroller's Decision Nos. 43,525 (2006) and 101,452 (2010)." It does not appear that the Comptroller's Decisions cited in the preamble as authority for the subparagraphs (D) and (E) found the owner's or operator's state of residence to be controlling. Comptroller Decision 43,525 found that no Texas use tax was due, even though the aircraft was brought into Texas within the first year. That decision noted that "[s]ome factors to be considered in determining whether an aircraft is hangared in this state include: (A) where the aircraft is rendered for ad valorem taxes; (B) whether the owner owns or leases hangar space in the state; and (C) declarations made to the Federal Aviation Administration, an insurer, or other taxing authority concerning the place of storage of the aircraft." While Comptroller Decision 101,453 noted that the sole member of the owner of the plane resided in Texas, that factor was not controlling for determining where the plane was hangared. The residence of the owner of the plane was disputed, but the Comptroller found other factors controlling – the majority of the use of the aircraft during the first year after purchase was in Texas (flight logs showed that 27 of 48 flights during the first year after the purchase originated in Texas, 27 of 48 flights terminated in Texas, and 15 flights were intrastate in Texas).

Further, as noted in the preamble, the existing and longstanding Rule 3.297, adopted in 1998, incorporates only Subparagraphs (A), (B), and (C). Based on the foregoing, we suggest the Comptroller delete the language of Subparagraphs (D) and (E) in their entirety.

2. *Determining Taxable Use of Aircraft in Texas and New Corresponding Reporting Requirements*

Proposed Rule 3.280(c)(3) addresses when an aircraft purchased, leased, or rented outside the state will be considered used (and therefore subject to use tax) in Texas. Subsection (c)(3) specifies: "An aircraft that is not hangared in this state is subject to use tax in Texas when it is used more than 50% of the time inside this state during the calendar year following the date that the owner or operator takes possession of the aircraft."

In determining the percentage of time the aircraft will be considered used in the state, both current Rule 3.297(c)(3)(A) and Proposed Rule 3.280(c)(3)(B) state that flight time (including interstate flights in Texas airspace) is to be taken into account. Proposed Rule 3.280(c)(3)(B), however, considers different, additional factors. In particular, Proposed Rule 3.280(c)(3)(B) states, "In determining the percentage of time the aircraft was used in this state, the comptroller will *consider all time spent on the ground in this state* and all flight time in this state, including the portion of interstate flights in Texas airspace, and the comptroller may examine all flight, engine, passenger, airframe, and other logs and records maintained on the aircraft" (emphasis added).

This additional factor significantly changes the equation in making the determination as to what constitutes a taxable use. In other tax contexts, an aircraft is typically considered "used" when it is in flight. We suggest that adopting this new requirement of including time on the ground as a basis for determining use of an aircraft in Texas may be inconsistent with longstanding Texas law.

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Proposed Rule 3.280(c)(3) also imposes certain reporting requirements on the operator of the aircraft. For example, Proposed Rule 3.280(c)(3) provides: "An aircraft that is not hangared in this state is subject to use tax in Texas when it is used more than 50% of the time inside this state during the 12 months following the date that the owner or operator takes possession of the aircraft." Subsection (c)(3)(A), in turn, provides that "[t]he owner or operator of the aircraft *must maintain records sufficient to show where the aircraft was hangared outside this state, where the aircraft was stored inside the state, if at all, and the percentage of time the aircraft was used both inside and outside this state*." (emphasis added).

While the "record maintenance" requirement in Proposed Rule 3.280(c)(3)(A) (*i.e.*, the italicized language above) may be appropriate to impose on the owner of an aircraft because the owner is the actual taxpayer potentially subject to use tax, the rule does not seem appropriate to impose on a "non-taxpayer" operator. Accordingly, we suggest deleting the term "operator" from the italicized language. Alternatively, if the intent is to address the lessee of a leased aircraft, the language should be clarified.

Also, relating to reporting requirements, Proposed Rule 3.280(c)(4) provides:

> An aircraft is not considered to be hangared in this state if the aircraft is purchased, leased, or rented outside this state and then brought into this state for the sole purpose of repairing, remodeling, maintaining, or restoring the aircraft. Such repair, remodeling, maintenance, or restoration includes flights solely for troubleshooting, testing, or training, and flights between service locations under an FAA-issued ferry permit. Any use of the aircraft for business or pleasure travel during the time that the aircraft is being repaired, remodeled, maintained, or restored means that the aircraft was not brought into Texas for the sole purpose of repair, remodel, maintenance, or restoration. *Flight and maintenance logs and passenger lists must be provided to establish the actual use of the aircraft*. (emphasis added).

The italicized sentence raises some concerns, particularly if the term "must" suggests that flight and maintenance logs are the <u>only</u> evidence that can be used to establish use of an aircraft. Undoubtedly flight records are the best type of evidence to establish use, but other types of evidence exist as well. For example, affidavits and oral testimony could be relevant when flight records are incomplete or may be inaccurate. Furthermore, what if flight records are destroyed by fire or by some other casualty or are otherwise lost? Use of the term "must" apparently would not allow establishing use of the aircraft by any other evidence other than the written flight and maintenance logs and passenger lists. We suggest adding language allowing the taxpayer to provide relevant information beyond flight and maintenance logs and passenger lists in order to show use of the aircraft. For example, the italicized sentence could be revised to read: "The taxpayer must provide evidence to establish the actual use of the aircraft, which includes but is not limited to, flight and maintenance logs and passenger lists, and any business records of qualifying FAA Part 125 charter operators of aircraft."

F. Fly-Away Exemption

The "fly-away exemption" provisions in Proposed Rule 3.280(d)(4) appear to exceed the scope of the statute as applied to aircraft purchased in Texas, moved to another state prior to any taxable use in Texas, and brought back into Texas for possible use. We note that Sales Tax Law Section 151.328(a)(4), which provides one of several sales and use tax exemptions for aircraft, exempts an aircraft from both the Texas sales tax and the Texas use tax if the aircraft is "sold in this state to a person for use and registration in another state or nation before any use in this state other than flight training in the aircraft and the transportation of the aircraft out of this state." The statute applies a "first use" rule; it apparently does not condition the exemption on not using the aircraft in Texas after the aircraft was originally moved outside of Texas.

Proposed Rule 3.280(d)(4) indicates that the exemption is conditioned on the taxpayer not using the aircraft in Texas even after the aircraft has been moved outside of Texas prior to any other use. This appears to be inconsistent with the Sales Tax Law. We respectfully suggest that the Comptroller consider revising Proposed Rule 3.280(d)(4) to conform to Sales Tax Law Section 151.328(a)(4).

G. Divergent/Taxable Use After Purchase

Proposed Rule 3.280(e)(1) states: "Sales and use tax is due when an aircraft, aircraft engine, or component part sold, leased, or rented tax-free under a properly completed resale or exemption certificate is subsequently put to a taxable use *other than the use allowed under the certificate*" (emphasis added). The italicized language highlighted in the prior sentence is somewhat confusing. It seems to imply that there may be a level of specificity taxpayers must insert in exemption certificates beyond what is required in the statute. We suggest that the Comptroller delete the italicized language in its entirety so the provision would read: "Sales and use tax is due when an aircraft, aircraft engine, or component part sold, leased or rented tax-free under a properly completed resale or exemption certificate is subsequently put to a taxable use."

H. Purchase of Aircraft for Lease

Proposed Rule 3.280(j)(3) states:

> A person purchases an aircraft for the sole purpose of leasing or renting the aircraft to another person in the normal course of business when the person enters into lease agreements that transfer to the lessee operational control of the aircraft, as defined by the FAA at 14 Code of Federal Regulations 1.1., and control over when, by whom, and for whom the aircraft is used, for the duration of the lease term. An agreement under which the purchaser of the aircraft reserves the right to use the aircraft at any time, retains the right to control the scheduling or the chartering of the aircraft to a third party, or remains responsible for the insurance, maintenance, or storage of the aircraft does not transfer control the aircraft to the lessee.

As an initial matter, we note that the language of Proposed Rule 3.280(j)(3) creates ambiguity, including from a temporal standpoint, and raises concerns about application to various reasonable commercial business leasing terms. A person may purchase aircraft with the intent to lease before the time "when" the person enters into a lease agreement. It is not feasible for a person who sells an aircraft, to a purchaser who certifies the intent to sell or lease the aircraft, to monitor subsequent leasing agreements. And a person who purchases an aircraft with the intent to sell or lease it should not be deemed to have a "divergent use" if the person enters into a true lease of the property. The owner of a leased asset should not be prohibited from exercising prudent business judgment to insure its position with regard to the asset or from restricting certain uses of the asset. Accordingly, we respectfully recommend that Proposed Rule 3.280(j)(3) be revised to delete the phrase, "and control over when, by whom, and for whom the aircraft is used" and to clarify that compliance with FAA regulations, including Part 135 charter operations standards, for transferring operational control of an aircraft will is a "safe harbor" for the lease agreement to be respected as a valid lease.

Proposed Rule 3.280(j)(5) states:

> For purposes of this subsection, if the effective monthly lease rate for an aircraft is less than 1% of the purchase price of the aircraft, the lease is presumed, in the absence of evidence to the contrary, to be leased at a rate that is below fair market value and not within the normal course of business. The owner of the aircraft may rebut this presumption with contemporaneous evidence that the transaction was executed at a fair market value.

We are concerned that the "contemporaneous" requirement may be too restrictive, especially for small business taxpayers who may not have knowledge of the proposed new requirement. Further, non-contemporaneous evidence may exist that is equally as good, or better, in showing fair market value. Proposed Rule 3.280(j)(5) should permit the fact-finder to consider the best evidence. Accordingly, we suggest the Comptroller delete the "contemporaneous" requirement in its entirety.

Further, this restrictive pricing requirement appears to be a special rule applicable only in the context of sale-for-lease transactions of aircraft. To our knowledge, such a requirement is not applied to sale-for-resale transactions involving any other category of assets in Texas. Because we are not aware of any authority permitting the Comptroller to single out this one category of business for such restrictions that would deny sales and use tax exemptions, this provision raises concerns of violation of the Equal and Uniform standards of Texas Constitution.

I. Lump-Sum versus Completed Contract Provisions

We recommend that Proposed Rule 3.280(a) be clarified to conform the language so that only one standard is used to distinguish between a lump-sum contract and a separated contract with respect to invoice requirements. As currently drafted, Proposed Rule 3.280(a) could be viewed as adopting different tests. In particular, Proposed Rule 3.280(a)(15) defines a lump-sum contract as:

> [a] written agreement in which the agreed price is one lump-sum amount and in which the charge for incorporated materials is not separated from the charge for skill and labor. Separated invoices

> or billings issued to the customer will not change a written lump-sum contract into a separated contract *unless the terms of the contract require separated invoices or billings*. (emphasis added).

A separated contact is defined under Proposed Rule 3.280(a)(26) as:

> [a] written agreement in which the agreed price is divided into a separately stated charge for incorporated materials and a separately stated charge for skill and labor. An agreement is a separated contract if the charge for incorporated materials and the charge for labor are separately stated on an invoice or billing that, *according to the terms of the contract, is deemed to be a part of the contract.* Adding the separated charge for incorporated materials and the separated charge for labor together to give a lump-sum total does not transform a separated contract into a lump-sum contract. An aircraft repair, remodeling, maintenance, or restoration contract that separates the charge for incorporated materials from the charge for labor is a separated contract even if the charge for labor is zero. emphasis added).

Because these standards are not clearly the same and because a contract should be categorized as either a lump-sum contract or a separated contract, we recommend that the language be revised and clarified to adopt a single test that more clearly distinguishes between these two categories of contracts.

III. <u>PROPOSED RULE 3.285 COMMENTS</u>

The overlapping issues between Proposed Rule 3.280 and Proposed Rule 3.285 illustrate the Comptroller's recognition that rules and policies on resale and other issues must work for all types of property. Because Proposed Rule 3.285 will undoubtedly impact even more taxpayers than the aircraft rule, we have included comments on Proposed Rule 3.285 as well.

A. Acceptance of Resale Certificate: Independent Verification

Proposed Rule 3.285(e)(3) provides:

> All resale certificates obtained on or after the date the comptroller's auditor actually begins work on the audit at the seller's place of business, or on the seller's records after the entrance conference, are subject to independent verification by the comptroller. All incomplete resale certificates will be disallowed regardless of when they were obtained.

Because the above-quoted language does not indicate what the "independent verification" language means, we recommend clarifying this provision. The independent verification process should focus on verifying that the subject taxable items were acquired by the purchaser for resale in the normal course of business. Accordingly, we recommend that Proposed Rule 3.285(e)(3) be revised to add the clarifying language as indicated below:

> All resale certificates obtained on or after the date the comptroller's auditor actually begins work on the audit at the seller's place of business, or on the seller's records after the entrance conference, are subject to independent verification by the comptroller *that the taxable items were acquired by the purchaser for resale in the normal course of the purchaser's business.* All incomplete resale certificates will be disallowed regardless of when they were obtained. (emphasis added only for reference to additional text).

B. Acceptance of Resale Certificate: Good Faith Requirements

Proposed Rule 3.285(e)(2) provides that "[a] seller does not owe tax on a sale, lease, or rental of a taxable item if the seller accepts a properly completed resale certificate in good faith . . ." Subsections (A) through (C) then provide the requirements for establishing good faith. Subsection (C) specifically states that good faith is deemed to exist if:

> [T]he seller does not know, and does not have reason to know, that the sale is not a sale for resale. It is the seller's responsibility to be familiar with this state's sales tax law as it applies to the seller's business and to take notice of the information provided by the purchaser on the resale certificate. For example, a jewelry seller should know that a resale certificate from a landscaping service is invalid because a landscaping service is not in the business of reselling jewelry.

We recommend that Subsection (C) be clarified to provide sellers adequate notice of the requirement intended by the "does not have reason to know" requirement. We note that a provision exists in Rules 3.287(d)(5) and (d)(6), relating to exemption certificates, but these provisions contain less subjective language and include examples of valid and unacceptable exemption certificates. Comptroller Rule 3.287(d)(5) states:

> The exemption certificate will be valid if the seller received it in good faith from a purchaser and if the certificate states valid qualifications for an exemption. A retailer must be familiar with the exemptions that are available for the items the retailer sells. A retailer may accept a blanket exemption certificate given by a purchaser who purchasers only items that are exempt . . . .

Comptroller Rule 3.287(d)(6) states:

> An exemption certificate is not acceptable when an exemption is claimed because tangible personal property is exported outside the United States . . .

We recommend that Subsection (C) be revised to provide more precise notice as to what a seller should know, and needs to be able to show, in order to meet the "good faith" requirement. For example, we suggest that Proposed Rule 3.285(e)(2)(C) could be revised to add the language italicized below:

> [T]he seller does not know, and does not have reason to know *from the purchaser's description on the resale certificate of taxable items generally sold, leased, or rented by the purchaser in the normal course of business,* that the sale

> is not a sale for resale. It is the seller's responsibility to be familiar with this state's sales tax law as it applies to the seller's business and to take notice of the information provided by the purchaser on the resale certificate. For example, a jewelry seller should know that a resale certificate from a landscaping service is invalid because a landscaping service is not in the business of reselling jewelry. (emphasis added only for reference to additional text.)

C. Blanket Resale Certificates

Proposed Rule 3.285(f) addresses blanket resale certificates. Proposed Rule 3.285(f) provides:

> A blanket resale certificate describing the general nature of the taxable items purchased for resale may be issued to a seller by a purchaser who purchases items for resale. *Each invoice from the seller must clearly identify the taxable items purchased tax-free for resale under the blanket resale certificate and must be attached, or refer directly, to the blanket resale certificate.* Items purchased for resale under the blanket resale certificate cannot be billed on the same invoice as other taxable purchases. A seller may rely on a blanket resale certificate until the certificate is revoked in writing by the issuer or no longer states a valid basis for exemption due to a change in the law. (emphasis added).

We recommend that the language of the italicized sentence be revised to address two points of possible confusion: (i) a single certificate is not easily attached to each invoice from the seller, so presumably the Comptroller intends that a copy of the certificate may be attached to each invoice; and (ii) the meaning of the language "clearly identify the taxable items purchased tax-free for resale" should be clarified. In particular, we suggest that the second sentence in Proposed Rule 3.285(f) be revised to read: "Each invoice for items purchased under a blanket resale certificate should include a general description of the items purchased under a blanket resale certificate and must either refer directly to the blanket resale certificate or be attached to a copy of the blanket resale certificate."

Further, the provisions in Subsection (f) appear to add multiple requirements that change the prior "blanket certificate" provisions contained in current Comptroller Rule 3.285(c). Current Comptroller Rule 3.285(c) states:

> A blanket resale certificate describing the general nature of the taxable items purchased for resale may be issued to a seller by a purchaser who purchases only items for resale. The seller may rely on the blanket certificate until it is revoked in writing.

We respectfully suggest that the Comptroller consider deleting the new requirement that items purchased under a blanket resale certificate cannot be invoiced with taxable purchases. The requirement appears to indicate, although it is not entirely clear, that a violation of the requirement could cause the blanket resale certificate to be lost as to the tax-free items. We believe such an interpretation would be in violation of general statutory rules related to taxable sales. Additionally, this new requirement may be not be workable with respect to certain invoicing software used by sellers. If the Comptroller decides not to delete the language, then we suggest the sentence "Items purchased for resale under the blanket resale certificate cannot be billed on the same invoice as other taxable purchases" be moved up in the paragraph in front of the second sentence.

IV. CONCLUSION

We greatly appreciate the opportunity to work with your office on these significant tax issues and hope these comments provide relevant analysis for your review. Thank you for your consideration.