All Hat and No Cattle or Meaningful Texas Tax Relief?

by Leah Robinson and Olga Jane Goldberg

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In this edition of A Pinch of SALT, Robinson and Goldberg discuss recent tax changes in Texas and conclude that the Legislature at least partially fulfilled the governor’s request to cut taxes. However, the authors write, it remains to be seen how the comptroller will enforce the new statutes.

In his State of the State address at the beginning of the year, Texas Gov. Greg Abbott (R) tasked the Legislature with enacting meaningful business tax relief. In doing so, he stated that “the best way to create more jobs is to permanently reduce the business franchise tax.”

The Legislature responded by reducing the franchise (also called the margin) tax rate and creating new exemptions and incentives for sales tax. At the same time, however, the Legislature cut funding for several economic incentive programs and added an additional layer of review by creating an Economic Incentive Oversight Board.

Abbott signed all tax relief legislation into law, with various effective dates for each bill.

I. Lower Franchise Tax Rates (HB 32)

HB 32 permanently lowers the Texas franchise tax rate by 25 percent, from 1 percent to 0.75 percent for most taxpayers, and from 0.5 percent to 0.375 percent for retailers and wholesalers. The bill also makes it easier for taxpayers to qualify for the E-Z tax calculation by raising the total revenue qualification threshold from $10 million to $20 million and lowering the E-Z tax rate from 0.575 percent to 0.331 percent. The rate reduction is estimated to cost the state (and save businesses) a whopping $2.56 billion over the next two years.

The new, lower rates take effect January 1, 2016, and will apply to franchise tax years beginning in 2016.

II. Sales Tax Exemption for Property Used in Large Data Centers (HB 2712)

Two years ago, Texas created an exemption for regular data centers, relieving them from paying the state-level sales tax on purchases of equipment and tangible personal property, including electricity, but providing no relief from local sales and use taxes. HB 2712 creates a large data center exemption, which covers the state and local sales and use taxes.

A “qualifying large data center project” must meet the following basic requirements:

• involve a data center at least 250,000 square feet in area;
• create at least 40 permanent jobs, each paying at least 120 percent of the county average weekly wage;
• include an agreement to invest at least $500 million in the data center over a five-year period; and
• include an agreement to contract for at least 20 megawatts of electricity transmission capacity for the data center’s operations.

The owner or operator of the large data center must apply and be approved for the exemption by the state’s comptroller. A data center will not qualify for the sales and use tax exemption if it previously received specific economic development property tax incentives.

This new large data center sales tax incentive appears to have already attracted at least one project. On July 7 Facebook Inc. announced its plans to construct a qualifying large data center in Fort Worth, Texas. On the same day, the comptroller issued a letter ruling approving a large data center project, thus providing potentially interested taxpayers with some guidance on the approval process.

III. Sale for Resale Exemption for Software Purchased by Internet Hosting Providers (SB 755)

As a general rule, tangible personal property used to perform a taxable service is not resold unless “care, custody, and control” of the property is transferred to the purchaser of the service. Thus, purchases made by Internet hosting...
providers (IHPs) often would not qualify for the sale for resale exemption because no software would be physically transferred to customers.

SB 755 expands the definition of a sale for resale in Tex. Tax Code section 151.006 to include the purchase of computer software by an IHP for sale to an end user of the software. The Senate Research Center’s bill analysis explains that the exemption became necessary because of “the proliferation of Internet hosting services, including ‘cloud computing’ services,” in which “computer programs are now being sold as part of a package of taxable services provided by Internet hosting companies.”5 Under new section 151.006(d), both the seller and the end user of the software must be unrelated to the IHP. Also, the IHP may not alter the software except for routine maintenance. And in the IHP’s contract with its user, the software must be identified and separately charged. Finally, the IHP may not retain the right to use the computer program.

The new sale for resale exemption for IHPs became effective June 10, 2015.

IV. Clarifications to Sales and Use Tax Treatment of Aircraft Transactions (SB 1396)

Texas’s approach to taxation of aircraft has experienced some turbulence over the years. The previous comptroller’s administration6 had aggressively targeted aircraft transactions for sales and use tax audits, particularly in situations in which an aircraft purchaser leased the plane to a related (or unrelated) party, which in turn leased the aircraft to related or unrelated third parties, or to the purchaser itself. The comptroller argued that this structure lacked economic substance, that this transaction was not in the purchaser’s normal course of business, and that the purchaser’s purpose was its own use of the aircraft rather than a resale. A number of these audits were settled,7 but many are still pending in district court.8

In October 2014 the comptroller proposed rules that would have drastically narrowed the availability of the sale for resale exemption for aircraft purchasers.9 The rules sparked an uproar in the aviation community, as they were seen as contradicting transactions structured to comply with Federal Aviation Administration rules and federal tax law.10 SB 1396 is intended to address the comptroller’s and the aviation community’s concerns.

SB 1396 creates new Tax Code Chapter 163, which applies exclusively to aircraft transactions and intends to clarify the general sales and use tax provisions in Chapter 151 as applied to these transactions.

Chapter 163 addresses the treatment of many of the aircraft leasing transactions challenged by the comptroller and makes them exempt from sales and use tax. Importantly, section 163.002 supplements the definitions of sale for resale in Tex. Tax Code section 151.006 to include provisions that clarify the purchaser’s purpose requirement, the definition of leasing or renting, and permissible use by the aircraft owner. Interestingly, under section 163.002(d), an aircraft purchaser is never subject to Tex. Tax Code section 151.154, which usually requires a purchaser to pay sales tax on the fair market rental value of a taxable item the purchaser puts to a nonexempt use. Further, section 163.006(a) explains that related or affiliated entities that otherwise qualify for an exemption from sales and use tax will be treated as though they are unrelated. This is a significant departure from the comptroller’s prior position, which relied on the relationship between the aircraft owner and its lessee as evidence of the owner’s intent to use the aircraft itself rather than to purchase the aircraft for lease.

Importantly, Chapter 163 does not address all of the comptroller’s concerns with aircraft leasing transactions. For example, the definitions of sale for resale applicable to aircraft leasing transactions require the lease to be in the purchaser’s “normal course of business.”11 In at least one district court case, the comptroller successfully argued that a below-market lease rate cannot be in the normal course of business.12 That issue was not addressed by the Legislature.

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6Susan Combs was the comptroller of public accounts from 2007 to 2014. Glenn Hegar took office on January 2, 2015.
11See National Business Aviation Association, Response to Comptroller Invitation for Comments Regarding Draft Comptroller Rule 3.280 Relating to Aircraft and Sales for Resale (Nov. 24, 2014), available at http://bit.ly/1HtpCHC (comments from the industry group, representing more than 10,000 member companies, describe the proposed rules as “arbitrary, vague and subjective standards” and generally “extra-statutory”).
12Findings of Fact and Conclusions of Law, Cantu Enterprises LLC v. Hegar, Cause No. D-1-GN-13-004369 (Travis County Dist. Ct.).
Tex. Tax Code Chapter 163 takes effect September 1, 2015.

V. Creation of an Economic Incentive Oversight Board (HB 26)

HB 26 creates an Economic Incentive Oversight Board that on September 1 will begin examining the effectiveness and efficiency of the programs and funds administered by Texas agencies, including the office of the governor and the comptroller. Board members are appointed by the speaker of the House of Representatives, the lieutenant governor, the comptroller, and the governor. The board is required to "develop a performance matrix that clearly establishes the economic performance indicators, measures, and metrics that will guide the board’s evaluations of those programs and funds." 

Notably, the 2016-2017 budget cuts funding for the incentive programs the board was created to oversee. For example, the Legislature eliminated the Emerging Technology Fund, splitting its $85 million in unexpended funding between the Governor’s University Research Initiative (the fund’s successor) and the Texas Enterprise Fund. The Texas Enterprise Fund’s budget was cut from $120 million in 2015 to $90 million in 2016. A state audit strongly criticized the fund’s management and questioned the method of awarding funding. The Texas Film Commission’s incentive budget was also cut, from $95 million to just under $32 million for both 2016 and 2017.

VI. Conclusion

The 84th Legislature followed the governor’s instruction to reduce taxes — at least somewhat. It enacted a number of directed tax savings but simultaneously reduced the funds available to discretionary incentive funds and increased oversight over those funds. It remains to be seen how Comptroller Glenn Hegar’s administration — which is perceived as more business-friendly and transparent than the previous administration — will enforce the new and existing Texas tax rules over the next two years.

14Id. at section 490G.005(b).
15Act of June 18, 2015, 84th Leg., R.S., section 1.01 (HB 26).
18Id.