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REPRESENTING YOUR CLIENTS BEFORE THE TEXAS COMPTROLLER OF PUBLIC ACCOUNTS

Outline by
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Representing Your Clients Before the Texas Comptroller of Public Accounts

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The Texas Comptroller of Public Accounts' office is significantly increasing the number of auditors on its staff. Audits are on the rise; and the likelihood of being audited is higher than ever. This outline is intended to provide practitioner's practical information in assisting their clients anticipate, prepare for and survive an audit by the Texas Comptroller of Public Accounts. This outline also discusses administrative and judicial forums for challenging assessments by the Texas Comptroller and related issues.

The reader should keep in mind that the information included herein is intended to be general in nature and is cautioned against relying on any part of this outline without seeking individual legal advice.

I. Pre Audit Activities: Before a taxpayer receives a notice of audit from the Texas Comptroller, there several things that a taxpayer may do to mitigate exposure to liability:

A. Know the Rules: Taxpayers and their representative should know the tax rules applicable to their particular industry. Potential traps for the unwary lie everywhere. This is most clearly the case in areas such as the Texas contractor rules, where the rules can be fairly technical. Taking the time to learn the rules will ensure that tax is collected, reported, remitted, and paid correctly.

B. Obtain Private Letter Rulings for Areas of Uncertainty: For taxpayers who engage in transactions whose taxability is uncertain or who may otherwise have exposure to state tax liability in their business affairs due to the uncertainty of how state tax laws may apply to their particular transaction, a private letter ruling may offer some protection. The Texas Comptroller's stated policy is to generally stand behind its written advice. If the Texas Comptroller ever recants its advice, a taxpayer may hold the Texas Comptroller to its position to the extent the taxpayer has relied on that advice and would suffer harm ("detrimental reliance"). Over the past several years, we have seen the following rules develop relative to detrimental reliance claims:

1. Writing Requirement: One of the challenges confronting taxpayers seeking to establish detrimental reliance is the burden of proving that they received certain advice from the Texas Comptroller's office. This is particularly difficult where the advice was provided orally. The Texas Comptroller will hold a taxpayer making a detrimental reliance claim to a fairly high standard in meeting its burden of proving the advice provided by the Texas Comptroller's office. Thus, it is generally advisable to obtain any advice from the Texas Comptroller in writing. *See* Tex. Comptroller Memo Rul. 200712099L (Dec. 13, 2007)

2. **The Taxpayer Followed the Advice:** The taxpayer must be able to show that the taxpayer followed the advice. See Tex. Comptroller Memo Rul. 200712099L (Dec. 13, 2007).

3. **The Taxpayer Must Give Complete and Accurate Information:** The taxpayer must establish that it gave sufficient information to the Texas Comptroller's office to have resulted in correct advice and did not misrepresent information or deliberately withhold or conceal information which would affect the advice. See Tex. Comptroller Memo Rul. 200712099L (Dec. 13, 2007).

4. **The Taxpayer Suffered or Will Suffer Harm Unless the Texas Comptroller Adheres to the Advice:** A Taxpayer must be able to show that it suffered or will suffer harm if the Texas Comptroller does not honor its advice. See Tex. Comptroller Memo Rul. 200712099L (Dec. 13, 2007). The type of harm suffered by the taxpayer also determines the type of relief the taxpayer will receive. The Texas Comptroller rulings have developed the following rules regarding the type of harm suffered by taxpayers and the type of relief they are entitled to:

a. **Erroneous Advice Regarding Purchases:** Historically, the Texas Comptroller's policy has been that a taxpayer who relies on erroneous advice with respect to purchases, is entitled to waiver of penalty and interest only. A number of prior Texas Comptroller Decisions have held that the only harm that is suffered by a taxpayer claiming detrimental reliance in situations where tax was not paid on purchases is the assessment of penalty and interest. See Texas Comptroller Decision No. 35,969 (Dec. 17, 2003). "The rationale is that the taxpayer would have bought the item anyway and paid the tax – the difference or harm encountered in an audit assessment being limited to additional penalties and interest on the taxes due." See Tex. Comptroller Memo Rul. 200712099L (Dec. 13, 2007).

However, the Texas Comptroller recently revised its rule regarding purchases. In an internal memorandum dated December 17, 2007, the Texas Comptroller's office stated that the following broadened guidelines will be used where a taxpayer has proven detrimental reliance related to taxable purchases (*i.e.*, where the taxpayer has expressly met the first three tests above):

- (i) All penalties and interest will be waived;
- (ii) Tax will be waived on materials directly utilized and consumed in the performance of a service or sale of a product for an unrelated third party;
- (iii) Tax can only be waived for indirect materials or services when the taxpayer can prove that these items were used in computing prices or bids;

(iv) Tax on assets or tools directly used in the performance or services or sales may be partially exempted based upon their purchase dates and remaining life of the assets. This is presuming that prices can be increased on future sales. A taxpayer with a long term contract or fixed bid can substantiate a larger waiver. For the purposes of computing the remaining life and value of an asset, the Texas Comptroller will use a 48 month useful life and straight line depreciation. The taxpayer cannot use other methods of valuation;

(v) Special consideration for full waiver and possible ongoing waiver will be made if a taxpayer can prove that the Texas Comptroller's advice was used in a decision to locate facilities to Texas. *See* Tex. Comptroller Memo Rul. 200712099L (Dec. 13, 2007)

b. Erroneous Advice Regarding Tax Collection Responsibilities: The Texas Comptroller recognizes that a seller who receives erroneous advice regarding its tax collection responsibilities is entitled to relief under the doctrine of detrimental reliance where sales tax is assessed after the fact on transactions where the seller failed to collect the tax. *See Texas Comptroller Decision No. 34,152* (March 20, 1996). A taxpayer who can establish that it received erroneous advice from the Texas Comptroller's office regarding its tax collection obligation and who relied on that advice to its detriment, can expect to receive waiver of tax, penalty and interest.

5. Franchise Tax: According to the Texas Comptroller's office, detrimental reliance relief has rarely been asserted or granted in the context of franchise tax. *See e.g., Texas Comptroller Decision 37, 816* (March 10, 2004).

C. Voluntary Disclosures for Areas of Non-Compliance: Where a taxpayer knows that they have underpaid and underreported tax to the state, the taxpayer may want to consider doing a voluntary disclosure to the Texas Comptroller. A successful voluntary disclosure will in some cases limit the taxpayer's liability to 4 years. In situations where the taxpayer has not filed tax returns, this can have the effect of significantly limiting their exposure to liability, given that the limitations period does not run with respect to a tax liability where no returns have been filed. The following rules apply to the Texas Comptroller VDAs:

1. Sales Tax on Purchases or Sales Tax Not Collected: Generally, the Texas Comptroller will limit the exposure to liability to four years, even where no returns have been filed. The Texas Comptroller will also grant waiver of interest and penalty.

2. Tax Collected Not Remitted: The Texas Comptroller will require that all tax collected be remitted to the State, regardless of how far back in time

the tax was collected. The Texas Comptroller will not waive interest, but will waive penalty.

3. **Franchise Tax**: Generally, the Texas Comptroller will limit the exposure to liability to four years, even where no returns have been filed. The Texas Comptroller will also grant waiver of interest and penalty.

4. **Procedures**. A taxpayer desiring to do a voluntary disclosure must carefully follow the procedures outlined in the Texas Comptroller's Publication 96-576 (*e.g.*, it must be done on an anonymous basis through a representative).

D. **Resale and Exemption Certificates**: Missing resale and exemption certificates represent easy adjustments for tax auditors and can provide the basis for large assessments of tax against taxpayers. The Tax Code requires that exempt sales be supported by either resale or exemption certificates. Sales for resale are per se taxable if not supported by a resale certificate. Taxpayers should therefore be sure to have all resale and exemption certificates on file before the commencement of an audit. Certificates obtained after the commencement of an audit are subject to greater scrutiny. Taxpayers also have a limited window of time to provide resale certificates once the Texas Comptroller's office makes a written request for them. *See* Tex. Comptroller Rule 3.285.

E. **Judicial Pre-Emptive Strikes**: Recent case law in Texas suggests that a taxpayer may be able to file a lawsuit seeking declaratory judgment even before the Texas Comptroller audits the taxpayer and even before a tax return for the year at issue has been filed. A taxpayer may want to do so where, for example, it anticipates that the Texas Comptroller will disagree with the taxpayer's reporting position on a specific issue. The benefit of filing a preemptive lawsuit is that a claim brought under the Uniform Declaratory Judgments Act enables the taxpayer to request attorney fees. *See Texas Entertainment v. Texas Comptroller*, 287 S.W.3d 852 (Tex. App. Austin, Texas 2009).

II. **Audits**.

A. **General Rules Regarding Audits**.

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

2. **Authority to Conduct Audits**.

a. **Texas Comptroller:** Most audits are conducted directly by the Texas Comptroller's team of auditors. Section 151.023(a) of the Texas Tax Code authorizes the Texas Comptroller to conduct sales and use tax audits. Section 171.211 of the Tax Code authorizes the Texas Comptroller to investigate or examine the records of a corporation to determine the franchise tax liability of a corporation. The Comptroller has recently begun to cross-train some of its auditors to conduct both sales and use tax and franchise tax audits.

b. **Contract Auditors:** Section 111.0045 was added in 2001 and authorizes the Texas Comptroller to contract with individuals or firms to perform audits of sales tax and other taxes. The Texas Comptroller issued a Regulation, effective February 28, 2002 that implements the contract audit program. *See* Texas Comptroller Rule 3.3. The Texas Comptroller uses contract auditors to conduct some audits.

c. **Managed Audits:** Section 151.0231 was added in 1999 and states that the Texas Comptroller may, in a written agreement, authorize a taxpayer to conduct an audit of its own records. The Texas Comptroller has promulgated rules for the implementation of managed audits in Rule 3.282.

(i) **Agreement to Conduct Audit:** A taxpayer who wishes to participate in a managed audit must request authorization from the Texas Comptroller's office to conduct a managed audit. Authorization will only be granted as part of a written agreement between the taxpayer and the Texas Comptroller's office. The agreement must (A) be signed by an authorized representative of the Texas Comptroller and the taxpayer; and (B) specify the period to be audited and the procedure to be followed. *See* Texas Comptroller Rule 3.282 (f)(1).

(ii) **Qualification:** In determining whether to authorize a managed audit, the Texas Comptroller may consider, in addition to other factors the Texas Comptroller considers relevant: (A) the taxpayer's history of tax compliance, including taxpayer (i) timely filing of all reports; (ii) timely payment of all taxes and fees due the estate; (iii) prior audit history; (iv) delinquency in other taxes; (v) correction of problems identified; (vi) collection of tax that was not remitted; and (vii) whether a penalty waiver had been denied on prior occasions and the reason for denial; (B) the amount of time and resources the taxpayer has available to dedicate to the audit; (C) the extent, availability, and completeness of the taxpayer's records for the period to be covered by the managed audit; (D) the taxpayer's ability to

pay any expected liability; and (E) the size and sophistication of the taxpayer. *See id.* 3.282(f)(2).

(iii) **Scope of Managed Audit:** Rule 3.282 states that a managed audit may be limited to certain categories of liability under the Tax Code, including (A) sales of one or more types of taxable items; (B) purchases of assets; (C) purchases of expense items; (D) purchases under a direct payment permit; or (E) any other category specified in an agreement with the Texas Comptroller under Rule 3.282(f). *See id.* 3.282 (f)(4).

(iv) **Penalty and Interest Waiver:** Rule 3.282 states that unless the audit or information reviewed by the Texas Comptroller discloses fraud or willful evasion of the tax, the Texas Comptroller may not assess a penalty and may waive all or part of the interest that would otherwise accrue on any amount identified to be due in a managed audit. This waiver does not apply, however, to any amount collected by the taxpayer that was a tax or represented to be a tax but was not remitted to the State. *See id.* 3.282(f)(7).

d. **Out-of-State Audits:** Section 111.036 authorizes the Texas Comptroller to contract with one or more appropriate persons to perform tax audits in any state that is not covered by a Texas Comptroller field office.

B. **Selection of Taxpayers for Audit**

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

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

2. **Priority I Audits:** Some taxpayers are designated as “Priority I” accounts. These include taxpayers who cumulatively report the top 65% of tax under Tax Code, Chapter 151, recalculated annually. *See Texas Comptroller Rule 3.368(a)(4).* Priority I taxpayers are generally audited every four years.

3. **Audit Leads:** Not surprisingly, some audits are generated through “audit leads.” Frequently, an auditor will audit one taxpayer and learn of another taxpayer who may not be in compliance. Other leads are obtained from “call-in” leads where someone simply calls the Texas Comptroller’s office to notify them of a non-compliant Taxpayer.

4. **Refund Audits:** Some audits are triggered by refund claims. The Texas Comptroller will sometimes audit a taxpayer who has filed a refund claim with the Texas Comptroller to verify that the taxpayer is entitled to a refund claim.

5. **Information Sharing Agreements:**

a. **Other Texas Agencies:** The Texas Comptroller regularly obtains information about transactions or persons that may not be in compliance with state tax laws from other State of Texas agencies (e.g., Texas Workforce Commission and the Texas Alcoholic Beverage Commission).

b. **Other States:** The Texas Comptroller has agreements in place with several other states for the sharing of information about potentially non-compliant taxpayers. Some audits are generated pursuant to this exchange of information.

c. **Internal Revenue Service:** The Texas Comptroller has an information sharing arrangement with the Internal Revenue Service. For example, 1099s issued to persons with an in-state address may lead the Texas Comptroller to believe that an out-of-state retailer has a physical presence in the State and therefore a sales tax collection and reporting obligation (“nexus”).

d. **U.S. Customs:** The Texas Comptroller obtains information about sales and deliveries made into Texas that may be subject to the State’s use tax from the U.S. Customs Office.

e. **Federal Aviation Administration:** The Texas Comptroller obtains information regarding sales and purchases of airplanes that may be subject to either Texas sales or use tax from the Federal Aviation Administration.

6. **Business Activity Research Team:** When the Texas Comptroller obtains information about a person that may have a sales tax reporting and payment obligation, but for which the Texas Comptroller does not have a record of any tax returns or reports being filed, the Texas Comptroller’s Business Activity Research Team will generally contact that person to determine if in fact a sales tax reporting obligation exists. The BART may issue, for example, a “Texas Nexus Questionnaire.” The results of this inquiry may result in an audit.

C. **Statute of Limitations**

1. **Section 111.201 of the Tax Code:** The Tax Code states that no tax may be assessed after four years from the date that the tax becomes due and payable. *See* Tex. Tax Code § 111.201.

2. **Exceptions:** The four year limitations period does not apply, and the Texas Comptroller may assess tax at any time if:

- a. with intent to evade the tax, the taxpayer files a false or fraudulent return;
- b. no report for the tax has been filed; and
- c. information contained in the report of the tax contains a gross error. A "gross error" is defined to mean that, after correction of the error, the amount of tax due and payable exceeds the amount initially reported by at least 25 percent.

See Tex. Tax. Code § 111.205.

3. **Tolling:** The Statute of Limitations is suspended for the following periods (1) the period following the date of a tax payment made under protest, but only if a lawsuit is timely filed; (2) the period during which a judicial proceeding is pending in a court of competent jurisdiction to determine the amount of the tax due; and (iii) the period during which an administrative redetermination or refund hearing is pending before the Texas Comptroller. *See* Tex. Tax. Code § 111.207(a). The suspension is limited to the issues that are contested. *See id* § 111.207(b). A bankruptcy case commenced under Title 11 of the United States Code also suspends the running of the statute of limitations until the bankruptcy case is dismissed or closed. *See id* § 111.207(c).

4. **Voluntary Disclosures:** Notwithstanding the above exceptions, a taxpayer may limit the period of assessment to four years by "voluntarily" disclosing a deficiency and paying the amount of tax due to the State following the procedures prescribed by the Texas Comptroller for doing voluntary disclosures. A voluntary disclosure may also provide the basis for waiver of penalty and interest. A taxpayer desiring to do a voluntary disclosure must carefully follow the procedures outlined in the Texas Comptroller's Publication 96-576 (*e.g.*, it must be done on an anonymous basis through a representative).

5. **Agreements to Extend:** Section 111.203 of the Texas Tax Code provides the Texas Comptroller with authority to enter into an agreement to extend the period of limitations. The agreement must be executed before the expiration of the limitations period and must contain the reasons the Comptroller and the taxpayer wish to extend the period. The following reasons are provided as legitimate reasons for extending the limitations period: (i) Without an extension, there might occur a revenue loss to the state; (ii) Either the taxpayer or the Comptroller, despite good faith efforts, requires more time to prepare for or complete the audit; (iii) without an extension, circumstances beyond the control of either the comptroller or the taxpayer would make an audit by the comptroller impractical or burdensome for either party; or (iv) an issue of law involved in the audit is awaiting determination in either litigation or an administrative proceeding. *See* Tex. Tax Code § 111.203. The Texas Comptroller's standard

extension agreement provides for the extension of credits and refunds for the extended periods as well.

D. Records.

1. Records Required: Section 151.025 of the Tax Code requires all sellers and other persons storing, using, or consuming in this state a taxable item purchased from a retailer to keep the following records:

a. Records of gross receipts, including documentation in the form of receipts, shipping manifests, invoices, and other pertinent papers, from each rental lease, taxable service, and taxable labor transaction occurring during each reporting period;

b. Records in the form of receipts, shipping manifests, invoices, and other pertinent papers of all purchases of taxable items from every source made during each reporting period; and

c. Records in the form of receipts, shipping manifests, invoices, and other pertinent papers that substantiate each claimed deduction or exclusion authorized by law.

2. Length of Time: A Taxpayer must keep the above records for not less than four years from the day they were made, unless the Texas Comptroller authorizes its destruction at an earlier date. *See* Tex. Tax Code § 151.025 Any taxpayer who is required to keep records must keep those records open to inspection by the Texas Comptroller, the attorney general, or the authorized representatives of either of them for four years. *See* Tex. Tax Code § 111.0041.

3. Out of State Records: A taxpayer may keep or store its records outside the State. *See* Tex. Tax Code § 151.026. If the Texas Comptroller requests to examine a record kept or stored outside this state, the taxpayer must bring the record into the state for the examination or permit the Texas Comptroller to examine the record at the out-of-state location. *See id.*

4. Confidentiality:

a. Sales Tax: Section 151.027 states that information obtained from a taxpayer's records through the course of an examination is confidential and not open to public inspection, except for information set forth in a lien or a sales tax permit.

b. Exception: Section 151.027 does not prohibit, in part, the examination of information by another state officer or law enforcement officer, by a tax official of another state, by a tax official of the United Mexican States, or by an official of the United States, if a reciprocal agreement exists.

c. **Franchise Tax**: Section 171.206 states that the following information is confidential and may not be made open to public inspection: (1) information that is obtained from a record or other instrument that is required to be filed with the Texas Comptroller; and (2) information, including information about the business affairs, operations, profits, losses, cost of goods sold, compensation, or expenditures of a taxable entity, obtained by an examination of the books and records, officers, partners, trustees, agents, or employees of a taxable entity on which a franchise tax is imposed by the Tax Code. The following information is expressly not confidential per Section 171.207: (1) information contained in a document filed with a county clerk as a notice of tax lien; and (2) information contained in a report required by Section 171.203 (public information report).

E. **Audit Procedures**

1. **Contact with Auditor**.

a. **Assignment to Audit Office and Auditor**: After a taxpayer has been selected for audit, the audit is assigned to the audit office for the area in which the taxpayer is located. There are 18 audit offices throughout the State of Texas, and 3 audit offices located outside the State. The audit offices in Texas are located in Abilene, Amarillo, Austin, Beaumont, Corpus Christi, Dallas East, Dallas West, El Paso, Fort Worth, Houston North, Houston South, Houston West, Lubbock, McAllen Odessa, San Antonio, Tyler, and Waco. The audit offices outside the state are located in Chicago, IL, New York, NY, and Tulsa, OK.

b. **Audit Questionnaire**: After an audit is assigned to an auditor, the auditor will send the taxpayer an audit questionnaire asking for certain information to assist the auditor in the audit.

(i) The Questionnaire asks the taxpayer to provide certain information, including:

(A) The names and titles of the individuals to contact to schedule an entrance conference.

(B) The name and title of the individual(s) authorized to enter into written agreements and to accept the notification of sampling procedures.

(C) The location of the taxpayer records and whether the taxpayer has completed resale or exemption certificates on file.

(D) A general description of the taxpayer's business activities.

(E) Electronic data processing information for evaluation to determine the feasibility of using computer assisted auditing.

(ii) **Failure to Respond to Audit Questionnaire:** The Texas Comptroller's Audit Manual instructs an auditor to do one of the following in the event a taxpayer fails to respond to an audit questionnaire:

(A) Visit the taxpayer's location in person:

(B) Subpoena the taxpayer's records

(C) Send a certified letter stating that the taxpayer has not responded to repeated attempts to conduct an audit of the business records and that, consequently, an estimated audit will be completed using the best sources of information available.

(D) **Estimate the Audit:** If the taxpayer does not respond to the certified letter and questionnaire the auditor may estimate the audit liability. This is a fairly common method used by the Texas Comptroller's office in dealing with non-responsive Taxpayers.

(E) **Obtain Records from Outside Sources**

(F) **Disallow Reported Deductions:** In the absence of verifiable documentation, the Texas Comptroller's Audit Manual instructs its auditors to disallow the reported deductions and assess tax on the reported "Total Sales" amount.

c. **Entrance Conference:** Upon receipt of the completed Audit Questionnaire, the auditor will contact the taxpayer to schedule an entrance conference. At the entrance conference, the auditor will hold a preliminary discussion with the taxpayer about the business and the audit. The auditor may also use this opportunity to tour the taxpayer's facilities.

2. **Location of Audit:**

a. **Taxpayer's Location:** Most audits are conducted at the taxpayer's location. However, even in situations where the audit is conducted elsewhere, the auditor will generally ask to visit the taxpayer's premises. The Texas Tax Code authorizes the Texas Comptroller's personnel to inspect at any time during business hours any business premises where a taxable event has occurred and examine, copy, and

photograph, the books, returns, records, papers, and equipment relating to the conduct in question. See Tex. Tax Code § 151.023(b)(1).

b. Taxpayer's Representative: A taxpayer may prefer to have the audit conducted at the office of his or her representative. The Texas Comptroller's office will generally honor this request. The representative must provide a power of attorney to the Texas Comptroller in order to represent the taxpayer. A power of attorney form (Form 86-113) may be obtained from the Texas Comptroller's website at www.window.state.tx.us.

c. Texas Comptroller's Office: Some audits are conducted at the Texas Comptroller's office. The taxpayer brings or sends its records to the Texas Comptroller's office for examination by the auditor. The Texas Comptroller's office is currently conducting some franchise tax audits using this method under its "Disk Audit" program.

3. Control Information and Documentation Flow:

a. Designating Person to Interface with Auditor: Careful consideration should also be given to the person who will be responsible for communicating with the auditor during the audit. It is generally a good idea to have only one person handle all communications with the auditor. Few things can undermine the integrity of an audit more than having multiple persons communicating with the auditor and potentially providing inconsistent information.

b. Document Production: The auditor should be asked to provide a specific list of documents that he or she wishes to review. The taxpayer should retain a copy of all documents provided to the auditor. In addition, we find it helpful to "bates label" all documents provided to the auditor in order to easily identify documents previously provided. Consideration should also be given to the auditor's access to a copy machine. It is generally a good idea to have someone copy the documents for the auditor instead of allowing the auditor to copy the documents herself. This provides the taxpayer an opportunity to copy the documents in duplicate in order and to determine any items of interest to the auditor.

4. Examination of Records:

a. The Texas Comptroller's website provides separate audit manuals for use by auditors for various different types of taxes. The manuals provide guidance on how an audit should be conducted depending on the type of tax and business at issue. The practitioner may find it helpful to examine the audit manual applicable to his or her client prior to commencement of an audit. The following is a list of audit manuals available on the Texas Comptroller's website:

- Audit Fundamentals
- Audit Procedures for Cigarette Taxes
- Audit Procedures for Cigar & Tobacco Product Taxes
- Audit Procedures for Contractors and Repairmen
- Grocery Stores
- Audit Procedures for Hotel Occupancy Tax
- IFTA Software and Audit Procedures
- Audit Procedures for Insurance Tax
- Audit Division Procedure Manual
- Manufacturer Manual
- Motor Fuels Audit Procedures Manual
- Motor Fuels Tax Audit Procedures Manual
- Motor Vehicle Tax Manual
- Oil Well Servicing Tax Manual
- Sampling Manual
- Audit Procedures for Sulphur Production Taxes
- Audit Procedures for Telecommunications Taxes
- Audit Procedures for Unclaimed Property
- Audit Procedures for Utilities Gross Receipts Tax

F. Resale Certificates: One of the most common areas of review by an auditor in a sales tax audit are resale certificates. This makes for an easy assessment where a taxpayer claims that sales were made for resale, but does not have a resale certificates to support those sales. The Texas Tax Code states that all gross receipts of a seller that are alleged to be exempt from tax on the basis of the resale exemption must be supported by properly completed resale certificates.

1. A sale is exempt if the resale certificate is accepted in good faith and the seller lacks actual knowledge that the sale is not a sale for resale. *See* Tax Code § 151.054. It is the seller's responsibility to take notice of the type of business generally engaged in by the purchaser as shown on the resale certificate. *See* Tex. Comptroller Rule 3.285(b)(2).

2. The seller should generally obtain a properly executed resale certificate at the time the taxable transaction occurs and have it on file at the time the audit commences. All certificates obtained on or after the date the Texas 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 verification. *See* Tex. Comptroller Rule 3.285 (b)(4).

3. Incomplete certificates are disallowed regardless of when they were obtained. *See id.* A resale certificate must include the following information to be complete:

- a.** the name and address of the purchaser;

b. the number from the sales tax permit held by the purchaser or a statement that an application for a permit is pending before the Texas Comptroller with the date the application for a permit was made. If the application is pending, the resale certificate is valid for only 60 days, after which time the resale certificate must be renewed to show the permanent permit number.

c. a description of the taxable items generally sold, leased, or rented by the purchaser in the regular course of business and a description of the taxable items to be purchased tax free by use of the certificate. The item to be purchased may be generally described on the certificate or itemized in an order or invoice attached to the certificate;

d. the signature of the purchaser and the date;

e. the name and address of the seller; and

f. If the taxpayer does not have a certificate on file, it has 60 days from the date written notice is received from the Texas Comptroller in which to deliver the certificates to the Texas Comptroller. *See id.* Rule 3.285(g).

G. Exemption Certificates: The Texas Comptroller's Regulations state that all gross receipts of a retailer are subject to sales or use tax unless a valid and properly completed exemption certificate is accepted by the seller.

1. A sale is exempt if the exemption certificate is accepted in good faith at the time of the transaction and the seller lacks actual knowledge that the claimed exemption is invalid. *See* Tex. Tax Code § 151.054(c); Tex. Comptroller Rule 3.287(d)(2).

2. 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. *See* Tex. Tax Code § 151.054(c).

3. The seller should obtain the properly executed exemption certificate at the time the transaction occurs. All certificates obtained on or after the date the Texas 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 verification. All incomplete certificates will be disallowed regardless of when they were obtained. The seller has 60 days from the date written notice is received by the seller from the Texas Comptroller in which to deliver the certificates to the Texas Comptroller. *See* Tex. Tax Code § 151.054(e).

H. Sampling Procedures

1. **Authority to Use Sampling Procedures:** Section 111.0042 of the Tax Code permits the Texas Comptroller to use sampling audit methods if:

a. The taxpayer's records are so detailed, complex, or voluminous that an audit of all detailed records would be unreasonable or impractical;

b. taxpayer's records are inadequate or insufficient, so that a competent audit for the period in question is not otherwise possible; or

c. The cost of an audit of all detailed records to the taxpayer or to the state will be unreasonable in relation to the benefits derived, and sampling procedures will produce a reasonable result.

2. **Notice:** Before using a sample technique to establish a tax liability, the Texas Comptroller or his designee must notify the taxpayer in writing of the sampling procedure to be used.

3. **Statutory Criteria:** Section 111.0042 of the Tax Code sets forth the following criteria for sampling procedures:

a. **Representativeness:** The sample must reflect as nearly as possible the normal conditions under which the business was operated during the period to which the audit applies. If a taxpayer can demonstrate that a transaction in a sample period is not representative of the taxpayer's business operations, the transaction must be eliminated from the sample and be separately assessed in the audit. If records are inadequate to reflect accurately the business operations of the taxpayer, the Texas Comptroller or his designee must determine the best information available and base his audit report on that information.

b. **Review Audit Sample:** It is generally a good idea to review the sample selected by the auditor. Things to look for include items that may not be representative of the taxpayer's business activity and should therefore be excluded (*e.g.*, extraordinary sales or purchases). Other items to look for include overpayments of tax. Any overpayments should also be included in the sample.

c. **Generally Recognized Procedures:** If the taxpayer demonstrates that any sampling method used by the Texas Comptroller was not in accordance with generally recognized sampling techniques, the audit will be dismissed as to that portion of the audit established by projection based upon the sampling method, and a new audit may be performed.

I. **Exit Conference:** Upon completion of the audit, the auditor will hold an "exit conference" with the taxpayer at which the auditor will explain the proposed audit adjustments and the auditor's recommendation as to penalty and interest waiver. The

taxpayer is generally also provided the opportunity to visit with an “Independent Audit Reviewer” and informed of their rights to a redetermination of the auditor’s adjustments.

III. Penalty and Interest

A. Civil Penalties and Interest

1. **Penalty for Failure to Report or Pay:** The Tax Code imposes a penalty on any person who fails to file a franchise or sales tax report as required when due or who fails to pay the amount of tax due. *See* Tex. Tax Code §§ 151.703(a), 171.362(a), and 111.061(a). The penalty is equal to 5% of the amount due. *See id.* If the person fails to file the report or pay the tax within 30 days after the day on which the tax or report is due, an additional 5% penalty applies. *See id.* §§ 151.703(b), 171.362(b). In a jeopardy determination, the additional 10% penalty applies if the determination becomes final without payment of the determination being made. *See* Tex. Tax Code § 111.022.

2. **Fraud Penalty:** The Texas Tax Code imposes an additional penalty of 50% of the tax due if it is determined that:

a. the failure to pay the tax or file a report when due was a result of fraud or an intent to evade the tax; or

b. the taxpayer alters, destroys, or conceals any record, document, or thing, or presents to the comptroller any altered or fraudulent record, document, or thing, or otherwise engages in fraudulent conduct, for the apparent purpose of affecting the course or outcome of an audit, investigation, redetermination, or other proceeding before the comptroller.

See Tex. Tax Code § 111.061(b).

3. **Additional Penalty for Final Assessments:** The Tax Code provides for an additional penalty of 10% if payment is not made within 10 days after it becomes “final.” This additional penalty also applies if the amount due is not paid within 20 days after the date that a Comptroller’s decision in a redetermination hearing becomes final. This additional penalty is applied against tax only. *See* Tex. Tax Code § 111.0081.

Note: The total civil penalties that could apply under the above provisions can be as much as 70%.

4. **Interest:** Delinquent tax draws interest beginning 60 days after the due date. The yearly interest rate on all delinquent taxes is at the rate of 12 percent for report periods originally due on or before December 31, 1999, after which the rate is the prime rate plus one percent, as published in *The Wall Street Journal* on the first day of each calendar year that is not a Saturday, Sunday, or a legal holiday. The interest rates since 1999 are as follows:

<u>Year</u>	<u>Annual Rate Prime +1</u>
2010	4.25 percent (.0425)
2009	4.25 percent (.0425)
2008	8.25 percent (.0825)
2007	9.25 percent (.0925)
2006	8.25 percent (.0825)
2005	6.25 percent (.0625)
2004	5.00 percent (.0500)
2003	5.25 percent (.0525)
2002	5.75 percent (.0575)
2001	10.50 percent (.1050)
2000	9.50 percent (.0950)

For taxes due on or before December 31, 1999, interest was assessed at **12 percent** per year.

5. **Waiver of Penalty and Interest:** The Texas Comptroller has set forth its procedures and criteria for waiving penalty and interest in 34 Tex. Admin. Code § 3.6.a. The Texas Comptroller has delegated to the audit manager the initial authority to waive penalty and interest.

(i) At the exit conference, the taxpayer will be told whether any penalty or interest will be waived. At this conference, the taxpayer may request the audit manager to reconsider her decision. The audit manager's decision is set forth in the audit cover letter sent with the copy of the audit schedules.

(ii) If a taxpayer's request for waiver is denied, the taxpayer may appeal the denial through the redetermination process.

a. **Criteria for waiver:** The Texas Comptroller has established a set of factors that will be considered in determining whether to waive penalty and interest.

(i) For waiver of penalty, the following factors will be considered:

- (A)** the taxpayer's audit history
- (B)** the tax issues involved;
- (C)** a change in Texas Comptroller policy during the audit period;
- (D)** size and sophistication of the taxpayer;
- (E)** whether tax was collected but not remitted;
- (F)** whether returns were timely filed;
- (G)** completeness of records;
- (H)** delinquencies in other taxes; and
- (I)** reliance on advice provided by the Texas Comptroller's office which caused the imposition of penalty and interest.

(ii) For waiver of interest, the following factors will be considered:

- (A)** undue delay caused by the Texas Comptroller personnel;
- (B)** reliance on advice provided by the Texas Comptroller's office which caused imposition of penalty and interest; and
- (C)** natural disasters.

b. Managed Audits: Unless the audit or other information discloses fraud or willful evasion of tax, the Texas Comptroller may not assess a penalty and may waive all or part of the interest that would otherwise accrue on any amount identified to be due in a managed audit or an audit performed under the CPA Audit Program. *See* Texas Comptroller Rule 3.282(f)(6). This does not apply to tax collected but not remitted to the State. *See id.*

B. Criminal Penalties Relating to Sales and Use Tax: The Tax Code imposes criminal penalties, in part, on a person who:

1. Intentionally or knowingly fails to pay sales or use tax collected (Section 151.7032);
2. Is a retailer and advertises, holds out or states that he will assume, absorb or refund a part of the tax, or will not add tax to the sales price of a taxable item (Section 151.704);
3. Is a retailer engaged in business in this state who fails to collect use tax as required under Section 151.103 (Section 151.705);
4. Misuse a resale or exemption certificate (Section 151.707);
5. Engages in business as a retailer in this state without a permit (Section 151.708);
6. Refuses to furnish a sales tax report (Section 151.709);
7. Intentionally or knowingly conceals, destroys, makes a false entry in, or fails to make an entry in records that are required to be made or kept under this chapter 151 of the Tax Code (Section 151.7102);
8. Fails to produce records or allow inspection thereof upon request by the Texas Comptroller (Section 151.7103).

C. Criminal Penalties Relating to Franchise Tax: The Tax Code imposes criminal penalties relating to the Texas franchise tax as follows:

1. A taxable entity is subject to a third degree felony if it willfully (i) fails to file a report; (ii) fails to keep books and records as required for Texas franchise tax purposes; (iii) files a fraudulent report; (iv) violates any rule of the comptroller for the administration and enforcement of the Texas franchise tax; or (v) attempts in any other manner to evade or defeat any tax imposed under the Texas franchise tax provisions of the Tax Code:
2. A person commits a third degree felony if the person is an accountant or agent for or an officer or employee of a taxable entity and the

person knowingly enters or provides false information on any report, return, or other document filed by the taxable entity under the Texas franchise tax provisions of the Tax Code.

See Tex. Tax Code § 171.363(a), (b), (d). These penalties are in addition to any civil penalties that may apply. *See id.* at §171.363(c)

IV. Independent Audit Review Conferences: The Texas Comptroller has implemented an informal process for taxpayer's to resolve disputes with an auditor's proposed adjustments, known as an "Independent Audit Review Conference." The process involves a conference with an "Independent Audit Reviewer" who considers the items at issue and issues a written opinion. Independent Audit Reviewers report directly to the Assistant Director of Tax Administration (currently Kevin Keller). The process is available to taxpayers before the audit is complete (*i.e.*, before the issuance of a Notice of Audit Results) is issued. This procedure can provide an effective and low-cost means for resolving or at least narrowing issues in an informal forum before initiating other appeals.

V. Persons Liable For Tax: The person or entity liable for the underpayment of tax in any given case is the person or entity that incurred the liability. In most instances, the identity of that person or entity is clear. However, the Tax Code includes some provisions that give the Texas Comptroller expanded authority in assessing tax against other persons as well. The same procedures apply in making assessments against these persons as well.

A. Seller vs. Purchaser: Under the Texas Tax Code, the obligation to collect sales or use tax is imposed on the seller. The seller is then obligated to report and remit the tax collected to the Texas Comptroller. However, Section 151.515 of the Tax Code makes clear that the Texas Comptroller may proceed against the purchaser for an amount of tax that the consumer should have paid but failed to pay.

B. Fraudulent Transfers: A person who acquires a business or the assets of a business from a taxpayer through a fraudulent transfer or a sham transaction is liable for any tax, penalty and interest owed by the taxpayer. *See* Tex. Tax Code § 111.024(a).

1. Fraudulent Acts: A transfer of a business or the assets of a business is considered to be a fraudulent transfer or a sham transaction if the taxpayer made the transfer or undertook the transaction (1) with intent to evade, hinder, delay, or prevent the collection of any tax, penalty, or interest owed to the state; (2) without receiving a reasonably equivalent value in exchange for the business or business assets subject to the transfer or transaction. *See id.* § 111.204(b).

2. Factors That Indicate Fraudulent Intent: In determining the intent of the taxpayer, consideration may be given, among other factors, to whether (1) the transfer was to a current or former business insider, associate, or employee of the taxpayer or to a person related to the taxpayer within the third degree of consanguinity by blood or marriage; (2) the transfer was to a third party who subsequently transferred the business or assets of the business to a current or

former business insider, associate, or employee of the taxpayer to a person related to the taxpayer within the third degree of consanguinity by blood or marriage; (3) the taxpayer retained possession or control of the business or the assets of the business after the transfer or transaction; (4) the taxpayer's business and the transferee's business are essentially operated as a single business entity at the same location; (5) before the transfer or the transaction occurred, the taxpayer had either been subjected to or approved of impending collection action by the Texas Comptroller or by the Texas Attorney General; (6) the transfer or transaction was concealed; (7) the taxpayer was insolvent at the time of the transfer or became insolvent not later than the 31st day after the date the transfer or transaction occurred; or (8) the transfer or transaction involved all or substantially all of the taxpayer's assets. *See id.* §111.024(c). The transfer of a business or the assets of a business are not subject to this provision if transferred (1) through a court order on dissolution of a marriage; or (2) by descent or distribution or testate succession on the death of a taxpayer. *See id.* at (d).

Note: A person determined to have acquired a business in a fraudulent transfer as defined in Section 111.024 may be held liable for the full amount of tax owed by the seller, not just the amount paid or value received on the transfer.

C. **Successor Liability:** If a person acquires a business, they may be held liable for the amount of tax owed by the predecessor owner unless they obtain a certificate of no tax due from the Comptroller. Section 111.020 states that if a person who is liable for the payment of an amount of tax sells the business or the stock of goods of the business or quits the business, the successor to the seller or the seller's assignee shall withhold an amount of the purchase price sufficient to pay the amount due until seller provides a receipt from the comptroller showing that the amount has been paid or a certificate stating that no amount is due. *See Tex. Tax Code* § 111.020(a).

1. **Certificate of No Tax Due:** The purchaser of a business may request that the Texas Comptroller issue a certificate stating that no tax is due or issue a statement of the amount required to be paid before a certificate may be issue. The Texas Comptroller must issue the certificate or statement within 60 days after receiving the request or within 60 days after the day on which the records of the former owner of the business are made available for audit, whichever period expires later, but in either event the Texas Comptroller must issue the certificate or statement within 90 days after the date of receiving the request. *See id.* at § 111.020(c). If the Texas Comptroller fails to mail the certificate or statement within the applicable period provided above, the purchaser is released from the obligation to withhold the purchase price or pay the amount due. *See id.* at § 111.020(d).

2. **Liability For Failure to Obtain Certificate of No Tax Due or Withhold Tax:** The purchaser of a business or stock of goods who fails to withhold an amount of the purchase price as required under Section 111.020(a) is liable for the amount required to be withheld to the extend of the value of the purchase price.

3. **Limitations Period for Assessment:** The period of limitation during which the obligation of a purchaser under Section 111.020 may be enforced begins when the former owner of the business sells the business or stock of goods or when a determination is made against the former owner, whichever occurs later. *See id.* at § 111.020(e).

D. **Personal Liability for Fraudulent Tax Evasion:** Certain responsible persons may be held personally liable for the liability of the entity they work for.

1. **Responsible Persons Liable:** Section 111.0611 states an officer, manager, or director of a corporation, association, or limited liability company, a partner of a general partnership, or a managing general partner of a limited partnership or limited liability partnership who, as an officer, manager, director or partner, took an action or participated in a fraudulent scheme or fraudulent plan to evade the payment of taxes due under Title 2 or 3 is personally liable for the taxes and any penalty and interest due. *See* Tex. Tax Code § 111.0611(a). The personal liability of an individual includes liability for the additional 50% fraud penalty provided by Section 111.061(b). *See id.* An assessment under Section 111.0611 is made in the same manner as an assessment against other persons or entities. *See id.*

2. **Factors That Indicate Existence of Fraud:** Actions that may indicate the existence of a fraudulent scheme or a fraudulent plan to evade the payment of taxes include (1) filing, or causing to be filed, a fraudulent tax return or report with the Texas Comptroller on behalf of the business entity; (2) intentionally failing to file a tax return, report, or other required document with the Texas Comptroller when the business entity is under a legal obligation to file; (3) filing, or causing to be filed, a tax return or report with the Texas Comptroller on behalf of the business entity that contains an intentionally false statement that results in the amount of the tax due exceeding the amount of tax reported by 25 percent or more; and (4) altering, destroying, or concealing any records, document, or thing, presenting to the Texas Comptroller any altered or fraudulent records, document, or thing, or otherwise engaging in fraudulent conduct with the intent to affect the course or outcome of a Texas Comptroller audit or investigation, a redetermination hearing, or another proceeding involving the Texas Comptroller. *See id.* at § 111.0611(b).

3. **Limitation on Liability:** To the extent the Texas Comptroller can verify and secure sufficient unencumbered assets of the corporation, association, or partnership to satisfy the liability, an individual's personal liability under Section 111.0611 is limited to the amount by which the total tax, penalty, and interest due under Section 111.0611 exceeds those assets. *See id.* § 111.0611(c).

VI. **Tax Adjustments Following an Audit:** Following the completion of an audit, the Texas Comptroller will generally issue a deficiency determination under Sections 151.501 and 111.008 of the Texas Tax Code (aka "Notification of Audit Results"). In some cases, however, the Texas Comptroller may choose to instead issue a jeopardy

determination under Section 111.022 if she believes that collection of tax may be jeopardized by delay.

A. Finality of Determination:

1. Notification of Audit Results: The Texas Comptroller's determination generally becomes final on the expiration of 30 days after the day on which the determination was served by personal service or by mail, unless a petition for redetermination is filed before the determination becomes final. *See* Tex. Tax. Code §§ 111.009, 151.505. An order or decision of the Texas Comptroller on a petition for redetermination becomes final 20 days after service on the petitioner of the notice of the order or decision. *See id.* at § 111.009. With the exception of jeopardy determinations discussed below, the amount of a determination becomes due and payable 10 days after it becomes final if no petition for redetermination is filed. *See id.* § 111.0081(a). If a petition for redetermination is filed, the amount is due and payable 20 days after the Texas Comptroller's decision in the redetermination hearing becomes final. *See id.* § 111.0081(c).

2. Jeopardy Determinations: The Texas Tax Code authorizes the Texas Comptroller to make assessments on an expedited basis by shortening the time period in which an assessment becomes final and by making the amount of the deficiency due and payable immediately. Specifically, Section 111.022 states that, if the Texas Comptroller believes that the collection of a tax required to be paid to the state or the amount due for a tax period is jeopardized by delay, the Texas Comptroller shall issue a determination stating the amount and that the tax collection is in jeopardy. The amount required to be paid to the state or due for the tax period is due and payable immediately. A jeopardy determination becomes final on the expiration of 20 days after the day on which the notice of the determination was served by personal service or by mail unless a petition for a redetermination is filed before the determination becomes final ("Jeopardy Determination"). *See* Tex. Tax Code § 111.022.

3. Challenging a "Final" Assessment: Once a determination becomes final, it may no longer be appealed on a prepayment basis. The only remaining issue becomes one of payment and collection. The taxpayer may still be able to appeal the adjustment by filing a claim for refund if the statute of limitations for filing a refund claim is still open. *See* Tex. Tax Code §§ 111.104.

B. Appeals Options: Taxpayers who receive a Notice of Audit Results from the Texas Comptroller generally have three options available to them. The first includes filing a petition for redetermination with the Texas Comptroller within 30 days after the date on which service of the notice of determination is completed (20 days for a Jeopardy Determination). *See* Tex. Tax Code §§ 111.009, 111.022. This has the effect of initiating an administrative appeal with the Texas Comptroller. The second option is to pay the tax and file a claim for refund with the Texas Comptroller. The refund claim must be filed within the applicable statute of limitations. Upon denial, the taxpayer may

then seek a redetermination of the denial. The third option is to pay the tax under protest and file a petition in District Court.

C. **Offset**: The Texas Comptroller is authorized to offset an overpayment, including interest, for one or more periods (e.g., refund claims) against an underpayment, penalty and interest accrued on the underpayment for the same period or one or more other periods. *See* Tex. Tax Code § 151.508.

D. **Reliance on Audit Results**: The Texas Comptroller has established a practice of including a statement in every Notice of Audit Results stating that the taxpayer may not rely on the results of any audit. The Texas Comptroller believes that this language precludes taxpayers from successfully asserting detrimental reliance on audit results where an auditor expressly or implicitly approved of the taxpayers accounting and tax reporting practices.

VII. **Redetermination Process**

A. **General**: The purpose for a redetermination hearing is to contest an assessment by the Texas Comptroller administratively by having the contested items decided by an administrative law judge. Previously, the administrative law judges were employees of the Texas Comptroller. In January 2007, Comptroller Susan Combs signed an Interagency Cooperation Contract with the State Office of Administrative Hearings (“SOAH”) under which she transferred all of the administrative law judges to SOAH along with the functions and duties they previously performed within the Comptroller’s office. The Texas Legislature codified this move in Senate Bill 242 as part of the 80th Regular Legislative Session in 2007 by adding a “tax division” to the SOAH. Senate Bill 242 is scheduled to sunset on September 1, 2011 unless the Legislature enacts a law continuing the SOAH tax division. *See* Tex. Gov’t Code § 2003.102(c).

B. **Qualifications of Administrative Law Judges**: An administrative law judge at SOAH’s tax division must (i) be a United States citizen; (ii) be an attorney in good standing with the State Bar of Texas; (iii) have been licensed in Texas to practice law for at least seven years; (iv) have substantial experience in tax cases in making the record suitable for administrative review or otherwise; and (v) have devoted at least 75 percent of the person’s legal practice to Texas state tax law in at least five of the past 10 years before the date on which the person begins employment in the tax division. *See* Tex. Tax Code § 2003.101(d).

C. **Adjustments to Determination Amounts**: The Tax Code authorizes the Texas Comptroller to increase or decrease the amount of the determination amount throughout the redetermination process. *See* Tax Code § 151.511. The Texas Comptroller may decrease the amount of a determination at any time before the determination becomes final. *See* Tex. Tax Code § 151.511(a). The Texas Comptroller may increase the amount of a determination that is not final if the additional claim is asserted by the Texas Comptroller at or before a hearing on a redetermination. *See* Tex. Tax Code § 151.511(b). If the Texas Comptroller asserts an additional claim, the petitioner is entitled to a 30-day continuance of the hearing. *See id.*

D. The Chronology of the Redetermination Process

1. Initiation of Redetermination: A redetermination hearing is initiated by filing a request for redetermination and a statement of grounds with the Texas Comptroller.

a. Timing: A petition for redetermination must be filed with the Texas Comptroller within 30 days from the date of the deficiency determination or within 20 days from the date of a jeopardy determination. Failure to submit the redetermination on time results in the denial of a hearing; and the taxpayer must pay the tax due and request a refund before any objection to the determination will receive administrative reconsideration. Tex. Comptroller Rule 1.5(a).

b. Content: The Texas Comptroller's Rules state that the request must include a statement of grounds that sets out in detail the reasons the taxpayer does not agree with the determination. The taxpayer must list and number the items, individually or by category, with which he disagrees, and list and number the factual and legal grounds why the tax should not be assessed or should be refunded. Legal authority must be cited if the taxpayer disagrees with the agency's interpretation of the law. A case may be dismissed if the statement of grounds does not comply with these requirements. If an item or transaction, or category thereof, is not listed in the Statement of Grounds, it may be barred from consideration in a hearing. A statement of grounds may be amended up to the time that a reply to the position letter is required. *See* Tex. Comptroller Rules 1.5 and 1.7.

c. 60-Day Letter: Upon receiving a timely filed petition for redetermination and statement of grounds, the Texas Comptroller will issue taxpayers a "60-Day Letter" which notifies the taxpayer that their request for a hearing has been granted and gives the taxpayer 60 days to provide any additional documentation that the taxpayer would like for the auditor to review. This is generally the last opportunity to resolve the disputed assessment with the auditor before the audit is referred to the administrative hearings section. The 60-Day Letter also gives the taxpayer 60 days to provide any resale or exemption certificates to support tax-free sales. Resale or exemption certificates that are not submitted within this 60-day time limit will not be accepted as evidence to support a claim of tax-free sale. Taxpayers should be particularly aware that any sales for resale that are not supported by resale certificates are presumed taxable. *See* Tex. Comptroller Rule 3.285(b)(4).

2. Position Letter: The Texas Comptroller will respond to the taxpayer's statement of grounds with a "Position Letter," which will accept or reject, in whole or in part, each contention of the taxpayer and set forth what the assistant general counsel finds is properly subject to or exempt from tax. The

Position Letter is filed by an attorney with the Texas Comptroller's Administrative Hearings Section. *See* Tex. Comptroller Rule 1.8.

3. Response: The taxpayer must accept or reject, in whole or in part, the position letter within 45 days after the day the position letter is dated. *See* Tex. Comptroller Rule 1.10.

a. Failure to respond within this 45 day period will result in filing of a motion to dismiss the hearing and disposition of the case according to the position of the Administrative Hearings Section.

b. A taxpayer must accept or reject the Texas Comptroller's Position Letter within 45 days from the date of the Position Letter, unless an extension is granted. The Position Letter will include a selection form that will offer the taxpayer two options:

(i) Agree with the Position Letter: If the taxpayer agrees with the Position Letter, the tax liability or refund will be calculated accordingly. An amended determination or final billing concludes the administrative proceeding. *See* Tex. Comptroller Rule 1.10(b)(1).

(ii) Disagree With The Position Letter: If the taxpayer disagrees with the Position Letter, the taxpayer must also submit a Reply to the Position Letter with the selection form. In the Reply, the taxpayer may present any additional facts, legal arguments, or documents for consideration. The Reply is essentially a legal brief in which all unresolved contentions are addressed with factual and legal support. All factual allegations must be supported by sworn affidavits, certified business records or otherwise admissible evidence. *See* Texas Comptroller Rule 1.10(b)(2); 1.15. The Texas Comptroller's office has been fairly flexible about granting taxpayers an initial 45-day extension. Additional extensions may be more problematic for taxpayers.

4. Administrative Hearings Response: The AHS may file a response to the taxpayer's Reply to the Position Letter if the taxpayer presents additional facts or legal arguments in its Reply. The AHS response is due within 45 days from the date the Taxpayer files its Reply. However, the AHS may grant itself an extension if it is unable to respond within that time period in which case the taxpayer will be notified of the delay and informed of the revised response date. *See* Tex. Comptroller Rule 1.16(a).

5. Transfer to SOAH for Hearing: If the parties are unable to resolve or settle all contested tax matters, the Tax Division will, at a taxpayer's request or on its own motion, file a Request to Docket Case form with the State

Office of Administrative Hearings (“SOAH”). The Request must be filed within 30 days from the date of the taxpayers’ Request unless the parties agree otherwise. The taxpayer is given the option of selecting:

- a. A written submission hearing before a SOAH administrative law judge, or
- b. An oral hearing before a SOAH administrative law judge.

See Tex. Comptroller Rule 1.22(d). The AHS has the option of requesting an oral hearing in any case in which it has the burden of proof.

6. **Proposed Decision**: The assigned administrative law judge will issue a proposal for decision (“PFD”) in accordance with SOAH’s Rules of Procedure. Both the Taxpayer and the AHS may file exceptions and response in accordance with those Rules.

7. **Final Decision**: After reviewing the PFD from SOAH any exceptions filed by the taxpayer and the assistant general counsel, the Texas Comptroller will issue a final decision. *See* Tex. Comptroller Rule 1.28(a).

a. **SOAH’s Decision**: The Texas Comptroller may either accept or reject SOAH’s decision in whole or in part. The Tax Code states that the Texas Comptroller may change a finding of fact or conclusion of law made by the administrative law judge or vacate or modify an order issued by the administrative law judge only if the Texas Comptroller: (1)determines that the administrative law judge (i) did not properly apply or interpret applicable law, then existing Comptroller rules or policies, or prior administrative decisions; or (ii) issued a finding of fact that is not supported by a preponderance of the evidence; or (2) determines that a Texas Comptroller policy or a prior administrative decision on which the administrative law judge relied is incorrect. *See* Tex. Gov’t Code § 2003.101(e). The Comptroller must state in writing the specific reason and legal basis for not accepting SOAH’s decision as described above. *See id.* at 2003.101(f).

b. **Date Decision Becomes Final**: The Texas Comptroller’s decision is final 20 days from the date the Texas Comptroller notifies the taxpayer of its final decision unless a motion for rehearing is filed within that 20 day period. *See* Texas Comptroller Rule 1.28(a).

E. **Additional Documentation**

1. **Other documentation**: If the taxpayer's statement of grounds raises issues that cannot be resolved from the material contained in the audit or statement of grounds, additional evidence may be obtained through:

- a. a preliminary conference;

- b. discovery;
- c. written or oral requests for additional evidence; and
- d. audit amendment.

2. **Discovery**: The Texas Comptroller's Regulations permit the use of discovery as a means of acquiring additional information from the other party in connection with the redetermination process. *See* Texas Comptroller Rule 1.33. Discovery at the AHS and while a hearing is docketed at SOAH is conducted under the SOAH Rules of Procedure, which may include:

- a. Requests for disclosure;
- b. Requests for production and inspection of documents and tangible things;
- c. Interrogatories;
- d. Oral or Written depositions; and
- e. Requests for admission

F. **Representation**: The Texas Comptroller's Rules state that a taxpayer may represent himself at any stage of a contested case or may be represented by an authorized representative, such as an attorney, accountant, or other person of his choice. The Texas Comptroller is represented by attorneys assigned to the Administrative Hearings Section, General Counsel Division. Hearings at SOAH on contested cases are not open to the public. *See* Texas Comptroller Rule 1.4.

G. **Exparte Communications**: The Government Code prohibits ex parte communications between an administrative law judge and any of the parties or their representatives. The Government Code states that the Texas Comptroller may not attempt to influence the findings of fact or the administrative law judge's application of the law except by evidence and legal argument. An administrative law judge also may not directly or indirectly communicate in connection with an issue of fact or law with a party or its representative except (i) on notice and opportunity for each party to participate; or (ii) to ask questions that involve ministerial, administrative, or procedural matters that do not address the substance of the issues or positions taken in the case. *See* Tex. Gov't Code § 2003.101(j); *see also* Texas Comptroller Rule 1.41.

H. **Administrative Sanctions For Certain Abusive Conduct**: Senate Bill 242 also authorizes an administrative law judge to impose sanctions against a party in certain cases. An administrative law judge, on the judge's own motion or on motion of a party and after notice and an opportunity for a hearing, may impose appropriate sanctions against a party or its representative for (1) filing a motion or pleading that is groundless and brought (A) in bad faith; (B) for the purpose of harassment; or (C) for any other

improper purpose, such as to cause unnecessary delay or needlessly increase in the cost of the proceeding; (2) abuse of the discovery process in seeking, making or resisting discovery; or (3) failure to obey an order of the administrative law judge or the Texas Comptroller. *See* Tex. Gov't Code 2003.101(g). Sanctions may include (1) disallowing further discovery of any kind or of a particular kind by the offending party; (2) holding that designated facts be deemed admitted for purposes of the proceeding; (3) refusing to allow the offending party to support or oppose a designated claim or defense or prohibiting the party from introducing designated matters in evidence; (4) disallowing in whole or in part requests for relief by the offending party and excluding evidence in support of such requests; and (5) striking pleadings or testimony, or both, wholly or partly, or staying further proceedings until the order is obeyed. *See id.* at § 2003.101(h).

I. Appeal to District Court: A final decision of the Texas Comptroller may be appealed to the Travis County District Court. A taxpayer must pay the tax under protest before going to District Court.

VIII. Appeals to District Court: Taxpayers who receive a final determination from the Texas Comptroller have the option of seeking judicial review of the determination. This may be done before or after an administrative appeals hearing. The statutorily prescribed procedures for challenging an adverse Comptroller decision call for payment of the tax before the lawsuit may be filed. It is possible to seek declaratory judgment following an adverse Comptroller decision without first paying the tax, but there is considerable uncertainty in taking that approach.

A. Statutorily Prescribed Refund Proceeding:

1. Payment Required: A person claiming that tax collected by the Texas Comptroller is unlawful who intends to bring suit for such tax may pay the amount claimed by the state and submit with the payment a protest. *See* Tex. Tax Code § 112.051(a).

2. Protest Required: The protest must be in writing and must state fully and in detail each reason for recovering the payment. It must also be made within the period of time limitations period for the filing of refund claims (*i.e.*, 4 years from the time the tax became due and payable or within 6 months from the date of a jeopardy or deficiency determination). *See* Tex. Tax Code § 112.051(b),(c).

3. Issues: The Tax Code states that the only issues that may be addressed in the suit are limited to those arising from the reasons expressed in the written protest. For this reason, the protest letter represents a critical stage in the preparation of filing a petition in district court. It is generally advisable to have the attorney who will represent the taxpayer in court to draft the protest letter. *See* Tex. Tax Code § 112.053(b).

4. Time for Filing Suit: The law suit must be brought before the 91st day after the date the protest payment is made, or the suit is barred. *See* Tex. Tax Code § 112.052(b).

B. Declaratory Relief on Pre-Payment Basis:

1. Statutory Prohibition Against Declaratory Relief: Section 112.108 of the Texas Tax Code precludes a court from issuing a restraining order, injunction, declaratory judgment, writ of mandamus or prohibition, order requiring the payment of taxes or fees into the registry or custody of the court or other similar legal or equitable relief against the state relating to the applicability, assessment, collection, or constitutionality of a tax or fee or the amount of the tax or fee due, except where an oath of inability is filed with the court.

2. Prohibition Against Declaratory Relief Held Unconstitutional: The Texas Supreme Court in *R. Communications, Inc. v. Sharp*, 875 S.W.2d 314 (Tex. 1994) held that Section 112.108 is unconstitutional insofar as it would preclude a taxpayer from obtaining judicial review of its tax liability by means of a declaratory judgment on the basis that it violates the guarantee of open courts found in article I, section 13 of the Texas Constitution. See *R. Communications*, 875 S.W.2d at 318. The Texas Legislature responded in 1995 by adding the “oath of indigency” exception in Section 112.108 to the general prohibition against declaratory relief. However, the Texas Court of Appeals for the Third Circuit in 2000 held that the amended version of Section 112.108 remains unconstitutional. See *Rylander v. Bandag Licensing*, 18 S.W.2d 296, 304 (Tex. App. – Austin, 2000). Thus, taxpayers are entitled to seek declaratory judgment.

3. Declaratory Relief Following Adverse Comptroller Hearing: *R. Communications* makes clear that a taxpayer may not be prohibited from seeking declaratory relief on a prepayment basis. Unfortunately, there is considerable uncertainty on how to accomplish this procedurally, given that the statutory provisions which govern court proceedings to challenge Comptroller determinations all require or assume prepayment. In addition, the Comptroller’s office has announced that, while the decision in *R. Communications* may provide access to the courts without paying the tax assessment, it does not prohibit the Texas Comptroller from pursuing collection activities while the lawsuit is pending. See *Elliott & Morris’ Texas Tax Code Annotated* § 111.105, Commentary (2009 ed). Thus a taxpayer seeking to file a declaratory judgment on a prepayment basis following an adverse Comptroller decision should probably anticipate that the Texas Comptroller will proceed with collecting the full amount of tax, penalty and interest while the case is pending. In addition, given that a Comptroller decision becomes final after 20 days under Section 111.009 and the fact that the statute of limitations on refund claims may not be viewed as tolled under Section 111.207 if it is brought under the Uniform Declaratory Judgments Act and not Chapter 112 of the Tax Code, and all the other attendant uncertainty regarding the applicable statutory provisions in light of *R. Communications*, a taxpayer wanting to file a lawsuit in state district court on a prepayment basis following an adverse Comptroller decision may want to file a protective refund claim under Section 111.104(c) immediately following the Comptroller decision.

IV. Claims For Refund

A. Who May File a Refund Claim?

1. History.

a. **Pre-Fleming Foods:** Prior to the Texas Supreme Court's decision in *Fleming Foods of Texas, Inc. v. Rylander*, 6 S.W.3d 278 (Tex. 1999) in 1999, the Texas Comptroller maintained that only a taxpayer who paid sales tax directly to the Texas Comptroller could file a claim for refund with the Texas Comptroller. Thus, a purchaser who paid sales tax to a vendor could only seek a refund from the vendor. Should the purchaser desire to seek a refund from the Texas Comptroller, he or she was required to first obtain an assignment from the vendor. The Texas Comptroller maintained that in such cases, the vendors' statute of limitations controlled the refund claim. Thus, where the period for filing a refund claim had expired for a vendor, the purchaser was likewise precluded from filing a refund claim under an assignment from the vendor even if the purchaser had previously extended the statute of limitations with the Texas Comptroller.

b. **Fleming Foods of Texas, Inc. v. Rylander, 6 S.W.3d 278 (Tex. 1999):** The Texas Supreme Court rejected the Texas Comptroller's interpretation of the Tax Code regarding the identity of persons who can file claims for refund. Fleming Foods filed a claim for refund following an audit contending that it had erroneously paid sales taxes on exempt packing materials over several years. The Texas Comptroller denied the claim on the basis that Fleming Foods' refund rights were derivative of its vendors' rights. As such, the Tax Code did not permit Fleming, as an indirect taxpayer, to obtain refunds from the State unless its vendors timely assigned to it their refund rights. In this case, many of the assignments obtained by Fleming Foods were outside the 4 year statute of limitations as applied to the vendors notwithstanding that Fleming Foods had extended its statute of limitations with the Texas Comptroller. The Supreme Court overruled the Texas Comptroller and well as two lower court decisions and held that indirect taxpayers such as Fleming Foods could seek refunds of sales tax directly from the State.

2. **Current Law following 2003 Legislative Amendments:** House Bill 2425 enacted into law in 2003 effectively returns non-permitted taxpayers seeking refund claims to the *Pre-Fleming Foods* era with a few exceptions. Section 111.104(b) now states that a tax refund claim may be filed with the Texas Comptroller only by the person who directly paid the tax to the state or by the person's attorney, assignee, or other successor. Section 151.430, however, permits certain permitted purchasers to file a claim for refund directly with the Texas Comptroller. The following rules represent the Texas Comptroller's interpretation of House Bill 2425, per a Special Notice issued in June 2003:

a. **Non-permitted Taxpayers:** A non-permitted taxpayer can seek a refund of tax only from the seller to whom the tax was paid unless a refund assignment is obtained from the seller. The refund assignment must be attached to the refund claim. When a refund assignment is obtained from the seller and submitted as part of the refund claim, the purchaser, as the assignee, steps into the shoes of the seller, the assignor. The seller's statute of limitations applies, and any defense against the seller applies to the assignee.

b. **Permitted Taxpayers Who Overpay Tax on Purchases:** Permitted taxpayers (*i.e.*, taxpayers holding a sales tax permit issued by the Texas Comptroller) have three ways to seek a refund of tax paid on purchases:

(i) Request a refund directly from the Texas Comptroller. In such case, the purchaser's statute of limitations applies.

(ii) Take a credit on a return.

(iii) Request a refund from the seller to whom the tax was paid.

B. Procedures For Filing Claims for Refund

1. **Writing Requirement:** Generally, there is no specific manner for filing a claim for refund with the Texas Comptroller. Section 111.104 states only that a claim for refund must (1) be written and (2) state fully and in detail each reason or ground on which the claim is founded and (3) be filed before the expiration of the applicable limitation period or before the expiration of six months after a jeopardy or deficiency determination becomes final. The Texas Comptroller's website states that all taxpayers must provide the following information when requesting a refund of taxes paid in error directly from the Texas Comptroller (i) a signed letter stating fully and in detail the reason for the refund claim; (ii) the amount of refund requested; (iii) the taxpayer name and number; (iv) the date when the tax was erroneously paid (begin and end date of the period); (v) copy of the invoices (if more than 10 invoices are at issue, the taxpayer must provide the same data as shown on the sample Schedule to Support Refunds (Texas Comptroller Form 01-911); and (vi) power of attorney or other written authorization if represented by an authorized agent. *See Sales Tax Refunds, Required Documentation for Requesting Refunds, http://www.window.state.tx.us/taxinfo/refunds/refunds_sales.html*

2. **Payment Under Protest v. Refund Claim:** Under the Tax Code, there is a difference between payments made "under protest" and a payment made with the anticipation of subsequently filing a claim for refund. A taxpayer who desires to pay the tax and file a claim for refund in order to obtain an administrative redetermination hearing need do nothing more than pay the tax and

thereafter timely file a written claim for refund. Upon the Texas Comptroller's denial of the refund claim, the taxpayer may then request a redetermination hearing. On the other hand, a taxpayer who desires to pay the tax and thereafter sue for a refund of the tax in court must pay the tax "under protest." *See* Tax. Code § 112.052(b). The taxpayer must thereafter file a claim for refund within 90 days after the protest payment is timely made or the suit is barred. Thus, a taxpayer should not label a payment as made "under protest" unless he intends to trigger the 90 day period for filing a lawsuit.

3. **No Duplication of Refund Claims:** The Code was amended in 2003 to prohibit taxpayers from refiling a claim for refund for the same transaction or item, tax type, period, and ground or reason that was previously denied by the Texas Comptroller. *See* Tax. Code § 111.107(b).

C. **Redetermination Hearing Following Denial of Claim for Refund**

1. **Right to a Hearing:** A person claiming a refund is entitled to a hearing on the claim if the person requests a hearing on or before the 30th day after the date the Texas Comptroller issues a letter denying the claim for refund. Tax Code § 111.104. Prior to the 2003 Legislature, a taxpayer had only 20 days to request a redetermination hearing.

2. **Finality of Decision:** A decision by the Texas Comptroller following a hearing on the refund claim becomes final 20 days after the service on the claimant of the notice of the order or decision, unless the taxpayer files a motion for rehearing within that time.

3. **180 Day Documentation Requirement:**

a. **General Rule:** Under Section 111.105(e) of the Tax Code, a person claiming a refund with the Texas Comptroller must submit documentation to enable the Texas Comptroller to verify the claim for refund. The 2003 Legislature also included a provision in this Section authorizing the Texas Comptroller to issue a notice of demand that all evidence to support the claim for refund must be produced before the expiration of a specified date in the notice, which may not be earlier than 180 days after the date the refund is claimed.

b. **Evidence Exclusion at Administrative Hearing:** Section 111.105(e) states that the Texas Comptroller may not consider evidence produced after the specified date in the notice in an administrative hearing. Thus, once the Texas Comptroller issues its notice of demand, the taxpayer must produce all evidence to support its claim for refund within the prescribed time period or face exclusion of the evidence at the administrative hearing. This exclusion applies only to the administrative hearing. It does not apply to judicial proceedings, which are generally conducted on a de novo basis.

D. Suit for Refund:

1. Right to File Suit For Refund: A person who has been denied a tax refund claim may sue the Texas Comptroller to recover an amount of tax, penalty or interest that was the subject of the refund claim if the person has:

- a. Filed a tax refund claim with the Texas Comptroller;
- b. File a motion for rehearing that has been denied by the Texas Comptroller; and
- c. Paid any additional tax found due in a jeopardy or deficiency determination that applies to the tax liability period covered in the tax refund claim.

These provisions generally require a taxpayer to exhaust its administrative remedies on a refund denial before filing a lawsuit in State District Court. *See Central Power & Light Co. v. Sharp*, 960 S.W.2d 617 (Tex. 1997).

2. Time for Filing Suit: The suit must be filed within 30 days from the date of the denial of the motion for rehearing. Tax Code § 112.151(c).

3. Issues in Suit: The Tax Code states that the only issues that may be raised in a suit for refund are the grounds of error contained in the motion for rehearing. *See* Tex. Tax Code § 112.152(a). A copy of the motion for rehearing must be attached to the original petition. For this reason, it is critical to consider carefully the issues that are raised in the motion for rehearing. The motion for rehearing should be prepared by the attorney that will represent the taxpayer in the subsequent lawsuit.

E. Statute of Limitations:

1. General 4 year limitations period applies: Generally, a claim for refund must be filed within 4 years from the date that the tax becomes due and payable. *See* Tex. Tax Code §§ 111.107(a); 111.201.

2. Six Month Limitations Period: A refund claim may also be filed before the expiration of six months after a jeopardy or deficiency determination becomes final. In such case, the refund claim is limited to the tax, penalty, interest and payment period for which the determination was issued. *See id.* § 111.104(c)(3).

3. Caution: Note that the limitations period runs from the date the tax is due and payable, not from the time that payment is made. *See id.* § 111.201. Thus, where a taxpayer pays tax to the Texas Comptroller for a year that is outside the statute of limitations, in the absence of a deficiency determination by the Texas Comptroller, the Texas Comptroller's position is that the taxpayer

may not thereafter file a claim for refund. *See Texas Comptroller Hearing No. 41, 675* (June 10, 2004).

4. **Tolling:**

a. **General Rule:** The limitations period is tolled for the period during which a refund hearing is pending before the Texas Comptroller. This tolling is limited to issues that were contested in the refund hearing. See Tex. Tax Code § 111.207.

b. **Informal Reviews:** The Code states that informal reviews of refund claims by the Texas Comptroller do not toll the limitations period. See Tex. Tax Code § 111.1042(d).

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