

NO. 08-1056

IN THE
SUPREME COURT OF TEXAS

TGS-NOPEC GEOPHYSICAL COMPANY
d/b/a TGS-NOPEC CORPORATION,
Petitioner,

VS.

SUSAN COMBS, SUCCESSOR-IN-INTEREST TO
CAROLE KEETON STRAYHORN, COMPTROLLER OF PUBLIC
ACCOUNTS AND GREG ABBOTT, ATTORNEY GENERAL OF TEXAS,
Respondents.

On Petition from the Court of Appeals
for the Third Judicial District of Texas

RESPONSE TO THE PETITION FOR REVIEW

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d/b/a TGS-NOPEC Corporation**

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TO THE HONORABLE SUPREME COURT:

Respondents Susan Combs, Comptroller of Public Accounts of the State of Texas, and Greg Abbott, Attorney General for the State of Texas, (collectively, the Comptroller”) respectfully file their response to the Petition of TGS-NOPEC Geophysical Company d/b/a TGS-NOPEC Corporation (“TGS”).

ISSUES PRESENTED

- 1) The legislature amended the franchise tax statute to specifically include receipts from the use of a license in Texas as “business done in this state” for apportionment purposes. Does this amendment apply to receipts, collected from licensees, in cases where the licensed data is either mailed to a Texas address or billed to a Texas address?
- 2) May the Comptroller constitutionally treat the receipts from the sale or licensing of computer software, under a licensing agreement, differently than TGS’s receipts generated from issuing a license for the use of geophysical data?
- 3) Was it reasonable for the Comptroller to treat the billing or shipping address of TGS’s customers as the location of use for apportionment purposes?

STATEMENT OF FACTS

The Court of Appeals correctly stated the nature of the case. TGS is a Delaware corporation with a principal place of business in Houston, Texas. CR 331. TGS performs geophysical seismic studies and licenses Texas and out-of-state exploration and production (E & P) companies to use the data to make prospecting decisions. CR 332.

TGS is subject to franchise tax. Tex. Tax Code Ann. § 171.001(a)(1). The contested gross receipts are revenue received from TGS's licensees in Texas. CR 126.

The Comptroller audited TGS and assessed additional franchise tax, penalty, and interest of \$1,757,570.89 for the 1997-2000 and 2001-2003 audit periods.¹ CR 129, 140, 310, 408. TGS paid taxes, penalty, and interest under protest, and timely filed this lawsuit. The assessments arose from TGS's failure to correctly apportion receipts from licenses.

TGS produced a summary report listing its Texas customers' mailing or billing addresses. CR 126. The Comptroller used the address to which data was mailed or billed to determine the location where it was used. CR 127.

APPORTIONMENT STATUTES & RULES IN EFFECT FOR 1998

Sections 171.103 and 171.1032 of the Tax Code apportion license receipts and provide, in relevant part:

In apportioning taxable capital, the gross receipts of a corporation from its business done in this state is the sum of the corporation's receipts from: . . . (4) the use of a patent, copyright, trademark, franchise, or license in this state; . . . Tex. Tax Code § 171.103(4) (1998).

. . .in apportioning taxable earned surplus, the gross receipts of a corporation from its business done in this state is the sum of the corporation's receipts from: . . . (4) the use of a patent, copyright, trademark, franchise, or license in this state;. . . Tex. Tax Code § 171.1032(a)(4) (1998).

¹ The statutory amendment at issue took effect on January 1, 1998, thus the Comptroller's assessment on the "location of use" issue did not include the 1997 tax year.

Rule 3.549 and Rule 3.557 implement the apportionment statutes and provide, in relevant part:

(30) Patents, copyrights, and other intangibles. (A) Receipts from the use of intangible rights. . . .(iii) For reports due prior to January 1, 1998, revenues received by the owner of a trademark, franchise, and license are apportioned to the location of payor. For reports due on or after January 1, 1998, revenues received by the owner of a trademark, franchise, or license are included in Texas receipts to the extent used in Texas. In regard to the sale/licensing of computer programs, paragraph (7) of this subsection is controlling. 34 Tex. Admin. Code § 3.549(e)(30)(A)(iii) (1998) (Taxable Capital: Apportionment).

(25) Patents, copyrights, and other intangible rights. (A) Revenues from the use of intangibles. . . .(iii) Revenues received by the owner of a trademark, franchise, and license are included in Texas receipts to the extent used in Texas; however, in regard to the sale/licensing of computer programs, paragraph (6) of this subsection is controlling. 34 Admin. Code § 3.557(e)(25)(A)(iii) (1998) (Earned Surplus: Apportionment).

SUMMARY OF ARGUMENT

The case turns on whether revenues from licensing non-exclusive geophysical data to licensees located in Texas are Texas receipts, and, if so, whether franchise tax rules distinguishing between licenses and software are constitutional under the equal and uniform taxation requirements of the Texas Constitution. Tex. Tax Code Ann. §§ 171.103, .1032 (West 1998-2003).²

TGS's statutory arguments are predicated on the fundamentally incorrect proposition that where license receipts are apportioned is an open question. The franchise

² Unless otherwise specified, references to the Tax Code will be to the statutes in effect from 1998-2003. Relevant statutes are in the Vernon 2002 volume. References to "§171._" are to the franchise tax statute.

tax statute was amended in 1997 to provide that revenues from licenses used in this state are Texas receipts beginning on January 1, 1998. §§ 171.103, .1032.

The 1997 amendment was a clear statement of legislative intent to abandon the prior (location of payor) apportionment standard. A plain reading of the statute as amended indicates that revenues received from the use of a license in Texas are Texas receipts for apportionment purposes. Comptroller rules, and letter rulings, based on the statute as it existed prior to the 1997 amendment are superseded by statute.

The difference in tax treatment applied to software receipts, as compared to license receipts, does not violate the equal and uniform taxation requirements of the Texas Constitution. The constitutional mandate requires only that all entities falling within the same class be taxed alike.

ARGUMENT

I. TGS's receipts from the issuance of non-exclusive geophysical data license are subject to apportionment as business in Texas, under the Texas Tax Code as amended by the Legislature in 1997.

A. Introduction to the franchise tax.

Franchise tax is imposed on a corporation's net taxable capital and earned surplus. § 171.002. Taxable capital is essentially net assets and earned surplus is adjusted reportable federal taxable income. §§ 171.101(a), .110(a).

Franchise taxes are based on Texas business done during the previous accounting year. §§ 171.153, .1532. Both of the tax bases are divided among Texas and other tax jurisdictions by multiplying them by an apportionment factor, the numerator of which is

gross receipts from Texas business, and the denominator of which is gross receipts from business everywhere. Taxpayers generate gross receipts by selling goods and services, receiving dividends and interest, realizing capital gains, and the like. §§ 171.103, .1032.

This case involves the size of the numerator, or how much of TGS's license revenue arises from business done in Texas.

B. TGS's claim that the 1997 amendment did not change how geophysical license receipts are apportioned conflicts with the plain language of the statute and the legislative history of the amendment.

1. The license receipts amendment clearly evidences a change in standards.

Before 1998, license receipts were considered to be revenue from the sale of intangible property, or "other business done in this state. . ." and were apportioned to the location of the licensees' legal domiciles—the states in which they were incorporated. §§ 171.103, .1032 (Vernon 1997); Pet. TAB 7 & 8. This standard bore no relationship to where licenses were used.

Since 1998, the franchise tax statute has provided that the "**use of a patent, copyright, trademark, franchise, or license in this state**" generates Texas receipts. § 171.103, .1032 (emphasis added). Pet. TAB 9 & 10. This standard relates the protections, opportunities and benefits afforded by the taxing state to the place of use. *See Amerada Hess Corp. v. Dir., Div. of Tax'n*, 490 U.S. 66, 79 (1989).

The 1997 amendment was enacted as S.B. 861 by the 75th Legislature in 1997, when the Comptroller sought legislation that would expressly apportion license, trademark, and franchise revenue to the place they are used, for both taxable capital and

earned surplus. Act of May 30, 1997, 75th Leg., R.S., ch. 1185, §§ 5-6, 1997 Tex. Gen. Laws 4569, 4569-70 (effective January 1, 1998); CR 215-218; (Appendix A).

The Comptroller's fiscal note analysis for S.B. 861, prepared at the request of the Legislative Budget Board, states:

Current franchise tax law sources the receipts from trademarks, franchises, and licenses used in Texas to the state of legal domicile of the corporation remitting the payments. Patents and copyrights are sourced to Texas if the patent or copyrights are used in Texas. **This bill would equalize treatment among these types of similar intangible assets:** The receipts would be sourced to Texas if the assets were used in Texas. [. . .] The changes related to sourcing receipts from certain intangible assets would provide a small revenue gain. (emphasis added)

COMPTROLLER FISCAL NOTE ESTIMATE, S.B. 861, 75th Leg., R.S. (1997); CR 220-222; Pet. TAB 16. Thus, the legislature considered that patents, trademarks, copyrights, and licenses are "types of similar intangible assets." A bill analysis prepared by the Senate Research Center states that S.B. 861 would make substantive changes to "deal with apportionment of gross receipts from the use of trademarks, franchises, and licenses in Texas; . . ." CR 235-237; Pet. TAB 18, ¶ 1. Thus, the information provided to the legislature relating to the effect of S.B. 861 indicates that the legislature acted with an affirmative intent to change the apportionment of license receipts from "location of payor" to "place of use."

The statute's plain language and legislative history demonstrate that receipts from licenses, trademarks, and franchises were brought, for the first time, into the same fold as patents and copyrights. TGS may disagree with this policy choice, but it was one the

legislature had every right to make. *See Nordlinger v. Hahn*, 505 U.S. 1, 12 (1992); *see also, Tex. Workers' Compensation Comm'n v. Garcia*, 893 S.W.2d 504, 520 (Tex.1995).

2. The license receipts amendment applies to TGS's license receipts.

TGS claims that the license amendment does not encompass geophysical seismic data licenses, but there is no support for this claim because the statute does not qualify or in any way limit the term "license." TGS's contracts are styled as a "Master License Agreement for Geophysical Data," and TGS's customers are designated as "licensees" in the agreements. CR 179-181; Pet. TAB 3 (Master License Agreement for Geophysical Data).

TGS licenses the use of data to its licensees. The fees paid to TGS by its licensees are receipts to TGS. A plain reading of sections 171.103(4) and 171.1032(a)(4) indicates that these payments, received by TGS, are gross receipts generated from the use of a license.

3. TGS relies on Comptroller policy that was superseded by an express statutory amendment.

TGS relies on superseded Comptroller policy documents for the proposition that the Comptroller irrevocably decided that receipts from licensees arise from the sale of intangible property and should be apportioned to the location of the payor – the licensees' legal domicile. In addition to failing to recognize that these policies were trumped by the 1997 amendment, TGS mischaracterizes them.

Before the 1997 amendment expressly included license revenues in the same category as patents and copyrights, the Comptroller analyzed the essence of the receipts-

generating transaction to determine which apportionment rule to apply. There were three possible categories for license transactions under the apportionment statutes: sales of tangible personal property, sales of intangible personal property, or sales of services. CR 80-81; Pet. TAB 11, ¶ 2 (Taxability Response No. 0851).

In answer to the question “Should gross receipts from the **licensing** of the geophysical ‘proprietary data’ be from sales of tangible personal property, from sales of intangible personal property or from services?” the Comptroller concluded in 1982 that the closest fit was sales of intangible personal property. The licensing agreements did not represent contracts for the sale of tangible personal property, and performance of a service required specific customers. *Id.* at ¶ 5. The only other category that fit was the sale of intangible personal property. Accordingly, license receipts were apportioned to licensees’ legal domicile.

When, in 1997, the legislature decided to apportion licenses the same as other transactions involving intangible property – such as patents and copyrights – the Comptroller withdrew the apportionment policies that had been in place before the 1997 amendment. The Comptroller does not, and TGS cannot, rely on superseded policies.

The legislature decided that licenses were more like patents, copyrights, trademarks, and franchises than the sale of other intangibles, and apportioned such receipts to the place of use. This legislative action precludes the Comptroller from apportioning license receipts to the location of payor after January 1, 1998.

4. The 1997 amendment to the apportionment statutes is a clear and specific legislative departure from the location of payor rule, satisfying the requirements established by *Humble Oil*.

TGS suggests that the 1997 amendment was not a sufficiently clear statement of the legislature's intent to abandon the location of payor test and thus must be invalid, at least as applied to TGS, per the standard established in *Humble Oil & Refining Co. v. Calvert*, 414 S.W.2d 172 (Tex. 1967). TGS's analysis misplaces the standard established in *Humble Oil*. In *Humble Oil*, the Comptroller made his decision to apply a different (i.e., business situs) test to receipts from certain intangibles, under the theory that the legislature abandoned the location of payor test by implication. *Id* at 177. The statutory amendment at issue in *Humble Oil* neither expressly rejected "location of payor" nor referenced the "business situs" test. The *Humble Oil* court determined that the Comptroller had read "too many far reaching concepts into an ambiguous subsection." *Id* at 177. In the instant case, the amendatory language is clear and specific. Receipts from the use of a license in Texas are expressly apportioned to Texas.

TGS's attempt to interject ambiguity by suggesting that the amended statute could be construed as applying to the apportionment formula of either the licensor or the licensee does not bear close inspection. The apportionment formula is a measure of receipts, and receipts are received by the entity granting a license; a franchise; or the right to use a trademark; not by the licensee or grantee. To the extent that a licensee generates income from the sale of a product or service created utilizing the license, then such receipts (of the licensee) would be apportioned based on the product or service sold.

5. TGS’s reliance on the legislative acceptance doctrine is misapplied.

TGS contends that taxability rulings issued by the Comptroller prior to the 1997 enactment of the statutory amendments should invoke the application of the legislative acceptance doctrine. CR 80-81, 74-75, 77-78; Pet TAB 11, 12, 13. Specifically, TGS argues that the policy announced in various letter rulings issued between 1982 and 1991 should trump the clear language of the 1997 statutory amendment. Such a conclusion would turn the legislative acceptance doctrine on its head.

Application of the legislative acceptance doctrine is specifically limited to those situations where a statute is re-enacted “without any substantial change in verbiage.” *Fleming Foods of Texas v. Rylander*, 6 S.W.3d 278, 282 (Tex. 1999). In addition, the statute at issue must be ambiguous in order for the doctrine to be applied. *Id.* at 282. In the instant case, neither condition is present.

The 1997 statutory amendment did effect a substantial change in verbiage by adding substantive language not contained in the prior law. Specifically, the legislature added the terms “trademark,” “franchise,” and “license” to the list of transaction types subject to apportionment to Texas. Those terms appeared nowhere in the prior statute. *See* Pet. TAB 7 & 8. Further, the statute as amended is not ambiguous. *See supra*, Part B.4.

The doctrine of legislative acceptance cannot be applied to contradict the plain meaning of the apportionment statute. *See Fleming Foods*, 6 S.W.3d at 282.

II. The Comptroller's treatment of TGS's receipts, while different than that applied to receipts generated from the sale or license of computer software, does not violate the equal and uniform taxation requirements of the Texas Constitution.

TGS's arguments based on the equal and uniform taxation requirements of the Texas Constitution are without merit.

TGS's reliance on *Bullock v. Sage Energy Co.*, 728 S.W.2d 465 (Tex. App.-Austin 1987, writ ref'd n.r.e.) is misplaced. The taxpayer in *Sage*, an oil and gas operating company, asserted a uniform and equal taxation claim based on Comptroller treatment of other oil and gas operating companies. The court of appeals decision in *Sage* was based on the premise of comparing the treatment of Sage Energy to "other similarly situated oil and gas operating companies." *Id.* at 468. In the instant case, TGS compares the apportionment treatment of its receipts from the lease of seismic data to the apportionment treatment applied to receipts from the sale or lease of computer software. These two types of companies make different products and operate in different markets. TGS's product is data, while software companies sell programs and operating systems.

A difference in industry products, operations, or business organizations justifies a difference in classification for taxation purposes. The constitutional mandate requires only that all persons falling within the same class be taxed alike. *Sharp v. Caterpillar, Inc.*, 932 S.W. 2d 230, 240 (Tex. App.-Austin 1996, writ denied); *Westcott Communications, Inc. v. Strayhorn*, 104 S.W.3d 141, 149-150 (Tex. App.-Austin 2003, pet. denied). TGS has not claimed that its receipts are being taxed differently than those

of other geophysical data companies, and thus has no basis for asserting an equal and uniform taxation claim.

TGS's attempt to shift, to the Comptroller, the burden of affirmatively documenting the reasonableness of a tax classification cannot be supported. Instead, when reviewing taxation statutes, Texas courts apply a "strong presumption of constitutional validity." *Vinson v. Burgess*, 773 S.W.2d 263, 266 (Tex. 1989); *Caterpillar, Inc.*, 932 S.W.2d at 240. Thus, a challenging party bears the burden of demonstrating that the statute is not rationally related to a legitimate state interest or that the statute's tax classification has no rational basis. *Upjohn Company v. Rylander*, 38 S.W.3d 600, 610 (Tex. App.-Austin 2000, pet. denied). TGS has made no such showing.

III. It was reasonable for the Comptroller to treat the billing or shipping address of TGS's customers as the location of use for apportionment purposes.

The Tax Code directs the comptroller to "determine the amount of tax to be paid from information contained in the [tax] report **or any other information available to the Comptroller.**" § 111.008(a) (emphasis added) (tax deficiency determinations).

The only documentary evidence available to the Comptroller to determine the location of use (and thus the resultant amount of tax to be paid) is contained in reports identifying TGS's Texas-based customers' shipping or billing addresses. CR 126-127, 170, 209. Relative to the facts in this situation, the Comptroller's decision was both reasonable and practical.

From a more general perspective, the Comptroller's decision is reasonable. The primary purpose of apportioning a tax base is to divide it among jurisdictions and avoid, as much as practicable, multiple-taxation (i.e., by several states) and under-taxation. If all states based "place of use" on customer shipping or billing addresses, no state would tax the same revenue twice, but all revenue would be taxed once, thereby fulfilling the purposes and policies of apportionment. *See Okla. St. Tax Comm'n v. Jefferson Lines*, 514 U.S. 175, 184-185, 195 (1995); *Container Corp. of America v. Franchise Tax Board*, 463 U.S. 159, 169 (1983).

TGS contends that if the Comptroller were to carry its position to its logical conclusion, that TGS (and all other industry participants) would be required to perpetually monitor its customers' future use of the seismic data. This is an absurd conclusion. First, there is nothing in the record that indicates that the Comptroller made any such request or indicated that such a level of documentation would be required. Second, it misses the key point that the gross receipts factors (Texas receipts and receipts from business everywhere) are used as measures of a taxpayer's ratio of business activity in Texas for a particular base year (i.e., the accounting year prior to tax year). Nothing in the Tax Code or in the record suggests that the "Texas receipts" factor for any particular accounting year would need to be subsequently adjusted merely due to events occurring after the close of the accounting year.

In contrast, basing place of use on shipping or billing addresses, in the absence of other evidence, promotes administrative convenience and efficiency, which provide a

rational basis for agency policies. *See Graves v. Morales*, 923 S.W.2d 754, 757 (Tex. App.-Austin 1996, writ denied); *Bullock v. Hewlett-Packard Co.*, 628 S.W.2d 754, 756 (Tex. 1982).

PRAYER

The Comptroller therefore prays that TGS's petition be denied and for such other and further relief to which it may be entitled.

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CERTIFICATE OF SERVICE

I do hereby certify that on the 27th of May, 2009, a true and exact copy of the foregoing *Response to the Petition for Review* was mailed via CERTIFIED MAIL, RRR to counsel of record:

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