State Tax Developments

(…with a dash of Property Tax…)

Oil & Gas
Rule & Case Law Update

Oil & Gas Sales Tax Case Law Update

- Southwest Royalties
- Westmoreland

TEXAS TAXPAYERS
TTARA
AND RESEARCH ASSOCIATION

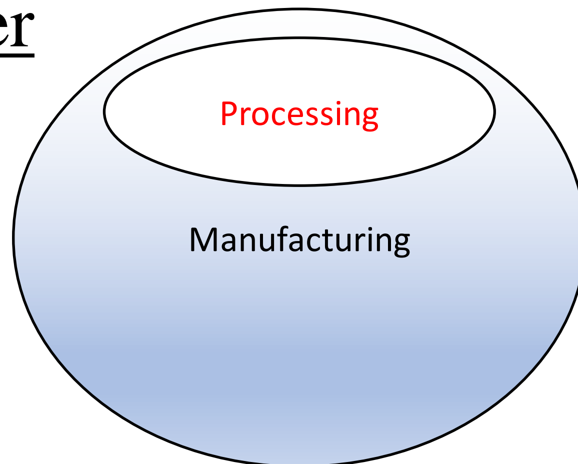
Southwest Royalties, Inc. v. Hegar
500 S.W.3d 400 (2016)
Processing occurred downhole – not caused by casing and tubing

- While manufacturing may well include "processing," the use of the separate term "processing" in statute indicates Legislature understood and intended that "processing" includes matters outside the confines of "manufacturing."
- The Legislature intended "processing" in subsections 151.318(a)(2), (5), and (10) to mean the application of materials and labor necessary to modify or change characteristics of tangible personal property.
- "No evidence identified any way Southwest's equipment acted upon the hydrocarbons to cause a modification or change in them other than by being the vehicle which caused them to exit, and through which they exited, the underground formation and traveled to the surface."
- "Our decision does not turn on the fact that the alleged processing occurred underground as opposed to above ground. Rather, it turns on the fact that the trial court did not find, and there is no evidence that, the equipment was applied to cause changes in their characteristics as the hydrocarbons moved from the reservoir to the surface."
- *See* Comptroller Hearing 31,253 (1998) ("It has long been the position of the Agency that the act of bringing oil to the surface of the earth is not processing.... [W]e have concluded that injecting carbon dioxide for the purpose of thinning or increasing the gravity of the oil creates a physical change in the oil and is, therefore, a processing activity."); Comptroller Letter Ruling 200903457L (2009)Letter Ruling 200903457L (2009) ("Although the act of producing oil or gas (bringing oil or gas to the surface of the earth) is not processing, the use of liquid carbon dioxide (CO2) to thin or increase the gravity of crude oil causes a physical change in the oil and thus constitutes processing for sales and use tax purposes.").

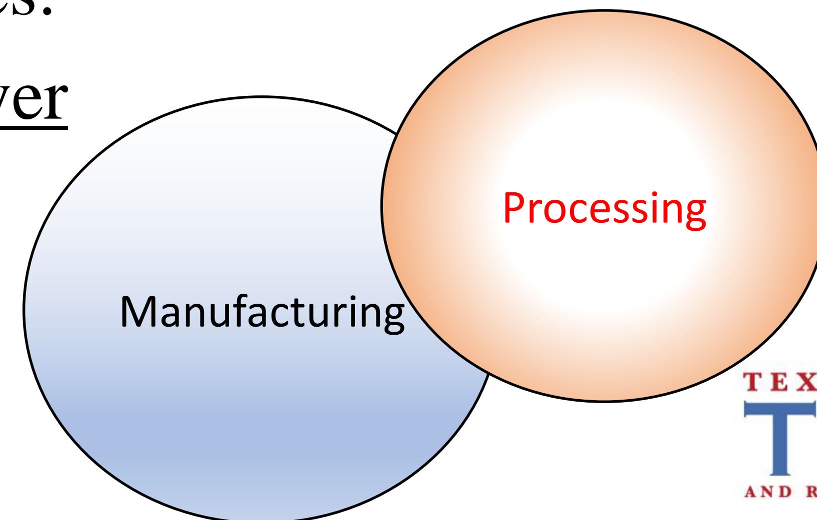
Hegar v. Texas Westmoreland Coal Company
636 S.W.3d 61 (Tex. App. – Austin 2021, *pet den.*)
Processing Real Property

- In Southwest Royalties, Supreme Court said that the "Legislature intended "processing" in subsections 151.318(a)(2), (5), and (10) to mean the application of materials and labor necessary to modify or change characteristics of *tangible personal property*."
- Why it mattered in Southwest Royalties:

<u>Comptroller</u>



<u>Taxpayer</u>



Hegar v. Texas Westmoreland Coal Company
636 S.W.3d 61 (Tex. App. – Austin 2021, *pet den.*)
Lignite Excavators

- Excavators satisfy clear and unambiguous statutory requirements: (1) the ultimate product Westmoreland offers for sale is tangible personal property (lignite), (2) the excavators are directly used or consumed in the production of lignite, and (3) the excavators make or cause a chemical or physical change to the lignite produced for ultimate sale.
- Does the lignite still embedded in the formation have to be tangible personal property itself in order for the excavators to be exempt?
- State argues that Southwest Royalties says that it does.

Hegar v. Texas Westmoreland Coal Company
636 S.W.3d 61 (Tex. App. – Austin 2021, *pet den.*)
Austin Court of Appeals Says No – Language of Statute

- Section 151.318(a)(2) does not require that raw materials be tangible personal property – "the only reasonable reading of the preposition "of" in the phrase "manufacturing, processing, or fabrication of tangible personal property for ultimate sale" is that the preposition is used to indicate the end product of a production process, not the inputs or the process itself."

The following items are exempted from the taxes imposed by this chapter if sold, leased, or rented to, or stored, used, or consumed by a manufacturer:

> (2) tangible personal property directly used or consumed in or during the actual manufacturing, processing, or fabrication of tangible personal property for ultimate sale if the use or consumption of the property is necessary or essential to the manufacturing, processing, or fabrication operation and directly makes or causes a chemical or physical change to:
>
> > (A) the product being manufactured, processed, or fabricated for ultimate sale; or
> >
> > (B) any intermediate or preliminary product that will become an ingredient or component part of the product being manufactured, processed, or fabricated for ultimate sale;

Hegar v. Texas Westmoreland Coal Company
636 S.W.3d 61 (Tex. App. – Austin 2021, *pet den*.)
Or Was Comptroller "Hoisted with his own petard"

- To read the statute as the Comptroller suggests would require the prepositional phrase "of tangible personal property for ultimate sale" to apply to the noun "processing" differently from how it applies to the nouns "manufacturing" and "fabrication." *Westmoreland*, at 66.
- "Of" is used to show the relationship between two nouns. The first one is an action done to the second noun. So, "of" has a similar meaning to "done to." *Ex.* The destruction of forests. https://langeek.co/en/grammar/course/747/of
- Court points out that *Southwest Royalties* cited "Comptroller decisions allowing exemption where equipment was used to shatter limestone formations to be processed into cement, explosives were used to blast rock and sandstone formations to be processed into gravel and sand, and dynamite was used to blast rock out of earth to be processed into gravel."

Oil & Gas Draft Rule Changes (3.300, 3.318, 3.324)

Changes effect the taxation, exemption status, & treatment of:

- Oil & Gas Services
- Chemicals
- CO_2
- Compressors
- Wastewater

Local Sales Tax
Rule & Case Law Update

Local Sales Tax Draft Rule Changes (Rule 3.334)

New subsection (c)(7) regarding the location where an order is received:

"The location where the order is received by or on behalf of the seller means the physical location of a seller or third party such as an established outlet, office location, or automated order receipt system operated by or on behalf of the seller where an order is initially received by or on behalf of the seller and not where the order may be subsequently accepted, completed or fulfilled. An order is received when all of the information from the purchaser necessary to the determination whether the order can be accepted has been received by or on behalf of the seller. The location from which a product is shipped shall not be used in determining the location where the order is received by the seller."

Sales Tax
Case Law Update

- GEO

The GEO Group, Inc. v. Hegar
661 S.W.3d 470 (Ct. App. – Amarillo 2023, pet. filed)

- Private entity operator of prison claims it is instrumentality of state and its purchases are exempt from sales tax under Section 151.309
- GEO seeks to distinguish itself from *U.S. v. New Mexico* and *Day v. Zimmerman* – argues that test of whether it is an "instrumentality" of the government should be whether GEO is a "means through which a government function was accomplished."
- Challenges validity of 34 TAC 3.322 requirement that "an organization must show by clear and convincing evidence that it meets the requirements of this section and the relevant statutes."

The GEO Group, Inc. v. Hegar
661 S.W.3d 470 (Ct. App. – Amarillo 2023, pet. filed)

- Amarillo Court of Appeals ruled that trial court properly imposed clear and convincing evidence standard. "GEO has cited no cases holding that a trial court is precluded from applying the standard established in Rule 3.322 in a tax exemption case tried de novo."
- Texas Supreme Court says"[n]o doctrine is more firmly established than that issues of fact are resolved from a preponderance of the evidence." *Sanders v. Harder*, 148 Tex. 593, 227 S.W.2d 206, 209 (1950). "Only in extraordinary circumstances, such as when we have been mandated to impose a more onerous burden, has this Court abandoned the well-established preponderance of the evidence standard." *Ellis County State Bank v. Keefer,* 888 S.W.2d 790, 792 (Tex. 1994).
- Legislature only imposed "clear and convincing" standard in two Sales and Use Tax Code provisions:
  - § 151.307 – documentation provided by licensed customs broker is presumed valid "in the absence of clear and convincing evidence that the tangible personal property covered by the documentation was not exported outside the territorial limits of the United States."
  - §151.159 – "The comptroller may issue the card only if the wholesaler or retailer shows by clear and convincing evidence that the wholesaler or retailer is a citizen and resident of a foreign country and that any tangible personal property purchased in this state by the wholesaler or retailer is for export purposes only and is to be used or consumed outside the territorial limits of the United States."

State and Local Tax – The Wild, Wild West

yarn.co

Property Tax
Case Law Update

Intangible Property – Property Tax

- *Rocksprings Val Verde Wind LLC v. Jackie Casanova, RPA, CCA, in her capacity as the Chief Appraiser of the Val Verde County Appraisal District*, Case No. 04-22-00524-CV, Fourth Court of Appeals, San Antonio
  - Wind Farm appraisal – value attributable to intangible production tax credits

- Ongoing dispute between regulated electric utility companies and Comptroller's Property Tax Assistance Division
  - Utility Company property tax appraisals – value attributable to regulatory assets and other similar intangible property

Intangible Property – Property Tax

TEXAS CONSTITUTION

ARTICLE 8. TAXATION AND REVENUE

Sec. 1. EQUALITY AND UNIFORMITY OF TAXATION; TAXATION OF PROPERTY IN PROPORTION TO VALUE; OCCUPATION AND INCOME TAXES; EXEMPTION OF CERTAIN TANGIBLE PERSONAL PROPERTY AND SMALL MINERAL INTERESTS FROM AD VALOREM TAXATION; VALUATION OF RESIDENCE HOMESTEADS FOR TAX PURPOSES.

(a) Taxation shall be equal and uniform.

(b) ***All real property and tangible personal property in this State***, unless exempt as required or permitted by this Constitution, whether owned by natural persons or corporations, other than municipal, ***shall be taxed in proportion to its value, which shall be ascertained as may be provided by law.***

(c) ***The Legislature may provide for the taxation of intangible property . . . .***

Intangible Property – Property Tax

TEXAS STATUTES

Tax Code Sec. 11.01. REAL AND TANGIBLE PERSONAL PROPERTY.
(a) All real and tangible personal property that this state has jurisdiction to tax is taxable unless exempt by law.

Tax Code Sec. 11.02. INTANGIBLE PERSONAL PROPERTY.
(a) Except as provided by Subsection (b) of this section, intangible personal property is not taxable.

(b) Intangible property governed by Article 4.01, Insurance Code, or by Section 89.003, Finance Code, is taxable as provided by law, unless exempt by law, if this state has jurisdiction to tax those intangibles.

Intangible Property – Property Tax

TEXAS STATUTES

Tax Code Sec. 1.04. DEFINITIONS. In this title:

(6) "Intangible personal property" means a claim, interest (other than an interest in tangible property), right, or other thing that has value but cannot be seen, felt, weighed, measured, or otherwise perceived by the senses, although its existence may be evidenced by a document. It includes a stock, bond, note or account receivable, franchise, license or permit, demand or time deposit, certificate of deposit, share account, share certificate account, share deposit account, insurance policy, annuity, pension, cause of action, contract, and goodwill.

JETI Act Proposed Rules Update

JETI Act Proposed Rules (§9.5000-9.5012)

- Performance Bond Amount
- Location of Job Requirements (site versus state)

Franchise Tax
Case Law Update

Anadarko Petroleum Corp. v. Hegar
Corpus Christi (13th) Ct. Appeals – October 19, 2023

- Whether payments Anadarko made in connection with the Deepwater Horizon oilspill can be included in its cost of goods sold deduction for franchise tax purposes
- Anadarko claims payments it sought to deduct was for costs associated with the production of goods. State argued that payments made settled tort liability claims
- Court found sufficient evidence to uphold trial court’s ruling that payment is question was made to settle liability claims
- Court ruled that such payments are not deductible as COGS

Hibernia Energy LLC v. Hegar
2023 WL 3027466 (Tex. App. – Austin 2023, pet. filed)

- Plea to Jurisdiction/Standing – Comptroller argues that prerequisite Motion for Rehearing filed in name of Hibernia did not comply with statutory requirement because Hibernia assigned its claim to Ryan prior to filing Motion for Rehearing
- "Texas common law has long recognized that when a cause of action is assigned, the assignee may sue either in its name or in the name of its assignor—either way, the trial court has subject-matter jurisdiction, and both the assignor and assignee are deemed to have standing to maintain the action."
- "Hibernia is the "tax refund claimant" with respect to the tax-refund claims at issue, and it is the statutorily designated party to whom rights related thereto attached. Section 111.105(a) authorizes a "person claiming a refund under Section 111.104" (i.e., tax-refund claimant) to request a formal hearing and, if dissatisfied with the Comptroller's decision thereafter, to file an MFR. *See id.* § 111.105(a), (c). It follows, therefore, that Hibernia is the very "tax refund claimant" authorized to file a motion for rehearing pursuant to Section 111.105 and required to file a tax-refund suit in district court."

Hibernia Energy LLC v. Hegar
2023 WL 3027466 (Tex. App. – Austin 2023, pet. filed)

- Whether Hibernia's gains from sale of oil-and-gas-leasehold interests Section171.1011 should be included in "total revenue"
- Hibernia argues: (1) "Form 1065 instructions expressly exclude the gains on the disposition of an interest in oil or gas properties because the applicable bullet point states merely "disposition of an interest" rather than "gains (loss) from the disposition of an interest," and (2) "a partnership cannot determine its "gain" from the disposition of an interest in oil or gas properties because adjustments to basis are only tracked and made at the partner level, which depends on varying characteristics and elections made by the partners that are unknown to the partnership."
- Court rules: (1) "we simply cannot agree with Hibernia that—in the midst of a non-exhaustive list of "any other type of income"—the Treasury Department (in drafting its statutorily mandated forms and instructions) intended to convey that gains (or losses) from the disposition of an interest in oil-and-gas properties need *not* be reported simply because the relevant bullet point states 'disposition of an interest' rather than '*gains (losses) from the* disposition of an interest.'" (2) "Hibernia *did* calculate its gains on its original franchise-tax reports and the above discussion clarifying that a partnership may not make adjustments to its basis for depletion or for IDCs if it has elected to fully deduct the IDCs in the year incurred (as Hibernia did)."

Any Questions?