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SUPREME COURT OF TEXAS
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**17-0894**

**IN THE SUPREME COURT OF TEXAS**

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**Glenn Hegar, Comptroller of Public Accounts of the State of Texas and Ken Paxton, Attorney General of the State of Texas, Petitioners and Counter-Respondents**

**v.**

**Gulf Copper and Manufacturing Corporation, Respondent and Counter-Petitioner.**

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On Petition for Review
from the Third Court of Appeals at Austin, Texas
Appeal No. 03-16-00250-CV

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# STATE PETITIONERS' BRIEF ON THE MERITS

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## RECORD REFERENCES

References to the Clerk's Record are in the form "CR.[Page#]"

References to the Reporter's Record are in the form "[Volume#].RR.[Page#]"

References to Plaintiff's Exhibits are in the form "PX[Exhibit#]"

References to Defendants' Exhibits are in the form "DX[Exhibit#]"

References to items in the Appendix are in the form "App.[Appendix#]"

## STATEMENT OF THE CASE

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| *Nature of the case*: | Franchise tax protest suit under Chapters 112 and 171 of the Texas Tax Code. |
| *Course of Proceedings*: | Lawsuit filed November 4, 2014. CR.3. Bench Trial February 1–2, 2016. Judgment entered February 22, 2016. CR.294–95, [App.A]. Notice of Appeal filed April 13, 2016. CR.302–03. |
| *Trial Court*: | 201st District Court, Travis County, Texas; The Honorable Amy Clark Meachum. |
| *Disposition:* | Judgment for Plaintiff/Appellee. Plaintiff/Appellee entitled to refund of $838,117.84 plus statutory interest. |

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| *Parties to the appeal*: | Appellants:<br>Glenn Hegar, Comptroller of Public Accounts of the State of Texas, and Ken Paxton, Attorney General for the State of Texas<br><br>Appellee:<br>Gulf Copper and Manufacturing Corporation |
| *Court of appeals*: | Third Judicial District of Texas at Austin |
| *Justices who participated*: | Chief Justice Rose,<br>Justices Field and Bourland |
| *Citation*: | *Hegar v. Gulf Copper and Manufacturing Corporation*, No. 03-16-0250-CV, 2017 WL 3471064 (Tex. App.—Austin Aug. 11, 2017) (herein, "Opinion at __.") [App. C] |
| *Disposition*: | The Third Court of Appeals, opinion by Justice Field, affirmed in part and reversed and remanded in part to 201st Judicial District Court, Travis County, Texas, for further proceedings. Motion for Rehearing denied September 21, 2017. |

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## STATEMENT OF JURISDICTION

This Court has jurisdiction under Texas Government Code section 22.001(a) because the case presents issues important to the jurisprudence of the state, specifically important issues of statutory interpretation that impact state revenue.

Although Gulf Copper can deduct the contested amounts on its federal corporate income tax return or its financial statements, not all legitimate business expenses are deductible for Texas margin tax purposes. By restricting margin tax deductions and thereby expanding the tax base, the Legislature was able to reduce the tax rate from 4.5 percent under the former earned surplus tax to one percent or less under the margin tax. *See*, Act of May 2, 2006, 79th Leg., 3rd C.S., ch. 1, § 5, 2006 Tex. Gen. Laws 1, 8 (former Tex. Tax Code § 171.101(a)), current version at Tex. Tax Code § 171.101(a)(1).

If, however, the balance between the low margin tax rate and the limited deductions is disrupted, there could be a significant revenue impact to the State of Texas. Accordingly, this Court should give serious consideration to the implications of the Opinion below, which: (1) allows service providers to take the cost-of-goods-sold deduction when they are not selling goods; (2) allows service providers to exclude revenues from margin merely because they are paying expenses owed under a contract; and (3) misapplies the burden of proof in de novo trials brought by taxpayers under Tax Code chapter 112.

## ISSUES PRESENTED

1. Do the services performed by Gulf Copper or its subsidiary constitute "furnishing labor or materials to a project for the construction, improvement, remodeling, repair, or industrial maintenance ... of real property" such that Gulf Copper may deduct under Tax Code section 171.1012(i) its costs of:

   a. Repairing or upgrading drilling rigs at Gulf Copper's waterfront facilities, before the commencement of offshore drilling; or

   b. Surveying marine vessels, including drilling rigs at Gulf Copper's waterfront facilities?

2. May Gulf Copper exclude from its total revenue, under Tax Code section 171.1011(g)(3), hourly payments made to subcontractors? This question turns on:

   a. Whether payments were "made under a contract . . . to provide services, labor, or materials *in connection with* the actual or proposed design, construction, remodeling, or repair of improvements *on real property*," when the subcontractor payments were for work repairing or upgrading drilling rigs at Gulf Copper's waterfront facilities, before the commencement of offshore drilling.

   b. Whether payments Gulf Copper made to subcontractors are "flow-through funds that are mandated by contract to be distributed to other entities," when Gulf Copper was not required by contract to use customer payments to pay subcontractors.

3. Gulf Copper had the burden of proof on its cost-of-goods-sold claim. Where Gulf Copper put on *no* evidence of allowable costs according with section 171.1012 or controverting the Comptroller's cost-by-cost analysis—relying instead on an erroneous legal argument—did the court of appeals err in remanding the case for a new trial on Gulf Copper's cost-of-goods-sold claim?

## STATEMENT OF FACTS

The court of appeals correctly stated the nature of the case as a suit "seeking a refund of franchise taxes that Gulf Copper paid under protest."

Gulf Copper and Manufacturing Corporation ("Gulf Copper") upgraded and repaired its customers' offshore oil drilling rigs at its facilities on the Texas coast. CR. 296–97[App. B] (Findings of Fact 10, 12, 13); 2.RR.131–32, 188, 192; *see also* Opinion at *5-6. Gulf Copper did not own or sell drilling rigs, drill wells, construct any improvements on real property, or repair rigs at drill sites. 3.RR.39–40; *see also* Opinion at *5-6. Gulf Copper's affiliate, Sabine Surveyors, inspected cargo and marine vessels, and upgraded and repaired Navy minesweepers. 2 RR. 81-82, 169-70; CR. 296–97 (Findings of Fact 1, 2).

The Comptroller audited Gulf Copper and its affiliate, Sabine Surveyors, for Report Year 2009 and assessed additional taxes. The two major audit adjustments were to the cost-of-goods sold deduction and the exclusion of flow-through funds from revenue. Gulf Copper skipped its right to a hearing at the State Office of Administrative Hearings, paid the assessment under protest, and filed this lawsuit. The two issues are the two major adjustments in the audit.

## SUMMARY OF THE ARGUMENT

***Cost-of-goods-sold deduction***

Not surprisingly, in order to take the cost-of-goods-sold deduction, a taxpayer has to sell goods. The Comptroller's auditor allowed Gulf Copper to deduct allowable costs associated with its production of goods, such as the costs of fabricating rig components it sold. These costs are not at issue.

The disallowed costs, and the costs at issue in this proceeding, are Gulf Copper's costs of providing *services* to its customers, such as Gulf Copper's labor costs incurred in installing components, removing defective components, painting, welding, fixing cranes, sandblasting, and coating, and Sabine Surveyor's costs for inspecting cargo and marine vessels.

Gulf Copper persuaded the trial court that it could deduct virtually all of its costs, including its service costs, because it was a "qualifying owner" "eligible" to take the cost-of-goods sold deduction by virtue of the fact that it sold some goods. The court of appeals properly rejected that argument, which was akin to an amusement park deducting the cost of operating the entire park because it sold curios in its gift shop. Gulf Copper's "qualifying owner" contention is not at issue in the State's Petition for Review, but it is at issue in Gulf Copper's cross-petition.

Although the court of appeals rejected Gulf Copper's "qualifying owner" contention, it remanded the case for the trial court to determine whether any of Gulf Copper's costs qualified under Tax Code § 171.1012(i), which is a special provision that allows a taxpayer to be deemed the owner of labor and materials furnished to a project for the construction or improvement of real property.

Instead of remanding, the court of appeals should have rendered a take-nothing judgment on this issue because there was no evidence that Gulf Copper furnished labor to any construction project. Rather, Gulf Copper furnished labor and materials to rig owners whose rigs were between drilling projects. Just as fixing a bulldozer before its delivery to and use on a construction site should be properly classified as the repair of tangible personal property rather than real-property improvements, so Gulf Copper's rig work at its waterfront yards constituted the repair and upgrading of tangible personal property, not "furnishing labor or materials to" a construction project. Gulf Copper's rig work added value to the rigs, but it did not add value to any real-property project.

Similarly, Gulf Copper's affiliate, Sabine Surveyors, did not, by virtue of its surveying services, furnish labor or materials "to a project for the construction, improvement, remodeling, repair, or industrial maintenance ... of real property," so as to qualify for the cost-of-goods-sold deduction.

The court of appeals also erred when it concluded that the Comptroller should have calculated the cost-of-goods-sold deduction differently. The burden of proving the amount of a refund claim always lies with the taxpayer.

For these reasons, the Comptroller requests the Court to render a take-nothing judgement on Gulf Copper's claims based on the cost-of-goods-sold deduction.

***Revenue exclusion for subcontractor payments***

The other issue is whether some or all of Gulf Copper's subcontracting payments were flow-through funds that could be excluded from revenue. In limited circumstances, the Texas Legislature has allowed taxpayers to exclude receipts that the taxpayers are obligated by law or contract or fiduciary duty to pass on to another. The theory is that the receipts do not truly represent revenue to the taxpayers. But taxpayers are not allowed to exclude receipts merely because the receipts are used to pay the taxpayers' expenses. If that were the case, the "margin" tax would become a net income tax.

One of the limited flow-through circumstances involves subcontracting payments for "services, labor, or materials in connection with the actual or proposed design, construction, remodeling, or repair of improvements on real property" under Texas Tax Code section 171.1011(g)(3). The trial court and the court of appeals allowed Gulf Copper to subtract as flow-through funds the amounts that it paid to its subcontractors for their services in repairing dry-docked drilling rigs at its waterfront yards.

But the repair of dry-docked drilling rigs is not the construction of improvements on real property. And those repairs are not even "in connection with" such construction because the rigs were between jobs and nowhere near any construction projects. For these reasons, the Comptroller requests the Court to render take-nothing judgment on Gulf Copper's claim to exclude the subcontracting payments from its revenue.

In the alternative, if the flow-through exclusion does apply, it is appropriate only in those instances in which Gulf Copper was contractually obligated to pay its subcontractors based on a percentage of the revenues that it received. The flow-through exclusion is never appropriate in instances in which a contractor is not contractually obligated to share a portion of its receipts with its subcontractors.

Therefore, in the alternative, the Comptroller requests the Court to render judgment for Gulf Copper only with regard to the payments to its subcontractors based on the percentage of revenue received, which would result in a refund of $161,566.51 plus interest. CR. 283.

## ARGUMENT

### I. Gulf Copper's costs in repairing and outfitting drilling rigs, and Sabine Surveyors' costs in surveying marine vessels, are not deductible as costs-of-goods sold.

#### A. Background: The Cost-of-Goods-Sold Deduction in Tax Code section 171.1012.

Gulf Copper determined its "margin" by deducting costs of goods sold from total revenue. Opinion at *3. The cost-of-goods-sold deduction is governed by Tax Code section 171.1012, which permits a business to subtract "all direct costs of acquiring or producing the goods," as well as the additional costs listed in subsection (d) and an amount not exceeding 4% of the taxable entity's indirect or overhead costs attributable to acquiring or producing the goods. *See* Tex. Tax Code § 171.1012(c), (d) and (f).

"Goods" means "real or tangible personal property sold in the ordinary course of business of a taxable entity." *Id.* § 171.1012(a)(1). The definition of "tangible personal property" expressly excludes "services." *Id.* § 171.1012(a)(3)(B)(ii). Thus, sellers of services are not ordinarily eligible for the cost-of-goods-sold deduction.

To take a deduction under the cost-of-goods-sold statute, the entity must own the "goods" that it sells. *Id.* § 171.1012(i). Gulf Copper did not own the drilling rigs that it repaired and outfitted, and Sabine Surveyors did not own the marine vessels that it surveyed. 3.RR.39–40; *see also* Opinion at *5–6. The third sentence of subsection (i), however, allows certain service providers to subtract their costs from revenue as cost-of-goods-sold by "considering" them to be owners of their labor and materials:

> A taxable entity furnishing labor or materials to a project for the construction, improvement, remodeling, repair, or industrial maintenance ... of real property is *considered to be an owner of that labor or materials and may include the*

> *costs, as allowed by this section*, in the computation of cost of goods sold.

Tex. Tax Code § 171.1012(i).

In sum, "the plain language of section 171.1012 confirms that calculating the COGS deduction for Texas franchise tax purposes requires a cost-by-cost analysis to determine whether the cost fits one of the types and categories eligible for inclusion in the calculation." Opinion at *18.

**B. There is no evidence of section 171.1012 costs—including those under subsection (i)—to support a remand.**

Even though section 171.1012 "requires a cost-by-cost analysis to determine whether the cost fits one of the types and categories eligible for inclusion in the calculation," Opinion at *18, Gulf Copper took an all-or-nothing approach at trial. That approach relied on a two-step interpretation of 171.1012.

In step one, Gulf Copper took the position that it was a taxable entity "qualified" or "eligible" to take the deduction because it was the owner and seller of "goods" or because it furnished labor and materials for the construction or improvement of real property. Opinion at *14-15. Then, in step two, it invoked subsection 171.1012(h), which provides that "[a] taxable entity shall determine its cost of goods sold, except as otherwise provided by this section, in accordance with the methods used on the federal income tax return on which the report under this chapter is based." Opinion at *14–15. On the basis of subsection 171.1012(h), Gulf Copper argued that the correct starting point for its calculation was the trial balance (a summary of all transactions for the accounting year) that it used to prepare its federal income tax return. *Id.*

From that dollar amount—that is, the cost-of-goods-sold deduction for federal income tax purposes—Gulf Copper subtracted the costs expressly excluded from the state calculation under subsections 171.1012(e) and (f). Tex. Tax Code § 171.1012(e) (list of costs in relation to taxable entity's goods that may *not* be included in cost-of-goods-sold calculation); (f) (taxable entity may include only four percent of taxable entity's total indirect or administrative overhead costs in cost-of-goods-sold calculation).[1]

[1] As the court of appeals recognized, the trial court erred when it accepted this approach and found that for report year 2009, Gulf Copper incurred expenses "eligible" to be included in the cost of goods sold subtraction in the amount of $152,116, and further found that "[t]he categories, classifications, locations and amounts of the costs eligible to be included in the cost of goods sold subtraction are accurately stated in Exhibit 56." CR.297–99 (Findings of Fact 36 and 37 and Conclusions of Law 14 and 15 [App.2]. Gulf Copper's total costs were $165,253,740. PX55 [App.5].

As justification for its approach, Gulf Copper explained it "did not parse the costs associated with its integrated business activities" because, among other things, "its accounting system (which captures a host of financial data necessary to operate the business but does not segregate its single integrated activity—rig repair—and its costs into component steps)." Opinion at *15.

As a consequence, Gulf Copper made no attempt to calculate or prove up its cost-of-goods-sold deduction in accordance with section 171.1012.

> In calculating its COGS deduction, Gulf Copper did not engage in a cost-by-cost analysis of each expense to determine whether it fit into one of the categories of costs the statute provides may properly be included in the calculation of cost of goods sold, *see* Tex. Tax Code § 171.1012(c), (d), (f), nor did it employ the analytic framework described above to determine whether its particular activities that involved furnishing labor to a project for construction or improvement of real property (as opposed to its activities that produced 'goods') were 'an essential and direct component' of a particular project, *see id.* § 171.1012(i).

Opinion at *14-15.

The court of appeals nonetheless concluded that "Gulf Copper presented evidence at trial that, to some extent, Gulf Copper's employees provided labor and materials to projects for improvement of real property (drilling oil wells)." So, "the Comptroller was obligated to consider to what extent the activities of Gulf Copper's employees were essential and direct components of those specific projects." Opinion at *20.

Similarly, the court of appeals concluded that "Sabine Surveyors' costs should have been analyzed on a cost-by-cost basis to determine which of those costs met the requirement that they be integral, essential, and direct components of the offshore drilling process." *Id.* These conclusions were error as explained below.

### C. As a matter of law, Gulf Copper's rig work at its waterfront yards is not a real-property project under section 171.1012(i).

There is no evidence of deductible costs under section 171.1012(i), because Gulf Copper's maintenance, repair and upgrading of drilling rigs at its waterfront yards is *not* the construction or improvement of real property. Opinion at *5-6; 2.R.R. 80, 84–85, 93–94. That work is not a real-property project at all. Nor does it constitute "furnishing labor and materials *to*" a real-property project. The rigs were between jobs and nowhere near any construction project. And there is no evidence that Gulf Copper performed any "running repairs" or maintenance work on actual offshore wells.

That E&P companies used the rigs to drill offshore, *after* Gulf Copper had finished its rig work at its waterfront facilities, does not and cannot transform its services into "furnishing labor or materials" to a real-property project. Stated another way, subsection (i) cannot be reasonably read to encompass the *indirect* contribution of labor and material to the real-property project via a service provider's repair or maintenance of tangible personal property thereafter used on the project. Gulf Copper is no different than an entity fixing construction equipment that is subsequently used on a construction site.

Even though Gulf Copper relied on a legal interpretation of 171.1012 in the trial court to support its cost-of-goods-sold calculation in the trial court—and even though it is undisputed that the taxpayer performed its rig work at its waterfront yards—the court of appeals concluded that Gulf Copper "had presented evidence at trial that, to some extent, [its] employees provided labor and materials to projects for improvement of real property (drilling oil wells)." Opinion at *20. That conclusion was error as explained below.

### 1. The court's decision departs from the plain language of section 171.1012(i).

Subsection (i)'s phrase "furnishing labor or materials" is nearly identical to the Property Code phrase "furnishes labor or materials." *See* Tex. Prop. Code § 53.021 ("Persons Entitled to Lien"). Therefore, it is reasonable to assume that the Legislature intended substantially similar meanings. *See, e.g., Sheshunoff v. Sheshunoff*, 172 S.W.3d 686, 692 (Tex. App.—Austin 2005, pet. denied) ("When the same or a similar term is used in the same connection in different statutes, the term will be given the same meaning in one as in the other, unless there is something to indicate that a different meaning was intended.")

The Property Code provides that a person who "furnishes labor or materials" for the construction, repair, or demolition of a real property improvement may establish a lien on the real property to secure payment for the labor done or material furnished. *See* Tex. Prop. Code §§ 53.021 and 53.023 ("Payment Secured by Lien."). The definitions limit "labor" and "materials" to those used in the "direct prosecution" of the work. *Id.*

at § 53.001(3) & (4).[2] Under the Property Code, the "direct prosecution" of the work would only include "running repairs" at the construction site. *Id*.

Even setting aside the nearly identical phrasing in the Property Code, the lower court's broad application of subsection 171.1012(i) does not accord with the words and phrases in the statute itself, or with the rules of grammar and usage.

The phrase "*to* a project for the construction, improvement . . . of real property" is a prepositional phrase that limits the antecedent phrase "furnishing labor or materials." *See* Tex. Gov't Code Ann. § 311.011(a). Read in its plain context, the word "to" denotes proximity and contact—that is, a *direct* connection.[3] It cannot be reasonably read to suggest that labor and materials are eligible for the deduction as long as they can be located somewhere on a chain of causation leading to real-property construction or improvements. In addition, under the court of appeals'

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[2] The Comptroller has amended 34 TAC § 3.588 to clarify that "labor" and "materials" as used in the Property Code have the same meaning in section 171.1012(i). *See* 42. Tex. Reg. 5235-36 (Sept. 29, 2017).

[3] That "to" functions in section 171.1012(i) to indicate contact or proximity can be seen from the following analogous sentences. "He is applying polish *to* the table." "When she hears the national anthem, she puts her hand *to* her heart." Gulf Copper is urging this court to conclude unreasonably that in this statutory context "to" is used simply to indicate a general direction.

decision it is unclear how the trial courts—and for that matter, the comptroller and taxpayers—are to draw the line between eligible and ineligible costs under subsection (i).

The intermediate court's analysis also fails to account for the differences between subsection 171.1011(g)(3)—dealing with exclusion of revenue from the franchise tax calculation—and subsection 171.1012(i). Both provisions deal with real-property projects. Subparagraph (g)(3) encompasses "labor, or materials" provided "*in connection with*" real-property projects—whereas subsection (i) refers more narrowly to "furnishing labor or materials *to*" such projects. To accept the appellate court's analysis, one would have to conclude that the legislature intended nothing by the different phrases. Even under (g)(3)'s broader phrasing, Gulf Copper's work is too "remote or attenuated" to qualify. *See infra* at 29-30; *Titan Transp. LP v. Combs*, 433 S.W.3d 625, 637–38 (Tex. App.—Austin 2014, pet. denied).

The taxpayer in *Combs v. Newpark Res., Inc.*, 422 S.W.3d 46, 47–48 (Tex. App.—Austin 2013, no pet.), was able to obtain the subsection (i) deductions for labor furnished in hauling away used drilling mud and other waste products from oil well drilling sites. But that labor was *provided to* the oil wells. In contrast, Gulf Copper's work was at least two steps removed from a real-property project. It provided outfitting and repair services to its customers—the rig owners—who, in turn, contracted with the E&P companies to provide them with the rigs for offshore drilling. The E&P companies then used the rigs in projects for real-property improvements or construction.

This Court has never adopted the court of appeals' "essential and direct components" test in *Newpark*. But even if the Court accepts that formulation, the repair and outfitting of a rig owned and operated by a third party, prior to commencement of drilling by yet another third party at a different site offshore, cannot be viewed as a "direct component" of drilling.

Gulf Copper's work—fixing construction equipment—is "too remote" from the real-property project. As a matter of law, fixing or upgrading construction equipment prior to its utilization is not "furnishing labor or materials *to* a project for the construction, improvement ... of real property" under subsection (i). Just as fixing a bulldozer before its delivery to and use on a construction site should be properly classified as the repair of tangible personal property rather than real-property improvements, so Gulf Copper's rig work at its waterfront yards constituted the repair and upgrading of tangible personal property, not "furnishing labor or materials to" a construction project. Gulf Copper's rig work added value to the rigs, but it did not add value to any real-property project.

This analysis applies with equal if not greater force to Sabine Surveyors, which inspected the rigs and other marine vessels. CR. 296–97[App. B] (Finding of Fact 1, 2). There is no evidence that any of the claimed costs reflected the subsidiary's inspection of offshore drilling operations or any other real-property improvements.

**2. In addition to departing from the statute's plain language, the lower court's decision contradicts other provisions in Chapter 171.**

The lower court's decision also undermines the explicit exclusion of "services" from the definition of "tangible personal property" and thus from the definition of "goods." *See id.* § 171.1012(a)(3)(B)(ii). It does so by allowing the taxpayer to deduct labor costs for installing components, removing defective components, painting, welding, fixing cranes, sandblasting, and coating—even though these services had only an indirect relationship to the construction or improvement of real property.

CR.296–97 (Findings of Fact No. 10, 12 and 13)[App. B]; 2.RR.131–32, 188, 192.

The cost of a service may be allowable in a cost-of-goods-sold deduction *only if the service is a cost of acquiring or producing a "good" that an entity sells or is labor in the "direct prosecution" of a real-property project.* Returning to the example of a bulldozer, this is why under section 171.1012, the salaries of employees who paint, repair, upgrade a bulldozer *for sale* would be includable in the seller's cost-of-goods-sold deduction. The salaries are costs of "producing" the equipment "sold."

But apart from the acquisition or production expenses for the sale of the bulldozer, costs of providing services to repair, upgrade, or paint the bulldozer are not deductible. And these services do not qualify for the deduction simply because the owner of the bulldozer that has been repaired, upgraded or painted subsequently provides it to a real-property project. Nor would the person who performed the repair, upgrade or painting be able to claim the deduction.

Similarly, Gulf Copper is not selling rigs to a third-party, but rather, is providing repair and outfitting services performed at its waterfront facility. That the rigs are then used by another third party to drill offshore does not transform Gulf Copper's services into "labor" used in "direct prosecution" of the project under subsection (i).

### D. The court of appeals' remand regarding other section 171.1012 costs misapplied the burden of proof.

In addition to the erroneous conclusion that there existed "some evidence" of subsection (i) costs associated with real property projects, the court's remand order relied on the Comptroller auditor's use of labor records to allocate other costs at Gulf Copper's facilities into allowable costs and non-allowable categories. Opinion at *19–20.

Because Gulf Copper did not keep track of allowable and non-allowable costs under the state statute, the auditor and Gulf Copper's accountant decided to use Gulf Copper's large labor costs (the majority of the costs at issue here) as a proxy for the much smaller costs that could not otherwise be allocated (5.RR.10–11), such as depreciation (5.RR.23–24), utilities (5.RR.25–26), and seminars (5.RR.26–27). PX 50.

Gulf Copper's accountant and the auditor agreed that 50% of labor costs at Port Arthur and Galveston and 5% of labor costs at Corpus Christi were costs of fabricating "goods" and thus allowable under section

171.1012(c). 5.RR.11, 14; PX 50.[4]

In basing its remand on the auditor's use of labor records as a "proxy" for other allowable and non-allowable costs across other categories, the court below misapplied the burden of proof. Gulf Copper, as the plaintiff in the de novo trial in the district court, had the burden of proving that "tax was overpaid and the exact amount of that overpayment." *Verizon Bus. Network Servs., Inc. v. Combs*, No. 07-11-0025-cv, April 3, 2013 WL 1343530, at *4 (Tex. App.—Amarillo 2013, pet. dismissed); *see also* Tex. Tax. Code §§ 112.051 and 112.151. The State did not have the burden to prove that its tax assessment was correct.

Yet in its prima facie case, Gulf Copper chose to rely on a legal argument under subsection 171.1012 that as an "eligible" or "qualified" taxable entity, it was entitled to begin its calculation with its cost-of-goods-sold deduction for federal income tax purposes. Because the court of appeals rejected that argument, there is no evidence in the record supporting the amount of Gulf Copper's claimed deduction.

[4] This included the large subcontractor labor costs at Port Arthur and Galveston, which the auditor did not allow as a revenue exclusion, but approximately half of which he did allow as cost of goods sold. 5.RR.34–36; CR. 277; PX 50.

Accordingly, the intermediate court should have rendered a take-nothing judgment on this issue. Instead, the court concluded that because the "Comptroller's percentages were derived by using labor costs as a proxy for other costs," "there is an insufficient basis for the *Comptroller's* allocation of costs as deductible direct costs of producing goods." Opinion at *20.

Even assuming for purposes of argument that the burden of proof *had* shifted to the comptroller, the State presented evidence quantifying its cost-of-goods-sold deduction and explaining the basis for that calculation. The Tax Code explicitly authorizes the comptroller to "determine the best information available and base his audit report on that information" when taxpayer records "are inadequate to reflect accurately the business operations of the taxpayer." Tex. Tax Code § 111.0042(d); *see also id.* at § 111.008. Gulf Copper tendered no evidence controverting this approach or supporting an alternative calculation that, it claimed, was based on more accurate or reliable information. It did not quantify any other alleged audit errors or obtain any findings of fact regarding other alleged audit errors, in response to the Comptroller auditor's calculation.

For these reasons, remand is not only erroneous—it provides no practical basis for further proceedings in the trial court. It is undisputed that the taxpayer did not maintain records allowing it to determine its allowable costs across these smaller cost categories. So the Comptroller's auditor relied on allowable and non-allowable percentages derived from the larger labor costs. Opinion at *19. The court of appeals remanded even though there is nothing in the record suggesting an alternative approach that would be more accurate or based on more reliable information.

It was also error for the court to base its remand on the conclusion that "Gulf Copper did [ ] present some evidence, and the Comptroller does not dispute, that it was entitled to take a COGS deduction and exclude from its taxable margin a significant amount of its costs." Opinion at *20. This misstates the issues before the trial court. Beginning with the comptroller's audit, the State has all along agreed that that a portion of Gulf Copper's costs were costs of goods sold, as shown by the auditor's testimony and by Defendants' Exhibit 3. 1 R.R. DX 3; *see also* CR. 282-84.

Thus, the issue at trial was not whether Gulf Copper had costs of goods sold—everyone agrees they did—but whether Gulf Copper was entitled to a deductible amount *that was greater than the amount allowed by the comptroller*. Put simply, the issue was whether Gulf Copper presented evidence supporting the inclusion of *disputed* or *contested* costs in the deduction. For this reason, the appellate court erred in relying on uncontested costs of goods sold as support for its remand order.

## II. The court of appeals erroneously excluded the contested subcontractor payments from revenue under Tax Code §171.1011(g)(3).

### A. Background: The Flow-Through Funds Exclusion in Section 171.1011(g)(3).

Taxpayers such as Gulf Copper must first determine their revenue before deducting cost of goods sold to determine "margin." In limited circumstances, the Texas Legislature has allowed taxpayers to exclude receipts that they are obligated by law or contract or fiduciary duty to pass on to another.

The theory is that the receipts do not truly represent revenue to the taxpayers. Taxpayers, however, are not allowed to exclude receipts merely because the receipts are used to pay the taxpayers' expenses. If that were the case, the "margin" tax would become a net income tax. To prevent just that outcome, Tax Code section 171.1011(i) specifically provides:

> Except as provided by Subsection (g), a payment made under an ordinary contract for the provision of services in the regular course of business may not be excluded.

Here, the question is whether the payments were made under an ordinary contract for the provision of services or whether they were "flow-through" payments to subcontractors under section 171.1011(g)(3), which provided during the period at issue:

> A taxable entity shall exclude from its total revenue, to the extent [reported to the IRS as income], only the following flow-through funds that are mandated by contract to be distributed to other entities:
> ....
>
> (3) subcontracting payments handled by the taxable entity to provide services, labor, or materials in connection with the actual or proposed design, construction, remodeling, or repair of improvements on real property or the location of the boundaries of real property.

Act of May 19, 2006, 79th Leg., 3d C.S., ch.1, § 5, 2006 Tex. Gen. Laws 1, 10 (amended 2013) ("the (g)(3) revenue exclusion").

There are two requirements at issue: there must be "flow-through funds that are *mandated by contract* to be distributed to other entities," and the flow-through funds must be for "services, labor, or materials *in* *connection with* the actual or proposed design, construction, remodeling, or repair of improvements on real property." *Id* (emphasis added).

### B. There is no evidence that the subcontractor payments constituted "flow-through funds that are mandated by contract to be distributed to other entities."

Under the (g)(3) revenue exclusion there must be evidence that the payments were mandated by contract to be distributed to the subcontractors. Gulf Copper's two biggest contracts with rig owners, the Pride and Helix contracts, involved two types of subcontractor labor—hourly and cost-plus.

Under the hourly labor provisions, employees of the subcontractor worked side-by-side with Gulf Copper employees, performing the same work. Gulf Copper paid these subcontractors a flat hourly rate. And under the Pride and Helix contracts, the rig owners paid Gulf Copper a higher flat hourly rate—paying the same rate for regular labor performed by Gulf Copper employees and its subcontractors. 2.RR.110–13. 4.RR.104–05; PX1 at P00220 (Pride Contract) [App.9]; PX2 at P0072 (Helix contract) [App.10]. Indeed, with respect to regular labor, the Pride and Helix contracts said nothing at all about subcontractors.

But as to the second type of subcontractor labor involving specialty services, the Pride and Helix contracts specified that payments were cost plus 15% (in the case of the Pride contract) and cost plus 20% (in the case of the Helix contract). PX1 at P00221 [App.9]; PX2 at P00073 [App.10]; 2.RR.112.[5]

At trial, the State recognized that $32 million in subcontractor payments—reflecting the specialty services governed by the cost-plus provisions in the Pride and Helix contracts—were funds mandated by contract to be distributed to the subcontractors. CR.272-77. But the State continued to urge that the other payments—reflecting the hourly-rate subcontractors—were not. With respect to those payments, no contract mandated that any customer payment for labor be distributed to the subcontractors. The trial court and the court of appeals erred when they concluded these payments were nonetheless flow-through funds mandated by contract to be distributed to other entities. Opinion at *10-11.

[5] Gulf Copper also made subcontractor payments under six other contracts in addition to the Pride and Helix contracts. But none of those six contracts were cost-plus contracts. PX3, PX4, PX5, PX6, PX7, PX8.

Though Gulf Copper was contractually obligated to pay the subcontractors for "labor," it was not *contractually obligated* to *pass on or flow-through* customer payments to them. That makes all the difference under the plain language of the statute. Neither the court of appeals nor Gulf Copper pointed to any contractual mandate in the customer contracts or in the subcontracts that required Gulf Copper to share customer payments with its subcontractors.

When examining statutory text, the Code Construction Act requires that the Court read words and phrases in context and construe them according to the rules of grammar and usage. Tex. Gov't Code Ann. § 311.011(a); *see also supra* at 14-15. The phrase "flow-through funds *that* are mandated by contract to be distributed to other entities" is a single unified requirement. The dependent clause "that are mandated by contract to be distributed to other entities" is an adjective that specifies and limits the type of flow-through funds excludable from revenue.

The court of appeals' approach effectively reads out of the statute the requirement that a contract mandate that funds be distributed to other entities. Gulf Copper was not contractually obligated to mark-up anything or, for that matter, to do anything at all besides paying the subcontractors an hourly rate.

Although the court of appeals relied on *Titan Transportation, LP v. Comb*s, 433 S.W.3d 625 (Tex. App.—Austin 2014, pet. denied), that case is readily distinguishable. There, the taxpayer had "contracts with its subcontractors that required [the taxpayer] to pay 84% of its gross receipts [from customers] to independent contractors." *Id*. at 630.

Alternatively, in the event of ambiguity, this statute is a tax exclusion, which like tax exemptions, must be construed strictly against Gulf Copper. *See Owens Corning v. Hegar*, 04-16-00211-CV, 2017 WL 1244444, at *3 (Tex. App.—San Antonio Apr. 5, 2017, pet. denied) (holding that the cost-of-goods-sold deduction is a tax exemption for the same reason).

### C. There is no evidence that the subcontract work constituted "services, labor, or materials *in connection with* the actual or proposed design, construction, remodeling, or repair of improvements on real property."

Finding of Fact 29 reads in part, "Gulf Copper, through its employees and subcontractors, provides labor and materials in connection with the actual or proposed construction or repair of improvements on real property;…" CR.298 [App.2]. This finding tracks the statutory language of section 171.1011(g)(3) and is really a conclusion of law reviewed de novo, without deference. It should be rejected.

As the court of appeals noted, the phrase "in connection with" is "one 'of intentional breadth,' but not without 'logical limit.'" Opinion at *7 (quoting *Titan Transp. LP*, 433 S.W.3d at 637–38 ). The "logical limit" has been exceeded here for these reasons:

- Gulf Copper's work was temporally remote from the projects to improve real property – the work was performed before drilling operations commenced.

- Gulf Copper's work was physically remote from the projects to improve real property – the work was performed on tangible personal property at Gulf Copper's waterfront yards and not at the offshore drilling sites, or oil and gas wells.

- Gulf Copper's work was contractually remote from the projects to improve real property – Gulf Copper's contracts were with the rig owners, not the project owners, and Gulf Copper was not a subcontractor to the project owners.

And, when Gulf Copper finished its work, the offshore drilling projects had no greater value than before Gulf Copper started. This too transgresses the (g)(3) revenue exclusion's "logical limit."[6]

True, the rigs Gulf Copper repairs and modifies are used by third parties to construct oil and gas wells. And oil and gas wells are, in turn, improvements to real property. This is why the State does not challenge Findings of Fact 20 ("Offshore drilling rigs are necessary and essential to the drilling of offshore oil and gas wells because the wells could not be drilled without the drilling rigs") or Finding of Fact 30 ("The labor and materials provided by Gulf Copper through its employees and subcontractors are necessary, essential, and integral to the construction … of oil and gas wells."). CR.298, 299 [App.2].

But just as focus on "essential" or necessary components of the project would improperly broaden the statutory test under subsection (i), these findings are, as a matter of law, insufficient to pull the subcontractor payments into the (g)(3) revenue exclusion. Neither

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[6] For the same reasons, the deduction of costs under subsection (i) is also foreclosed, because Gulf Copper was not "furnishing labor and materials *to*" a real-property project. *See Supra* 11-13. In any event, the court of appeals' analysis does not account for the different wording in these two subsections.

subsection is met by a cause-in-fact or "but for" showing by the taxpayer. Undoubtedly, there are many necessary or essential preconditions—business organization, administrative services support, surveying, geoseismic testing, research—for oil wells and other real-property projects. And, no doubt, these and other necessary preconditions will themselves require the furnishing of labor or materials.

But the mere fact that the disputed labor or materials are in the causal chain leading up to the real-property project is not evidence supporting the (g)(3) revenue exclusion, much less the deductions under subsection (i). Another precondition of the project would be a written drilling contract between the rig owner and the E&P company. Should the law firm that drafted the contract for the rig owner be able to exclude its expenses because such expenses were incurred "in connection with" the improvement of real property? Surely, the answer is no. Yet Gulf Copper is in the same position as the law firm, providing services to the rig owner antecedent to the drilling project and not providing any value to the drilling project itself.

## PRAYER

For these reasons, the court should grant the petition for review and reverse and render take-nothing judgment for the Comptroller, or in the alternative, render judgment for $161,566.51, which represents the tax refund resulting from the subtraction of $32 million in flow-through funds paid to subcontractors under Gulf Copper's cost-plus contracts.

Respectfully submitted,


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## CERTIFICATE OF COMPLIANCE

I certify the foregoing document contains 6,119 words, excluding portions exempted by Rule 9.4(i)(1).

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## CERTIFICATE OF SERVICE

I certify that on December 12, 2018, a copy of this document was served on all parties and counsel of record by email and/or eservice, as follows:

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