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SUPREME COURT OF TEXAS
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No. 17-0894

In the Supreme Court of Texas

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 & Manufacturing Corporation,
Respondent and Counter-Petitioner

ON REVIEW FROM THE COURT OF APPEALS
FOR THE THIRD DISTRICT OF TEXAS, AUSTIN, NO. 03-16-00250-CV

GULF COPPER'S RESPONSE TO THE COMPTROLLER'S BRIEF ON THE MERITS

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RESPONSIVE ISSUES PRESENTED

1. Did the lower courts properly hold that Gulf Copper may subtract costs of goods sold under Texas Tax Code Section 171.1012(i) because it furnishes labor and materials to projects for the drilling of offshore oil wells by rebuilding the oil rigs pre-contracted to drill in these projects?

    a. Did the lower courts properly hold that Section 171.1012 allowed Gulf Copper to subtract its costs of producing rig components affixed to those offshore oil rigs?

    b. Did the lower courts properly hold, under Section 171.1014(b), that the Comptroller may not isolate Sabine Surveyors from Gulf Copper's combined group and treat it as a separate taxable entity?

2. During a four-day bench trial, Gulf Copper presented 1,075 pages of business and accounting records detailing the nature and treatment of its costs, as well as two days of testimony by Gulf Copper's Chief Financial Officer explaining the nature of the company's costs and how they were eligible for inclusion in its cost of goods sold subtraction. Does this constitute "no evidence"?

3. Did the lower courts properly hold, under Section 171.1011(g)(3), that Gulf Copper may exclude from revenue the payments it made to subcontractors for labor and materials sold in connection with the actual or proposed construction of real property (*i.e.*, the development of offshore oil reserves)?

TO THE HONORABLE SUPREME COURT OF TEXAS:

STATEMENT OF FACTS

Gulf Copper described the nature of its overall business and the procedural history of the parties' dispute in its opening brief on the merits. Here, Gulf Copper addresses its use of subcontractors, which affects the revenue exclusion challenged by Issue II of the Comptroller's Brief.

Gulf Copper hires two types of subcontractors: "hourly" laborers and outside "specialty" contractors. (2.RR.110, 122, 134, 154; 3.RR.38). The hourly laborers work alongside Gulf Copper's employees as "a blended crew" to perform tasks like welding and fitting. (2.RR.111, 167, 203). They are "essential components of [Gulf Copper's] work force." (2.RR.167). The specialty contractors supplement the skill sets offered by Gulf Copper's employees. (2.RR.110; 3.RR.38).

Gulf Copper's customers approve its use of subcontractors and sometimes require that Gulf Copper use specific subcontractors for the work. (CR.298, FOF.23; 2.RR.108-109, 116, 118, 125, 132, 134, 139-140, 180; 3.RR.81; *see, e.g.*, 6.RR.P.Ex.1 (§7.2, Appx.1); P.Ex.4 (pg.665). The customers often have representatives in the yard to supervise the work and validate all labor hours incurred by the subcontractors and employees. (CR.298, FOF.23; 2.RR.109, 123).

Gulf Copper charges its customers for subcontractor work using a formula based on Gulf Copper's actual subcontractor costs, plus a mark-up. This is true for both types of subcontractors used by Gulf Copper. (CR.298, FOF.24; 3.RR.24-25, 72). For hourly subcontractors, Gulf Copper bills the customer on an hourly basis according to a rate sheet included in the customer's contract. (2.RR.111-112, 125-126, 134, 155, 167, 201-203). Gulf Copper has contractual agreements to pay hourly subcontractors between $35-$38/hour and to charge its customers a marked-up rate of $54/hour for this work. (2.RR.113, 126, 205-208; 3.RR.81-83; 4.RR.108-109; 6.RR.P.Ex.17, 19, 21-24). For specialty subcontractors, Gulf Copper bills the customer at the subcontractor's cost, plus a mark-up between 15-20%. (2.RR.110, 112, 114, 126, 130, 134, 155, 179-181, 184-186, 190, 194-195, 208-210; 3.RR.24-25, 81-83; 6.RR.P.Ex.1 (§§4.1-4.3); P.Ex.12 (pg.310), P.Ex.14 (pg.303), P.Ex.44 (pgs.298-301)).

Regarding both, Gulf Copper is contractually required to provide its customers supporting documentation, including the subcontractors' invoices. (2.RR.114, 134, 179-182, 190, 194-195, 201-204; 3.RR.18-19, 24; 6.RR. P.Ex.1 (§§4.1-4.3); P.Ex.12 (pg.310), P.Ex.14 (pg.303), P.Ex.44 (pgs.298-301)). Gulf Copper also provides the customer a list of all individuals who performed hourly work, identifying each as an employee or subcontractor. (2.RR.201-203).

When a customer pays Gulf Copper for work performed by a subcontractor, Gulf Copper retains its portion of the payment and distributes (or "flows through") the subcontractor's portion to the subcontractor. (CR.298, FOF.25-27; 2.RR.116-117, 184; 3.RR.65-67, 70, 72). Gulf Copper is "in the middle of that" arrangement. (2.RR.117). The amount invoiced by the subcontractor and paid by Gulf Copper to the subcontractor—whether hourly or specialty—represents the "revenue that [the subcontractor] achieved through th[e] job." (2.RR.185; *see also* 3.RR.65-66; 6.RR.P.Ex.54). The marked-up amount represents revenue earned by Gulf Copper. (2.RR.185, 190; 3.RR.24-25, 67; 4.RR.108-109).

Gulf Copper's customer and subcontractor contracts (including the supporting invoices, work orders, purchase orders, accounting records, and course of dealings) mandate that Gulf Copper distribute the specified amount of flow-through funds to the subcontractors. (CR.298, FOF.28; 2.RR.183, 185, 186, 190, 195, 204-210; 3.RR.70-71; 4.RR.103; 6.RR.P.Ex.11, 13, 15, 24, 25). This mandate is enforced via a "no-lien provision" in the customer contract. (2.RR.115). When the subcontractor performs necessary work on the rig, it gives rise to a lien under federal maritime law. (2.RR.115). In addition, Texas Property Code Chapter 56 creates a statutory lien in the oilfield project itself for the unpaid work of contractors, like Gulf Copper, who rebuild the rigs to be used to drill in the oilfield projects. The "customers are very concerned about [] that," so they mandate or "dictate" that Gulf Copper pay the subcontractors to "avoid[] the creation of any liens on the [rig]." (2.RR.115-116).

SUMMARY OF THE ARGUMENT

The Third Court of Appeals properly held that Gulf Copper is entitled to (1) calculate its franchise tax by claiming the Cost of Goods Sold (COGS) subtraction based upon its work furnishing labor and materials to projects for the development of oil and gas reserves, and (2) claim a revenue exclusion for $79.4 million in payments to subcontractors. The Comptroller's challenges to Gulf Copper's qualification under the COGS and revenue exclusion statutes, as well as his no evidence arguments, are without merit. As we explain below, the Comptroller's arguments would require this Court to rewrite clear statutory language and to defy legislative intent. Consequently, these portions of the Third Court's opinion should be affirmed.

However, the Third Court incorrectly remanded the COGS issue for recalculation by the trial court. This portion of the opinion should be reversed, as addressed in Gulf Copper's Petitioner's Brief on the Merits.

This Court should render judgment in Gulf Copper's favor that, for Report Year 2009, it was entitled to (1) subtract COGS of $72,711,734, and (2) exclude from its revenue subcontractor payments of $79,405,230. Alternatively, if this Court were to conclude that Gulf Copper is not entitled to exclude those subcontractor payments, then it should reclassify them as COGS, and render judgment that Gulf Copper is entitled to a total COGS subtraction of $152,116,964. *See* Appx.2 (Gulf Copper Franchise Tax Calculations). Under either alternative, the Comptroller is liable to reimburse Gulf Copper for the full amount of its protest payment ($838,117.84), plus all statutory interest and costs as allowed by law.

ARGUMENT

I. THIS COURT SHOULD AFFIRM GULF COPPER'S ENTITLEMENT TO CLAIM THE COGS SUBTRACTION.

The Third Court of Appeals properly recognized that Gulf Copper's rig work at its Port Arthur and Galveston shipyards qualifies Gulf Copper to subtract COGS as a taxable entity "furnishing labor or materials" to projects for the drilling of oil and gas wells, under Texas Tax Code Section 171.1012(i), *third sentence*. In response to Issue I of the Comptroller's Petitioner's Brief, Gulf Copper addresses why this conclusion should be affirmed. However, as also addressed in Gulf Copper's Petitioner's Brief, the Third Court failed to affirm the trial court's judgment on the amount of the COGS subtraction under Section 171.1012(i), *third sentence*, and also failed to analyze Gulf Copper as an *actual* producer of goods under Section 171.1012(i), *first sentence*. As a result, the Third Court improperly remanded the COGS issue for recalculation, when it should have rendered judgment entitling Gulf Copper to subtract the entirety of its COGS subtraction in accordance with the record before it.

The Comptroller also contends the Third Court erred in remanding the COGS issue, but for the opposite reason. The Comptroller argues there was "no evidence" to support Gulf Copper's subtraction of any COGS under

Section 171.1012. Below, Gulf Copper provides a comprehensive response to the COGS dispute.

A. Gulf Copper Qualifies for COGS Because it Furnishes Labor or Materials to Offshore Projects for the Development of Offshore Oil and Gas Reserves.

A taxable entity may subtract COGS if it "furnish[es] labor or materials to a project for the construction, improvement, remodeling, repair, or industrial maintenance . . . of real property." Tex. Tax Code § 171.1012(i), *third sentence*. Gulf Copper furnishes labor and materials when it rebuilds oil rigs. The drilling companies use the oil rigs to drill into areas believed to contain oil and gas reserves. Before the oil rigs are brought to Gulf Copper for inspection and rebuilding, the drillers have contracts in place for the drilling of wells into the areas believed to contain oil and gas reserves. Accordingly, Gulf Copper furnishes labor or materials to an oilfield, which constitutes an existing project for the construction or improvement of real property.

Courts and the Comptroller have long recognized that the drilling and construction of oil and gas wells qualifies as the "construction or improvement to real property." *Hegar v. CGG Veritas Servs. (U.S.), Inc.*, No. 03-14-00713-CV, 2016 WL 1039054, *8 (Tex. App.—Austin March 9, 2016, no pet.); *Combs v. Newpark Res., Inc.*, 422 S.W.3d 46, 55 (Tex. App.—

Austin 2013, no pet.). Thus, taxpayers, like Gulf Copper, who furnish labor or materials to projects for the drilling of oil-and-gas wells are eligible to claim a COGS subtraction.

The Comptroller argues that Gulf Copper failed to establish that it qualifies for the COGS subtraction under this provision. However, neither the plain text of the statute nor the evidentiary record supports his argument.

1. The Statute's Plain Language.

The Comptroller advances definitions of several terms used in the third sentence of Section 171.1012(i) that are inconsistent both with the ordinary and plain meaning of those terms and with definitions of those terms previously provided by the Comptroller and the Courts. The Court should ignore the Comptroller's extra-statutory offers and construe the statute's words according to their plain and common meaning. *EXLP Leasing, LLC v. Galveston Cent. Appraisal Dist.*, 554 S.W.3d 572, 582 (Tex. 2018).

a. Labor.

The Court should define the term "labor" consistent with its ordinary meaning as both the Third Court in its decisions and Comptroller in his rule 3.588(d)(1) have done. The Court should reject the Comptroller's present litigating position, which is supported by nothing other than a rule amendment he adopted in an attempt to skirt the impact of governing case law.

The term "labor" as used in Section 171.1012(i), *third sentence* is also used in Section 171.1012(c), which includes "labor costs" as one of the costs that may be subtracted as COGS. Although undefined in the statute, "there is no reason to believe that 'labor' under subsection 171.1012(i) means anything different than labor under section 171.1012 generally." *Newpark*, 422 S.W.3d at 56 ("[C]ourts presume that same terms used in same connection in different statutes have same meaning").

As used in Section 171.1012, "'[l]abor' is a broad term that encompasses a wide range of activities." *Id.* It is ordinarily defined as the "expenditure of physical or mental effort especially when fatiguing, difficult, or compulsory." *Id.* (quoting Webster's Third New International Dictionary 1259, 2075 (Phillip Gove Ed. 2002)). This meaning demonstrates legislative intent "to allow taxable entities to deduct a wide range of labor expenses." *Id.*; *see also CGG Veritas*, 2016 WL 1039054 at *9-10 (utilizing *Newpark*'s analysis).

The Comptroller has similarly defined labor broadly, allowing taxable entities to subtract as COGS "labor costs, other than service costs, [that are of the type subject to capitalization under Internal Revenue Code Regulation 1.263A . . .] as direct labor costs, indirect labor costs . . . and other related costs." 34 Tex. Admin. Code § 3.588(d)(1); (6.RR.P.Ex.61). "Service costs" are defined as administrative overhead costs associated with a specific service department or function, like personnel, accounting, and legal. 34 Tex. Admin. Code § 3.588(b)(9).

b. Materials.

Section 171.1012 does not define "materials," and no appellate court has construed its meaning for COGS. "Materials" commonly means "elements, constituents, or substances of which something is composed or can be made," and includes "equipment, apparatus, and supplies used by an organization or institution." Merriam-Webster's Collegiate Dictionary 765 (11th ed. 2012). Nothing in the statute's plain text indicates an intention for the term to have any narrower meaning.

c. Furnish to a Project.

The COGS statute does not state when labor and materials are "furnish[ed] to a project for" qualifying real estate activities. However, the ordinary meaning of these terms establishes their breadth. Webster's Dictionary defines "furnish" as "to provide with what is needed; supply, give." *Compare* Merriam-Webster's Collegiate Dictionary 508 (11th ed. 2012) ("furnish") *with* Merriam-Webster's Collegiate Dictionary 920 (11th ed. 2012) ("perform:" "carry out, do"). "Project" means "a specific plan or design: scheme." Merriam-Webster's Collegiate Dictionary 993 (11th ed. 2012).

This language parallels the Section 171.1011(g)(3) revenue exclusion's "actual or proposed" language because the ordinary definition of "project" includes future or prospective real property plans. Neither "furnishing" nor "to a project" limits the availability of the COGS subtraction to taxable entities that are present at the site or drilling the wells. To hold otherwise reads the words "furnishing . . . to a project for" out of the statute. *See Morales v. Trans World Airlines, Inc.*, 504 U.S. 374, 385–86 (1992) (rejecting Texas Attorney General's argument that statute prohibiting state regulation "relating to rates, routes, or services" only prevents States from "actually prescribing rates, routes, or services" because "[t]his simply reads the words 'relating to' out of the statute. Had the statute been designed to pre-empt state law in such a limited fashion, it would have forbidden the States to "*regulate* rates, routes, and services."). Moreover, broad construction of these statutory terms is consistent with the broad scope of labor costs authorized for subtraction by the Comptroller's COGS rule, which allows subtraction of both direct and indirect labor costs at 100%. *See* 34 Tex. Admin. Code § 3.588(d)(1).

The Third Court of Appeals construed the statutory language to mean that taxable entities whose acts are an "essential and direct component of the drilling process" qualify for the COGS subtraction. *Newpark*, 422. S.W.3d at 57. On this basis, the Third Court previously held that taxpayers qualified for the subtraction for (1) hauling and disposing oil and gas waste, *id*.; and (2) shooting seismic images of potential drilling sites even where no drilling had commenced (and may never commence), *CGG Veritas*, 2016 WL 1039054 at *1. In both cases, the taxpayers' work occurred either after portions of the well had been drilled (waste disposal) or before any drilling had occurred (remote, undeveloped areas). The Third Court allowed both taxpayers to claim the COGS subtraction, finding that the taxpayers' work (labor or materials) was essential to the drilling process and the development of oil and gas reserves. Under these holdings, the taxpayer's work need not occur at a drilling or construction site nor occur contemporaneously with the actual drilling. Consistent with these decisions, in 2014, the Comptroller notified his entire audit division that the statute does not "require an entity to actually physically touch the property or make a change to the property to qualify for the COGS deduction." (6.R.R.P.Ex.60).[1]

[1] This memo was superseded and replaced by STAR Document No. 201606856L (Appx.3.), which changes portions of the memo relating to a revenue exclusion, but maintains the above-cited quote and has not been superseded; publicly-available at https://star.comptroller.texas.gov/view/201606856L?q1=201606856L (last accessed Feb. 14, 2019).

2. *The Comptroller's Extra-statutory Requirements Should Be Rejected.*

The Comptroller raises several arguments to deny Gulf Copper the COGS subtraction, but his positions violate the plain language of the statute and the rules of statutory construction. The Comptroller's positions impose extra-statutory requirements and improperly borrow from another statutory scheme to swap one undefined term for another and unilaterally restrict the scope of the COGS subtraction, inconsistent with the Legislature's intent.

In March of 2018, the Comptroller amended his COGS rule to generate support for his litigating positions and to eschew final court decisions. 43 Tex. Reg. 1640 (2018) (codified at 34 Tex. Admin. Code § 3.588), (Appx.4). Although the Comptroller stated the relevant amendments do not apply retroactively, the Comptroller advances them here as support for previously restricting Gulf Copper's COGS subtraction. Specifically, the Comptroller asserts that Gulf Copper did not furnish labor or materials to projects for the development of offshore drilling projects because Gulf Copper did not prove that its work created a statutory lien in the real property under Chapter 53 of the Property Code. This provision requires, but does not define, work in "direct prosecution" of the construction of above-ground structures.[2] *Compt. Petitioners' Brf., pgs.* 13-14.

The Comptroller's 2018 rule amendments incorporate definitions of "labor" and "materials" for real property COGS that "require[] that the labor and materials be used in the 'direct prosecution' of a project." *Id.* (codified at 34 Tex. Admin. Code § 3.588(c)(9)(B)(i)-(ii)). The Comptroller's definitions came from Chapter 53 of the Texas Property Code, which creates a statutory lien for mechanics and materialmen to secure payment for their work. *Id.* ("The definitions of 'labor' and 'material' [come] verbatim from Property Code, §53.001 (3) and (4) (Definitions), except that the [] amendment replaces the term 'work' with the term 'project.'"). The Comptroller said that he looked to Property Code Chapter 53 because "[t]he Tax Code phrase 'furnishing labor and [sic] materials' is similar to the Property Code phrase 'furnishes labor and [sic] materials.' Therefore, [per the Comptroller,] it is reasonable to assume that the Legislature intended similar definitions." *Id.* According to the Comptroller, when the Chapter 53 definitions are applied to COGS, the determination of whether a taxpayer furnishes labor or materials in direct prosecution of a project turns upon

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[2] As discussed further in Section I.A.2.b, Property Code Chapter 53 does not govern real property liens in the oil and gas context. Property Code Chapter 56 governs liens for work relating to the development of mineral interests, and, it would create for Gulf Copper a statutory lien to secure payment for its work.

whether the taxpayer could obtain a lien in the real property. *Id.* at 1640-41.

The Comptroller expressly acknowledges that his amendments are inconsistent with existing case law construing the statute according to the terms' plain meaning. *Id.* at 1640. Now, in his briefing before this Court, the Comptroller seeks to add even more requirements, beyond those found in his newly-crafted rule, suggesting without any statutory, rule, or case law support that Gulf Copper must also add value directly to the real property. *Comp. Petitioners' Brf., pg.* 17. This Court should reject the Comptroller's extra-statutory requirements and follow the plain language of the statute.

a. The Comptroller Impermissibly Adds Words to the Statute.

Notably, the Comptroller's "direct prosecution," lien litmus test, and his "value-added" requirements are not found, or even implied, anywhere in the text of Section 171.1012. This is important because the Legislature has demonstrated, for this tax, that when it intends to adopt specific or unique definitions for COGS, it does so expressly. *See* Tex. Tax Code § 171.1012(a) (providing definitions for several terms, not including labor or materials).

Similarly, the Legislature also carefully and explicitly references other Texas statutes when it intends to incorporate them into the COGS framework. For example, in the definitional section of the COGS statute, the Legislature expressly incorporated the sales tax statute definition of "computer program." *See id* at § 171.1012(a)(3)(A)(iii). The Legislature also incorporated the Comptroller's sales tax rule definition of "maintenance" to define the type of industrial maintenance that qualifies a taxpayer for COGS based upon real property activities. *See id* at § 171.1012(i), *third sentence*. Further, when our Legislature has determined that the availability of a lien is a precondition to claim an exclusion or subtraction, it expressly stated so. *See id* at § 171.1011(g-3)(1)(B) (providing a revenue exclusion for certain "funds subject to a lien").

Here, the Legislature did not define the terms within "furnish labor or materials," nor did it incorporate by reference any lien provisions for this purpose. Our Legislature was well aware that it could have done so, because it incorporated other statutes by reference within Section 171.1012 and created a lien test under the provision allowing the revenue exclusion for certain payments by attorneys. *See id* at § 171.1011(g-3)(1)(B).

When the Legislature acts with this level of precision, the courts should not assume that similar language has the same meaning across two statutory schemes with very different purposes. As stated by this Court:

> [We] note that there is a distinct difference between consulting other statutory definitions to determine common meaning and engrafting a special definition from one statute to circumscribe the plain meaning of a term used in another. While doing so may be appropriate when a word with an established

> meaning is employed in a subsequently enacted statute of similar purpose, that is not the case here. . . . [W]e are not persuaded that resorting to extra-textual sources informs the statutory analysis, and we do not agree that the special definition [in one statute] can be adopted to restrict the plain meaning of the words the Legislature enacted in [another]. Doing so would add limitations neither found in nor supported by the text and is unnecessary to avoid an absurd consequence.

Colorado County v. Staff, 510 S.W.3d 435, 453 (Tex. 2017).

In *EXLP Leasing, LLC v. Galveston Central Appraisal District*, 554 S.W.3d 572 (Tex. 2018), this Court again focused on the specific statutes and overarching framework at issue in a property tax dispute and rejected the government's proffered statutory borrowing. There, the Court was asked to determine taxable situs for dealer-held heavy equipment. Unlike the general property tax statutes, the dealer-held heavy equipment statutes did not expressly address taxable situs. *Id.* at 581-82. Galveston County argued that the general statute's term of art should govern taxable situs for the equipment-specific provision. *Id.* at 582. This Court rejected the argument, stating that "the omission of 'taxable situs' as a term of art in [the dealer-held heavy equipment statutes] does not mean they say nothing on the subject." *Id.* The Court then looked to the "statutory framework specific to dealer-held heavy equipment that assumes or necessitates a taxable-situs rule different from [the general statute]" and "ascertain[ed] legislative intent for a rule specific to the circumstances at hand that overcomes the general situs rules . . . ." *Id.* at 583. The Court held that the dealer-held heavy equipment framework could not function if the general taxable situs provisions prevailed. Thus, the lack of statutory definitions for Section 171.112(i), *third sentence*, is not an issue requiring remedy by the Comptroller.

Moreover, this Court should reject the Comptroller's attempt to engraft the Texas Property Code definitions into the franchise tax statute because the underlying purposes of each statute are fundamentally different. The Property Code provision exists to protect businesses from customers who fail to pay them for their work. The COGS provision exists so that qualifying taxpayers may uniformly determine their tax bases by subtracting those costs to yield "gross profits" or "margin." The Comptroller's amended rule turns this pro-business rule on its head and, instead, serves as an anti-business measure to prevent some of the otherwise eligible taxpayers from calculating their margins using COGS. In doing so, his extra-statutory requirements increase the likelihood of creating significant differences in margin tax liabilities amongst similarly-situated taxpayers and defeats the purpose of the lien provisions, which is to protect contractors—not to financially harm them.

If the Legislature intended the words "furnish[] labor or materials" to have common meaning between the Property Code and COGS, it would have adopted the Property Code definitions as part of the COGS statute or expressly referenced Chapter 53. *See Harris County Appraisal Dist. v. Texas Workforce Comm'n*, 519 S.W.3d 113, 129 (Tex. 2017) (declining to recognize an additional exemption from the Labor Code's definition of "employment" where "the Legislature illustrated its ability to formulate exemptions based on conduct in the very same statute at issue by creating three exemptions that focus on specific tasks" and recognizing that "if the Legislature intended those performing judicial functions to be included in the list of exemptions, we must presume it would have said so, either by broadening the definition of the term judiciary . . . or by creating another conduct-based exemption.").

The Comptroller's value-added argument, likewise, fails because it is not supported by the text of the statute. Further, unlike the Property Code definitions upon which the Comptroller relies, the value-added requirement is not even part of the Comptroller's newly-amended rule. It is merely an afterthought—a litigating position entitled to no deference. *Compare* 34 Tex. Admin. Code § 3.584(d)(3) (expressly imposing a value-added element [increased sales price] to determine whether a taxable entity that produces some goods may still qualify for the lower retailer's rate).

The Comptroller's argument is also misplaced because the more appropriate inquiry is whether Gulf Copper's work adds value to the *project* (not the real property), and the findings of fact provide a resounding "yes." Gulf Copper's work on the oil rigs adds value to existing offshore projects because the projects could not be developed or improved without oil rigs that can drill into the potential reserves safely, legally and efficiently. It is Gulf Copper's work that allows the development and improvement of the reserves to occur.

"A court may not judicially amend a statute by adding words that are not contained in the language of the statute. Instead, it must apply the statute as written." *ExxonMobil Pipeline Co. v. Coleman*, 512 S.W.3d 895, 900 (Tex. 2017) (per curiam). Thus, Gulf Copper urges the Court to reject the Comptroller's arguments and to apply the statute as written.

b. Property Code Chapter 53 Does Not Provide Clarity as Alleged by the Comptroller.

Definitions from Property Code Chapter 53 are a poor choice to resolve the Comptroller's alleged COGS concerns. Most importantly, incorporating Property Code Chapter 53 does not resolve this case because Chapter 53 covers above-ground construction. *See* Tex. Prop. Code §§ 53.021, 53.001(2) (defining "improvement"). Here, the real estate projects are for the development of mineral interests, which lie below ground and have been recognized by both the Comptroller and the courts as projects eligible for the COGS subtraction. *See, e.g.*, *Combs v. Newpark Res., Inc.*, 422 S.W.3d 46 (Tex. App.—Austin 2013, no pet.); *see also Hegar v. CGG Veritas Servs. (U.S.), Inc.*, No. 03-14-00713-CV, 2016 WL 1039054 (Tex. App.—Austin March 9, 2016, no pet.) (mem. op.); (6.RR.P.Ex.60). Property Code *Chapter 56* provides the rules for liens for mineral contractors or subcontractors "to secure payment for labor or services related to the mineral activities"—*e.g.*, drilling, operating, completing, maintaining, or repairing an oil or gas well. Tex. Prop. Code §§ 56.001-002. Both mineral contractor and mineral subcontractor are defined terms focusing on a person who "performs labor" or "furnishes or hauls material." *Id.* at § 56.001.

Courts have broadly construed Chapter 56 for many years. For example, in *Sun Coast Plumbing Co. v. Shell Offshore, Inc.*, a plumbing subcontractor contractor filed suit against Shell to foreclose on a mineral lien for material and labor it provided for the construction of living quarters to be attached to the hull of Shell's offshore rig. No. B-09-204, 2010 WL 1404371 at *1 (S.D. Tex. April 7, 2010). Shell filed a motion for summary judgment asserting that Sun Coast's "plumbing work on the living quarters was not related to 'mineral activities'" and was "too geographically attenuated to establish a valid lien because the plumbing work was performed in Harris County Texas, while Shell's lease was located hundreds of miles away in the Gulf of Mexico." *Id.* The Southern District of Texas denied Shell's motion, holding:

> [W]here the work done to support a mineral property lien is to be incorporated into an offshore platform used to house and support the crew that will work on exploiting a mineral lease, the work is sufficiently related to the mineral activities on the mineral lease to support a mineral property lien under the TPC.

Id. at *4.

The court further held that "there is no requirement under the Texas statute that the work be performed on the mineral lease itself." *Id.* at *5. Rather, location of the work is but one factor to be considered. *Id.* Noting Sun Coast's evidence that its work is "integral to the assembly of the [rig,] which itself is integral to the exploitation of the mineral lease" and the fact that "plumbing work, like the repair of drilling tools, is not the sort of work which is normally possible to do on an offshore mineral lease," the court held that Shell failed to demonstrate that there was no genuine issue of material fact regarding whether the work was too geographically remote and, thus, denied its motion for summary judgment. *Id.* The court's ruling was consistent with its holding twenty-two years before that a caterer to an offshore oil rig who supplied materials and labor to feed the crew was entitled to a Chapter 56 lien against drilling sites and had priority to well proceeds over the lease holder, drilling contractor, and lender. *World Hospitality, Ltd., Inc. v. Shell Offshore, Inc.*, 699 F. Supp. 111 (S.D. Tex. 1988).

Moreover, even if Chapter 53 applied to projects to develop mineral interests, the Comptroller construes the common statutory terms too narrowly. The Comptroller uses Chapter 53's "direct prosecution" requirement to restrict the scope of COGS qualifying labor notwithstanding the fact that "chapter 53 of the property code affords protection to those who 'furnish labor' as well as those who actually labor on a construction project in Texas." *Advance'd Temporaries Inc. v. Reliance Nat'l Indem. Co.*, 165 S.W.3d 1, 4-5 (Tex. App.—Corpus Christi 2005, pet. granted), *aff'd*, 227 S.W.3d 46 (Tex. 2007). Thus, furnishing labor under Property Code Chapter 53 is not limited to those engaged in acts of construction at the job site, and the Comptroller's restrictive interpretation of Chapter 53's "direct prosecution" requirement fails to deny Gulf Copper the COGS subtraction.

Finally, the Comptroller's assertion that he must impose "direct prosecution" and lien requirements to reduce uncertainty and to avoid controversies is simply wrong. Imposing these extra-statutory conditions will *create* uncertainty and controversy. 43 Tex. Reg. 1640 (2018); *see also Compt. Petitioners' Brf., pgs.* 14-15. The term "direct prosecution" is not defined by Chapter 53; thus, the Comptroller simply swaps one undefined term for another under the guise of providing clarity, but, in reality, invites further litigation while improperly narrowing the statute's scope. The Comptroller's lien test may be understandable by real-estate lawyers, but not by the professionals who prepare the tax reports. Accountants are not trained to know when a taxable entity's work gives rise to a statutory lien under the Property Code. Thus, taxpayers will be forced to bear the additional expense of obtaining a legal analysis under the Property Code simply to file their franchise tax return; and even then, taxpayers will face uncertainty created by the Comptroller because the issue of who may obtain a lien under the Property Code is not free from litigation even after more than 120 years of disputes. *See, e.g.*, *Trammel v. Mount*, 4.S.W. 377 (Tex. 1887); *Reliance Nat'l Indem. Co. v. Advance'd Temporaries Inc.*, 227 S.W.3d 46 (Tex. 2007).

c. The Comptroller's Position Fails Under the Doctrine of Legislative Acceptance.

Even assuming Section 171.1012 was ambiguous and, thus, warranted clarification—a point that Gulf Copper hotly contests—the Comptroller's rule amendments and position in this case fail under the doctrine of legislative acceptance. *See, e.g.*, *Tex. Dep't of Protective & Regulatory Servs. v. Mega Child Care, Inc.*, 145 S.W.3d 170, 176 (Tex. 2004); W*ausau Underwriters Ins. Co. v. Wedel*, 557 S.W.3d 554, 557-58, 560 (Tex. 2018). For the life of the margin tax (roughly ten years), the Comptroller provided only one COGS definition each for labor and materials, and these definitions comported with the common meaning of the terms as construed by the courts. *See* Tex. Admin Code § 3.588(d)(1)-(3); *see also, e.g., Combs v. Newpark Res, Inc.*, 422 S.W.3d 46, 56 (Tex. App.—Austin 2013, no pet.). During this same time, the Legislature amended the COGS statute several times, but did not amend the statute to adopt different definitions the third sentence of Section 171.1012(i).

The Comptroller now attempts to depart from his longstanding definitions by re-defining the same terms differently within the same rule. Under the doctrine of legislative acceptance, the Legislature is presumed to have been familiar with the Comptroller's original construction and to have adopted it, given the Legislature's re-enactment of the statute without adopting definitions specific to real property COGS. *Mega Child Care*, 145 S.W.3d at 176. Therefore, this Court should construe terms within Section 171.1012 according to their ordinary meaning and not per the Comptroller's new rule.

3. Gulf Copper Satisfies the Statute's Plain Language.

The COGS statute is broad and should not be re-written by the Comptroller for the above-stated reasons. The statute requires only that the taxable entity furnish labor or materials to projects for certain real estate activities, such as the drilling (construction) of oil wells. The statute does not require that the taxable entity engage in the specific activities, such as construction or drilling. The Comptroller previously recognized this breadth when, in response to taxpayer comments, he abandoned his proposed rule amendment that would have effectively deleted the word "project" from the statute. *Compare* 42 Tex. Reg. 5235 (2017) *with* 43 Tex. Reg. 1640 (2018). However, the Comptroller's brief now does exactly that through word play (*e.g.*, Gulf Copper must furnish labor or materials "*to a* construction project" rather than the statute's broader *to a project for* the construction of real property) and overreliance on the word "to," which renders meaningless the other words of substance. *Compt. Petitioners' Brf., pg.* 3 (emphasis added).

To argue that Gulf Copper does not furnish labor or materials to specific projects belies the record and defies common sense. The trial court made several specific Findings of Fact in this regard:

> No. 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."
>
> No. 19: "Rig owners do not hire Gulf Copper to repair or upgrade their rigs or manufacture new components unless they have a revenue-generating contract in place for the drilling of offshore oil and gas wells."

> No. 17: "A rig cannot be used for drilling unless it is properly certified, compliant, and satisfies the contractual requirements for the project."
>
> No. 16: "Gulf Copper's work enables the rigs (1) to meet and maintain the certification requirements imposed by classification societies, (2) to comply with governing regulations, and (3) to satisfy an exploration and production ("E&P") company's contractual requirements for a specific drilling project.
>
> No. 29: "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; and to projects for the construction, improvement, repair, or industrial maintenance of real property."
>
> No. 30: "The labor and materials provided by Gulf Copper through its employees and subcontractors are necessary, essential, and integral to the construction, improvement, repair, and industrial maintenance of oil and gas wells."

(CR.297-99). Notably, the Comptroller does not challenge the sufficiency of the evidence supporting any of these findings. "Unchallenged findings of fact are binding on an appellate court unless the contrary is established as a matter of law or there is no evidence to support the finding." *CGG Veritas*, 2016 WL 1039054 at *4 (citing *McGalliard v. Kuhlmann*, 722 S.W.2d 694, 696–97 (Tex. 1986). As addressed herein, these findings are "amply supported by record evidence," just as in *CGG Veritas*. Thus, the findings are binding on this Court.

As Gulf Copper's President and Chief Executive Officer testified at trial, rig owners will not spend millions of dollars to rebuild a rig that is not pre-contracted to drill. (2R.R. 108, 160; 3.RR.25-26). Instead, the rig is put into lay-up status (*i.e.*, parked) until it gets a drilling contract. (3RR.26). The ultimate drilling destination determines Gulf Copper's contractual scope of work because each location has different marine conditions that dictate anti-corrosive measures, different geology and subsurface formations that require different drilling platform configurations and equipment, and different regulatory requirements imposed by the governing country. (2.RR.26-28, 92-94, 95-97, 177-180; 3.RR.21-24; 6.RR.P.Ex.9-10, 44). The rigs are not "between jobs," as alleged by the Comptroller. *Compt. Petitioners' Brf., pgs.* 3, 5, 11. Rather, Gulf Copper's work is part of a project for the development of oil and gas reserves that must be performed in advance of actual drilling because such extensive work would interfere with drilling. (2.RR.85-86, 91, 118-119, 120, 133, 138).

The Third Court of Appeals properly recognized that Gulf Copper qualified to subtract COGS because it rebuilds oil and gas rigs pre-contracted to drill specific leases. However, the court remanded the case, in error, for unnecessary factual development because it mistakenly believed that Gulf Copper's customers might contract to rebuild an oil rig when there was no drilling contract in place. The statute and the record are clear that judgment should be rendered in Gulf Copper's favor. This result would both further the Legislature's intent to protect economy-driving industries, like offshore drilling, and to promote fairness and uniformity in taxation by broadly construing provisions essential to achieving a tax base of "margin."

B. The Comptroller's No Evidence Challenge to COGS Fails.

To support his legal sufficiency challenge and to distract from the detailed record in this case, the Comptroller asserts that Gulf Copper took an all-or-nothing approach to calculating COGS that was premised upon an erroneous legal interpretation. *Compt. Petitioners' Brf., pg.* 8. The Comptroller is incorrect.

At trial, Gulf Copper established two independent COGS calculation methods, referred to as "federal piggybacking" and "cost-by-cost." Both methods employ a two-step process requiring the taxpayer to first establish eligibility to subtract COGS (qualification) and then to compute the amount of the subtraction (calculation). The primary difference between the two methods is the administrative and professional time required to perform a cost-by-cost calculation. The federal-piggybacking calculation uses accepted efficiencies and, hence, is less time-consuming and, thereby, pro-business. Notwithstanding, the evidence was legally and factually sufficient to establish the full amount of Gulf Copper's COGS subtraction under either method.

1. Federal Piggybacking.

Gulf Copper presented federal piggybacking as one method of determining its COGS subtraction. "Federal piggybacking" or "conformity," is used by over 40 states in calculating state income and franchise taxes. Harley T. Duncan, Relationships Between Federal and State Income Taxes, ¶ 2.2 (Federation of Tax Administrators, April 2005). Under this method, a state taxpayer incorporates amounts from its federal income tax return as the starting point for some aspect of the state tax calculation.

a. The Method.

A taxable entity must first qualify for COGS under Section 171.1012(i), which provides: "A taxable entity may make a subsection under [Section 171.1012] in relation to the cost of goods sold only if that entity owns the goods." Tex. Tax Code § 171.1012(i). Thus, a taxable entity seeking to subtract COGS must own goods or rely upon some alternative, industry-specific provision addressing eligibility. *See, e.g.*, Tex. Tax Code § 171.1012(i) [third sentence], (k), (k-1), (k-2), (o) and (t) (addressing specific industries). A taxpayer typically owns goods by producing or acquiring them.

Upon establishing a qualifying business activity, the taxable entity moves to the calculation step, which begins with Section 171.1012(b):

> Subject to [the combined reporting statute,] Section 171.1014, a taxable entity that elects to subtract cost of goods sold for the purpose of computing its taxable margin shall determine the amount of that cost of goods sold as provided by this section.

Id. at § 171.1012(b). Subsection (h) then provides the starting point for how a taxable entity shall determine the COGS amount:

> 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 [Texas Tax Code Chapter 171] is based. This subsection does not affect the type or category of cost of goods sold that may be subtracted under this section.

Id. at § 171.1012(h) (emphasis added). The methods used on a taxable entity's federal income tax report on which the franchise tax report is based are those stated in Section 171.1012(g)— *e.g.*, Internal Revenue Code ("IRC") Section 263A, 460, and 471. Contrary to the Comptroller's arguments, Subsection (h) is not a reference to cash versus accrual accounting because those methods are not relevant once franchise tax revenue is calculated—a step in the margin tax calculation that concludes *before* the COGS analysis even begins. Rather, the federal income tax methods relevant to COGS are the Internal Revenue Code provisions cited in Subsection (g), which align the timing of federal deductions with the revenue generated by those federal deductions. Like Section 171.1012, these federal income tax methods address the proper treatment of costs.

However, Subsection (h) modifies a taxable entity's federal methods in two ways. First, the clause "except as otherwise provided by this Section," acknowledges Subsection (g)'s election for the taxpayer to expense (immediately subtract) costs that must be capitalized (delayed subtraction) on its federal income tax return, "except for costs excluded under Subsection (e), or in accordance with Subsections (c), (d), and (f)." *Id.* at §§ 171.1012(g), (h). Second, Subsection (h) provides that piggybacking on federal income tax methods "does not affect the type or category of cost of goods sold that may be subtracted under [Section 171.1012]"— that is, as Texas COGS. *Id.* at § 171.1012(h). As detailed in prior briefing, the costs addressed in IRC Section 263A greatly overlap with Section 171.1012. However, there are differences with respect to the classification of costs as direct or indirect, and Section 171.1012 prohibits some costs and limits other costs that are otherwise deductible at 100% for federal income tax purposes. For example, Subsection (e) prohibits the subtraction of officer compensation and interest expense and Subsection (f) limits the costs of personnel operations to 4%. *Id.* at § 171.1012(e)-(f). Thus, the second sentence of Subsection (h) serves to reconcile the statute's directive to determine COGS based upon the taxpayer's federal income tax methods as adjusted by the Texas-specific limitations found in Section 171.1012(c)-(f).

b. Gulf Copper's Application of the Federal Piggybacking Method.

After establishing that it qualified for the COGS subtraction as both a producer of goods and/or the furnisher of labor or materials to projects for the improvement of real-property,[3] Gulf Copper calculated the amount of its COGS subtraction by adjusting its federal treatment of costs under IRC Section 263A to align with Section 171.1012. Specifically, Gulf Copper removed costs prohibited by Subsection (e), limited to 4% the service costs listed in Subsection (f), and confirmed that the remaining costs were within the scope of the non-exhaustive list of costs allowed by (c) and (d) – *i.e.*, all of the "*direct* costs of acquiring or producing the goods" or "costs in relation to the taxable entity's goods." Tex. Tax Code § 171.1012(c)-(f) (emphasis

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[3] As detailed in Gulf Copper's Petitioner's Brief, the trial court properly recognized—but the Third Court of Appeals failed to consider—that Gulf Copper's production activities provide an independent basis upon which Gulf Copper may qualify for COGS. When the legal scope of "production" under Section 171.1012 is properly construed and applied to the record, it is clear that the costs generated by all phases of Gulf Copper's manufacturing process (initial, intermediate, and final) at each of its shipyards are properly included in the COGS subtraction. Gulf Copper's prior arguments supporting the scope of "production" should be considered in further response to the Comptroller's no evidence challenge. Gulf Copper incorporates those arguments hereto without needlessly restating them.

added).

In support of its federal piggybacking calculation, Gulf Copper provided Exhibits 46, 49, and 55. Exhibit 46 is Gulf Copper's federal income tax return and supporting workpapers. Exhibit 49 is Gulf Copper's trial balance reflecting its modification of its federal treatment of its costs.[4] Column AB of Exhibit 49 "COGS" identifies costs allowed at 100%, Column AD "G&A" identifies costs now limited to 4% under Subsection (f), and Column AF "Excluded" identifies costs disallowed by Subsection (e). (3.RR.75-76). Exhibit 55 summarizes the calculation and shows Gulf Copper lost more than $13 million in federal deductions when computing its Texas COGS.[5] (4.RR.56-57; 6.RR.P.Ex.55). Thus, the Comptroller incorrectly alleges that Gulf Copper "made no attempt to calculate or prove up its cost-of-goods-sold deduction in accordance with Section 171.1012." *Compt. Petitioners' Brf.*, pg. 10.

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4 The calculations in Exhibit 49 were performed before the audit began and Gulf Copper realized that it had erroneously limited all of Sabine's costs to 4%. However, Exhibit 49 is illustrative of Gulf Copper's process, and its correction of roughly $3 million of Sabine's costs is reflected in Exhibits 55 and 56.

5 Exhibit 55's $152 million in Texas COGS reflects the maximum amount that Gulf Copper could include for franchise tax report year 2009 because it covers (1) Gulf Copper's original COGS amount of $70 million, plus (2) the additional $3 million of Sabine's reclassified costs, plus (3) the $79 million of subcontractor costs, if they are moved from the revenue exclusion to the COGS subtraction, as addressed in Argument II. Aside from the additions of (2) and (3) in Exhibit 55, it reflects a consistent "base" amount of COGS with Exhibit 49.

2. Cost-by-Cost.

Gulf Copper also presented the trial court with a cost-by-cost COGS calculation, which tied the costs reflected in its general ledger accounts to the specific paragraphs of the COGS statute allowing their subtraction. As reflected on the first page of Exhibit 56, Gulf Copper grouped its costs to distinguish those relating to its work as a producer of goods from its costs generated by furnishing labor and materials to real estate projects (rebuilding oil rigs). Of Gulf Copper's shipyards, it used only the Port Arthur and Galveston's facilities to rebuild rigs during report year 2009. Under a cost-by-cost method, Gulf Copper's Corpus Christi work (and, therefore, its costs) qualifies for COGS, but only as an actual producer of goods. This work will not qualify as furnishing labor or materials to projects for the improvement of real property because Navy vessels are not associated with real property projects.

Gulf Copper also separately identified Sabine's costs due to the Comptroller's isolation and disparate treatment of this combined group member during the audit. However, Sabine's costs are properly included in COGS under this method because (1) Section 171.1014 treats the combined group members as a single taxable entity allowed only one subtraction and (2) Sabine's work was an integral to both Gulf Copper's production and real property work.

Next, Gulf Copper identified each of its costs, now segregated by account type and type of work, with the examples of allowable costs found in the subparagraphs of Section 171.1012(c), (d), and (f). Exhibit 56 at Pages P01158-P01177 and P04041-P04048 shows this detail. Aside from the worksheet column explaining the nature of the costs within each account, the account number itself consists of four sets of numbers further detailing the department and division generating the cost. Despite this specific evidence, the Comptroller erroneously claims—with no supporting citation—that "[i]t is undisputed that the taxpayer did not maintain records allowing it to determine its allowable costs across these smaller cost categories." *Compt. Petitioners' Brf.*, pg. 22.

As recognized by the trial court, the evidence was sufficient to render judgment in Gulf Copper's favor. This Court can render judgment in Gulf Copper's favor on either of two grounds. First, this Court may render judgment by determining that federal piggybacking is an appropriate calculation method under the plain language of the statute, and the record demonstrates as a matter of law that Gulf Copper's COGS subtraction under that method is $72,711,734. Second, if this Court determines that a cost-by-cost calculation is required, it may still render judgment in Gulf Copper's favor that it is entitled to a COGS subtraction of $72,711,734, because once all of Gulf Copper's costs incurred at each stage of its business are be considered under the proper legal interpretations of "production" and "furnishing labor or materials" to projects for the construction or improvement of real property, the record demonstrates as a matter of law that each cost included in this calculation is tied to COGS-qualifying work.[6] Either way, the Comptroller's no evidence complaint is without merit.

3. The Comptroller's Burden of Proof Argument Is Without Merit.

Finally, the Comptroller asserts that the Third Court's alleged misapplication of the burden of proof led to an improper remand of the COGS issue. *Compt. Petitioners' Brf.*, pgs. 4, 20-23. However, this argument improperly restates his challenge to the appropriate legal standard as an evidentiary complaint.

The Comptroller maintains that Gulf Copper provided no evidence that it furnished labor to any construction project, despite the multiple findings of fact and the Third Court's conclusion in Gulf Copper's favor. The Comptroller asserts that Gulf Copper performed work on drilling rigs that

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6 And under both calculation methods, the total COGS amount would be $152,116,964 if the $79,405,230 in subcontractor payments were moved to the COGS subtraction. (CR301, COL No. 17); Appx.2.

were between projects, likening that work to repairing a bulldozer before delivery to a construction site. However, the record establishes that the rigs were pre-contracted to drill and that, unlike a generic bulldozer repair, the scope of Gulf Copper's work to upgrade the rigs is driven by the unique characteristics of the drilling project itself. Thus, the Comptroller's complaint is that the Third Court misconstrued the statutory language to allow taxpayers whose work he deems too attenuated from the drilling project to subtract COGS. Based on his erroneous interpretation of the legal standard and his mischaracterization of the record, the Comptroller then complains that Gulf Copper failed to carry its burden of proof. This Court should reject the Comptroller's attempt to turn his litigating position into an evidentiary standard.

Moreover, the Comptroller's reliance on refund suit cases is an unpersuasive bootstrapping of this argument. The Comptroller contends that Gulf Copper "had the burden of proving that 'tax was overpaid and the exact amount of that overpayment." *Id.* at pg. 20 (citing *Verizon Bus. Network Servs., Inc. v. Combs*, No. 07-11-0025-CV, 2013 WL 1343530 (Tex. App.—Amarillo Apr. 3, 2013, pet. dism'd). However, *Verizon* is a refund suit under Texas Tax Code Chapter 111—not a protest suit under Chapter 112. In a refund case, a taxpayer must establish that it overpaid the tax at issue and the exact amount of the overpayment so that both the Comptroller and the court are aware of the amount in controversy—*i.e.*, the refund sought. However, in a protest suit, the amount in controversy is established by the tax assessment that the taxpayer pays under protest and sues to recover (here, the audit assessment). Thus, in this protest suit, Gulf Copper must simply prove that it is entitled to recover its protest payment. Gulf Copper did so here, and the Comptroller's burden of proof attack fails.

C. Conclusion on COGS.

This Court should affirm the Third Court's holding that Gulf Copper qualifies for the COGS subtraction as a taxpayer that furnishes labor or materials to projects for the improvement of real property. Beyond that, as addressed in Gulf Copper's Petitioner's Brief, this Court should hold that Gulf Copper also qualifies for the COGS subtraction as a producer of goods, and interpret the relevant statutory terms of "production," "manufacture," and "installation" to cover all aspects of Gulf Copper's integrated business model and combined-group status. Based on these holdings and the ample record before the Court, judgment should be rendered in Gulf Copper's favor that it was legally entitled to subtract the full amount of its COGS calculation.

II. THIS COURT SHOULD AFFIRM GULF COPPER'S ENTITLEMENT TO THE REVENUE EXCLUSION FOR SUBCONTRACTOR FLOW-THROUGH FUNDS.

For franchise tax report year 2009, Gulf Copper excluded $79,405,230 from its revenue for flow-through funds paid to its subcontractors under Section 171.1011 (g)(3). (3.RR.65-66, 69-70; 4.RR.43; 6.RR.P.Ex.47-48). Contrary to the Comptroller's argument under Issue II of its Petitioner's Brief, the Third Court of Appeals correctly concluded that Gulf Copper was entitled to do so, and this Court should affirm. (CR.300, COL.2).

A. The Requirements of Section 171.1011(g)(3).

Section 171.1011 (g)(3) provides a mandatory exclusion from revenue that taxpayers must make in calculating their amount of franchise due:

> (g) A taxable entity shall exclude from its total revenue ... 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.

Tex. Tax Code § 171.1011 (g)(3).[7] Without the exclusion, both the contractor and the subcontractor would pay tax on the same funds. Hence, "[a] manifest purpose" of this exclusion "is to except from taxation gross receipts that do not constitute actual gain or income to the taxpayer," and thereby "prevent[] double taxation." *Titan Transp., L.P. v. Combs*, 433 S.W.3d 625, 628, 641 (Tex. App.—Austin 2014, pet. denied); (3.R.R. 68, 84). The revenue exclusion is important in industries where the use of independent contractors is widespread, thereby creating the potential for multiple entities to be taxed on the same "margin" or "gross profits."

Section 171.1011(g)(3) requires a taxpayer to satisfy three elements:

1. <u>Flow-through funds</u>: The funds in question must flow from the taxpayer's customers, through the taxpayer, to the subcontractors.

2. <u>Mandated by contract</u>: The taxpayer must be mandated by contract to distribute the funds to another entity besides itself (*i.e.*, to its subcontractors).

3. <u>In connection with actual or proposed real property improvements</u>: The taxpayer must handle these subcontractor payments to provide services, labor, or materials in connection with the actual or proposed design, construction, remodeling, or repair of improvements on real property.

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[7] The 2008 version of the statute, as quoted above, is applicable to Gulf Copper's report year 2009 franchise tax calculation. All references herein are to that version.

However, the Comptroller conflates elements 1 and 2 to form a hyper-technical standard that is narrower than our Legislature intended. *Compt. Petitioner's Brf., pgs.* 24-25. Regardless, the Comptroller's arguments fail.

B. Gulf Copper Satisfies the Statutory Requirements.

Gulf Copper properly excluded $79.4 million in subtractor payments from revenue for report year 2009 because it satisfies all requirements of Section 171.1011(g)(3).

1. Flow-through Funds.

The $79.4 million excluded by Gulf Copper constitutes funds that it received from customers to satisfy payment obligations owed to subcontractors who performed work on the customers' rigs, which Gulf Copper "flowed through" in payment to the subcontractors.[8] Both hourly and specialty subcontractors performed work for Gulf Copper's customers during report year 2009. (2.RR.110, 122, 134, 154; 3.RR.38). When invoicing customers for this work, Gulf Copper charged the cost of the subcontractors' work, plus a markup of approximately 15-20%. (CR.298, FOF.24). Gulf Copper retained only the mark-up as its revenue, flowing the remaining amount of the customers' payments through to the subcontractors

8 These amounts arose only from Gulf Copper's rig work. (3.RR.69-71, 80).

who performed the customer work. (CR.298, FOF.25). Hence, the excluded amounts are "flow-through funds," "handled by the taxable entity" and distributed to "other entities," as required by Section 171.1011(g)(3). (CR.298, FOF.26-27).[9] Given the Comptroller's conflation of elements one and two, Gulf Copper addresses the Comptroller's arguments regarding "flow-through funds" under the next section.

2. Contractual Mandate.

The Comptroller concedes that Gulf Copper's payments to specialty subcontractors made under cost-plus contracts were flow-through funds mandated by contract to be distributed to the subcontractors. In doing so, the Comptroller agrees that roughly $32 million of Gulf Copper's $79.4 million in subcontractor payments qualify as flow-through funds mandated by contract. *Comp. Petitioners' Brf., pgs.* 26-31. The Comptroller's challenge is limited to the remaining $47.4 million in payments that Gulf Copper made to its hourly subcontractors. *Id., pg.* 26.

Contrary to the Comptroller's argument, the statute simply requires a taxable entity be "mandated by contract" to distribute "*to other entities*" the types of subcontracting payments described therein. Tex. Tax Code

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9 The Comptroller does not challenge the sufficiency of the evidence supporting Findings of Fact 24-27. Because the unchallenged findings are supported by evidence in the record, they are binding on this Court. *CGG Veritas*, 2016 WL 1039054 at*4.

§ 171.1011(g)(3) (emphasis added). Nowhere in the language is a requirement that Gulf Copper have a contract with its customer mandating that Gulf Copper will distribute the customer's payment to the subcontractors. The Comptroller's position would require Gulf Copper to set aside and trace, dollar-for-dollar, the exact funds paid by the customers to the subcontractors. The Third Court correctly held that "[t]he State's position is contrary to the plain language of the statute and to [the] previous holding in *Titan Transportation LP v. Combs*, 433 S.W.3d 625 (Tex. App.—Austin 2014, pet. denied)." *Hegar v. Gulf Copper & Mfg. Corp.*, 535 S.W.3d 1, 11 (Tex. App.—Austin 2017, pet. filed).

The Comptroller's interpretation does not serve any legitimate purpose. In fact, his position is directly contrary to the "evident purpose of the (g)(3) revenue exclusion [of] prevent[ing] double taxation of funds that are not truly gain or income to the taxpayer." *Titan Transp.*, 433 S.W.3d at 641. It creates taxing disparities within industries that rely heavily on the use of subcontractors and that the Legislature was clearly trying to protect by enacting the revenue exclusion.

Further, the Legislature has already stepped in once to stop the Comptroller from construing the statute's plain language in a manner contradictory to industry practice. In 2013, the Legislature enacted clarifying language authorizing the exclusion of "flow-through funds that are mandated by contract *or subcontract* to be distributed to other entities." Act of June 14, 2013, 83rd Leg., R.S., ch. 1034, § 1 (effective Jan. 1, 2014) ("H.B. 2766") (emphasis added). The Legislature stated that the addition of "or subcontract" was necessary to "clarify current law" and to reject the Comptroller's interpretation requiring taxpayers to have "a contract in place that states a specific portion of the work will be subcontracted"—*i.e.*, one contract reflecting the flow-through nature of the customer, contractor, and subcontractor relationship—because it was inconsistent with "contracts in the industry." SENATE RESEARCH CTR., *Bill Analysis*, Tex. H.B. 2766, 83rd Leg. R.S., 2013. The argument advanced by the Comptroller here is a renewed attempt to circumvent the statutory requirements, as clarified by our Legislature.

The trial court found that "Gulf Copper's contractual mandates to distribute flow-through funds to its subcontractors are contained within its customer contracts, its contracts with the subcontractors, supporting invoices, work orders, purchase orders, and other accounting records. They are also embodied in the course of Gulf Copper's dealings with its customers and subcontractors. (CR.298, FOF.28; *see also, e.g.*, 2.RR.114, 134, 185-186, 204-210).[10] The Comptroller does not challenge the sufficiency of the evidence in support of Findings of Fact 23-24 or 28, and the record provides ample evidence in support. *See Gulf Copper*, 535 S.W.3d at 11 & n.16 ("The evidence and exhibits admitted at trial, including contracts with the [hourly] subcontractors ... establish that Gulf Copper was obligated by those contracts to pay the [these] subcontractors for that labor.") (discussing, as an example, Gulf Copper's Master Service Agreement with Maxum Industries, LLC). Consequently, these findings are binding on this Court.

Based on this record, the Third Court correctly held that Gulf Copper satisfied the statutory requirement of a contractual mandate. *Id*. at 11 & n.17. This Court should affirm that holding and conclude that Gulf Copper is entitled to the full amount of its revenue exclusion for report year 2009.

3. In Connection With Actual or Proposed Construction of Improvements on Real Property.

Finally, the record establishes that Gulf Copper handled its subcontractor payments "to provide services, labor, or materials in connection with the actual or proposed design, construction, remodeling, or

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10 The customers understood that Gulf Copper charged a markup plus its costs for the subcontractors' work, both hourly and specialty. Gulf Copper's customers often approved Gulf Copper's use of specific subcontractors and were involved in the process of their selection, hiring, and payment. (CR.298, FOF.23-24).

repair of improvements on real property." Tex. Tax Code § 171.1011(g)(3). The Comptroller concedes—as found by the trial court in Findings of Fact 20 and 30, and as affirmed by the Third Court—that "[t]he 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," and those wells constitute "improvements to real property." *Compt's Petitioners' Brf.*, pg. 30 (citing CR.298-99). The Comptroller's only challenge to this element is whether there was a *sufficient connection* between the labor/materials provided and the "actual or proposed construction, or repair of improvements on real property." *Id.*, pgs. 28-29.

As acknowledged by the Comptroller, the phrase "in connection with" is one of intentional breadth." *Gulf Copper*, 535 S.W.3d at 12 (quoting *Titan Transp.*, 433 S.W.3d at 637). The Third Court held that "in connection with" means that "there must be a reasonable—*i.e.*, more than tangential or incidental—relationship between the activities delineated in the statute and the services, labor, or materials for which the subcontractors receive payment." *Titan*, 433 S.W.3d at 638.

More recently, this Court construed the phrase even more broadly under the Texas Citizens Participation Act, holding that "in connection with" does <u>not</u> require "more than a 'tangential relationship.'" *See ExxonMobil*

Pipeline Co. v. Coleman, 512 S.W.3d 895, 900 (Tex. 2017) (per curiam). In *ExxonMobil,* this Court considered whether employee communications were "in connection with" matters of public concern (health and safety), and held that "the [Fifth] [C]ourt of [A]ppeals improperly narrowed the scope of the TCPA by ignoring the Act's plain language and inserting the requirement that communications involve more than a 'tangential relationship' to matters of public concern." *Id.* at 900. Under the broad meaning of "in connection with" as interpreted by this Court, Exxon's communications about an employee's duty to record the fluid volume of various petroleum product storage tanks was sufficiently "related to a 'matter of public concern'" because the purpose of the duty was "at least in part, to reduce the potential environmental, health, safety, and economic risks associated with noxious and flammable chemicals overfilling and spilling onto the ground." *Id.* at 897, 901.

Similarly, the United States Supreme Court has recognized the expansive breadth of the phrase "connection with," finding it synonymous with "relating to." *Altria Group, Inc. v. Good,* 555 U.S. 70, 86 (2008) ("'relating to' is synonymous with 'having a connection with'" *citing Morales v. Trans World Airlines, Inc.*, 504 U.S. 374, 383–86 (1992) (citing Black's Law Dictionary to state: "The ordinary meaning of ['relating to'] is a broad one—'to stand in some relation; to have bearing or concern; to pertain; refer; to bring into association with or connection with . . . .'" and construing the phrase to mean "having a connection with or reference to")).

Whether using the Third Court's *Titan* standard or the more expansive interpretations of the higher courts, Section 171.1011(g)(3)'s "in connection with" standard requires, *at most*, that the work performed by the subcontractors "have a reasonable connection" to the planned improvement of the real property. *Id*. at 638-39. As correctly concluded by the Third Court, the work provided by Gulf Copper's subcontractors to enable rigs to drill safely, legally and effectively into the oil and gas formations that underlie the specific areas for which they are pre-contracted to drill satisfies this requirement. *Gulf Copper*, 535 S.W.3d 12-13 ("[I]t is evident that doing work on offshore drilling rigs—equipment that is undisputedly integral to drilling offshore wells—that renders them able to perform the drilling services required to drill a particular oil well is an activity that is reasonably connected to the construction of that oil well," and the Comptroller waived any argument to parse out certain discrete activities from the whole of the work performed). "On this record, there is sufficient evidence to support the trial court's conclusion that Gulf Copper was entitled to include the $79,405,230 in payments to subcontractors as flow-through funds falling within the (g)(3) revenue exclusion." *Id*. at 13.

The Comptroller argues that Gulf Copper's subcontractor work is not sufficiently connected to the real property improvements because it is temporally, physically, and contractually attenuated from the drilling of the well. *Compt. Petitioner's Brf., pg.* 29. In essence, these arguments seek to limit the revenue exclusion to payments for work performed directly at the construction or well sites, notwithstanding the statute's plain language, which covers a much broader scope of activities. *See Morales v. Trans World Airlines, Inc.*, 504 U.S. 374, 385–86 (1992) (rejecting Texas Attorney General's argument that statute prohibiting state regulation "relating to rates, routes, or services" only prevents states from "actually prescribing rates, routes, or services" because "[t]his simply reads the words 'relating to' out of the statute. Had the statute been designed to pre-empt state law in such a limited fashion, it would have forbidden the states to "*regulate* rates, routes, and services."). Thus, as with the COGS subtraction's "to a project" language, the revenue exclusion's "in connection with" standard should not be restricted to those at the construction site because such an interpretation reads words out of the statute, including "actual or proposed."

Section 171.1011(g)(3) allows the revenue exclusion for subcontractor work in connection with "actual or *proposed*" real property improvements.

Thus, the statute contemplates subcontractor work that is temporally, physically, and contractually attenuated from the drilling or construction site. An oil-and-gas subcontractor providing services, labor, or materials to a *proposed* drilling project does not perform his work after drilling operations have commenced. *Compt. Petitioner's Brf., pg.* 29. Similarly, such a subcontractor is not required to perform his work at the drilling site because drilling may never even commence if the owner abandons the project. *Id.* Moreover, the Section 171.1011(g)(3) expressly allows subcontractor "design" work, which is typically performed at an office away from the drilling or construction site even when done in connection with the "*actual* . . . construction . . . of improvements." Tex. Tax Code § 171.1011(g)(3) (emphasis added). Finally, there is no statutory requirement that Gulf Copper contract with the drilling project owner. *Compt. Petitioner's Brf., pg.* 29. The statute simply requires Gulf Copper to have a legal obligation to pay the amounts for which the revenue exclusion is sought. The Comptroller's position also ignores the reality of the construction industry. Work that is necessary, essential, or integral to the improvement of real property may not be performed at the construction site for various reasons, including limited space or safety concerns. *See Sun Coast Plumbing Co., Inc. v. Shell Offshore, Inc.*, No. B-09-204, 2010 WL 1404371 at *5 (S.D.

Tex. April 7, 2010) ("[T]he plumbing work, like the repair of drilling tools, is not the sort of work which is normally possible to do on an offshore mineral lease.").

The Comptroller's "value-added" requirement also fails for the revenue exclusion. *Compt. Petitioner's Brf., pgs.* 30-31. Like Section 171.1012, qualifying payments or costs may arise in connection with work that is merely "proposed." If the work is merely "proposed," then there may never be a project to which a taxpayer could "add value." Notwithstanding, Gulf Copper, through its subcontractor work, adds value to the real property improvement because it rebuilds the rigs so that they may drill safely, legally and effectively into the oil and gas formations that underlie the specific areas for which they are pre-contracted to drill. Without Gulf Copper, the drilling would not occur. (CR.297, FOF.16-20, 30). Thus, Gulf Copper, through its subcontractor work, adds value to both the rig and to the offshore project.

The Comptroller contends that his restrictive interpretations of the revenue exclusion and COGS statutes are necessary to give them independent meaning. *See Compt. Petitioner's Brf.*, pgs. 15, 30-31, n.6. However, both statutes anticipate a broad scope of permissible work—Section 171.1012 through the use of "to a project" and Section 171.1011 through the use of "actual or proposed." Both of these phrases anticipate construction or drilling activities that may occur in the future. The ordinary definition of "project" for COGS includes "a specific plan or design: scheme," and the revenue exclusion expressly contemplates *proposed* improvements. In fact, the Legislature addressed the overlap between the revenue exclusion and COGS because it expressly stated in Section 171.1011(j) that any amount excluded under [the revenue exclusion] section may not be included in the determination of cost of goods sold undersection 171.1012 . . . ." Tex. Tax Code § 171.1011(j).

Finally, the Comptroller's law firm example is unpersuasive. *Compt. Petitioner's Brf., pg.* 31. Under the Comptroller's example, we are asked whether a law firm should be able to exclude from revenue its payments to subcontractors who drafted a drilling contract for a rig owner under Section 171.1011(g)(3). However, Section 171.1011(g-3)(1)(D) independently authorizes a revenue exclusion for this situation, regardless of whether the subcontractor lawyers' work has any connection to the improvement of real property. Tex. Tax Code § 171.1011(g-3)(1)(D) (providing for a revenue exclusion for a "taxable entity that provides legal services" for "fees paid an attorney in the matter who is not a member, partner, shareholder, or employee of the taxable entity"). Thus, our Legislature did contemplate the Comptroller's example and, contrary to the Comptroller's conclusion, would expressly allow the attorneys to claim the exclusion for subcontractor payments to co-counsel.

Accordingly, this Court should affirm the Third Court's judgment on the revenue exclusion issue.[11]

C. The Comptroller Mischaracterizes the Revenue Exclusion as an Exemption.

This Court should reject the Comptroller's mischaracterization of the revenue exclusion as a tax exemption to be strictly construed against Gulf Copper. *Comp. BOM* at 28. As detailed in Section II.D of Gulf Copper's Petitioner's brief, exclusions and subtractions that serve to calculate the tax base itself do not constitute exemptions. Further, the Comptroller's citation to *Owens Corning v. Hegar*, 534 S.W.3d 28 (Tex. App.—San Antonio 2017, pet. denied), is inapplicable because, there, the Fourth Court of Appeals *erroneously* construed the COGS subtraction—not the revenue exclusion—

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[11] If the Court were to reverse this portion of the opinion and conclude that Gulf Copper was not entitled to exclude its $79.4 million of subcontractor payments under Section 171.1011(g)(3), then those payments should be reclassified costs for purposes of the COGS subtraction. That is what the Comptroller did in his audit, and he does not dispute such a reclassification on appeal. However, the parties dispute what should happen to these amounts once moved into the COGS category. If the Court agrees with Gulf Copper about how to interpret and apply the COGS subtraction, then the entirety of the subcontractor payments should be included in the COGS subtraction, as found by the trial court, without the arbitrary reductions applied by the Comptroller's auditor. (CR.299, FOF Nos. 36-37; CR.300-01, COL Nos. 2, 5, 17); *see* Appx.5. But if the Court agrees with the Comptroller that reductions should be made to Gulf Copper's COGS subtraction, then the matter should be remanded for further proceedings consistent with the Court's Opinion.

as an exemption.

PRAYER

Counter-Petitioner/Respondent Gulf Copper and Manufacturing Corporation respectfully maintains its prayer as stated in its Petitioner's Brief.

Respectfully submitted,

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ATTORNEYS FOR RESPONDENT AND COUNTER-PETITIONER GULF COPPER & MANUFACTURING CORPORATION

CERTIFICATE OF COMPLIANCE

I hereby certify that Gulf Copper's Brief on the Merits complies with the typeface requirements of Tex. R. App. P. 9.4(e) because it has been prepared in a conventional typeface no smaller than 14-point for text and 12-point for footnotes. This document also complies with the word-count limitations of Tex. R. App. P. 9.4(i) because, according to the word count tool of the computer program used to prepare this document, it contains 11,672 words, excluding any parts exempted by Tex. R. App. P. 9.4(i)(1).

/s/James F. Martens
James F. Martens

CERTIFICATE OF SERVICE

Pursuant to the Texas Rule of Appellate Procedure 9.5, a true and correct copy of the foregoing was served on counsel below via e-mail and e-service on the 15th day of February 2019.

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APPENDIX

1. Excerpt from Gulf Copper's contract with Pride Foramer

2. Gulf Copper Franchise Tax Calculations

3. Comptroller Memo, (STAR Document No. 201606856L) (June 30, 2016)

4. 43 Tex. Reg. 1640 (2018)

5. Findings of Fact and Conclusions of Law

PLAINTIFF'S EXHIBIT 1

VESSEL REPAIR AND MODIFICATION AGREEMENT

THIS VESSEL REPAIR AND MODIFICATION AGREEMENT (this "**Agreement**") is entered into as of the 11 th day of May, 2007, by and between Pride Foramer S.A.S., a French company herein called ("**Owner**"), and Gulf Copper, INC., a Texas corporation herein called ("**Contractor**"). The performance of Owner's obligations hereunder shall be guaranteed by Pride Forasol S.A.S., a company organized under the laws of France, and such guaranty shall be evidenced by a separate agreement to be executed contemporaneously with this Agreement

WITNESSETH:

WHEREAS, Owner is the owner of the drilling rig referred to as the Pride Mexico, Official Number 8496 (Liberia), IMO No. 736 7457 (the "**Vessel**"); and

WHEREAS, Owner and Contractor desire for Contractor to perform certain repair and modification work with respect to the Vessel in accordance with the terms and conditions of this Agreement;

NOW, THEREFORE, in consideration of the mutual covenants and provisions herein, the parties hereto agree as follows:

ARTICLE I
SCOPE OF WORK

1.1. Performance of Work. Contractor agrees to provide all management, supervision, labor, materials, machinery, tools, working area, equipment, plant, consumables, facilities, licenses, permits, bonds and other services and items as are reasonably required to complete the repairs, renewals, alterations, replacements, modifications, and/or conversions requested by Owner to the Vessel in accordance with the terms of this Agreement (hereinafter called the "**Work**"). It is understood and agreed that the Work shall include the obtaining of necessary dimensions, detailed additional plans, drawings, labor, machinery, materials, supplies and equipment (other than the equipment and other items set forth on Exhibit D attached hereto and made a part hereof, hereinafter referred to as "**Owner Furnished Equipment**"). Owner reserves the right to alter, enlarge, reduce, modify or otherwise change the Work at any time for any reason in accordance with the provisions of Article III.

1.2. Contractor General Requirements and Scope of Work. All Work performed by Contractor shall be performed strictly in accordance with (a) the Contractor General Requirements and Scope of Work Outline attached hereto as Exhibit A and made a part hereof (the "**General Requirements**") and (b) the Detailed Scope of Work Definition attached hereto as Exhibit B and made a part hereof (the "**Scope of Work**"). By execution of this Agreement, Contractor agrees that it has read and understands the General Requirements and Scope of Work and covenants that the prices, timelines and other undertakings of Contractor under this Agreement have been agreed to by Contractor after reviewing and taking into account such General Requirements and Scope of Work.

(e) remove all the equipment or materials of Contractor from the immediate area in which the Work or the relevant part thereof is being performed, unless otherwise instructed by Owner;

(f) within thirty (30) days of the effective date of termination, deliver to Owner all of the technical information provided by Owner and the originals, copies and reproductions of all documents prepared by the Contractor or any of its subcontractors.

6.5. Continuation of Liability. In the event of termination under this Article VI, Contractor shall not be relieved of any continuing obligations or liabilities under this Agreement or at Law except as expressly provided herein.

6.6. Survival of Provisions. It is expressly agreed that all of the provisions contained within this Article VI, Article VIII, Article IX, Article XII, Article XVII, Article XVIII, Article XIX and Article XXII shall survive the termination of this Agreement.

ARTICLE VII
INDEPENDENT CONTRACTOR; SUBCONTRACTORS; COMPLIANCE WITH LAW

7.1. Independent Contractor. All Work done by Contractor shall be required to meet the reasonable approval of Owner's Representative, but the detailed manner and method of doing the Work shall be under the control of Contractor. It is understood that Contractor is an independent contractor as to all Work performed hereunder, and that Contractor's employees and subcontractors and their employees shall not be deemed to be employees or agents of Owner, whether by "borrowed servant" or any other legal theory.

7.2. Subcontractors. Contractor may perform certain of the Work by the use of one or more subcontractors. Contractor must notify Owner in advance of the use of any major subcontractor and, unless otherwise agreed by Owner in writing, Contractor may only use the subcontractors listed on Exhibit H. Subcontracting of any of the Work shall not relieve Contractor of its responsibilities and obligations under this Agreement.

7.3. Compliance with Law. Contractor shall comply and secure compliance by its subcontractors with all applicable laws, ordinances, requirements or regulations of any municipal, local or any other governmental authorities or agency. Subject to the express indemnity obligations of this Agreement, Contractor shall defend, indemnify and hold Owner harmless from all liability for all such claims, suits and proceedings brought against Owner and liability imposed on Owner by reason of any violation or alleged violation of law by Contractor or its subcontractors.

ARTICLE VIII
WARRANTY

8.1. General Warranty. Contractor hereby warrants to Owner that (i) Contractor's workmanship and materials shall be free from material defects (except that with respect to painting and coating, Contractor warrants only that same shall be applied in accordance with the instructions of the supplier thereof) and (ii) that Owner furnished equipment shall be installed properly in a good and workmanlike manner (any failure to meet the requirements of (i) or (ii) being herein a

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<u>**Gulf Copper Franchise Tax Calculations**</u>

Line	Description	GC's Original RY09 Return	GC's Primary Request (Rev. Excl. & COGS)	GC's Alternative Request (Subcontractors in COGS)	Comptroller's Request
8	Total Gross Revenue	$173,875,422	$173,875,422	$173,875,422	$173,875,422
9	Revenue Exclusions	$79,568,533	$79,568,533	$163,303	$163,303
10	**Total Revenue**	**$94,306,889**	**$94,306,889**	**$173,712,119**	**$173,712,119**
11	COGS (100%)	$69,934,905	$72,352,198	$151,757,428	$76,933,452
12	COGS (capped at 4%)	$461,314	$359,536	$359,536	$207,317
14	**Total COGS**	**$70,396,219**	**$72,711,734**	**$152,116,964**	**$77,140,769**
22	**MARGIN**	**$23,910,670**	**$21,595,155**	**$21,595,155**	**$96,571,350**
23	TX Receipts	$83,060,815	$83,060,815	$162,466,045	$162,466,045
24	Everywhere Receipts	$94,306,889	$94,306,889	$173,712,119	$173,712,119
25	**Apportionment Factor**	**0.8808**	**0.8808**	**0.9353**	**0.9353**
28	Taxable Amount	$21,060,518.00	$19,021,012.50	$20,197,948.50	$90,323,184.00
34	**TAX DUE (1%)**	**$210,605.18**	**$190,210.13**	**$201,979.49**	**$903,231.84**
Recovery Due to GC			**$838,117.84 + interest and costs**	**$838,117.84 + interest and costs**	**None**

Texas Comptroller of Public Accounts STAR System

201606856L

DATE: June 30, 2016

TO: Denise Stewart, Audit Division
Jim Arbogast, General Counsel

FROM: Teresa Bostick, Tax Policy Division

SUBJECT: Policy change based on TITAN and NEWPARK

Note: This memo supersedes the June 10, 2014 memo (201406920L) on the interpretation of "mandated by contract" as provided in Tax Code Section 171.1011(g). The policy was overturned in *Titan Transp., LP v. Combs* , 433 S.W.3d 625 (Tex.App.—Austin 2014, pet. denied).

ISSUE

Based on the courts' language and analysis in TITAN and NEWPARK, we are revising the policy with regard to payments eligible for exclusion under Section 171.1011(g) and qualifying activities for the COGS deduction under Section 171.1012(i).

BACKGROUND

The court in TITAN found that Titan Transportation, L.P. (Titan), which is in the business of hauling, delivering, and depositing aggregate at real property construction sites, was entitled to exclude from revenue, pursuant to Section 171.1011(g)(3), payments the taxpayer made to its subcontractors providing this service for its customers.

Newpark Resources, Inc. (Newpark), an oil field service business, was the reporting entity for a combined group which included its subsidiary, Newpark Environmental Services, L.L.C. (NES). The court in NEWPARK found that Newpark was entitled to take a COGS deduction under Section 171.1012(i) for NES's activities of removal and disposal of waste materials from oil and gas well drilling sites.

REVISED POLICY

This change has immediate effect and a taxable entity may file an amended franchise tax report for years that are open within the statute of limitations.

Section 171.1011(g) states, "A taxable entity shall exclude from its total revenue…only the following flow-through funds that are mandated by contract to be distributed to other entities:…"

According to the Third Court of Appeals, the term "other entities," as used in Section 171.1011(g), merely means someone other than the taxable entity. The court explained the "purpose of the (g)(3) revenue exclusion is to prevent double taxation of funds that are not truly gain or income to the taxpayer, and this purpose is satisfied regardless of whether the mandate is contained in a contract with a customer or with a subcontractor." *Titan Transp., LP v. Combs* , 433 S.W.3d 625, 641 (Tex. App. Austin 2014, pet. denied).

Under the revised policy, a payment is mandated by contract to be distributed to other entities and qualifies as flow-through funds under Section 171.1011(g) if the taxable entity has a contract with its customer providing that a subcontractor may be used and requiring payment to the subcontractor, or by a written contract between the taxable entity and the subcontractor where the payment is based on the funds paid to the taxable entity by the taxable entity's customers. For example, the contract between the taxable entity and the subcontractor require payment based on a percentage of the funds the taxable entity receives from its customer. The timing of the payments does not determine if a payment qualifies as a flow-through fund.

Further, payments which qualify as flow-through funds under Section 171.1011(g) and have a reasonable nexus to the actual or proposed design, construction, remodeling, or repair of improvements on real property or the location of boundaries of real property, may be excluded from revenue pursuant to Section 171.1011(g)(3).

With regard to COGS, Section 171.1012(i) states, "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 costs of goods sold."

Under the revised policy, we are expanding the interpretation of what is considered to be furnishing labor or materials to a project for the construction, improvement, remodeling, repair, or industrial maintenance of real property and will no longer require an entity to actually physically touch the property or make a change to the property to qualify for the COGS deduction.

The policy changes are similar for both Sections 171.1011(g)(3) and 171.1012(i), but with one slight difference. The policy for both Sections will permit industries such as transportation companies delivering aggregate and other similar materials to a construction site, waste removal companies, demolition companies, and inspectors, among others, to claim either a COGS deduction or an exclusion from revenue – provided the transaction meets the contractual requirement of flow-through funds as described above. The one slight difference is that Section 171.1011(g)(3) uses the term "proposed" – absent from Section 171.1012(i) – which may permit costs for activities performed by architects and engineers to qualify as exclusions from revenue, without regard to whether construction occurs.

Costs considered too far removed from the construction, improvement, remodeling, repair, or industrial maintenance of real property do not qualify for either an exclusion from revenue or a COGS deduction. For example, entities providing services that are defined as "service costs" under Rule 3.588(b)(9), such as legal services and accounting services, are too far removed and do not qualify for either an exclusion from revenue or a COGS deduction.

Further, the revised policy does not change the treatment of taxable entities renting or leasing equipment to others for use in or during such projects. Section 171.1012(k-1) still limits the COGS deduction to taxpayers renting or leasing certain items to others. Taxpayers who rent or lease equipment other than heavy construction equipment, such as fencing or port-a-potties, to others for use in projects for the construction, improvement, remodeling, repair or industrial maintenance of real property, are not eligible for the COGS deduction under Section 171.1012.

ACCESSION NUMBER: 201606856L
SUPERSEDED: N
DOCUMENT TYPE: L
DATE: 2016-06-30
TAX TYPE: FRANCHISE-MARGIN

ADOPTED RULES

Adopted rules include new rules, amendments to existing rules, and repeals of existing rules. A rule adopted by a state agency takes effect 20 days after the date on which it is filed with the Secretary of State unless a later date is required by statute or specified in the rule (Government Code, §2001.036). If a rule is adopted without change to the text of the proposed rule, then the *Texas Register* does not republish the rule text here. If a rule is adopted with change to the text of the proposed rule, then the final rule text is included here. The final rule text will appear in the Texas Administrative Code on the effective date.

TITLE 4. AGRICULTURE

PART 1. TEXAS DEPARTMENT OF AGRICULTURE

CHAPTER 21. CITRUS

The Texas Department of Agriculture (the Department) adopts the repeal of Title 4, Part 1, Subchapter A, Citrus Quarantines, §§21.1, 21.6 - 21.9; the repeal of Subchapter C, Foundation Block, Increase Block, and Production of Certified Budwood, §21.38 and §21.39; the repeal of Subchapter D, Citrus Nursery Stock Certification Program, §21.61 and §21.63; and the repeal of Subchapter E, Citrus Nursery Stock Propagation in Areas of Texas Outside the Citrus Zone, §21.80. The Department adopts amendments to §21.5 of Subchapter A, and new §21.1, and new §§21.6 - 21.10; the amendment of the title of Subchapter C to "Foundation Block, Scion Block, Increase Block, and Production of Certified Budwood," and amendments to §§21.31, 21.35, 21.36, and 21.41, and new §21.38 and §21.44; amendments to Subchapter D, §§21.60, 21.62, 21.67, and new §21.61 and §21.63; amendments to Subchapter E, §21.83 and §21.84, and new §21.80; and amendment of the title of Subchapter F to "State Certified Clean Citrus Stock Program," and the amendment of §21.90. All of the rules are adopted without changes to the proposal published in the November 24, 2017, issue of the *Texas Register* (42 TexReg 6569), with the exception of new §§21.6, 21.9 and 21.10 in Subchapter A, and new §21.61 and §21.63, and amended §21.62 in Subchapter D, which are adopted with changes.

The adopted rules are necessary to protect the state's vital citrus fruit and nursery production areas by combatting the spread of citrus greening, citrus canker and other dangerous citrus pests and diseases.

The Department has determined that the citrus and nursery industries are in peril because of the spread of citrus greening disease and citrus canker disease. The rules are proposed to reduce the threat of irreparable and widespread damage to commercial citrus groves, citrus plant production nurseries, and ornamental citrus in non-infected areas caused by citrus greening and citrus canker. The proposed rules consolidate and clarify definitions, amend requirements and restrictions for citrus and revise the regulatory framework for the growing of citrus nursery stock for commercial or noncommercial use.

The Department received comments from Mr. Richard Young, COO of Greenleaf Nursery Co., and Mr. Paul Heller, on behalf of Wonderful Citrus, in general support of the Department's proposal and efforts to mitigate citrus pests and disease in Texas.

Comments submitted by Mr. Heller which were unrelated to the proposed rules as published will not be addressed at this time.

The Department also received comments from Mr. Ricky Becnel, on behalf of Saxon Becnel & Sons Citrus Nursery, and Mr. Jeff Stokes on behalf of the Texas Nursery Landscape Association.

Mr. Heller submitted a comment regarding §21.61 that a requirement for a 5-foot buffer when using a single-wall approved screening for facility structures is overly burdensome. Under current USDA and TDA requirements, double-layer screening is required. The proposed buffer, only when using a single-layer interior screen, is an option for facilities, not a new restriction or requirement. As a matter of clarification, TDA has removed the reference to the 5-foot buffer.

Mr. Becnel requested clarification regarding the square footage fees related to insect exclusionary structures in §21.62. The Department has responded by clarifying the fee structures in §21.62 to state that the total structure shall be up to 25,000 square feet, and additional fees will be for square footage that exceeds that total amount.

Mr. Stokes commented regarding §21.63(a)(3) the requirement which precludes nursery employees from returning to a certified citrus nursery structure in the same day after working in a non-certified structure. Both Mr. Becnel and Mr. Stokes submitted comments regarding §21.63(a)(4) which requires that certified citrus nursery structure employees wear mandated garments. After review, the Department has stricken §21.63(a)(3) - (4) after determining that these sections do not significantly improve risk management or mitigation of citrus pests and diseases.

Mr. Heller commented that §21.63(a)(6), regarding restrictions on "growing media storage area" should be removed due to the variables and management at each nursery. The Department has reviewed this recommendation and removed this referenced from §21.63(a)(6).

Mr. Becnel has commented in general support of §21.63(a)(7) - (9), however, due to the differing business practices of each grower, seeks a more broad requirement which defers to the grower. Mr. Heller and Mr. Stokes commented in favor of striking §21.63(a)(7), and §21.63(a)(9). The Department has eliminated §21.63(a)(7) - (9) and replaced them with new §21.63(a)(5).

SUBCHAPTER A. CITRUS QUARANTINES

4 TAC §§21.1, 21.6 - 21.9

The adoption is made pursuant to Chapters 19, 71 and 73 of the Texas Agriculture Code (Code), which authorize the Department to adopt rules necessary to protect agricultural and horticultural interests and administer citrus programs; the adoption is also made under Chapter 12 of the Code, which authorizes the Department to assess administrative penalties for violations related to Chapters 19 and 73 of the Code.

Chapters 12, 19, 71 and 73 of the Texas Agriculture Code are affected by the adoption.

The agency certifies that legal counsel has reviewed the adoption and found it to be a valid exercise of the agency's legal authority.

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SUBCHAPTER V. FRANCHISE TAX

34 TAC §3.588

The Comptroller of Public Accounts adopts amendments to §3.588, concerning margin: cost of goods sold, with changes to the proposed text as published in the September 29, 2017, issue of the *Texas Register* (42 TexReg 5235).

The comptroller amends the section to implement House Bill 500, 83rd Legislature, 2013. The changes also add definitions and interpret ambiguous statutory language.

The comptroller received comments regarding the proposed amendments from the Associated General Contractors- Texas Building Branch (AGC-TBB); David Gilliland of Duggins Wren Mann & Romero, LLP, Attorneys at Law; Jimmy Martens of Martens, Todd, Leonard & Ahlrich, Attorneys at Law; and the State Bar of Texas, Tax Section (State Bar).

Mr. Martens requested a public hearing on the proposed amendments. The comptroller declines to conduct a public hearing, as the request does not meet the requirements of Government Code §2001.029(b) (Public Comment). The State Bar requested a roundtable discussion. The comptroller declines to hold a roundtable discussion at this time.

The comptroller amends subsection (a) to indicate that specific provisions of this section apply to reports other than those originally due on or after January 1, 2008.

The comptroller amends subsection (c) to add new paragraph (8) concerning movie theaters. New paragraph (8) implements House Bill 500, Section 10, which enacted Tax Code, §171.1012(t), effective September 1, 2013. The language in this paragraph mirrors the statutory language except as noted below in response to comments received. Subsequent paragraphs are renumbered accordingly.

The State Bar requests the addition of the phrase "in addition to costs otherwise allowed by this section" to the language in subsection (c)(8). The State Bar takes the position that the costs a movie theater may include in its cost of goods sold calculation are not limited to the items listed in Tax Code, §171.1012(t). The comptroller agrees in part and amends the subsection to state that movie theaters may also include the costs of concessions as costs of goods sold.

The comptroller amends renumbered paragraph (9), which implements Tax Code, §171.1012(i), concerning the ownership of goods, to add a presumption that the legal title holder is the owner of the goods and to define several additional terms that are used in the current paragraph.

Paragraph (9) is reorganized to add new subparagraph (A). Existing language for determining when a taxable entity is the owner of goods is located in new subparagraph (A). The comptroller amends the existing language to add a rebuttable presumption that the legal title holder is the owner of the goods. A taxpayer may rebut the presumption by proving an ownership right superior to the legal title holder.

In written comments, the State Bar, Mr. Martens, and Mr. Gilliland request the removal of the proposed rebuttable presumption of ownership from subsection (c)(9)(A). They argue that the presumption is contrary to the legislature’s intent and inconsistent with the language in §171.1012(i), which requires the consideration of "all factors and circumstance" in the determination of ownership. The comptroller appreciates the points made in these comments, but has determined the proposed language is necessary to ensure that multiple taxable entities do not claim ownership and are therefore eligible to deduct costs of goods sold with respect to the same goods. The comptroller therefore declines to make the requested change.

The comptroller proposed amending relettered subparagraph (B) to define the terms "labor," "material," and "project" for purposes of paragraph (9) only. The proposed amendment used the definitions of "labor" and "material" verbatim from Property Code, §53.001 (3) and (4) (Definitions), except that the proposed amendment replaces the term "work" with the term "project." The definition of "project" tracked the language of Tax Code, §171.1012(i).

Tax Code, §171.1012(i) states that a taxable entity "furnishing labor and materials to a project" is considered to be the owner of the labor and materials and may include the costs as allowed by §171.1012 in the computation of cost of goods sold. However, §171.1012(i) does not define "labor" or "materials." The lack of definitions has created uncertainty and generated numerous controversies. The courts have held that a contractor may claim labor and material costs if they are "an essential and direct" component of a project but not if they are "too far removed" from the project. Combs v. Newpark Resources, Inc., 422 S.W.3d 46, 57 (Tex. App.- Austin 2013, no pet.); Hegar v. CGG Veritas Services (U.S.), Inc., No. 03-14-00713-CV (Tex. App.- Austin 2016, no pet.) (mem. op.).

The boundaries between "essential and direct" and "too far removed" are uncertain. To reduce the uncertainty, the comptroller proposes to add definitions of "labor" and "materials" based on the definitions used in Texas Property Code, Chapter 53 (Mechanic's, Contractor's, or Materialman's Lien). The Tax Code phrase "furnishing labor and materials" is similar to the Property Code phrase "furnishes labor and materials." Therefore, it is reasonable to assume that the Legislature intended similar definitions.

The comptroller will consider case law interpreting Property Code, Chapter 53, but may adapt Property Code interpretations to conform to needs of the Tax Code. Because the proposed amendment requires that the labor and materials be used in the "direct prosecution" of a project and the franchise tax case law requires that the labor and material be "direct and essential" components of a project, the proposed amendments are generally consistent with the direction given by the courts. However, outcomes could vary depending upon the facts. For example, it is conceivable that a seismic surveyor's work could be performed in the direct prosecution of a particular drilling project so that the surveyor could obtain a lien on the project. In that instance, the tax outcome would be consistent with the outcome of the CGG Veritas court decision. On the other hand, it is also conceivable that a seismic surveyor's work could be performed generically so that the surveyor could not obtain a lien on a particular project. In that instance, the tax outcome might be inconsistent with the outcome of the CGG Veritas court decision. The court decision did not discuss the ability of CGG Veritas to obtain a lien.

Finally, these definitions, which require that the labor and materials be used in the "direct prosecution" of the project, are limited to the determination of whether the taxable entity furnishing the labor and materials is considered to be an "owner" under §171.1012(i), and do not affect the determination of allowable costs under other subsections. For example, these definitions do not apply to direct labor costs described under subsection (d)(1) of this section.

With respect to the proposed amendments to subsection (c)(9)(B), AGC-TBB asks the comptroller to modify the second sentence concerning determination of ownership of labor and materials by adding the words "the sole" before the word "purpose" and deleting the phrase "related to that labor and materials." The comptroller agrees in part. The comptroller declines to add the phrase "the sole," since the phrase neither adds nor subtracts from the meaning of the sentence. However, the comptroller agrees to delete the phrase "related to that labor and materials."

The State Bar requests the removal of the definitions of the terms "labor" and "material" from subsection (c)(9)(B). The State Bar points out that the Third Court of Appeals in three appellate decisions (Newpark, CGG Veritas, and Hegar v. Gulf Copper Mfg. Corp., No. 03-16-00250-CV (Tex. App.- Austin 2017, pet. filed)) have addressed whether a taxable entity furnishing labor to a project for the construction improvement, remodeling, repair, or industrial maintenance of real property is qualified to subtract cost of goods sold by analyzing whether the activities with respect to such labor are an "essential and direct component" of the project. The State Bar argues that this section should follow the Third Court of Appeals' holdings, not adopt the "direct prosecution" test from the Property Code. Furthermore, the State Bar argues that the legislature did not intend for these definitions from the Texas Property Code to apply in the franchise tax context.

Mr. Martens requests revising the definition of "labor" by tracking the definition of the term in subsection (d)(1). He also requests revising the definition of "material" to state "incorporated items, supplies, equipment leased or rented, or repairs, maintenance, improvement, overhaul, and restoration of, or to, equipment leased or rented to be used at particular projects."

The comptroller has determined that the definitions in subsection (c)(9)(B) memorialize the concept that labor and materials must be used in the "direct prosecution of the work" and provide a relevant test for determining when an activity is "too far removed." In response to the State Bar's and Mr. Martens' comments, the comptroller declines to remove or modify the proposed definitions of "labor" and "material." In response to Mr. Martens' first request, the comptroller notes that not all "labor" as defined under subsection (d)(1) qualifies under subsection (c)(9).

The State Bar and Mr. Martens also request the removal of the definition of the term "project" from subsection (c)(9)(B). Both suggest the proposed definition provides a narrow interpretation of Tax Code, §171.1012(i) inconsistent with the language of the statute and court's analysis. Mr. Martens also requests that if the definition of "project" is kept, then the comptroller should provide a broad definition of "project," which encompasses furnishing labor or materials to "one or more existing or potential construction, industrial, or oilfield sites, whether provided at the sites themselves or not." The comptroller agrees to delete the definition of the term "project" in subsection (c)(9)(B)(iii). The comptroller also adds back language that was proposed to be deleted from subsection (c)(9)(B) tracking the third sentence of Tax Code, §171.1012(i).

The comptroller amends subsection (c) to add new paragraph (10) concerning pipeline entities. New paragraph (10) implements House Bill 500, Section 9, which enacted Tax Code, §171.1012(k-2) and (k-3), concerning pipeline entities. The language in paragraph (10) mirrors the statutory language. Subsequent paragraphs are renumbered accordingly.

The comptroller amends renumbered paragraph (11) concerning rentals and leases. To better distinguish this provision from subsection (d)(7) of this section, the phrase "rental or leasing companies" replaces the phrase "rentals and leases."

Additional amendments to paragraph (11) interpret ambiguous statutory language. Tax Code, §171.1012(k-1) provides that motor vehicle rental or leasing companies, heavy construction equipment rental or leasing companies, and railcar rolling stock rental or leasing companies may subtract as costs of goods sold "the costs otherwise allowed by this section in relation to tangible personal property that the entity rents or leases in the ordinary course of business of the entity."

The amendments to renumbered paragraph (11) reflect comptroller policy as affirmed in the Third Court of Appeals in Hegar v. Sunstate Equipment Co., LLC, 2017 WL 279602 at *5 (Tex. App.-Austin Jan. 20, 2017, pet. filed) (mem. op.). The court agreed with the comptroller's interpretation of Tax Code, §171.1012(k-1)(2), "which is that Sunstate may deduct 'all direct costs of acquiring or producing the [heavy construction equipment]' that forms the basis of Sunstate's business, as well as additional costs 'in relation to the taxable entity's [heavy construction equipment].'" The court held, "This reading of the statute is logical and consistent with the apparent purpose of §171.1012(k-1) to extend to renters of heavy equipment the same cost of goods sold deductions available to a company that sells identical equipment." Id.

The amendments provide that certain kinds of motor vehicle rental or leasing companies, a railcar rolling stock rental or leasing company, or a heavy construction equipment rental or leasing company may deduct costs otherwise allowed by Tax Code, §171.1012 in relation to the motor vehicles, railcar rolling stock, or heavy construction equipment that the entity rents or leases in the ordinary course of its rental or leasing business.

The State Bar requests that no substantive changes be made to renumbered subsection (c)(11) in regard to rental and leasing companies. It argues that the proposed language is too restrictive and goes beyond the statute, and additionally, that the comptroller should avoid relying on pending litigation. Mr. Martens requests revising the rule language to allow qualifying rental or leasing companies to subtract as cost of goods sold, the costs otherwise allowed by this section in relation to tangible personal property that the entity rents or leases in the ordinary course of business of the entity. He argues that the proposed language confines the deduction to the costs incurred to limited types of property, which is inconsistent with the statute.

The comptroller declines to make the changes the State Bar and Mr. Martens have requested. The amendment is a reasonable construction of ambiguous language and memorializes agency policy. See Comptroller's Decision No. 111,557 (2017).

Mr. Martens requests the addition of the phrase "regardless of whether the taxable entity is the producer of the good it sells" to the language of subsection (d)(9), concerning cost of goods sold expenses for research, experimental, engineering, and design activities, to memorialize comptroller guidance provided in STAR Accession No. 201504069L (Apr. 23, 2015). The comptroller agrees to make this change.

Finally, Mr. Martens requests that the amendments to this section be given a prospective rather than retroactive effect with an effective date of no earlier than franchise tax reports originally due on or after January 1, 2018. The comptroller agrees in part. In order to provide certainty to taxpayers, the comptroller will apply amended subsection (c)(9)(B)(i) and (ii), defining labor and materials, respectively, on a prospective basis as of the effective date of this section.

These amendments are adopted under Tax Code, §111.002 (Comptroller's Rules; Compliance; Forfeiture), which provides the comptroller with the authority to prescribe, adopt, and enforce rules relating to the administration and enforcement of the provisions of Tax Code, Title 2.

These amendments implement Tax Code, §171.1012.

§3.588. Margin: Cost of Goods Sold.

(a) Effective Date. The provisions of this section apply to franchise tax reports originally due on or after January 1, 2008, except as otherwise noted.

(b) Definitions. The following words and terms, when used in this section, shall have the following meanings, unless the context clearly indicates otherwise.

(1) Arm's length--The standard of conduct under which entities that are not related parties and that have substantially equal bargaining power, each acting in its own interest, would negotiate or carry out a particular transaction.

(2) Computer program--A series of instructions that are coded for acceptance or use by a computer system and that are designed to permit the computer system to process data and provide results and information. The series of instructions may be contained in or on magnetic tapes, printed instructions, or other tangible or electronic media.

(3) Goods--Real or tangible personal property sold in the ordinary course of business of a taxable entity.

(4) Heavy construction equipment--Self-propelled, self-powered, or pull-type equipment that weighs at least 3,000 pounds and is intended to be used for construction. The term does not include a motor vehicle required to be titled and registered.

(5) Lending institution--An entity that makes loans and:

(A) is regulated by the Federal Reserve Board, the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation, the Commodity Futures Trading Commission, the Office of Thrift Supervision, the Texas Department of Banking, the Office of Consumer Credit Commissioner, the Credit Union Department, or any comparable regulatory body;

(B) is licensed by, registered with, or otherwise regulated by the Department of Savings and Mortgage Lending;

(C) is a "broker" or "dealer" as defined by the Securities Exchange Act of 1934 at 15 U.S.C. §78c; or

(D) provides financing to unrelated parties solely for agricultural production.

(6) Principal business activity--The activity in which a taxable entity derives the largest percentage of its "total revenue".

(7) Production--Construction, manufacture, installation occurring during the manufacturing or construction process, development, mining, extraction, improvement, creation, raising, or growth.

(8) Related party--A person, corporation, or other entity, including an entity that is treated as a pass-through or disregarded entity for purposes of federal taxation, whether the person, corporation, or entity is subject to the tax under this chapter or not, in which one person, corporation, or entity, or set of related persons, corporations, or entities, directly or indirectly owns or controls a controlling interest in another entity.

(9) Service costs--Indirect costs and administrative overhead costs that can be identified specifically with a service department or function, or that directly benefit or are incurred by reason of a service department or function. For purposes of this section, a service department includes personnel (including costs of recruiting, hiring, relocating, assigning, and maintaining personnel records or employees); accounting (including accounts payable, disbursements, and payroll functions); data processing; security; legal; general financial planning and management; and other similar departments or functions.

(10) Tangible personal property--

(A) includes:

(i) personal property that can be seen, weighed, measured, felt, or touched or that is perceptible to the senses in any other manner;

(ii) films, sound recordings, videotapes, live and prerecorded television and radio programs, books, and other similar property embodying words, ideas, concepts, images, or sound, without regard to the means or methods of distribution or the medium in which the property is embodied, for which, as costs are incurred in producing the property, it is intended or is reasonably likely that any medium in which the property is embodied will be mass-distributed by the creator or any one or more third parties in a form that is not substantially altered; and

(iii) a computer program, as defined in paragraph (2) of this subsection.

(B) does not include:

(i) intangible property or

(ii) services.

(c) General rules for determining cost of goods sold.

(1) Affiliated entities. Notwithstanding any other provision of this section, a payment made by one member of an affiliated group to another member of that affiliated group not included in the combined group may be subtracted as a cost of goods sold only if it is a transaction made at arm's length.

(2) Capitalization or expensing of certain costs. The election to capitalize or expense allowable costs is made by filing the franchise tax report using one method or the other. The election is for the entire period on which the report is based and may not be changed after

the due date or the date the report is filed, whichever is later. A taxable entity that is allowed a subtraction by this section for a cost of goods sold and that is subject to Internal Revenue Code, §§263A, 460, or 471 (including a taxable entity subject to §471 that elects to use LIFO under §472), may elect to:

(A) Capitalize those costs in the same manner and to the same extent that the taxable entity capitalized those costs on its federal income tax return, except for those costs excluded under subsection (g) of this section, or in accordance with subsections (d), (e), and (f) of this section. A taxable entity that elects to capitalize costs on its first report due on or after January 1, 2008, may include, in beginning inventory, costs allowable for franchise tax purposes that would be in beginning inventory for federal income tax purposes.

(i) If the taxable entity elects to capitalize those costs allowed under this section as a cost of goods sold, it must capitalize each cost allowed under this section that it capitalized on its federal income tax return.

(ii) If the taxable entity later elects to begin expensing those costs allowed under this section as a cost of goods sold, the entity may not deduct any cost incurred before the first day of the period on which the report is based, including any ending inventory from a previous report.

(B) Expense those costs, except for those costs excluded under subsection (g) of this section, or in accordance with subsections (d), (e), and (f) of this section.

(i) If the taxable entity elects to expense those costs allowed under this section as a cost of goods sold, costs incurred before the first day of the period on which the report is based may not be subtracted as a cost of goods sold.

(ii) If the taxable entity later elects to begin capitalizing those costs allowed under this section as a cost of goods sold, costs incurred prior to the accounting period on which the report is based may not be capitalized.

(3) Election to subtract cost of goods sold. A taxable entity, if eligible, must make an annual election to subtract cost of goods sold in computing margin by the due date, or at the time the report is filed, whichever is later. The election to subtract cost of goods sold is made by filing the franchise tax report using the cost of goods sold method. An amended report may be filed within the time allowed by Tax Code, §111.107 to change the method of computing margin to the cost of goods sold deduction method or from the cost of goods sold deduction method to the compensation deduction method, 70% of total revenue, or, if otherwise qualified, the E-Z computation method. An election may also be changed as part of an audit. See §3.584 of this title (relating to Margin: Reports and Payments).

(4) Exclusions from total revenue. Any expense excluded from total revenue (see §3.587 of this title (relating to Margin: Total Revenue)) may not be included in the determination of cost of goods sold.

(5) Film and broadcasting. A taxable entity whose principal business activity is film or television production or broadcasting or the sale of broadcast rights or the distribution of tangible personal property described by subsection (b)(10)(A)(ii) of this section, or any combination of these activities, and who elects to use cost of goods sold to determine margin, may include as cost of goods sold:

(A) the costs described in this section in relation to the property;

(B) depreciation, amortization, and other expenses directly related to the acquisition, production, or use of the property, including

(C) expenses for the right to broadcast or use the property.

(6) Lending institutions. Notwithstanding any other provision of this section, if the taxable entity is a lending institution that offers loans to the public and elects to subtract cost of goods sold, the entity may subtract as a cost of goods sold an amount equal to interest expense.

(A) This paragraph does not apply to entities primarily engaged in an activity described by category 5932 of the 1987 Standard Industrial Classification Manual published by the federal Office of Management and Budget.

(B) For purposes of this subsection, an entity engaged in lending to unrelated parties solely for agricultural production offers loans to the public.

(7) Mixed transactions. If a transaction contains elements of both a sale of tangible personal property and a service, a taxable entity may only subtract as cost of goods sold the costs otherwise allowed by this section in relation to the tangible personal property sold.

(8) Movie theaters. Effective for reports originally due on or after September 1, 2013, if a taxable entity that is a movie theater elects to subtract cost of goods sold, the cost of goods sold for the taxable entity shall be the costs described by this section in relation to the acquisition, production, exhibition, or use of a film or motion picture, including expenses for the right to use the film or motion picture, and the costs otherwise allowed by this section in relation to concessions sold.

(9) Owner of goods. A taxable entity may make a subtraction under this section in relation to the cost of goods sold only if that entity owns the goods.

(A) A taxable entity that holds the legal title to the goods is presumed to be the owner of the goods for purposes of this section. A taxable entity may rebut this presumption by proving an ownership right superior to the legal title holder based on all of the facts and circumstances, including the various benefits and burdens of ownership vested with the taxable entity.

(B) A taxable entity furnishing labor or materials to a project for the construction, improvement, remodeling, repair, or industrial maintenance (as the term "maintenance" is defined in §3.357 of this title (relating to Nonresidential Real Property Repair, Remodeling, and Restoration; Real Property Maintenance)) of real property is considered to be an owner of the labor or materials and may include the costs, as allowed by this section, in the computation of the cost of goods sold. For purposes of determining whether a taxable entity is considered an owner of the labor or materials under this paragraph, and eligible to deduct costs as described in subsections (d), (e), and (f) of this section, the following terms mean:

(i) Labor--Labor used in the direct prosecution of the project.

(ii) Material--All or part of:

(I) the material, machinery, fixtures, or tools incorporated into the project, consumed in the direct prosecution of the project, or ordered and delivered for incorporation or consumption;

(II) rent at a reasonable rate and actual running repairs at a reasonable cost for construction equipment used or rea-

sonably required and delivered for use in the direct prosecution of the project at the site of the project; or

(III) power, water, fuel, and lubricants consumed or ordered and delivered for consumption in the direct prosecution of the project.

(C) Solely for the purposes of this section, a taxable entity shall be treated as the owner of goods being manufactured or produced by the entity under a contract with the federal government, including any subcontracts that support a contract with the federal government, notwithstanding that the Federal Acquisition Regulations may require that title or risk of loss with respect to those goods be transferred to the federal government before the manufacture or production of those goods is complete.

(10) Pipeline entities. Effective for reports originally due on or after January 1, 2014, and notwithstanding paragraph (9) of this subsection and subsection (g)(3) of this section, a pipeline entity that provides services for others related to the product that the pipeline does not own and to which this paragraph applies may subtract as a cost of goods sold its depreciation, operations, and maintenance costs allowed by this section related to the services provided.

(A) For purposes of this paragraph, "pipeline entity" means an entity:

(i) that owns or leases and operates the pipeline by which the product is transported for others and only to that portion of the product to which the entity does not own title; and

(ii) that is primarily engaged in gathering, storing, transporting, or processing crude oil, including finished petroleum products, natural gas, condensate, and natural gas liquids, except for a refinery installation that manufactures finished petroleum products from crude oil.

(B) For purposes of this paragraph, "processing" means the physical or mechanical removal, separation, or treatment of crude oil, including finished petroleum products, natural gas, condensate, and natural gas liquids after those materials are produced from the earth. The term does not include the chemical or biological transformation of those materials.

(11) Rental or leasing companies. Notwithstanding any other provision of this section:

(A) a motor vehicle rental company that remits a tax on gross receipts imposed under Tax Code, §152.026, or a motor vehicle leasing company, may subtract as costs of goods sold the costs otherwise allowed by this section in relation to motor vehicles that the company rents or leases in the ordinary course of its business;

(B) a heavy construction equipment rental or leasing company may subtract as costs of goods sold the costs otherwise allowed by this section in relation to heavy construction equipment that the company rents or leases in the ordinary course of its business; and

(C) a railcar rolling stock rental or leasing company may subtract as costs of goods sold the costs otherwise allowed by this section in relation to railcar rolling stock that the company rents or leases in the ordinary course of its business.

(12) Reporting methods. 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. This subsection does not affect the type or category of cost of goods sold that may be subtracted under this section.

(13) Restaurants and bars. Entities engaged in activities described in Major Group 58 (Eating and Drinking Places) of the Standard Industrial Classification Manual may deduct for cost of goods sold only those expenses allowed under subsections (d), (e) and (f) of this section, that relate to the acquisition and production of food and beverages. Any costs related to both the production of food and beverages and to other activities must be allocated to production on a reasonable basis.

(d) Direct costs. The cost of goods sold includes all direct costs of acquiring or producing the goods. Direct costs include:

(1) Labor costs. A taxable entity may include in its cost of goods sold calculation labor costs, other than service costs, that are properly allocable to the acquisition or production of goods and are of the type subject to capitalization or allocation under Treasury Regulation Sections 1.263A-1(e) or 1.460-5 as direct labor costs, indirect labor costs, employee benefit expenses, or pension and other related costs, without regard to whether the taxable entity is required to or actually capitalizes such costs for federal income tax purposes.

(A) For purposes of this section, labor costs include W-2 wages, IRS Form 1099 payments for labor, temporary labor expenses, payroll taxes, pension contributions, and employee benefits expenses, including, but not limited to, health insurance and per diem reimbursements for travel expenses, to the extent deductible for federal tax purposes.

(B) Labor costs under this paragraph shall not include any type of costs includable in subsection (f) or excluded in subsection (g) of this section. Costs for labor that do not meet the requirements set forth in this paragraph may still be subtracted as a cost of goods sold if the cost is allowed under another provision of this section. For example, service costs may be included in a taxable entity's cost of goods sold calculation to the extent provided by subsection (f) of this section.

(2) Incorporated materials. A taxable entity may include in its cost of goods sold calculation the cost of materials that are an integral part of specific property produced.

(3) Consumable materials. A taxable entity may include in its cost of goods sold calculation the cost of materials that are consumed in the ordinary course of performing production activities.

(4) Handling costs. A taxable entity may include in its cost of goods sold calculation handling costs, including costs attributable to processing, assembling, repackaging, and inbound transportation.

(5) Storage costs. A taxable entity may include in its cost of goods sold calculation storage costs, including the costs of carrying, storing, or warehousing property, subject to subsection (g) of this section, concerning excluded costs.

(6) Depreciation, depletion, and amortization. A taxable entity may include in its cost of goods sold calculation depreciation, depletion, and amortization reported on the federal income tax return on which the report under this chapter is based, to the extent associated with and necessary for the production of goods, including recovery described by Internal Revenue Code, §197, and property described in Internal Revenue Code, §179.

(7) Rentals and leases. A taxable entity may include in its cost of goods sold calculation the cost of renting or leasing equipment, facilities, or real property directly used for the production of the goods, including pollution control equipment and intangible drilling and dry hole costs.

(8) Repair and maintenance. A taxable entity may include in its cost of goods sold calculation the cost of repairing and maintain-

ing equipment, facilities, or real property directly used for the production of the goods, including pollution control devices.

(9) Research and development. A taxable entity may include in its cost of goods sold calculation the costs attributable to research, experimental, engineering, and design activities directly related to the production of the goods, including all research or experimental expenditures described by Internal Revenue Code, §174, regardless of whether the taxable entity is the producer of the good it sells.

(10) Mineral production. A taxable entity may include in its cost of goods sold calculation geological and geophysical costs incurred to identify and locate property that has the potential to produce minerals.

(11) Taxes. A taxable entity may include in its cost of goods sold calculation taxes paid in relation to acquiring or producing any material, including property taxes paid on buildings and equipment, and taxes paid in relation to services that are a direct cost of production.

(12) Electricity. A taxable entity may include in its cost of goods sold calculation the cost of producing or acquiring electricity sold.

(13) A taxable entity may include in its cost of goods sold calculation a contribution to a partnership in which the taxable entity owns an interest that is used to fund activities, the costs of which would otherwise be treated as cost of goods sold of the partnership, but only to the extent that those costs are related to goods distributed to the contributing taxable entity as goods-in-kind in the ordinary course of production activities rather than being sold by the partnership.

(e) Additional costs. In addition to the amounts includable under subsection (d) of this section, the cost of goods sold includes the following costs in relation to the taxable entity's goods:

(1) deterioration of the goods;

(2) obsolescence of the goods;

(3) spoilage and abandonment, including the costs of rework, reclamation, and scrap;

(4) if the property is held for future production, preproduction direct costs allocable to the property, including storage and handling costs, as provided by subsection (d)(4) and (5) of this section;

(5) postproduction direct costs allocable to the property, including storage and handling costs, as provided by subsection (d)(4) and (5) of this section;

(6) the cost of insurance on a plant or a facility, machinery, equipment, or materials directly used in the production of the goods;

(7) the cost of insurance on the produced goods;

(8) the cost of utilities, including electricity, gas, and water, directly used in the production of the goods;

(9) the costs of quality control, including replacement of defective components pursuant to standard warranty policies, inspection directly allocable to the production of the goods, and repairs and maintenance of goods; and

(10) licensing or franchise costs, including fees incurred in securing the contractual right to use a trademark, corporate plan, manufacturing procedure, special recipe, or other similar right directly associated with the goods produced.

(f) Indirect or administrative overhead costs. A taxable entity may subtract as a cost of goods sold service costs, as defined in subsection (b)(9) of this section, that it can demonstrate are reasonably allocable to the acquisition or production of goods. The amount subtracted may not exceed 4.0% of total indirect and administrative overhead costs.

(1) Any costs already subtracted under subsections (d) or (e) of this section may not be subtracted under this subsection.

(2) Any costs excluded under subsection (g) of this section may not be subtracted under this subsection.

(g) Costs not included. The cost of goods sold does not include the following costs in relation to the taxable entity's goods:

(1) the cost of renting or leasing equipment, facilities, or real property that is not used for the production of the goods;

(2) selling costs, including employee expenses related to sales;

(3) distribution costs, including outbound transportation costs;

(4) advertising costs;

(5) idle facility expenses;

(6) rehandling costs;

(7) bidding costs, which are the costs incurred in the solicitation of contracts ultimately awarded to the taxable entity;

(8) unsuccessful bidding costs, which are the costs incurred in the solicitation of contracts not awarded to the taxable entity;

(9) interest, including interest on debt incurred or continued during the production period to finance the production of the goods;

(10) income taxes, including local, state, federal, and foreign income taxes, and franchise taxes that are assessed on the taxable entity based on income;

(11) strike expenses, including costs associated with hiring employees to replace striking personnel, but not including the wages of the replacement personnel, costs of security, and legal fees associated with settling strikes;

(12) officers' compensation;

(13) costs of operation of a facility that is:

(A) located on property owned or leased by the federal government; and

(B) managed or operated primarily to house members of the armed forces of the United States;

(14) any compensation paid to an undocumented worker used for the production of goods, provided that, as used in this paragraph only, the following terms shall have the following meanings:

(A) "undocumented worker" means a person who is not lawfully entitled to be present and employed in the United States; and

(B) "goods" includes the husbandry of animals, the growing and harvesting of crops, and the severance of timber from realty; and

(15) costs funded by a partnership contribution, to the extent that the contributing taxable entity made the cost of goods sold deduction under subsection (d)(13) of this section.

The agency certifies that legal counsel has reviewed the adoption and found it to be a valid exercise of the agency's legal authority.

Filed with the Office of the Secretary of State on March 2, 2018.

Filed in The District Court
of Travis County, Texas

MAR 11 2016

At 3:54 P.M.
Velva L. Price, District Clerk

CAUSE NO. D-1-GN-14-004620

GULF COPPER & MANUFACTURING CORPORATION, **Plaintiff**	§	**IN THE DISTRICT COURT OF**
v.	§	**TRAVIS COUNTY, TEXAS**
GLENN HEGAR COMPTROLLER OF PUBLIC ACCOUNTS OF THE STATE OF TEXAS; AND KEN PAXTON, ATTORNEY GENERAL OF THE STATE OF TEXAS, **Defendants**	§	**53rd JUDICIAL DISTRICT**

FINDINGS OF FACT AND CONCLUSIONS OF LAW

Based on the evidence, the briefing, the pleadings, and arguments of counsel, the Court makes the following findings of fact and conclusions of law:

I. Findings of Fact

1. Gulf Copper owns all of the outstanding shares of a subsidiary named Sabine Surveyors.
2. Sabine Surveyors is a limited partnership primarily engaged in the business of marine vessel surveying.
3. Gulf Copper and Sabine Surveyors share certain physical locations, customers and managerial staff. They also refer business to each other.
4. Gulf Copper and Sabine Surveyors are affiliated and engaged in a unitary business.
5. Gulf Copper and Sabine Surveyors are members of a combined group, which files combined franchise tax reports.
6. Gulf Copper serves as the reporting entity for the franchise tax combined group.
7. For franchise tax report year 2009 (the accounting period of May 1, 2007 to April 30, 2008), Gulf Copper, Sabine Surveyors, and others (hereinafter collectively referred to as "Gulf Copper") joined in the filing of combined franchise tax report.

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8. Gulf Copper satisfied all procedural prerequisites to maintain a protest suit under Texas Tax Code Chapter 112.

9. Gulf Copper's customers are primarily rig owners and drilling contractors who use their offshore rigs to drill for oil and gas on behalf of exploration and production ("E&P") companies.

10. Gulf Copper is primarily engaged in the business of surveying, manufacturing, upgrading, and repairing offshore drilling rigs.

11. Gulf Copper provides everything necessary to satisfy the customer's work order, including all labor, materials, equipment, and supplies.

12. Gulf Copper repairs rigs by removing defective portions, manufacturing replacement components, and installing the replacement components onto the rigs. Gulf Copper also manufactures and installs new components for rigs that do not replace an existing component.

13. Gulf Copper's work is labor-intensive and requires specialized training and experience. Examples of Gulf Copper's employee and subcontractor labor includes: manufacturing (e.g., steel components, drain systems, and fuel systems); installation; welding; fitting; cutting; blasting, coating, and painting; hot work; analytical stress testing; and electrical and hydraulic work. Gulf Copper's work is complex, requiring precise measurements and several levels of inspection and compliance.

14. In performing its work through its employees and subcontractors, Gulf Copper furnishes materials, including steel, gasket materials, blasting medium, paint, and other industrial materials.

15. In completing its work, Gulf Copper utilizes all aspects and the entire breadth of its facility yards, whether the rig sits on the dry dock, in the yard, or in the water. This includes the lay down areas, the warehouses, the fabrication shops, the welding areas, and the stacking areas.

16. Gulf Copper's work enables the rigs (1) to meet and maintain the certification requirements imposed by classification societies, (2) to comply with governing regulations, and (3) to satisfy an exploration and production ("E&P") company's contractual requirements for a specific drilling project.

17. A rig cannot be used for drilling unless it is properly certified, compliant, and satisfies the contractual requirements for the project.

18. Gulf Copper's work increases the rig's value.

19. Rig owners do not hire Gulf Copper to repair or upgrade their rigs or manufacture new components unless they have a revenue-generating contract in place for the drilling of offshore oil and gas wells.

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.

21. Gulf Copper has elected, for federal income tax purposes, to use the accrual method of accounting. This method matches the costs incurred by Gulf Copper with the revenues generated by those expenses.

22. Gulf Copper performs its work using both employees and subcontractors.

23. Gulf Copper's customers often approve or require Gulf Copper's use of certain subcontractors to complete the work. The customers remain very involved throughout the project. They often have field representatives at Gulf Copper's facilities and monitor the specific deadlines by which the work must be completed.

24. Gulf Copper charges its customers for subcontractor work using a formula that is based upon Gulf Copper's actual cost of the subcontractor(s) plus a mark-up. Regardless of how the subcontractor is billed, Gulf Copper's resulting mark-up to the customer is generally between 15-20 percent.

25. When Gulf Copper's customers pay Gulf Copper for work performed by subcontractors, Gulf Copper retains the portion of the payment attributable to its mark-up (generally between 15-20 percent) and flows through the remainder of the customer's payment to the subcontractor.

26. The subcontractor payments flow from Gulf Copper's customer, through Gulf Copper, to Gulf Copper's subcontractors who performed the work for the customer.

27. The subcontractors are legal entities separate from Gulf Copper.

28. Gulf Copper's contractual mandates to distribute flow-through funds to its subcontractors are contained within its customer contracts, its contracts with the subcontractors, supporting invoices, work orders, purchase orders, and other accounting records. They are also embodied in the course of Gulf Copper's dealings with its customers and subcontractors.

29. 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; and to projects for the construction, improvement, repair, or industrial maintenance of real property.

30. The labor and materials provided by Gulf Copper through its employees and subcontractors are necessary, essential, and integral to the construction, improvement, repair, and industrial maintenance of oil and gas wells.

31. Gulf Copper's proper apportionment factor is .8808.

32. Gulf Copper manufactures, develops, improves, and installs tangible personal property for its customers.

33. Gulf Copper resells tangible personal property to its customers.

34. Gulf Copper sometimes sells the scrap metal generated by its rig repair work.

35. Gulf Copper owns tangible personal property that it sells in the ordinary course of business.

36. For report year 2009, Gulf Copper incurred expenses eligible to be included in the cost of goods sold subtraction in the amount of $152,116,964.

37. The 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.

38. Any finding of fact that is more properly characterized as a conclusion of law shall be considered a conclusion of law.

II. Conclusions of Law

1. Gulf Copper consists of a combined group, including Gulf Copper, Sabine Surveyors and others, and this combined group is a single taxable entity for purposes of the Texas franchise tax.

2. Gulf Copper is entitled to exclude from its revenue $79,405,230 in subcontractor payments under Tex. Tax Code § 171.1011(g)(3).

3. Oil and gas wells constitute improvements on real property for purposes of Tex. Tax Code § 171.1011(g)(3).

4. Texas Tax Code § 171.1011(g)(3) does not require that the mandate for payment be contained in a customer contract or subcontract. The statutory mandate element is satisfied as long as the taxpayer is legally obligated by contract to pay a portion of the customer funds to the subcontractor.

5. Alternatively, Gulf Copper is entitled to include the $79,405,230 in subcontractor payments in its cost of goods sold subtraction under Tex. Tax Code § 171.1012.

6. Under Tex. Tax Code § 171.1055, Gulf Copper may not include receipts excluded from total revenue in either the numerator or the denominator of its apportionment calculation.

7. Gulf Copper properly excluded from the numerator and denominator of its apportionment factor its subcontractor payments totaling $79,405,230.

8. Gulf Copper properly calculated its franchise tax due amount using an apportionment factor of .8808.

9. Gulf Copper owns goods as required by the first sentence of Tex. Tax Code § 171.1012(i).

10. Gulf Copper qualifies for the cost of goods sold subtraction under the second sentence of Tex. Tax Code § 171.1012(i) and as defined by § 171.1012(a)(1).

11. Gulf Copper qualifies for the cost of goods sold subtraction under the third sentence of Tex. Tax Code § 171.1012(i).

12. Oil and gas wells constitute real property for purposes of Tex. Tax Code § 171.1012(i).

13. The limitations imposed by the Comptroller upon Gulf Copper's cost of goods sold calculation violate Tex. Tax Code § 171.1012.

14. Gulf Copper is entitled to include the costs of Sabine Surveyors in its cost of goods sold subtraction, as allowed by Tex. Tax Code § 171.1012(g)-(h), (c)-(f).

15. As a qualifying owner of goods, Gulf Copper properly included each of the costs shown on Exhibit 56 as costs of goods sold allowed for subtraction under Tex. Tax Code § 171.1012(g)-(h), (c)-(f).

16. In addition to the revenue exclusion stated in Conclusion of Law No. 2, Gulf Copper is entitled to claim a cost of goods sold subtraction in the amount of $72,711,734 for franchise tax report year 2009, as set forth in Exhibit 56.

17. Alternatively, Gulf Copper is entitled to include its $79,405,230 in subcontractor payments in its cost of goods sold subtraction for a total subtraction of $152,116,964 for report year 2009, as set forth in Exhibit 56.

18. Any conclusion of law that is more properly characterized as a finding of fact shall be considered a finding of fact.

SIGNED this 11th day of March, 2016.

THE HONORABLE AMY CLARK MEACHUM
201st District Court,
Travis County, Texas