FILED
17-0894
12/20/2017 1:53 PM
tex-21414862
SUPREME COURT OF TEXAS
BLAKE A. HAWTHORNE, CLERK

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,

v.

Gulf Copper and Manufacturing Corporation, Respondent.

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

Petition for Review

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RECORD REFERENCES

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STATEMENT OF THE CASE

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

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

STATEMENT OF JURISDICTION

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

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

If, however, the balance between the low margin tax rate and the limited deductions is disrupted, there could be a significant revenue impact to the State of Texas. Accordingly, this Court should give serious consideration to the implications of the Opinion below, which

allows service providers to take the cost-of-goods-sold deduction when they are not selling goods, and further, allows taxpayers to exclude revenues from margin merely because they are paying expenses owed under a contract.

ISSUES PRESENTED

1. Do the services performed by Gulf Copper or its subsidiary constitute "furnishing labor or materials to a project for the construction, improvement, remodeling, repair, or industrial maintenance ... of real property" such that Gulf Copper may deduct under Tax Code section171.1012(i) its costs of:
   a. Repairing or upgrading drilling rigs at Gulf Copper's waterfront facilities, before the commencement of offshore drilling; or
   b. Surveying marine vessels, including drilling rigs at Gulf Copper's waterfront facilities?

2. May Gulf Copper exclude from its total revenue, under Tax Code section 171.1011(g)(3), hourly payments made to subcontractors? This question turns on:
   a. Whether payments were "made under a contract . . . to provide services, labor, or materials *in connection with* the actual or proposed design, construction, remodeling, or repair of improvements *on real property*," when the subcontractor payments were for work repairing or upgrading drilling rigs at Gulf Copper's waterfront facilities, before the commencement of offshore drilling.
   b. Whether payments Gulf Copper made to subcontractors are "flow-through funds that are mandated by contract to be distributed to other entities," when Gulf Copper was not required by contract to use customer payments to pay subcontractors.

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

STATEMENT OF FACTS

The margin tax dispute.

The court of appeals correctly stated the nature of the case as a suit "seeking a refund of franchise taxes that Gulf Copper paid under protest." Specifically, this franchise or "margin" tax case involves a dispute over (1) the amounts Gulf Copper may deduct as cost of goods sold, and (2) the amounts that it may exclude from its revenues.

Gulf Copper's business.

The trial court made the following findings of fact regarding Gulf Copper's business. Gulf Copper is primarily engaged in the business of surveying, manufacturing, upgrading, and repairing offshore drilling rigs. CR. 296-97[App. B] (Finding of Fact 10).[1] 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

[1] Although Gulf Copper manufactures *components* for the rigs, it is undisputed that it does not own, manufacture or sell the rigs themselves. 3.RR.39–40; *see also* Opinion at *4-5.

replace an existing component. Finding of Fact 12.

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. Finding of Fact 9. Gulf Copper's work enables the rigs (1) to meet and maintain the certification requirements by classification societies, (2) to comply with governing regulations, and (3) to satisfy an E&P company's contractual requirement for a specific drilling project. Finding of Fact 16.

Gulf Copper owns all of the outstanding shares of a subsidiary named Sabine Surveyors. Finding of Fact 1. Sabine Surveyors is a limited partnership primarily engaged in the business of marine vessel surveying. Finding of Fact 2. 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. Finding of Fact 7.

With regard to the exclusions from revenue, the trial court made

these additional findings of fact. Gulf Copper performs its work using both employees and subcontractors. Finding of Fact 22. Gulf Copper's customers often approve or require Gulf Copper's use of certain subcontractors to complete the work... Finding of Fact 23.

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. Finding of Fact 24. 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. Finding of Fact 25. The subcontractor payments flow from Gulf Copper's customer, through Gulf Copper, to Gulf Copper's subcontractors who performed the work for the customer. Finding of Fact 26.

Finally, it is undisputed that "[t]he drilling rigs are delivered to Gulf Copper's facility where Gulf Copper performs the work…" Opinion at * 4.

The Comptroller's audit.

The Comptroller audited Gulf Copper and assessed additional franchise taxes in the amount of $692,626.66 (plus interest, for a then current total of $838,117.84). The two major adjustments were to: (1) the cost-of-goods-sold deduction and; (2) the exclusion from revenue of subcontractor payments.

The Comptroller allowed the cost-of-goods-sold deduction for labor costs incurred in the production or "fabrication" of rig components and parts installed on the rigs (and thus "sold" to the rig owners), plus other costs specifically allowable under the statute. *See* Opinion at * 3; *see also* Tex. Tax Code § 171.1012(c), (d), (f). But the Comptroller disallowed, as non-deductible "services," Gulf Copper's labor costs incurred in installing components, removing defective components, painting, welding, fixing cranes, sandblasting, and coating—because none of those labor costs were shown to be costs of acquiring or producing "goods" for sale. *See id.*

§ 171.1012(a)(3)(B)(ii) and (c)(1); CR. 297 (Findings of Fact 10, 12, 13 [App. B]; 2.RR.131-32, 188, 192.

The Comptroller auditor also disallowed Sabine Surveyors' costs in his calculation of Gulf Copper's cost-of-goods-sold deduction—because surveying is a service and the costs of surveying are not costs of acquiring or producing "goods" for sale. 5.RR.11–15.

As to the second audit issue, the Comptroller auditor determined that the $79,405,230 in payments to subcontractors did not meet the statutory requirements for the exclusion from revenue, and should be considered instead in the calculation of Gulf Copper's cost-of-goods-sold deduction.

Gulf Copper paid the assessment under protest, and these two adjustments are the principal issues in this Petition for Review.

SUMMARY OF THE ARGUMENT

Cost-of-goods-sold deduction

There is no evidence in the record to support the contested deductions. Gulf Copper does not own or sell drilling rigs – it repairs and outfits them at its waterfront facility. The repair and outfitting of

drilling rigs is not the sale of "goods." Therefore, Gulf Copper's costs in repairing and outfitting the rigs are not deductible as costs of acquiring or producing "goods" under Tax Code § 171.1012(c), (d), or (f).

Furthermore, in performing rig work at its waterfront facility, Gulf Copper is not "furnishing labor or materials to a project for the construction, improvement, remodeling, repair, or industrial maintenance . . . of real property. . ." Rather, it is providing repair and outfitting services to the owner of equipment, who in turn, contracts with the E&P company to provide that equipment for offshore drilling. This indirect relationship does not qualify Gulf Copper for the cost-of-goods-sold deduction under Tax Code § 171.1012(i). Gulf Copper's rig work adds value to the rigs, but it does not add value to any real-property project.

Gulf Copper's affiliate, Sabine Surveyors, does not own or sell goods either. And similarly, Sabine Surveyors is not by virtue of its surveying services, furnishing labor or materials "to a project for the construction, improvement, remodeling, repair, or industrial maintenance ... of real property," so as to qualify for the cost-of-goods-sold deduction under Tax Code § 171.1012(i).

Revenue exclusion for subcontractor payments

With regard to the flow-through exclusion from revenue, the payment of subcontractors for rig repair, before the commencement of drilling, does not constitute evidence of payment for "services, labor, or materials in connection with the actual or proposed design, construction, remodeling, or repair of improvements on real property" under Texas Tax Code §171.1011(g)(3).

Furthermore, the flow-through exclusion is proper only where the taxpayer is *contractually* obligated to pay its subcontractors from or based on payments that it has received from other parties, and, here, there is no such contract in evidence.

ARGUMENT

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

A. Background: Tax Code section 171.1012.

Gulf Copper determined its "margin" by deducting cost of goods sold from total revenue. Opinion at *3. The cost-of-goods-sold deduction is governed by Tax Code section 171.1012, which permits a business to

subtract "all direct costs of acquiring or producing the goods." Tex. Tax Code § 171.1012(a)(1) and (c).

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

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

> A taxable entity furnishing labor or materials to a project for the construction, improvement, remodeling, repair, or industrial maintenance ... of real property is *considered to be an owner of that labor or materials and may include the costs, as allowed by this section*, in the computation of cost of goods sold.

B. There was no evidence of section 171.1012(i) costs to support a remand.

Because there was no evidence supporting application of the subsection (i)'s third sentence, the court of appeals erred when it concluded that:

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

Opinion at *14.

Similarly, the court erred when it concluded that "Sabine Surveyors' costs should have been analyzed on a cost-by-cost basis to determine which of those costs met the requirement that they be integral, essential, and direct components of the offshore drilling process." *Id.*

Remand is inappropriate here, because Gulf Copper and its subsidiary's services do not constitute "furnishing labor and materials to a project for the construction, improvement, remodeling, repair, or industrial maintenance ... of real property. . ." Thus, their services do not qualify for the cost-of-goods-sold deduction under subsection (i). Tex. Tax. Code § 171.1012(i).

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

The Property Code provides that a person who "furnishes labor or materials" for the construction, repair, or demolition of a real property improvement may establish a lien on the real property to secure payment for the labor done or material furnished. *See* Tex. Prop. Code §§ 53.021 and 53.023 ("Payment Secured by Lien."). The definitions limit "labor" and "materials" to those used in the "direct prosecution" of the work. *Id.* at § 53.001(3) & (4).[2]

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[2] The Comptroller has proposed rules amending 34 TAC § 3.588, which would use the Property Code definitions to define "labor" and "materials" in section 171.1012(i). *See* 42. Tex. Reg. 5235-36 (Sept. 29, 2017).

Application of the Property Code definitions provides this clear test for costs claimed under subsection (i): could Gulf Copper obtain a lien on the offshore drilling project? Here, the answer is "no." Mechanics and materialman's liens are limited to "running repairs" performed on equipment while it is being used on the project site. *See* Tex. Prop. Code § 53.001(4)(B).[3]

Gulf Copper tendered *no* evidence that the costs it seeks to deduct included any of these activities. Indeed, to establish its entitlement to the disputed deductions, Gulf Copper relied solely on an erroneous legal interpretation of subsection 171.1012(h)—which the court of appeals expressly rejected. Opinion at *9, 12. This lack of evidence requires a rendition of judgment regarding section 171.1012 costs rather than remand.

The definitions of "labor" and "materials" in the Property Code – limiting the terms to labor and materials used in the "direct prosecution" of a project – accord with subsection (i)'s words and phrases in their

---

[3] Furthermore, mineral property liens under Property Code Chapter 56 are limited to "digging, drilling, torpedoing, operating, completing, maintaining, or repairing an oil, gas, or water well." Tex. Prop. Code § 56.001(1).

proper context, as well as with the rules of grammar and usage. *See* Tex. Gov't Code Ann. § 311.011(a) (West 2013). The phrase "*to* a project for the construction, improvement . . . of real property" is prepositional phrase that functions as an adjective modifying and limiting the antecedent phrase "furnishing labor or materials."

The court of appeals nonetheless concluded that Gulf Copper "presented evidence at trial that, to some extent" it provided labor or materials that were "essential and direct components" of "specific projects." Opinion at *14. The court's "essential and direct components" language comes from its opinion in *Newpark*. In that case, the court distinguished labor that was an "essential and direct component" of the drilling project from labor "too far removed" from the project. Opinion at *14 (citing *Combs v. Newpark Resources, Inc.*, 422 S.W.3d 46, 57 (Tex. App.—Austin 2013, no pet.)).

The taxpayer in *Newpark* was able to obtain the subsection (i) deductions for labor furnished in hauling away used drilling mud and other waste products from oil well drilling sites. 422 S.W.3d at 48. But that labor was *provided to* the oil wells. In contrast, Gulf Copper's work was at least two steps removed from a real-property project. It provided

outfitting and repair services to its customers—the rig owners—who, in turn, contracted with the E&P companies to provide them with the rigs for offshore drilling. The E&P companies then used the rigs in projects for real-property improvements or construction.

This Court has never adopted the "essential and direct components" test in *Newpark*. But even if the Court accepts that formulation, the repair and outfitting of a rig owned and operated by a third party, prior to commencement of drilling by yet another third party at a different site offshore, cannot be viewed as a "direct component" of drilling. Gulf Copper's work is "too far removed" from the construction project.

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

Copper's rig work added value to the rigs, but it did not add value to any real-property project.

This analysis applies with equal if not greater force to Sabine Surveyors, which inspected the rigs and other marine vessels. There is no evidence the subsidiary inspected offshore drilling operations or any other real-property improvements.

C. The court of appeals' decision regarding section 171.1012(i) also defeats other key provisions in the cost-of-goods-sold statute.

The court's decision undermines the explicit exclusion of "services" from the definition of "tangible personal property" and thus from the definition of "goods." *See id.* § 171.1012(a)(3)(B)(ii). It does so by allowing the taxpayer to deduct labor costs for installing components, removing defective components, painting, welding, fixing cranes, sandblasting, and coating—even though these services had only an indirect relationship to the construction or improvement of real property. CR. 296-97 (Findings of Fact No. 10, 12 and 13)[App. B]; 2.RR.131–32, 188, 192.

The cost of a service may be allowable in a cost-of-goods-sold deduction *only if the service is a cost of acquiring or producing a "good"*

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

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

Similarly, Gulf Copper is not selling rigs to a third-party, but rather, is providing repair and outfitting services performed at its waterfront facility.[4] That the rigs are then used by another third party

[4] Again, the comptroller has already allowed the deduction for the labor costs incurred in "producing" "goods"—i.e., parts and components Gulf Copper installed on the rigs and thus sold.

to drill offshore does not transform Gulf Copper's services into "labor" used in "direct prosecution" of the project under subsection (i).

II. Gulf Copper cannot exclude the contested subcontractor payments from revenue under Tax Code §171.1011(g)(3).

A. Background: Section 171.1011(g)(3)

Taxpayers such as Gulf Copper must first determine their revenue before deducting cost of goods sold to determine "margin." In limited circumstances, the Texas Legislature has allowed taxpayers to exclude receipts that they are obligated by law or contract or fiduciary duty to pass on to another. The theory is that the receipts do not truly represent the revenue of the taxpayers. However, taxpayers are not allowed to exclude receipts merely because the receipts are used to pay the taxpayers' expenses. If that were the case, the "margin" tax would become a net income tax. To prevent just that outcome, Tax Code §171.1011(i) specifically provides:

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

In this case, the question is whether the payments were made under an ordinary contract for the provision of services or whether they

were flow-through payments to subcontractors under section 171.1011(g)(3), which provided during the period at issue:

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

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

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

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

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

The court of appeals conceded that the phrase "in connection with" is "one 'of intentional breadth,' but not without 'logical limit.'" Opinion at *7 (quoting *Titan Transp. LP v. Combs*, 433 S.W.3d 627, 637-38 (Tex. App.—Austin 2014, pet. denied)). The "logical limit" has been exceeded here for these reasons:

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

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

And, when Gulf Copper finished its work, the offshore drilling projects had no greater value than before Gulf Copper started. This is the "logical limit" of the (g)(3) revenue exclusion.[5]

Of course, the rigs that Gulf Copper repairs and modifies are used by third parties to construct oil and gas wells, and oil and gas wells are improvements to real property. For this reason, the State does not challenge Findings of Fact 20: "Offshore drilling rigs are necessary and essential to the drilling of offshore oil and gas wells because the wells could not be drilled without the drilling rigs") or Finding of Fact 30 ("The labor and materials provided by Gulf Copper through its employees and subcontractors are necessary, essential, and integral to the construction

[5] While this part of the (g)(3) revenue exclusion is similar to the real-property project requirement in the third-sentence of subsection (i), there are differences. Subsection (i) does not contain the word "services." It refers to "labor or materials furnished "*to*" a real-property project, rather than "services, labor or materials" provided "*in connection with*" such projects. Nevertheless, Gulf Copper's work does not qualify for the revenue exclusion even under the broader phrasing in subsection (g)(3). It is still too "remote or attenuated" to qualify. *See Titan Transp.* 433 S.W.3d at 638. The court of appeals' decision does not account for the use of different words and phrases in these two subsections.

… of oil and gas wells.”). CR.298, 299 [App.2].

But just as narrow focus on necessity or indispensability would improperly broaden the statutory test under subsection (i), these findings are, as a matter of law, insufficient to pull the subcontractor payments into the (g)(3) revenue exclusion. The taxpayer's indispensability argument—which is really none other than a “but for,” cause-in-fact argument—“proves too much.” Undoubtedly, there are many necessary or essential preconditions—business organization, administrative services support, surveying, geoseismic testing, research—for oil wells and other real-property projects. And, no doubt, these and other necessary preconditions will themselves require the furnishing of labor or materials.

But the mere fact that the disputed labor or materials are in the causal chain leading up to the real-property project is not evidence supporting the (g)(3) revenue exclusion. Another precondition of the project would be a written drilling contract between the rig owner and the E&P company. Should the law firm that drafted the contract for the rig owner be able to exclude its expenses because the expenses were incurred “in connection with” the improvement of real property? Gulf

Copper is in the same position as the law firm, providing services to the rig owner antecedent to the drilling project and not providing any value to the drilling project itself.

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

Even if the Court rejects the State's primary contention and finds that the subcontractor payments were made in connection with the construction or improvements of real property, there must still be evidence that the payments were mandated by contract to be distributed to the subcontractors.

Gulf Copper's two biggest contracts with rig owners, the Pride and Helix contracts, involved two types of subcontractor labor – hourly and cost-plus.

Under the hourly labor provisions, employees of the subcontractor worked side-by-side with Gulf Copper employees, performing the same work. Gulf Copper paid these subcontractors a flat hourly rate. And under the Pride and Helix contracts, the rig owners paid Gulf Copper a higher flat hourly rate—paying the same rate for regular labor performed

by Gulf Copper employees and its subcontractors. 2.RR.110–113. 4.RR.104–05; PX1 at P00220 (Pride Contract) [App.9]; PX2 at P0072 (Helix contract). Indeed, with respect to regular labor, the Pride and Helix contracts said nothing at all about subcontractors.

But for the second type of subcontractor labor involving specialty services, the Pride and Helix contracts specified that payments were cost plus 15% (in the case of the Pride contract) and cost plus 20% (in the case of the Helix contract). PX1 at P00221 [App.9]; PX2 at P00073 [App.10]; 2.RR.112.[6]

At trial, the State conceded that $32.0 million in subcontractor payments—reflecting the specialty services governed by the cost-plus provisions in the Pride and Helix contracts—were flow-through funds mandated by contract to be distributed to the subcontractors. But the State continued to urge that the other payments—reflecting the hourly-rate subcontractors—were not flow-through funds. With respect to those payments, no contract mandated that any customer payment for

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

labor be distributed to the subcontractors. The trial court and the court of appeals erred when they concluded these payments were nonetheless flow-through funds mandated by contract to be distributed to other entities. Opinion at *6.

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

When examining statutory text, the Code Construction Act mandates that the Court read words and phrases in context and construe them according to the rules of grammar and usage. Tex. Gov't Code Ann. § 311.011(a) (West 2013); *see also supra* at 11-12. The phrase "flow-through funds *that* are mandated by contract to be distributed to other entities" is a single unified requirement. The dependent clause "that are mandated by contract to be distributed to other entities" is an adjective

that specifies and limits the type of flow-through funds excludable from revenue.

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

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

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

PRAYER

For these reasons, the court should grant the petition for review and upon further briefing on the merits, reverse and render judgment.

Respectfully submitted,

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CERTIFICATE OF COMPLIANCE

I certify the Petitioner's Petition for Review contains 4493 words, excluding portions exempted by Rule 9.4(i)(1).

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CERTIFICATE OF SERVICE

I certify that on December 20, 2017, a copy of this document was served on all parties and counsel of record by email and eservice, as follows:

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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,

v.

Gulf Copper and Manufacturing Corporation, Respondent.

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

APPENDIX TO PETITIONERS' PETITION FOR REVIEW

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