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 BRIEF ON THE MERITS

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STATEMENT OF THE CASE

Nature of the Case	This is a franchise tax protest suit concerning two provisions of the Texas Tax Code: (1) the cost of goods sold (COGS) subtraction in Section 171.1012; and (2) the revenue exclusion for subcontractor flow-through funds in Section 171.1011(g)(3).
Trial Court	201st District Court, Travis County, Texas The Honorable Amy Clark Meachum.
TC Disposition	After a four-day trial to the bench, the court ruled in favor of Gulf Copper. (CR.294-295, Appx.1). It entered detailed findings of fact and conclusions of law supporting why Gulf Copper properly calculated the full amount of its revenue exclusion and COGS subtraction. (CR.296-301, Appx.2).
Parties to Appeal	Appellants: Glenn Hegar, Comptroller of Public Accounts of the State of Texas, and Ken Paxton, Attorney General of the State of Texas. Appellee: Gulf Copper & Manufacturing Corporation.
Court of Appeals	Third Court of Appeals, Austin; Opinion by Justice Scott Field, joined by Chief Justice Jeff Rose and Justice Cindy Bourland.
CA Opinion	*Hegar v. Gulf Copper & Manufacturing Corporation,* 535 S.W.3d 1 (Tex. App.—Austin 2017, pet. filed) (Appx.3).
CA Disposition	The Third Court affirmed the trial court's judgment on the revenue exclusion and reversed and remanded to determine the amount of the COGS subtraction. (Appx.4). The Third Court denied the Comptroller's Motion for Rehearing on September 21, 2017.

STATEMENT OF JURISDICTION

The Court has jurisdiction because this appeal presents questions of law that are important to the jurisprudence of the State. Tex. Gov't Code § 22.001(a). This appeal concerns how to interpret and apply the Cost of Goods Sold ("COGS") provision of the Texas franchise tax statute. *See* Tex. Tax Code § 171.1012. The outcome has important implications for taxpayers, tax professionals, and legal professionals across our State—especially in the industries of oilfield services, construction, and manufacturing. The outcome also has important implications for Texas's economy and business climate, serving to attract or to deter new development within our borders.

ISSUES PRESENTED

1. As both a producer of goods and a furnisher of labor or materials to real-property improvement projects, was Gulf Copper legally entitled to a COGS subtraction of $73 million or, alternatively $153 million?

    - Texas Tax Code Sections 171.1012(c), (d), and (f) provide lists of the types of costs that may be included for subtraction, while Subsection (e) defines specific costs that cannot be included. Should these provisions be construed broadly or narrowly?

    - As a producer of goods, may Gulf Copper include the costs it incurred throughout its production process, or is it limited to including costs from only isolated phases of production, considering that Subsection (a)(2) defines "production" to include a broad range of activities?

2. Did Gulf Copper properly calculate its COGS amount using a "federal piggybacking" method or was a "cost-by-cost" calculation required?

3. If a cost-by-cost calculation was required, did the Third Court of Appeals err by disregarding evidence in support thereof and remanding to the trial court for a re-calculation?

TO THE HONORABLE SUPREME COURT OF TEXAS:

STATEMENT OF FACTS

While the Third Court of Appeals' opinion correctly states the nature of the case in part, the opinion failed to state all relevant facts regarding Gulf Copper's manufacturing process, as supported by a six-volume reporter's record and thirty-eight detailed findings. *See* Tex. R. App. P. 55.2(g).

I. NATURE OF GULF COPPER'S BUSINESS

Gulf Copper builds, rebuilds and repairs marine vessels, like Navy ships and offshore drilling rigs. (CR.297, FOF.10; 2.RR.79, 87, 168-69). However, Gulf Copper's customers are primarily rig owners and drilling contractors who use their offshore rigs to drill for oil and gas. (CR.296, FOF.1). While idle, these rigs stand or float in harsh marine environments until they are contracted to drill wells in specific areas. (2.RR.131-132; 3.RR.26). These specific areas span the globe and vary in climate, water depth, and subsurface geology. They are also subject to differing governmental regulations. The environmental and regulatory conditions present in the specific areas, along with the rig's present condition, inform the rig owner of the work required and, thereby, Gulf Copper's contractual scope of work. (2.RR.92-96, 193-194, 197). When Gulf Copper completes its work under the contract, the rig will be able to drill safely, legally and

effectively into the oil and gas formations that underlie the specific areas for which the rig was pre-contracted to drill. (CR.297, FOF.16-17).

For example, as part of Gulf Copper's $52 million contract to prepare the Pride rig to drill in Brazilian waters (as shown below), Gulf Copper had to rebuild the living quarters because Brazilian regulations allow no more than four workers to reside in one room on the rig, whereas other jurisdictions allow up to eight. (2.RR.177-180; 3.RR.112, 6.RR.P.Ex.1, 9-10). Governmental standards also required Gulf Copper to produce a mud piping system for the Pride rig so that it could comply with the site's zero discharge requirements. (2.RR.96-97).

Similarly, Gulf Copper's second largest contract that year, for Helix Energy Service's Q4000 rig, was for work to prepare the rig for its drilling

contract with a consortium of oil companies who were pre-contracted to drill in the Gulf of Mexico. (2.RR.122). Helix paid Gulf Copper $25 million for this work on the rig shown below. (3.RR.112).

A. Securing the Work

With these environmental, regulatory, and present rig conditions in mind, the rig owners subject the rigs to inspections by marine classification societies and companies, like Sabine Surveyors, to define the scope of work to be competitively bid by shipyards. (CR.296, FOF.2; 2.RR.81-83, 90-94, 151). Sabine is a member of Gulf Copper's combined group, as discussed

further below. (CR.296, FOF.4-5). Sabine is primarily engaged in surveying (inspecting) marine vessels, including offshore rigs. (CR.296, FOF.2; 4.RR.117). For example, Sabine may survey a rig to identify damaged portions or to determine regulatory deficiencies in the rig requiring correction by a shipyard, like Gulf Copper, so that the rig may drill legally, safely, and efficiently. (2.RR.81; 6.RR.P.Ex.29-31). Sabine and Gulf Copper share facilities, senior management, industry knowledge, and customers. (CR.296, FOF.3; 2.RR.82; 3.RR.58). They refer business to each other, although customer concerns about a conflict of interest may prevent the combined group members from performing both the surveying and the rebuilding of the rig. (CR.296, FOF.3; 2.RR.81-83, 171-174; 4.RR.117).

B. Performing the Work

If a rig owner contracts with Gulf Copper, the rig owner moves the rig to one of Gulf Copper's deep-water facilities along the Texas coast to have it rebuilt. (2.RR.80, 84, 93). Throughout the duration of Gulf Copper's work, rig owner representatives and marine classification society inspectors are present onsite to oversee and approve of the work. (2.RR.91, 93).

The work to rebuild a rig begins in either the drydock or the yard, both of which are shown above. (CR.297, FOF.15). One common type of work is the replacement of corroded portions of the rig's steel hull, as identified by the inspections and required under the contract. (CR.297, FOF.12; 2.RR.131, 195-199; 3.RR.17). Before a rig can legally and safely drill in a specific area, its structural and operational integrity must meet the applicable governmental and marine classification society standards. (CR.297, FOF.16-17; 2.RR.92-94, 173). These standards establish, among other requirements, the necessary thickness and tolerance of the rig's steel hull. (2.RR.197). The rig's steel hull can become corroded and weak from standing or floating in harsh marine environments. (2.RR.131-32, 191-194).

Gulf Copper performs its work using both employees and subcontractors (collectively, "workers"). (CR.298, FOF.22; 2.RR.85, 108, 110-111, 125, 167). The workers cut out the large, corroded sections of steel and place them in bins to sell for scrap. (2.RR.197-198; 3.RR.17).

Gulf Copper's workers then move large plates of raw steel from inventory to the fabrication shop where they are rough-cut, milled to the correct diameter of thickness, generally sized into new sections of the hull, and welded together based on engineered drawings. (2.RR.86-87, 145, 147, 161, 188-189, 198-199; 3.RR.24, 38-39).

Next, Gulf Copper's workers move the rough product to other areas of the yard, typically by crane due to its size and weight. (2.RR.100, 164). Gulf

Copper then sandblasts the rough product and rig so that liquid materials will adhere and applies multiple coats of specialty paint and other materials designed to withstand corrosion in the saltwater environment. (2.RR.87, 131-132, 146, 162, 191-194, 198, 209). Coating and painting the various components, as well as the rig itself, is a science. (2.RR.192-194). If not properly coated to withstand the elements present at the offshore site, the steel will quickly corrode. (*Id.*) Generally, if corrosion causes the steel to lose more than 25% of its thickness, the steel must be replaced – one of the most expensive types of work to be done on a vessel. (*Id.*)

After the intermediate product is sandblasted, coated and painted, the workers modify it further and incorporate it into the rig. This third step, known as "field fitting," is a very complicated and expensive process. (2.RR.157-159, 198-199). Field fitting generally requires substantial modification of the intermediate product so that it will fit properly. (2.RR.158, 198-199). It may even require the manufacture of additional components to make adjustments on the rig. (*Id.*) Gulf Copper may even have to cut through and then re-weld large obstructions, like a bulkhead, to get the product on board and in the right place. (2.RR.158). Gulf Copper must erect and weld the large components with great precision. (2.RR.146, 148). In doing so, Gulf Copper continues to change the physical shape of the

intermediate product. Throughout the field-fitting process, workers must test the tolerances and integrity of the components and the structure as a whole. (2.RR.162, 199). Significant piping and electrical work may be required to connect everything in the hydraulic, fuel, water, and drainage systems. (2.RR.162-164). The final act of manufacture occurs when the installed component is inspected. Contractually, Gulf Copper's job is "not over until [the manufactured component is] not just installed, but commissioned and functioning." (2.RR.157; 3.RR.42).

Before Gulf Copper begins its work, a rig is only worth scrap value. (2.RR.173). Gulf Copper's work adds substantial value to the rig, well in excess of 10%, and Gulf Copper's work gives rise to statutory liens in the rig to ensure payment for its work. (2.RR.115, 3.RR.29). These liens give Gulf Copper a superior right of possession and control over the titled owners of the rigs. (3.RR.29).

II. PROCEDURAL HISTORY OF TAX DISPUTE

The franchise tax period at issue is report year ("RY") 2009.[1] (3.RR.30, 50). This covers revenue generated by Gulf Copper's activities during the fiscal period of May 1, 2007 through April 30, 2008. (3.RR.30, 33, 50-51).

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[1] The 2008 version of the statute (Appx.5) applies to this dispute. For ease of reference, all citations herein to Section 171.1012 refer to the 2008 version unless otherwise specified.

A. Franchise Tax Report

Gulf Copper timely filed its RY 2009 report, paying $210,605 in tax due. (3.RR.57; 6.RR.P.Ex.47). Gulf Copper calculated its tax base (margin) by, among other things: (1) excluding from its gross revenue $79,405,230 as subcontractor flow-through funds per Texas Tax Code Section 171.1011(g)(3);[2] and (2) subtracting $70,396,219 in allowable costs of goods sold ("COGS") per Section 171.1012. (3.RR.46-57; 6.RR.P.Ex.47-48).

The franchise tax laws mandate that Gulf Copper file a single franchise tax report (called a "combined group report") because its business operations are conducted through affiliated, separate but integrated companies. *See* Tex. Tax Code § 171.1014 (a); 171.0001(1), (17). The franchise tax laws further require that the combined group elect a single subtraction that applies to all members of the combined group. *Id.* at § 171.1014(d). This rule applies even if one or more of the members would not separately qualify for the group's subtraction. For report year 2009, Gulf Copper's combined group filed using the COGS subtraction. (3.RR.57-60, 110; 6.RR.P.Ex.47).

Gulf Copper serves as the reporting entity for the combined group. (CR.296, FOF.6; 3.RR.59). Throughout this brief, the combined group is

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[2] Gulf Copper also reported $163,303 in other types of revenue exclusions. The Comptroller allowed that amount and there is no dispute about it here. (3.RR.62, 65-66, 68-69; 6.RR.P.Ex.54, pg.P00887).

collectively referred to as "Gulf Copper" unless indicated otherwise.

B. Audit and Assessment

The Comptroller assessed additional franchise taxes totaling $692,606, not including interest. (6.RR.P.Ex.54, 57). The Comptroller agreed that Gulf Copper qualified to claim the COGS subtraction. (3.RR.114-115; 6.RR.P.Ex.54, pg.860). However, the Comptroller disallowed the entirety of Gulf Copper's $79.4 million revenue exclusion related to subcontractor payments. (3.RR.61-62; 4.RR.69). Initially, he moved this amount to Gulf Copper's COGS subtraction, which increased it to over $149 million. (3.RR.61-63, 114; 4.RR.69). From that total COGS amount, the Comptroller made across-the-board reductions based on his incorrect conclusions about the nature of Gulf Copper's activities and his incorrect interpretation of Section 171.1012. (3.RR.116; 4.RR.74-75). The Comptroller's reductions totaled nearly $73 million, leaving Gulf Copper with a COGS subtraction of only $77 million and no subcontractor revenue exclusion. (6.RR.P.Ex.54, pg.860). Consequently, Gulf Copper was forced to pay tax on a much higher amount than it originally calculated in accordance with the statute. Moreover, the Comptroller put Gulf Copper through an intensely burdensome, time-consuming process that severely strained the resources of Gulf Copper's accounting and operations

department, all to re-calculate a single amount – COGS – on Gulf Copper's franchise tax report. (4.RR.82-84, 88-89).

C. Protest Litigation

Gulf Copper paid the assessment under protest and filed suit. (3.RR.64; CR.3, 74-105, 297, FOF No. 8); Tex. Tax Code §§ 112.051-.054, .060; Tex. Gov't Code § 403.211. Prior to trial, Gulf Copper realized that it was entitled to approximately $3 million more in COGS, for a total subtraction of approximately $73 million. (3.RR.101-102; 4.RR.67-68; 6.RR.P.Ex.56, Appx.6).[3]

Following a week-long bench trial, the court ruled that Gulf Copper was entitled to recover the full amount of its protest payment ($838,117.84), plus all statutory interest and costs as allowed by law. (CR.294-295). The trial court entered detailed findings and conclusions in support of its judgment. (CR.296-301). The trial court correctly determined that Gulf Copper qualifies for the COGS subtraction on two, independent grounds. First, Gulf Copper produces goods that it sells in the ordinary course of business. (CR.300, COL.10). Second, Gulf Copper furnishes labor or materials to projects for the improvement of real property. (CR.300, COL.11). In

[3] Nevertheless, Gulf Copper did not increase the amount of its requested recovery because it is statutorily-limited to the amount of its protest payment. *See* Tex. Tax Code § 112.052.

calculating Gulf Copper's RY 2009 franchise taxes, the court concluded that Gulf Copper is entitled to:

- a revenue exclusion of $79.4 million, as originally reported, in subcontractor flow-through payments (COL.2);
- a COGS subtraction of $73 million, covering the $70 million originally reported plus $3 million in subsequently-discovered COGS, without the arbitrary reductions imposed by the Comptroller (COL.1, 13-16); and
- alternatively, a COGS subtraction of $153 million, covering the $73 million addressed above plus $79.4 million in subcontractor payments if treated as COGS rather than as a revenue exclusion, without the arbitrary reductions imposed by the Comptroller (COL.5, 17).

(CR.300-301).

The Comptroller appealed. As governed by *Titan Transportation, LP v. Combs*, 433 S.W.3d 625 (Tex. App.—Austin 2014, pet. denied), the Third Court correctly affirmed the entirety of Gulf Copper's $79.4 million revenue exclusion. 535 S.W.3d at 9-13, 21. Regarding COGS, the court correctly held that Gulf Copper qualified to calculate its taxes using the COGS subtraction but incorrectly concluded that Gulf Copper was not entitled to the full COGS amount of $73 million or, alternatively, $153 million. *Id.* at 13-18, 21. This conclusion was flawed in several respects, as argued below.

SUMMARY OF THE ARGUMENT

The Third Court of Appeals' partial reversal and remand for re-calculation of Gulf Copper's COGS subtraction was legally incorrect for the following reasons.

First, the court ignored Gulf Copper's activities as an actual producer of goods, focusing instead on only Gulf Copper's activities as a furnisher of labor or materials to projects for real property construction. On this basis, the Third Court failed to consider significant evidence supporting the full amount of Gulf Copper's COGS subtraction. The Comptroller agrees that Gulf Copper qualifies as the producer of goods and that Gulf Copper incurred subtractible costs as a producer of goods. However, the Comptroller imposed a far-narrower view of "production" than the statute supports. This Court should consider the entirety of Gulf Copper's qualifying activities and conclude, under the proper interpretation of the statute, that Gulf Copper was legally entitled to the full amount of its COGS subtraction.

Second, the court misinterpreted the statute as a matter of law by holding that "federal piggybacking" is an improper COGS calculation method. This Court should conclude, based on the plain language of the statute, that Gulf Copper was legally entitled to calculate its COGS subtraction using this method, and that the record supports the full amount

of Gulf Copper's COGS calculation under this method.

Third, even if a "cost-by-cost" calculation is required, then the court incorrectly determined that Gulf Copper failed to present sufficient evidence to support the full amount of its COGS subtraction under this method. In addition to other testimony and exhibits, Gulf Copper's Exhibit 56 supported such a calculation in detail, and was admitted at trial without objection. Nevertheless, the Third Court disregarded Exhibit 56 without analysis or appropriate justification. Exhibit 56 is a summary of Gulf Copper's detailed trial balance, which contains over 4,000 accounts and was also admitted without objection. (6.RR.P.Ex.49). The court's error in striking Exhibit 56 is further compounded by its failure to consider Gulf Copper's COGS eligibility as the producer of goods, which independently supports the full amount of its COGS subtraction.

Judgment should be rendered in Gulf Copper's favor based on the proper legal interpretations of "production" and the statutory calculation method. Alternatively, Gulf Copper seeks a remand to the intermediate court for further review of the evidence under the proper legal standards advised by this Court.

ARGUMENT

The Third Court properly held that Gulf Copper is entitled to a $79.4 million revenue exclusion. The portion of its judgment based on this holding should be affirmed.[4]

The Third Court incorrectly held that Gulf Copper is not entitled to the full amount of its COGS subtraction ($73 million or, alternatively, $153 million), and remanded for a recalculation by the trial court. Based on the statute's plain language, sound taxing policy, and the ample record in support of Gulf Copper's arguments, the portion of the Third Court's judgment based on this holding should be reversed.

I. EXPLANATION OF THE COST OF GOODS SOLD SUBTRACTION

While this Court is generally familiar with the revised franchise "margin" tax, it has not yet addressed issues arising under the COGS subtraction. To put the COGS subtraction in context, Gulf Copper includes a diagram of the overall franchise tax calculation as Appendix 7.

At a high-level, the COGS subtraction consists of two steps: qualify then calculate. Not all taxable entities qualify to calculate their margin using the COGS subtraction. *See* Tex. Tax Code § 171.1012(g) (referring to whether

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[4] Gulf Copper reserves its argument on the merits of this issue for its Respondent's Brief.

an entity is "allowed" to take a COGS subtraction). A taxable entity must engage in a qualifying business to be eligible to use the subtraction.

The primary qualification provision is Section 171.1012(i), which begins with a basic statement that "[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." *Id.* § 171.1012(i), *first sentence*. As relevant to this appeal, the Legislature specified two ways by which a taxpayer may qualify as an "owner of goods" and, thus, become eligible to subtract COGS. *See id.*, *second and third sentences.*[5] A taxpayer may own the goods outright – like a jeweler who makes and sells jewelry – or it may provide labor or materials to projects for real property construction that are either contemplated or underway.

Like the other subtractions allowed by the margin tax, the COGS subtraction is made at the entity level. The statute treats combined groups like Gulf Copper, as a single taxable entity. In doing so, combined groups are limited to a single filing subtraction. This means the subtraction applies to all members of the group, even if some, individually, would not use it to determine margin due to the small amount of eligible costs. "It would be inconsistent with th[e] framework [of section 171.1014, the combined group

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5 Additionally, the Legislature has carved out several other industry-specific qualification activities, none of which apply to Gulf Copper. *See, e.g., id.* § 171.1012 (k) (public lending institutions); (k-1) (specified rental or leasing entities); (k-2) (certain pipeline entities).

rule,] to consider a combined group as a single taxable entity, require each member to take the same general deduction, but nevertheless treat each member as an isolated entity for purposes of determining eligibility to take the cost-of-goods-sold deduction." *Combs v. Newpark Res, Inc.*, 422 S.W.3d 46, 52 (Tex. App.—Austin 2013, no pet.).

Similarly, a taxpayer's business must be viewed as a whole (whether considering a single entity or combined group). Otherwise, the treatment of the business for purposes of COGS begins to diverge from the economic reality of the business and the tax base of margin (gross profits).

After establishing eligibility to subtract COGS, a taxpayer must then review the related costs and calculate the amount allowed for subtraction as COGS under 171.1012, read as a whole. Subsections (c) and (d) provide non-exhaustive lists of direct costs and other related costs that may be subtracted at 100%. Tex. Tax Code § 171.1012(c)-(d). Subsection (e) provides a finite list of fourteen (14) costs that cannot be subtracted, like outbound transportation and advertising. *Id.* at (e). Our Legislature determined that these types of services and other costs are too far removed from production activities to be included in the subtraction. Subsection (f) allows for the subtraction of indirect or administrative overhead costs (*e.g.*, accounting, legal, personnel departments) that are allocable to the taxpayer's goods,

although these costs are capped at 4%. *Id.* at (f).

II. THIS COURT SHOULD BROADLY CONSTRUE THE COST OF GOODS SOLD SUBTRACTION.

The COGS statute's text and structure demonstrate the Legislature's intent to broadly construe the subtraction. Legislative history and the rules of construction further support a broad construction.

A. The Structure of the COGS Statute Demonstrates its Expansive Breadth.

Our Legislature wrote and structured Section 171.1012 to demonstrate its expansive breadth. First, it used words of expansion when listing the types of eligible costs. Subsection (i) authorizes taxpayers to "make a subtraction under this section **in relation to** the cost of goods sold." Tex. Tax Code § 171.1012(i) (emphasis added); *Morales v. Trans World Airlines, Inc.*, 504 U.S. 374, 383–84 (1992) (citing to 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"). Subsection (c) then provides for the inclusion of "**all** direct costs of producing goods," Tex. Tax Code § 171.1012(c) (emphasis added). Subsection (d) echoes Subsection (i), using

"**in relation to**"—also a term of intentional breadth—to describe additional costs that may be subtracted. *Id.* at § 171.1012(d) (emphasis added).

Second, within Subsections (c) and (d), the Legislature provides non-exhaustive, partial lists of costs includable in COGS as shown by using the words "includes" and "including." *Id.* at § 171.1012(c)-(d); *see also* Tex. Gov't Code § 311.005(13); *In re Allcat Claims Serv., L.P.*, 356 S.W.3d 455, 468 (Tex. 2011). In contrast, Subsection (e) provides a complete and finite list of disallowed costs (mainly service and administrative costs not associated with goods or real property projects, such as bidding, rehandling, selling, advertising, and leasing facilities not used for production). *Id.* at § 171.1012(e). Similarly, Subsection (f), which also addresses costs further removed from goods, limits a taxpayer's ability to subtract certain overhead and administrative costs by capping them at 4%. *Id.* at § 171.1012(f).

Read collectively, Subsections (c), (d), (e), and (f) show our Legislature's intent to allow taxpayers to subtract broad categories of costs incurred in the ordinary course of their qualifying businesses, subject to an express, specific list of limited or disallowed costs. This framework openly allows subtractible costs while narrowly circumscribing those it limits. In doing so, the costs of a business' operations (and its margin) will more closely parallel its economic margin (and its gross profits), thereby increasing the

likelihood that taxable entities will be taxed uniformly.

B. The Illustrative Costs Further Demonstrate the Expansive Breadth of COGS.

The Legislature's examples of allowable costs further demonstrate the breadth of the COGS subtraction. Importantly, the Legislature allowed the subtraction of costs far beyond those incorporated into or touching the goods. Allowable **direct costs** may be several steps removed from the goods.

The ability to subtract the cost of repairs to pollution control devices regulating production equipment illustrates this point. Subsection (c)(7) allows, as a direct cost, the subtraction of the cost to rent production equipment. The cost of this equipment is one step removed from the goods because it affects, but does not become part of the goods produced (unlike incorporated materials allowed by Subsection (c)(2)). Subsection (c)(7) also allows, as a direct cost, the subtraction of rental costs of pollution control equipment. These costs are two steps removed because they affect the production equipment, which in turn affects the goods. Then, Subsection (c)(8) authorizes the subtraction of even further removed direct costs: the cost of repairs to the pollution control equipment. Such costs are three steps removed because the repairs affect the pollution control equipment, which

affects the production equipment, which affects but does not become part of the goods.

Treating all of these costs as "direct costs of acquiring or producing goods" shows the Legislature's intent to broadly include costs that are distant or removed from the goods. Tex. Tax Code § 171.1012(c). And, the Comptroller's interpreting rule also generally recognizes the breadth of allowable costs. For example, the Comptroller's rule defines direct labor costs to include both direct and indirect costs within the meaning of Internal Revenue Code Section 263A. *See* 34 Tex. Admin. Code §§ 3.588 (d)(1), (2); 26 U.S.C. § 263A. The Comptroller's rule also authorizes taxpayers to subtract the cost of services incurred "**in relation to** the tangible personal property sold." Tex. Admin. Code § 3.588 (c)(7) (emphasis added).

The Legislature's partial listing of allowed costs is also temporally broad, permitting costs incurred both before and after the production process. For example, the statute allows the following pre-production costs:

- Subsection (c)(4) – costs of transporting raw materials to the taxable entity's location;
- Subsection (c)(9) – costs of research, experimental, engineering and design activities, which occur well before commercial production of goods begins;
- Subsection (c)(10) – geological and geophysical costs incurred before a taxable entity acquires an oil lease and begins to drill; and

- Subsection (d)(4) – pre-production direct costs when the "property" (*e.g.*, the rigs Gulf Copper rebuilds) is held for "future production" (*e.g.*, the drilling of wells).

The Legislature has also provided for the subtraction of post-production costs:

- Subsection (c) (5) – cost of storing produced products;

- Subsection (d)(9) – costs of replacing defective components pursuant to warranty polices; and

- Subsection (d)(5) – "post production direct costs allocable to the property."

Subsections (d)(4) and (d)(5)'s use of the words "property" and "allocable" further expands the subtraction because "property" is broader than "goods," and "allocable" means "[a] cost that can be assigned or charged to one or more activities or items (cost objects) on the basis of benefits received or other such equitable or logical association, although a direct (causal) relationship may not be established." "Allocable," http://www.businessdictionary.com/definition/allocable-cost.html (last accessed on Dec. 7, 2018); *see also* Tex. Tax Code § 171.1012(a)(2) (unlike "goods," the statute does not require "property" to be owned or sold by the taxpayer in the ordinary course of business). "Cost objects" for this purpose means goods or projects.

By providing examples of qualifying costs incurred both before and after the production of goods and expanding the relevant inquiry from goods to property, our Legislature once again evidenced its intent to broadly interpret the scope of costs included in the COGS subtraction.

C. Legislative History Confirms Broad Construction Is Proper.

In 2006, the Legislature revised the franchise tax statute to create a new tax base called "margin." Margin means "gross profits." *See* "Gross Profit," https://www.thesaurus.com/browse/gross%20profit (last accessed Dec. 7, 2018) (margin is a synonym for gross profit); "Margin," https://www.investopedia.com/terms/m/margin.asp (last accessed Dec. 7, 2018) ("In business accounting, margin refers to the difference between revenue and expenses"); "Gross Profit," https://www.investopedia.com/terms/g/grossprofit.asp (last accessed Dec. 7, 2018) (stating that gross profit "can be calculated with this formula: Gross profit = Revenue - Cost of Goods Sold."); *Easton v. Smitty's Supply, Inc.*, 4:15-CV-00640-O, 2016 WL 10749161, at *4 (N.D. Tex. Apr. 8, 2016) (citing to Black's Law Dictionary to give "gross profits" its "usual and customary definition" of "total sales revenue less the cost of the goods sold, no adjustment being made for additional expenses and taxes").

Contrary to the Comptroller's unsupported assertions regarding legislative intent, our Legislature's purpose was two-fold: to achieve fairness by establishing a uniform tax base and to eliminate the rampant tax avoidance arising under the former tax. A wealth of public information, including the report issued by the Texas Tax Reform Commission (the drafters of the margin tax legislation), unequivocally states that change was needed to make the tax fair in these respects. *See, e.g.,* John Sharp, TAX FAIRNESS: PROPERTY TAX RELIEF FOR TEXAS, (Report of the Texas Tax Reform Commission, Mar. 29, 2006), (Appx.8), at cover letter, 1, 2, 15;[6] *see also, e.g., Allcat*, 356 S.W.3d at 458-59 ("The amendments [] codified in Chapter 171 of the Tax Code [] reflect many of the Commission's proposals, including its proposal to increase the number of business forms subject to the franchise tax."). The tax base of gross profits or "margin," provided the uniformity and fairness sought.

Capital-intensive industries – like oil and gas, construction, and manufacturing – had long borne the brunt of Texas taxes through the former Texas franchise tax on their equity (termed "capital") and high property taxes

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[6] Gulf Copper respectfully requests that this Court take judicial notice of John Sharp, TAX FAIRNESS: PROPERTY TAX RELIEF FOR TEXAS, (Report of the Texas Tax Reform Commission, Mar. 29, 2006) *publicly available at* https://govinfo.library.unt.edu/ttrc/files/TTRC_report.pdf (last accessed Dec. 7, 2018).

on their assets, while the growing service sector largely escaped taxation. *See* Rep. of the Tex. Tax Reform Comm'n at 1, 2, 12, 14. Additionally, businesses easily avoided paying the former franchise tax by transferring their operations to limited partnerships and other entities not subject to the tax. *See id.* at 1, 2, 18. The Legislature intended to remedy these inequities by expanding the list of taxable entities to include most forms of business entities, expanding the tax base to reach the growing service sector, and by requiring related entities to file a single tax report, which in turn allowed a reduction in the tax rate. *See id.* at 1, 18; Senate Comm. on Finance, Bill Analysis, Tex. H.B. 3, 79th Leg., 3rd C.S. (Tex. 2006), (Appx.9);[7] Josh Haney & Bruce Wright, *The History of the Texas Franchise Tax*, Fiscal Notes Newsletter from the Office of Glenn Hegar, Tex. Comp. Pub. Acc'ts, (May 2015), at 5, n.4, (Appx.10).[8]

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[7] "Since many Texas businesses that receive liability protection from the State do not pay the franchise tax, H.B. 3 raises state revenue by amending Chapter 171, Tax Code, to close the loopholes in the current franchise tax by extending coverage to certain active businesses. At the same time, it broadens the tax base and lowers the rate." *Id.* at 1. Gulf Copper respectfully requests that this Court take judicial notice of the Senate Bill Analysis, *publicly available at* https://capitol.texas.gov/BillLookup/Text.aspx?LegSess=793&Bill=HB3 (last accessed Dec. 7, 2018).

[8] Gulf Copper respectfully requests that this Court take judicial notice of Josh Haney & Bruce Wright, *The History of the Texas Franchise Tax* (May 2015), *publicly available at* https://comptroller.texas.gov/economy/fiscal-notes/archive.php (last accessed Dec. 7, 2018).

Constructions of this tax should comport with legislative intent to tax fairly – *i.e.*, in a manner that preserves the health of economy-driving industries (the capital-intensive industries prompting the revisions) and minimizes the differences, across industries, in how taxable entities calculate their "margins" to achieve the uniform tax base envisioned by the Legislature.

D. The Rules of Construction Also Support a Broad Construction.

The Court should construe the COGS subtraction against the Comptroller because its label, purpose, placement, and plain text establish that the subtraction is not an exemption to be strictly construed against taxable entities. *See 20801, Inc. v. Parker*, 249 S.W.3d 392, 396 (Tex. 2008) (observing that, when interpreting a particular provision, "we must consider its role in the broader statutory scheme.").

First, our Legislature was careful to label it a "subtraction" and not an "exemption." During this report year, the statute contained three possible subtractions. Rather than subtracting COGS, a taxable entity could calculate its margin by subtracting the amount of its compensation or 30% of revenue. (6.RR.P.Ex.47, lines 19-21); Tex. Tax Code §§ 171.101, 171.1013. None of

these alternatives use the term "exemption." *See* Tex. Tax Code §§ 171.101, .1012, .1013.

Second, the COGS subtraction does not serve the purpose of an exemption. An exemption carves out items otherwise included in the tax base to accomplish a specific legislative purpose, such as promotion of agricultural or manufacturing activities. This Court has previously noted the distinction:

> When a tax exemption is claimed, there is a contrary presumption favoring the taxing entity rather than the taxpayer. However, the heart of the [taxpayer's] claim is that they are excluded from the tax in the first instance, not that they are entitled to an exemption from a tax that would otherwise cover them. The [taxpayers] are claiming an exclusion rather than an exemption, making the presumption favoring the government inapplicable.

TracFone Wireline, Inc. v. Comm'n on State Emergency Commc'ns, 397 S.W.3d 173, 183 (Tex. 2013) (internal citations omitted).

The COGS subtraction does not exempt costs that would otherwise be subject to the tax; rather, the subtraction includes certain costs in order to calculate the tax base of margin itself. "Simply because a portion of [revenue] goes untaxed, it does not necessarily follow that an exemption results." *Tex-Air Helicopters, Inc. v. Appraisal Review Bd. of Galveston County*, 940 S.W.2d 299, 302 (Tex. App.—Houston [14th Dist.] 1997), *aff'd*, 970 S.W.2d

530 (Tex. 1998). Thus, the subtraction should be construed in Gulf Copper's favor because, "[i]n construing the statutory reach of the tax, we must follow the rule that the statute is construed with strictness against the taxing authority." *Wilson Commc'ns, Inc. v. Calvert*, 450 S.W.2d 842, 844 (Tex. 1970).

The placement of the COGS subtraction further confirms that it is not an exemption. Section 171.1012 is found in Subchapter C, "Determination of Taxable Margin; Allocation and Apportionment," not Subchapter B, "Exemptions." The statute's plain text is also informative. Subsections (b), (h), and (i) refer to the *subtraction* of COGS, and Subsection (d) refers to amounts "*includable*," not deductible. In contrast, the franchise tax statutes use the term "deduction" when allowing a reduction in the tax base of margin after it is calculated. *See* Tex. Tax Code § 171.107(b) (taxpayer "may *deduct* from its apportioned margin 10 percent of the amortized cost of a solar energy device"); (6.RR.P.Ex.47, line 27). In construing a statute, "[w]e presume the Legislature intended precisely what it enacted and strive to give statutory language its fair meaning. To do this, we analyze a statute as a cohesive, contextual whole, accepting that lawmaker-authors chose their words carefully, both in what they included and in what they excluded." *Sommers for Alabama & Dunlavy, Ltd. v. Sandcastle Homes, Inc.*, 521

S.w.3d 749, 754 (Tex. 2017). Therefore, this Court should not strictly construe COGS in violation of legislative intent.

III. GULF COPPER QUALIFIES FOR THE COGS SUBTRACTION.

The COGS statute allows qualifying taxpayers to calculate their margin by subtracting the costs using the formula provided in Texas Tax Code Section 171.1012. The trial court correctly determined that Gulf Copper qualified for COGS on two independent grounds. (CR.298, 300; FOF.29, COL.10-11). First, Gulf Copper qualifies as the producer of goods sold in the ordinary course of business. Second, Gulf Copper qualifies because it furnishes labor or materials to projects for the construction and improvement of real property. The Third Court improperly ignored the first ground, thereby leading it to improperly disregard all of the evidence supporting subtraction of Gulf Copper's costs on that basis.

When the proper scope of Gulf Copper's activities is considered, under the correct legal interpretations of the governing statutory provision, it is apparent that Gulf Copper is legally entitled to the full amount of its COGS subtraction. The Third Court erred in holding otherwise.

A. Gulf Copper Qualifies for COGS Because It Produces Goods.

Gulf Copper briefed arguments to the Third Court regarding Gulf Copper's activities as a "producer" of goods, and how the term "production" and related terms of "manufacture," "installation," and "services" should be legally interpreted and applied in this case. *See Gulf Copper's Appellee's Brief*, pgs. 42-44, 58-63. Nevertheless, the Third Court failed to consider these activities and related costs, or to provide any legal analysis of the critically-disputed statutory terms. Proper consideration of the costs incurred by Gulf Copper throughout its production process supports the full amount Gulf Copper's COGS subtraction.

The Comptroller joins issue on the need for legal guidance by this Court about the meanings of the disputed terms under the statute. Gulf Copper requests that this Court interpret those terms as briefed herein, and apply them to the facts of this case to conclude that Gulf Copper engages in such activities throughout the duration of its contractual work. As such, all of the costs Gulf Copper included in its COGS subtraction were legally allowed. Judgment should be rendered in Gulf Copper's favor under this analysis.

Alternatively, to the extent the Third Court analyzed these issues for factual sufficiency, it erred in applying that standard of review by failing to "detail the evidence relevant to the issue in consideration and clearly state

why the [] finding is factually insufficient or is so against the great weight and preponderance as to be manifestly unjust; why it shocks the conscience; or clearly demonstrates bias" and by failing to "state in what regard the contrary evidence greatly outweighs the evidence in support of the [judgment]." *Golden Eagle Archery, Inc. v. Jackson*, 116 S.W.3d 757, 761 (Tex. 2003). Moreover, by ignoring Gulf Copper's activities as a producer of goods, the Third Court did not "properly conduct a factual sufficiency review" because it did not "first have a clear understanding of the evidence that is pertinent to its inquiry." *Id.* at 762.

If this Court does not render judgment under a proper legal interpretation of the statute, then it should remand to the Third Court to conduct a further sufficiency review based on the legal issues decided by this Court.

1. The Scope of Production.

A taxpayer who produces "goods" qualifies to subtract COGS. *See* Tex. Tax Code § 171.1012(i), (a)(1), (3)(A)(i). "Goods" includes "tangible personal property sold in the ordinary course of business." For the relevant franchise tax report year, "'production' includes construction, installation, manufacture, development, mining, extraction, improvement, creation, raising, or growth." Tex. Tax Code § 171.1012(a)(2). By rule, the Comptroller

allows the costs of "installation occurring during the manufacturing or construction process." 34 Tex. Admin. Code § 3.588 (b)(7).

The COGS statute does not define "manufacture," but the ordinary definitions of the term are "to make into a product suitable for use" or "to make from raw materials by hand or by machinery." Merriam-Webster's Collegiate Dictionary 757 (11th ed. 2012). The Comptroller has similarly defined "manufacture" to mean "to make (as raw material) into a product suitable for use." Comptroller Hearing No. 104,871 (STAR No. 201109248H) (Sept. 12, 2011), *publicly available at* https://star.cpa.texas.gov/view/201109248h?terms=104,871 (last accessed Dec. 7, 2018), (Appx.11). Under this policy, the Comptroller concluded that a butcher engages in manufacturing when it cuts a large piece of meat into smaller pieces because the butcher has made a "physical change" to the property, which makes it "suitable for sale." *Id.* Moreover, the Comptroller views a taxpayer to be engaged in production if its work increases the property's value by more than 10%. *See* 34 Tex. Admin. Code § 3.584(d)(3)(B) construing Tex. Tax Code § 171.002 (c)(2). In that instance, the Comptroller treats the *entirety* of the sale as revenue arising from production. *Id.*

2. The Full Scope of Gulf Copper's Manufacturing Process Constitutes Production.

In the ordinary course of business, Gulf Copper manufactures and sells custom components for its customers' vessels (usually drilling rigs). (2.RR.87, 145, 147, 161, 188-189, 198-199; 3.RR.24). Further, once Gulf Copper commences work on a rig or other vessel at its shipyard, it acquires rights of possession and control over the rig itself that are superior to the rights held by the titled owner. (3.RR.29).

As detailed in the Statement of Facts, Gulf Copper's manufacturing process entails three phases: initial manufacture of the rough components from raw materials; intermediate acts of manufacture, including sandblasting, coating and painting; and final acts of manufacture, such as field fitting and final inspection of the work. In each phase, Gulf Copper physically changes the tangible personal property to make it suitable for the vessel's intended use. Gulf Copper's manufacturing process occurs both before and during installation.

The "physical change" resulting from Gulf Copper's work is far more substantial than that of a butcher, and Gulf Copper's work adds significant value to the rig. Hence, under the Comptroller's own standards, Gulf Copper's work constitutes the "production" of goods.

The Comptroller largely concedes Gulf Copper's entitlement to the costs incurred in the first phase, with the exception of costs related to the removal of defective rig parts. *Comptroller's Petition for Review (hereinafter "Comp. PFR")* at 14. However, these acts inform the fabrication to occur next and independently generate goods for sale: scrap. (2.RR.197-198; 3.RR.17; 4RR.49); *see* Tex. Tax Code §§ 171.1012(a)(1), (d)(3). Further, the intermediate steps of sandblasting and coating physically change the component to allow it to withstand harsh marine environments, serving to prevent corrosion. (2.RR.131-132, 162, 191-194, 198, 209). Gulf Copper's third phase of manufacturing likewise physically changes the component to make it suitable for the customers' use. Field fitting is a very complicated and expensive process that generally requires substantial modification of the intermediate product to ensure that it will properly affix to the existing structure of the rig. (2.RR.157-159, 198-199). It may even involve manufacturing additional components to make adjustments on the rig to accommodate the component. (*Id.*)

Thus, each phase improves the component and constitutes an act of "manufacture" and, therefore, satisfies the definition of "production." As a result, the trial court properly allowed the entirety of Gulf Copper's COGS subtraction in relation to its production activities for rigs and other vessels.

And, even if the Court were to adopt the Comptroller's narrow definition of manufacturing, essentially limiting it to fabrication notwithstanding his rule allowing costs through the installation process, Gulf Copper would still be entitled to subtract all of its costs. *See* 34 Tex. Admin. Code § 3.588(b)(7). The statute defines production to include activities well beyond manufacturing, and Subsections (c) and (d) expansively allow all production-related costs, including those occurring pre- and post-production. *See, e.g.,* Tex. Tax Code § 171.1012(d)(4), (d)(5); (4.RR.112).

In the alternative, Gulf Copper qualifies to include its subtractible costs as the temporary owner of the vessels upon which it performs work. All of Gulf Copper's production activities occur while Gulf Copper has ownership rights in the vessel superior to the customer. Specifically, it has superior rights to possessing and controlling the rig as a result of statutory maritime liens arising under 46 U.S. Code § 31342. (2.RR.115, 3.RR.29). As a result, Gulf Copper should be treated as the owner of the rig while it remains in Gulf Copper's custody for the duration of the work. *See* 43 Tex. Reg. 1643 (2018) (codified at 34 Tex. Admin. Code § 3.588 (c)(9)(A)), (Appx.12). Gulf Copper's status as a temporary owner is yet another independent reason entitling Gulf Copper to subtract all of the costs incurred to rebuild the rig.

3. The Comptroller's Position is Incorrect.

The Comptroller concedes that Gulf Copper is entitled to subtract COGS because it produces goods, but he seeks to circumscribe the scope of Gulf Copper's manufacturing process to deny approximately half of its eligible costs. Specifically, the Comptroller relabels portions of Gulf Copper's manufacturing process as "services" of "repair" and "outfitting" to dovetail with his erroneous position that the costs of services may not be included in COGS. *Comp. PFR* at 4, 5-6, 14-15. As established above, the Comptroller's position is factually incorrect, as Gulf Copper is engaged in one continuous manufacturing process. It is not engaged in separate, unrelated businesses.

The Comptroller's position also suffers from faulty statutory construction. The statute does not exclude services from COGS. Rather, the statute excludes "services" from the definition of "tangible personal property" and, thus, "goods." Tex. Tax. Code § 171.1012(a)(1), (a)(3)(B)(i). As a result, the bar against services relates to whether a taxable entity qualifies to subtract COGS, not to the costs included in the COGS subtraction. *EXLP Leasing, LLC v. Galveston Cent. Appraisal Dist.*, 554 S.W.3d 572, 582 (Tex. 2018) *quoting Lamar Homes, Inc. v. Mid-Continent Cas. Co.*, 242 S.W.3d 1, 19 (Tex. 2007) ("We consider the statute as a whole and construe it in a manner which harmonizes all of its various provisions.").

Generally, taxpayers who purely provide "services" do not qualify to subtract COGS. *But see, e.g., id.* at § 171.1012(k-2) (authorizing a COGS subtraction for "a pipeline entity providing services"). But once a taxpayer qualifies, the statute does not automatically exclude from the calculation all service-related costs that the taxpayer incurs. *See, e.g., id.* at § 171.1012(c)(11) (allowing subtraction of "taxes paid in relation to acquiring or producing any material, or taxes paid in relation to *services* that are a direct cost of production") (emphasis added).

This Court should determine the types of disallowed costs of services by following the express terms of the statutory provisions that disallow or limit the costs of services. This Court should reject the Comptroller's invitation to create an implied limitation based upon the mischaracterization and misuse of the statute's definition of "tangible personal property."

Gulf Copper advances several reasons for its position. First, when the Legislature intends to exclude certain costs from the COGS calculation, it does so expressly. *See Twin Creeks Golf Grp. v. Sunset Ridge Owners Ass'n*, 537 S.W.3d 535, 541 (Tex. App.—Austin 2017, no pet.) (declining to interpret a Property Code statute to create an exemption because if the Legislature had intended one "it could have done so expressly," stating "[t]he Texas Supreme Court instructs us that a court may not judicially amend a statute by adding

words that are not contained in the language of a statute. Instead, it must apply the statute as written.") (internal quotations omitted); *ExxonMobil Pipeline Co. v. Coleman*, 512 S.W.3d 895, 899 (Tex. 2017) (stating that "[h]ad the Legislature intended to limit the [TCPA] to publicly communicated speech, it could have easily added language to that effect' . . . [but] because the statute lacked such limiting language, 'we must presume that the Legislature broadly included both public and private communication") (internal quotations omitted).

Section 171.1012(e) is the Legislature's finite list of costs incurred "in relation to the taxable entity's goods" that are nonetheless excluded from the subtraction. Nowhere within Subsection (e) will the Court find a categorical ban of "service costs." Rather, within Subsection (e), the Legislature targeted specific types of services, the costs of which are disallowed. They include, for example, the services of advertising, selling, bidding, and rehandling. *See, e.g.,* Tex. Tax Code §§ 171.1012(e)(2), (4), (6), (7)-(8).

Second, the illustrative costs in Subsections (c) and (d) expressly allow for subtraction at 100% costs of performing services in relation to goods. *See, e.g.*, Tex. Tax Code §§ 171.1012(c)(4) (handling costs); (c)(5) (storing or warehousing property); (c)(9) (research costs); (d)(7)-(9) (assorted quality control costs). Additionally, Subsection (f) allows for the subtraction of

service-department (or headquarter) costs capped at 4%. *Id.* § 171.1012(f). Thus, the statute's own text belies the Comptroller's argument that, after mischaracterizing portions of Gulf Copper's manufacturing process as services, this Court must throw out the costs generated by these processes.

4. Neither the Amended Definition of Production nor Autohaus Change the Outcome.

In 2017, the Legislature amended the statutory definition of "production" to remove "installation" as a stand-alone type of production. Senate Fin. Comm., Bill Analysis, Tex. H.B. 4002, 85th Leg., R.S. (2017), (Appx.13). In doing so, our Legislature aligned the statute with the Comptroller's rule, which treats "installation occurring during the manufacturing or construction process" as a qualifying act of production. 34 Tex. Admin. Code § 3.588 (b)(7). Following the statutory amendment, this rule controls which acts of installation qualify as "production." All of Gulf Copper's installation activities occur during the manufacturing process and, hence, qualify as production.

Because Gulf Copper's acts of installation occur during the manufacturing process, this case is factually distinguishable from *Autohaus LP, LLP v. Hegar*, 514 S.W.3d 897 (Tex. App.—Austin 2017, pet. filed), which also presents the issue of how to interpret "production" for COGS purposes.

Autohaus sells and repairs vehicles. As part of this activity, it installs parts in vehicles. However, Autohaus does not manufacture the parts it installs. Gulf Copper, on the other hand, manufactures every component that it installs, and its manufacturing work occurs throughout the installation of these components. Consequently, all phases of Gulf Copper's work should be included within the definition of "production," thereby allowing for subtraction of all allowed costs incurred during that work. Thus, even if the Court affirmed the Third Court's judgment in *Autohaus*, it would not require ruling against Gulf Copper.

B. Gulf Copper Qualifies for COGS Because It Furnishes Labor or Materials to Projects for Real Property Improvements.

The trial court and Third Court of Appeals properly recognized that Gulf Copper's rig work at its Port Arthur and Galveston shipyards provides an independent basis upon which it may qualify for COGS, meaning that its costs related to these activities further support the full amount of Gulf Copper's COGS subtraction. To the extent the Comptroller's Petitioners' Brief may challenge Gulf Copper's qualification for COGS as a furnisher of labor and materials to real property improvement projects, Gulf Copper reserves its arguments on the merits for its Respondent's Brief.

IV. Gulf Copper Properly Calculated Its COGS Subtraction.

Having qualified for the COGS subtraction on two independent bases, Gulf Copper's team of professional accountants took a diligent approach in calculating the amount of its COGS subtraction to ensure statutory compliance. At trial, Gulf Copper presented two calculation methods supported by sufficient evidence.

The Third Court of Appeals legally erred in its conclusion that the first method ("federal piggybacking") was not allowed under the statute. The Court should reverse this holding and conclude, as a matter of law, that Gulf Copper's federally-based calculation method was proper.

The Third Court held that a "cost-by-cost" calculation was required, and that Gulf Copper failed to provide factually sufficient evidence in support of its calculation under this method. For similar reasons as discussed above, the court failed to conduct a proper factual sufficiency review in reaching this holding. It improperly disregarded critical evidence without proper analysis, and failed to fully weigh all of the evidence in the record and explain why it was ultimately insufficient. *See Golden Eagle,* 116 S.W.3d at 761-62.

The Court should either render judgment in Gulf Copper's favor based on a proper interpretation of the statute or, alternatively, remand to the

Third Court for further sufficiency review based on the legal issues decided by this Court.

A. Federal Piggybacking

To prepare its franchise tax report, Gulf Copper began with the trial balance used to prepare its federal income tax return and related deductions. (3.RR.49-50, 52; 6.RR.P.Ex.48-49). Gulf Copper began with this document because Section 171.1012(h) directs a taxpayer to use the accounting methods and costs from its federal income tax return as the starting place for its Texas COGS calculation. (3.RR.52-54; 4.RR.44-45).

Subsection (h) provides:

> 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.

Tex. Tax Code § 171.1012(h) (emphasis added). The introductory phrase "shall determine" appears nowhere else in Section 171.1012, which demonstrates that federal income tax methods are the starting place for its Texas COGS calculation.[9] When Gulf Copper applied its federal income tax

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[9] Consistent with subsection (h), other COGS sections reference a correlation between the federal and state calculations. *See, e.g., id.* §§ 171.1012(c)(6), (c)(9), (g).

methods to its transactional data (payments for direct, indirect, and service department costs), the result constituted Gulf Copper's COGS for federal income tax purposes. (6.RR.P.Ex.46, 49). From here, Gulf Copper performed additional calculations to arrive at its Texas COGS amount, as explained below.

Starting with its federal calculations was beneficial because Gulf Copper could rely on the accounting work previously performed. This method is commonly called "federal piggybacking" or "conformity," and 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) (Appx.14).

Specifically, Gulf Copper had already segregated its costs into categories that were relevant for its Texas COGS calculation. (4.RR.46-48, 95-97). For federal income tax purposes, Gulf Copper qualifies a producer of goods and, thus, must calculate its federal COGS pursuant to the accounting method imposed by Internal Revenue Code Section 263A.[10] 26 U.S.C. § 263A (b); (4.RR.45-46). Section 263A is expressly incorporated into Section 171.1012(g), and it appears our Legislature used the

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10 This section is commonly pronounced "263-cap-A."

corresponding treasury regulation (C.F.R. § 1.263A-1) as an outline to draft the COGS statute.

As relevant to this appeal, both Section 263A and Section 171.1012 require a taxpayer to identify direct costs of production activities, indirect costs of production activities, and service-department costs. *See* 26 C.F.R. § 1.263A-1(e)(2)-(4); (4.RR.46-48, 95-97); Tex. Tax Code § 171.1012(c)-(d), (f).[11] However, Gulf Copper could not simply "copy and paste" its federal calculations to determine its Texas COGS amount because Subsection (h) states that incorporation of federal accounting methods "does not affect the type or category of cost of goods sold that may be subtracted" for COGS; rather a taxable entity "shall determine the amount of that cost of goods sold as provided by this section." *See* Tex. Tax Code §§ 171.1012(b), (h). Thus, Subsections (c), (d), (e) and (f) govern the types and categories of subtractible costs.

Gulf Copper followed the statutory framework. (3.RR.94). First, Gulf Copper removed all of the costs prohibited by 171.1012(e). *See* Tex. Tax Code § 171.1012(e); (3.RR.97; 4.RR.54-55; 6.RR.P.Ex.49, 55). Then, Gulf Copper

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[11] There are variances, however. For example, the Texas Legislature adopted a broader definition of direct costs than Section 263A by including several costs that would be listed as indirect costs under the federal statute. *Compare, e.g.*, Tex. Tax Code § 171.1012(c)(4)-(7), *with* 26 C.F.R. § 1.263A-1 (e)(3)(ii)(G)-(I). Regardless of whether these costs are classified as direct or indirect, they remain subtractible as Texas COGS at a rate of 100%.

identified its service-department costs from its federal return and related workpapers. *See* Tex. Tax Code § 171.1012(f); (3.RR.96-97). Pursuant to Section 171.1012(f), Gulf Copper limited its subtraction of service-department costs to 4% of the total, even though it deducted 100% of these costs for federal income tax purposes. (3.RR.95-97; 4.RR.54-57; 6.RR.P.Ex.49, 55).

Gulf Copper's remaining costs aligned with the Texas cost categories under Subsections (c) and (d), which allow for subtraction at 100%. (3.RR.94-95). Gulf Copper added the amount of its costs subtractible at 100% costs with its 4%-capped costs to arrive at Gulf Copper's COGS subtraction. (6.RR.P.Ex.47, lines 11 and 12; 6.RR.P.Ex.49 at 1031; 6.RR.P.Ex.55). For RY 2009, Gulf Copper originally totaled this amount to be $70,396,219 because it misclassified roughly $3 million of Sabine costs as Subsection (f) costs limited to 4%. (4.RR.67; 6.RR.Ex.49 at 1031).[12]

Based on these adjustments, Gulf Copper's COGS subtraction for Report Year 2009 totaled **$11 million less than its federal deductions**.

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12 As part of its modification of its federal calculation for Texas COGS purposes, Gulf Copper originally treated the costs of its group member Sabine under Subsection (f) and limited them to 4%. (3.RR.102). In the course of reviewing its calculation as part of trial preparation, Gulf Copper corrected this calculation error by recategorizing each of Sabine's costs in line with Subsections (c), (d), and (f), meaning that some costs moved into the 100%-allowed category. (3.RR.102; 4.RR.67-68, 116). This resulted in an approximately $3 million increase to Gulf Copper's COGS total. (3.RR.101-102; 4.RR.68; *compare* 6.RR.P.Ex.49 with P.Ex.56).

(3.RR.97-100; 6.RR.P.Ex.55, Appx.15). This demonstrates the differences between net income and margin and belies the Comptroller's claims that Gulf Copper seeks to subtract all costs allowed for federal income tax purposes. *Comp. PFR* at x. Moreover, given the Legislature's express incorporation of many of Section 263A's categories of costs into the COGS statute, it is disingenuous for the Comptroller to dispute federal piggybacking while arguing that real property COGS should be governed by the Property Code based upon four common words. *See, e.g.,* 26 C.F.R. § 1.263A-1(e) (costs common to Section 171.1012 include, but are not limited to, labor, materials, purchasing, handling, storage, rent, taxes, insurance, repairs and maintenance, engineering and design costs, spoilage, quality control).

The Third Court of Appeals rejected Gulf Copper's federal piggybacking method because it believed the calculation "essentially render[ed] subsections (c) and (d) superfluous" and failed to follow Subsection (b)'s to determine the amount of COGS "as provided by this section:" Section 171.1012. *Hegar v. Gulf Copper*, 535 S.W.3d 1, 16 (Tex. App.—Austin 2017, pet. filed); Tex. Tax Code § 171.1012(b) (emphasis added). However, Gulf Copper's calculation does exactly that. Gulf Copper adjusted its federal calculation, as provided by Section 171.1012, to remove disallowed costs under Subsection (e) and to limit the costs capped at 4% by

Subsection (f). The remaining costs were in line with the categories allowed by Subsections (c) and (d), which are not rendered superfluous given their non-exhaustive nature. Moreover, the Legislature provides examples of qualifying costs within Subsections (c) and (d) notwithstanding its allowance of federal piggybacking because the Texas COGS subtraction extends to taxpayers who are not subject to Internal Revenue Code Section 263A in computing federal COGS and, thus, may not have already performed this detailed analysis. Finally, the fact that Section 171.1012 does not expressly reference the COGS line on the federal income tax form does affect this analysis. Although there is an undeniable correlation between a taxpayer's federal deductions and the Texas COGS subtraction, Section 171.1012 cannot instruct a taxable entity to simply use the amount reported for COGS on its most recent federal income tax return for reasons like the year-end conformity rules applicable to combined groups.[13]

[13] All members of a combined group must conform their year-end accounting periods to that of the reporting entity. *See* Tex. Tax Code § 171.1014(h). If the reporting entity has a December 31st accounting year-end, the group members must calculate their COGS using the costs incurred during the twelve months preceding December 31st to conform to the reporting entity's reporting period. This may create a disconnect between accounting periods used on the Texas franchise tax report and the federal income tax return.

B. Cost-by-Cost

As an alternative to its federal piggybacking calculation, Gulf Copper prepared a second COGS calculation for the trial court's consideration: Exhibit 56, which was admitted into evidence without objection. (2.RR.61, 75; 6.RR.P.Ex.56).

Gulf Copper's Chief Financial Officer provided detailed testimony about the calculations reflected on Exhibit 56. Gulf Copper began with its 4,000-line trial balance, which shows the summary of all transactions for the accounting year and provides financial detail by location, line of business, and accounting category, including revenues, costs, and expenses. (3.RR.50; 4.RR.59, 61; 6.RR.P.Ex.49). Gulf Copper reviewed each trial balance account, confirmed when the account related to Gulf Copper's integrated vessel rebuilding business, and identified the Section of 171.1012 that either allowed or disallowed the category of costs within that account – just as the Comptroller's auditor had done using restrictive interpretations of the statute. (4.RR.57-63; 6.RR.P.Ex.56, 59). As shown by Exhibit 56, Gulf Copper independently reached the same figure as its federal piggybacking calculation.

As established at trial but as misunderstood by the court of appeals, Gulf Copper's two methods yield the same subtraction when its costs are

evaluated under a definition of production that recognizes all steps in its manufacturing process. (*Compare* 6.RR.P.Ex.49 [as revised by P.Ex.56 to correct previously misclassified costs] *with* 6.RR.P.Ex.55).

The Third Court disregarded Exhibit 56 in its entirely. Without any analysis, the court held: "We also reverse the finding that '[t]he categories, classifications, locations and amounts of the costs eligible to be included in the cost of goods subtraction are accurately stated in Exhibit 56.'" *Gulf Copper*, 535 S.W.3d 1, 18 (Tex. App.—Austin 2017, pet. filed). This holding was in error. This Court should reverse the holding and consider Exhibit 56 in support of Gulf Copper's cost-by-cost calculation, as the exhibit merely summarizes the more than 4,000 financial accounts reflected in detail by Gulf Copper's trial balance admitted as Exhibit 49.

Exhibit 56 supports the rendition of judgment in favor of Gulf Copper on the full amount of its COGS subtraction, when the proper legal standards are applied to the scope of its activities, and when the exhibit is reviewed in the context of supporting testimony and related evidence. Alternatively, this Court should remand to the Third Court for a further sufficiency review, with instructions to consider Exhibit 56 as part of the relevant evidence in support of Gulf Copper's COGS subtraction.

V. SOUND TAXING AND BUSINESS POLICY SUPPORTS JUDGMENT IN FAVOR OF GULF COPPER.

This Court should reject the Comptroller's restrictive interpretations because, not only do they defy the plain language of the COGS statute, they create poor taxing policies and negatively impact business.

A. Calculating COGS Should Not Overwhelm a Taxpayer's Resources.

This Court should reject the Comptroller's restrictive COGS positions because they impose undue burden on Texas taxpayers. *See EXLP Leasing, LLC v. Galveston Cent. Appraisal Dist.*, 554 S.W.3d 572, 585 (Tex. 2018) (rejecting an interpretation of a taxing scheme that was "neither sensible nor workable"); *see Combs v. Roark Amusement & Vending, L.P.*, 422.S.W.3d 632, 637 (Tex. 2013) ("We believe that in the area of tax law, like other areas of economic regulation, a plain-meaning determination should not disregard the economic realities underlying the transactions in issue"). The audit of Gulf Copper, alone, is illustrative.

In his audit, the Comptroller disagreed that Gulf Copper furnished labor or material to real-property improvement projects. (4.RR.23). Consequently, his review focused on differentiating Gulf Copper's costs into two categories – fabrication and repairs – neither of which are found in the

COGS statute. (4.RR.69, 75-77, 147, 190-91; 5.RR.11). He disallowed the latter. (*Id.*) As explained in Argument III.A.3, this position is incorrect. In doing so, the Comptroller severely limited the scope of Gulf Copper's manufacturing process and, thus, the appropriate costs to be subtracted.

For example, regarding repair work, the Comptroller prohibited Gulf Copper from including in its COGS subtraction the costs associated with the removal of defective rig parts or the installation of new or replacement components that it manufactured. (4.RR.48-49, 144-148, 154-155). Gulf Copper's accounting systems were not set up to divide a single job into three separate activities of removal, manufacture, and installation because that is not how such a job is viewed for business purposes. (4.RR.93-94). Rather, Gulf Copper captured costs by type, location, and project. (3.RR.48-50, 73-49; 6.RR.P.Ex.49).

Contrary to this economic reality, for many types of costs, the Comptroller forced Gulf Copper to generate percentages based on his limited definition of "production" to identify the costs that he considered attributable fabrication; he then disallowed all other costs. (4.RR.69-70, 74; 6.RR.P.Ex.50); *see Combs v. Roark Amusement & Vending, L.P.*, 422.S.W.3d 632, 637 (Tex. 2013). This proved to be an incredibly burdensome task. For the several biggest contracts for each yard location,

Gulf Copper's accounting and operations employees dug through years-old records to ferret out individual tasks on invoices performed for work for for each project that satisfied the Comptroller's limited definition of manufacturing. (4.RR.74-75, 79-81). Gulf Copper was not simply identifying which invoice line items constituted production. Rather, Gulf Copper had to review all of the documentation underlying each line item on each invoice to determine whether each line item charge related in full or in part to fabrication of a rough component part. (*Id.*).

The Comptroller's COGS methodology created an administrative nightmare for Gulf Copper and ignored the economic reality of how it, and similarly-situated taxable entities, do business and maintain their accounting records. These standard methods are sufficient for financial statement accounting and federal income tax purposes — but apparently not for Texas franchise tax calculations. (4.RR.93-94). The Comptroller's auditor spent 127 hours (about three weeks) recalculating his view of Gulf Copper's taxes. (4.RR.199, 206-207). In turn, he required Gulf Copper to spend over 250 hours (about a month and a half) and $35,000 in professional time to prepare new schedules and other accounting documents in compliance with his view of the COGS subtraction. (4.RR.88-89). All of this time was expended to calculate just one amount: the Texas COGS

subtraction; and, this was after Gulf Copper's entire accounting team had calculated all of its deductions for federal purposes. (5.RR.4-7).

It is inconceivable that our Legislature contemplated the enactment of a tax regime that would require a business to lose a month and a half of work time or hire additional accounting staff to calculate a single subtraction amount on a tax return, which was based on complete and accurate records and accounting methods – especially in an industry prone to downturns requiring layoffs, not hires. (4.RR.94-95).

B. Adopting Restrictive Interpretations Disincentivizes Businesses and Bad Policy.

The Comptroller's restrictive policies also have a negative ripple effect. Texas prides itself on being a business-friendly state. However, fair and uniform taxation is critical to maintaining that reputation. The Comptroller's strict and narrow interpretations of franchise tax exclusions and subtractions – seemingly intended to allow optimistic financial forecasts based upon ever-increasing tax collection[14] – are short-sighted,

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[14] Gulf Copper respectfully requests that this Court take judicial notice of the following publicly-available items authored by Comptroller Hegar. *See* Glenn Hegar, *The 2018-19 Certification Revenue Estimate Update* (Jul. 11, 2018), https://comptroller.texas.gov/transparency/reports/certification-revenue-estimate/2018-19-update/ (last accessed Dec. 7, 2018) (Appx.16); Glenn Hegar, *State Grows Faster Than Expected; New Ruling to Change Sales Taxation* (Jul. 26, 2018), https://comptroller.texas.gov/about/media-center/op-eds/2018/ftd-18-07-26.php (last accessed Dec. 7, 2018) (Appx.17).

unprincipled, and do not promote a positive business climate.[15] Instead, they defy the statutory framework and create bad economic and business policy.

For example, the Comptroller's efforts to restrict both the availability and the amount of the COGS subtraction prevents many industries from paying tax on a uniform tax base (margin), which is set by the Legislature and not subject to change by the Comptroller. The issue is often compounded under the combined reporting provisions, which require affiliated taxable entities that engage in a unitary business to file one report as a single taxable entity. In this instance, every business must use the same subtraction only to be limited by the Comptroller in the amounts included in the COGS subtraction due to his narrow reading of the statute. His taxing policy discourages successful business owners from expanding into naturally-related activities because their companies will be forced into a combined group that must elect a single type of subtraction for the entire group, which the individual group members may not elect if they could do so

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15 Gulf Copper respectfully requests that this Court take judicial notice. Texas Public Policy Foundation Margins Tax, *2019-20 Legislator's Guide to the Issues*, (Sept. 7, 2018), *publicly available at* https://files.texaspolicy.com/uploads/2018/10/03133012/2019-20-LegeGuide-WEB.pdf (last accessed Dec. 7, 2018) (stating that "Texas does not have a revenue problem," and calling for the repeal or phase out of the margin tax because compliance is "complex, costly, and difficult") (Appx.18, excerpts).

independently. That is exactly what happened here.

The following example illustrates inequities arising under the Comptroller's enforcement of the franchise tax by contrasting the margin generated by two activities conducted by separate taxable entities with that of a single taxable entity who performs both.

	/------------- Cabinets	--------------/	
	Fabricate	Install	Combined
Revenue	$10,000	$10,000	$20,000
less COGS (or)	**7,000**	2,000	9,000
less Compensation	2,000	**7,000**	9,000
Margin	**$3,000**	**$3,000**	**$11,000**

Under the Comptroller's policies, the taxable entity that fabricates and sells cabinets would choose COGS to subtract the costs of its labor and materials, generating margin of $3,000. However, the separate taxable entity that installs the cabinets would subtract Compensation to reduce its revenue by the cost of its labor force, also generating margin of $3,000. The total margin of these two separate taxpayers is $6,000. But, if instead, a single taxable entity both fabricates and installs the cabinets, the Comptroller's policies would dictate margin of $11,000 – an 83% increase in the tax base solely

because a single entity conducted both activities. It is not reasonable to conclude that our Legislature intended this unjustified level of disparity in the tax base.

Then, there's the matter of outside business that Texas would like to attract. In late June, the United States Supreme Court handed down the *Wayfair* decision that removed the disincentives to expanding business activities across state lines. *South Dakota v. Wayfair, Inc.*, 138 S. Ct. 2080, 2094 (2018). Accordingly, many out-of-state businesses may consider expanding their operations into other states, including Texas. Yet, a tax base that is enforced without regard to uniformity and rife with litigation does not lay out the welcome mat.

In addition, the Comptroller's regulatory plan to overturn final court decisions by adopting rule amendments to bolster litigation positions is bad for businesses inside and outside of Texas, as well as for our courts. It is bad for Texas businesses who rightfully relied upon judicial opinions construing governing statutes and who now face audit exposure due to the Comptroller's regulatory measures adopted expressly to overturn and limit judicial decisions. It is bad for Texas' economy because businesses outside of the state may forego expansion into Texas due to the Comptroller-created instability in our tax laws. It is bad for taxpayer litigants who invest

substantial time and resources into judicial resolution of disputes with the Comptroller only to see a rule amendment put them back to square one. And, it is a violation of the doctrine of separation of powers for an executive agency to overturn, by a retroactive administrative rule, final judicial decisions. This occurred here, where Gulf Copper filed its tax report almost ten years ago, following the plain language of the taxing statute, and has spent hundreds of thousands of dollars successfully litigating its filing positions. This Court should affirm reverse the Third Court of Appeals' judgment, in part, and reinstate the trial court's final judgment in full.

PRAYER

Counter-Petitioner/Respondent Gulf Copper and Manufacturing Corporation respectfully prays that this Court grant Gulf Copper's Petition for Review, reverse the portion of the Third Court of Appeals' judgment regarding the COGS calculation, affirm the portion of the Third Court judgment regarding the revenue exclusion, and render judgment in Gulf Copper's favor on both issues, consistent with the trial court's final judgment. Specifically, Gulf Copper prays for a rendition of judgment that Petitioners/Counter-Respondents Glenn Hegar, Comptroller of Public Accounts of the State of Texas, and Ken Paxton, Attorney General of the State of Texas, shall pay Gulf Copper the full amount of its Report Year 2009

protest payment ($838,117.84), plus all statutory interest and costs as allowed by law.

Alternatively, if further factual sufficiency review is necessary based upon the legal issues decided by this Court, then Gulf Copper prays for a remand to the Third Court of Appeals with instructions to proceed consistent with the Opinion of this Court.

Alternatively still, if any recalculation of the amount of franchise tax due for Gulf Copper in Report Year 2009 is necessary based on the Court's holdings but without the need for intermediate review, then Gulf Copper prays for a remand to the trial court with instructions to proceed consistent with the Opinion of this Court.

Respectfully submitted,

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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 11,614 words, excluding any parts exempted by Tex. R. App. P. 9.4(i)(1).

/s/James F. Martens
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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 12th day of December 2018.

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