

No. 17-0894

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In the Supreme Court of Texas

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

v.

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

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

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**RESPONSE TO PETITION FOR REVIEW**

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## **STATEMENT OF JURISDICTION**

Gulf Copper agrees that the Court has jurisdiction under Texas Government Code Section 22.001(a). However, as addressed in the Introduction below, the Comptroller's Statement of Jurisdiction misstates both the Legislature's intent in enacting the margin tax and the court of appeals' holding.

## **RESPONSIVE ISSUES PRESENTED**

1. Did the lower courts properly hold that Gulf Copper is entitled to subtract cost of goods sold under Texas Tax Code Section 171.1012(i) because it furnishes labor and materials to projects for the drilling of offshore oil wells by rebuilding the oil rigs pre-contracted to drill offshore?
  - a. Did the lower courts properly hold that Section 171.1012 allowed Gulf Copper to subtract its costs of producing rig components affixed to those offshore oil rigs?
  - b. Did the lower courts properly hold, under Section 171.1014(b), that the Comptroller may not isolate Sabine Surveyors from Gulf Copper's combined group and treat it as a separate taxable entity?
2. Did the lower courts properly hold, under Section 171.1011(g)(3), that Gulf Copper may exclude from revenue the payments it made to subcontractors for services, labor, and materials in connection with the actual or proposed construction of real property (*i.e.*, the drilling of oil wells)?
  - a. Did the lower courts properly hold that Gulf Copper may alternatively include these subcontractor payments in its COGS subtraction?
3. [Unbriefed] During a four-day bench trial, Gulf Copper presented 1,075 pages of business and accounting records detailing the nature and treatment of its costs, as well as two days of testimony by Gulf Copper's Chief Financial Officer explaining how the company's costs were eligible for inclusion in its cost of goods sold subtraction. Does this constitute "no evidence"?

TO THE HONORABLE SUPREME COURT OF TEXAS:

**STATEMENT OF FACTS**

The Comptroller's Statement of Facts cherry-picks among the trial court's findings to mischaracterize the nature of Gulf Copper's business. The voluminous record supports the following facts, which are directly responsive to the Comptroller's recitation.

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.RR26). These areas span the globe and vary in climate, water depth, and subsurface geology. (3.RR.21-22, 26-28). They are also subject to differing governmental regulations. (2.RR.96-97, 177-180; 6.RR.P.Ex.9-10, 44). Once the rig owner has a contract to drill, the conditions present in the specific areas inform the rig owner of the work required to rebuild the rig and, thereby, Gulf Copper's contractual scope of work. (2.RR.92-94, 95-96). When Gulf Copper completes its work under the contract, the rig will be able to drill safely and effectively into the oil and gas formations, withstand the marine environment, and satisfy mandatory certification standards and governing regulations imposed in the specific area. (CR.297, FOF.16-17).

With these considerations in mind, the rig owner subjects the rigs to various surveys 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). If Gulf Copper gets the contract, 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). Gulf Copper then performs manufacturing work described in the Statement of Facts in Gulf Copper's Petition for Review, using both employees and subcontractors working side-by-side. Rig owner representatives and marine classification society inspectors remain onsite to oversee and approve of the work performed by Gulf Copper. (2.RR.91, 93).

## **INTRODUCTION**

The Comptroller's Petition for Review is rooted in misstatements of both the Legislature's intent in enacting the margin tax and the court of appeals' holding. Contrary to the Comptroller's unsupported assertions, the Texas Legislature did not revamp the franchise tax to limit and restrict deductions in exchange for a lower tax rate. Comptroller's Petition at x. In 2006, the Legislature revised the franchise tax to impose a tax on margin. Its purpose was two-fold: to achieve fairness amongst taxpayers and to eliminate rampant tax avoidance. 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.*, Rep. of the Tex. Tax Reform Comm’n (March 29, 2006), (Appx.1),<sup>1</sup> at cover letter, 1, 2, 15. A 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 on their assets, while the growing service sector largely escaped taxation. *See id.* 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 remedied these inequities by expanding the list of taxable entities to include almost all business forms with liability protection, expanding the tax base to reach the growing service sector, and by treating related entities as a single taxpayer that must 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.

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<sup>1</sup> Gulf Copper respectfully requests that this Court take judicial notice of the Report of the Texas Tax Reform Commission, which is publicly available at [https://govinfo.library.unt.edu/ttrc/files/TTRC\\_report.pdf](https://govinfo.library.unt.edu/ttrc/files/TTRC_report.pdf) (last accessed August 20, 2018).

H.B. 3, 79th Leg., 3rd C.S. (Tex. 2006), (Appx.2);<sup>2</sup> 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.3).<sup>3</sup>

Therefore, our Legislature's purpose in enacting the margin tax does not support the Comptroller's request for this Court to reverse the lower courts' holdings that Gulf Copper is entitled to the exclusions and subtractions sought.<sup>4</sup> Comptroller's Petition at x. Rather, the decisions rendered by the lower courts further the Legislature's intent to (1) preserve the health of economy-driving industries, like offshore drilling, and (2) to promote fairness and uniformity by construing exclusions and subtractions

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<sup>2</sup> "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, which is publicly available at <https://capitol.texas.gov/BillLookup/Text.aspx?LegSess=793&Bill=HB3> (last accessed August 20, 2018).

<sup>3</sup> Gulf Copper respectfully requests that this Court take judicial notice of this May 2015 Texas Comptroller of Public Accounts article, which is publicly available at <https://comptroller.texas.gov/economy/fiscal-notes/archive.php> (last accessed August 20, 2018).

<sup>4</sup> For example, the 2013 Legislature ratified this purpose when it enacted clarifying amendments to the revenue exclusion at issue here to stop the Comptroller from applying the provision inconsistently with industry practice. Gulf Copper respectfully requests that this Court take judicial notice of Senate Research Ctr., Bill Analysis, Tex. H.B. 2766, 83rd Leg., R.S. 2013, which is publicly available at <https://capitol.texas.gov/BillLookup/Text.aspx?LegSess=83R&Bill=HB2766> (last accessed August 20, 2018), (Appx.4).

allowed by the statute to calculate “margin.” Yet, the Comptroller ignores these underlying policies and compounds his errors by claiming that the subtraction and exclusion at issue should be treated like a tax exemption to be strictly construed against business entities and for which a higher burden of proof is required. Comptroller’s Petition at 24. These arguments impose additional, extra-statutory roadblocks that defy legislative intent.

Moreover, the Comptroller’s Petition for Review erroneously states that the Third Court held that “service providers” could subtract cost of goods sold (“COGS”) without selling goods. Comptroller’s Petition at xi. That issue was not even before the court. Both courts held, *and the Comptroller unequivocally agreed*, that Gulf Copper qualified to claim the COGS subtraction. (CR.296-301); *Hegar v. Gulf Copper & Manuf. Corp.*, 535 S.W.3d 1, 7, 19-20 (Tex. App.—Austin 2017, pet. filed). Until now, the dispute concerned only the scope of the costs that Gulf Copper could subtract. Similarly, the lower courts did not hold that taxpayers could exclude revenues from margin simply because they were paid under a contract. Comptroller’s Petition at xi. Rather, the courts held that Gulf Copper could exclude from its revenues the payments made to its subcontractors because they satisfied *all* of the elements of Section 171.1011(g)(3). Nonetheless, the Comptroller asks this Court to uphold his audit positions – full denial of the revenue exclusion and cutting Gulf

Copper's COGS from \$152 million to \$77 million – which essentially converts Gulf Copper's tax base from margin to a distorted figure bearing no relation to gross profits. In doing so, The Comptroller increases Gulf Copper's franchise tax by **326%**.

Gulf Copper's Petition for Review presents the critical issues that capital-intensive industries face. While Texas could once tout itself as a business-friendly state, the Comptroller's attempts to tax in excess of the governing statutes has created an unfriendly business environment – which is especially problematic in light of the United States Supreme Court's recent decision in *South Dakota v. Wayfair*. *S. Dakota v. Wayfair, Inc.*, 138 S. Ct. 2080 (2018).

The *Wayfair* Court removed disincentives to expanding across state lines. *Id.* at 2094. Accordingly, many out-of-state businesses will likely consider expanding their operations into other states, including Texas. However, the Comptroller's administration of the margin tax presents a substantial disincentive – ask any of the Texas businesses currently petitioning this Court for review of their COGS subtractions. *Hegar v. Autohaus LP, LLP*, 514 S.W.3d 897 (Tex. App.—Austin 2017, pet. filed); *Hegar v. Sunstate Equip. Co., LLC*, No. 03-15-00738-CV, 2017 WL 279602 (Tex. App.—Austin Jan. 20, 2017, pet. filed) (mem. op.); *American Multi-Cinema, Inc. v. Hegar*, No. 03-14-00397-CV, 2017 WL 74416 (Tex. App.—

Austin Jan. 6, 2017, pet. filed) (mem. op.). Or, ask those businesses facing huge tax assessments with no access to any state court to challenge them because they cannot pay them in full. *Hegar v. EBS Sols., Inc.*, No. 03-17-00506-CV, 2018 WL 1885170 (Tex. App.—Austin Apr. 20, 2018, pet. filed) (mem. op.); *Hegar v. CHZP, LLC*, No. 03-17-00214-CV, 2018 WL 3150839 (Tex. App.—Austin June 28, 2018, no pet.); *Hegar v. Compass Directional Guidance, LLC*, No. 03-17-00597-CV (Tex. App.—Austin filed Sept. 12, 2017), No. D-1-15-003797 (419<sup>th</sup> Judicial Dist. Ct., Travis County, Tex.).

Therefore, Gulf Copper asks this Court to grant its Petition for Review and to deny the Comptroller’s Petition for Review, as the latter seeks unwarranted review of issues properly decided by the courts below – such as the exact same revenue-exclusion issue that his office already argued and lost in *Titan Transp., L.P. v. Combs*, 433 S.W.3d 625 (Tex. App.—Austin 2014, pet. denied).

## **ARGUMENT**

### **I. GULF COPPER IS ENTITLED TO THE COGS SUBTRACTION ON TWO SEPARATE GROUNDS.**

Gulf Copper qualifies to subtract cost of goods sold (“COGS”) on two separate grounds. The Comptroller’s Petition for Review improperly rejects both.

**A. Gulf Copper Produces and Sells Goods in the Ordinary Course of Business.**

Despite previously conceding that Gulf Copper is entitled to subtract its cost of goods sold because it produced and sold goods, the Comptroller's Petition for Review now relabels Gulf Copper's work as "repair" and "outfitting" to misclassify Gulf Copper's business as a "service" for which he argues no COGS subtraction is allowed. Comptroller's Petition at 4, 5-6, 14-15. In doing so, the Comptroller blurs the issue of whether Gulf Copper *qualifies* for the subtraction with the types of costs that may be *included*. Thus, the Comptroller's Petition for Review is premised upon a mischaracterization of both the statute and Gulf Copper's business.

The sandblasting, coating, and painting of components for rigs and other vessels are not "services" independent from Gulf Copper's production process. Comptroller's Petition at 4, 14-15. They are intermediate steps in Gulf Copper's manufacturing process. In each phase, Gulf Copper physically alters the product sold in substantial and functional ways to create the final product. Thus, the trial court properly concluded that, except for the costs disallowed or limited by Section 171.1012, Gulf Copper is entitled to subtract its eligible costs incurred at each phase of its manufacturing process and should not be subjected to the artificial limits imposed by the Comptroller's auditor. *See* 34 Tex. Admin. Code § 3.588(b)(7) (defining "production" to

include “installation occurring during the manufacturing or construction process”).

**B. Gulf Copper Furnishes Labor and Materials to Projects for the Construction of Offshore Oil and Gas Wells.**

Gulf Copper also qualifies for the COGS subtraction because it furnishes labor and materials to projects for the drilling of oil and gas wells. The Comptroller’s position was properly rejected by the lower courts because it imposes extra-statutory requirements, ignores a detailed evidentiary record, and creates harmful taxing policy.

**1. The Comptroller advances extra-statutory requirements that harm taxpayers and the market.**

In March of 2018, the Comptroller amended his COGS rule. 43 Tex. Reg. 1640 (2018) (to be codified as an amendment to 34 Tex. Admin. Code § 3.588) (Comptroller of Public Accounts), (Appx.5). Although these amendments do not apply to Gulf Copper’s report year at issue, the Comptroller now advances them to deny Gulf Copper the COGS subtraction.

Specifically, the Comptroller relies upon portions of the Texas Property Code to assert that Gulf Copper did not furnish labor or materials to offshore projects. Comptroller’s Petition at 10-12. Notably, however, Section 171.1012 neither expressly states nor incorporates by reference the statutory lien and “direct prosecution” requirements advanced by the Comptroller. This Court

should decline the Comptroller's invitation to write these requirements in because, aside from contravening the statute's plain language, they create harmful taxing policy.

The property code's materialmen's lien is a pro-business rule that promotes the financial stability of the construction and oil and gas industries, which are of prime importance to this state. In contrast, the Comptroller's lien requirements preclude many within these industries, including Gulf Copper, from subtracting their costs. In doing so, the Comptroller creates a non-uniform tax base that does not equate to margin. Because the Comptroller's extra-statutory requirements transform a pro-business rule into an anti-business rule without any statutory or policy support, this Court should reject them.

**2. Gulf Copper satisfies the plain language of Section 171.1012(i).**

The COGS statute is broad and should not be re-written by the Comptroller. The statute only requires that the taxable entity furnish labor or materials to projects involving certain real estate activities, such as the drilling (construction) of oil wells. The statute does not require the taxable entity to engage in the specific construction activities, such as drilling.

Under the statute's plain language, Gulf Copper is entitled to subtract the costs associated with its initial, intermediate, and final phases of its work

on rigs contracted to perform specific drilling projects. After hearing four days of evidence, the trial court agreed with Gulf Copper and made detailed findings in support thereof. (CR.297-99, FOF.16-17, 19-20, 29-30). Thus, the Third Court properly recognized that Gulf Copper was entitled to subtract the costs generated by all phases of its work to rebuild offshore rigs pre-contracted to drill in specific project areas. However, the court remanded the case, in error, for unnecessary factual development because it mistakenly believed that Gulf Copper's customers might contract to rebuild an oil rig when there was no drilling contract in place. But the record is clear and judgment should be rendered in Gulf Copper's favor, as Gulf Copper's Petition requests.

**C. Sabine Surveyors Should Not Be Taxed in Isolation.**

Sabine Surveyors is a member of Gulf Copper's combined group. (CR.296, FOF.4-5). The mandatory combined reporting requirements transform related taxable entities into a single taxable entity for franchise tax purposes. *See* Tex. Tax Code §§ 171.1014; 171.0001 (17). As a single taxable entity, a combined group may elect only one subtraction to reduce its revenue to margin, even though the individual companies within the group would make different elections if the statute allowed them to do so. Therefore, the Comptroller's attempt to isolate Sabine Surveyors and to deny its costs should be rejected. Otherwise, the combined group rules function

as a penalty, which is contrary to the principles of fairness that drove the tax's enactment. Under the Comptroller's position, combined groups would be penalized by their organizational structure and pay tax on more than margin because some group members would be barred from subtracting any costs incurred to generate taxable revenues.

## **II. GULF COPPER IS ENTITLED TO EXCLUDE SUBCONTRACTOR FLOW-THROUGH FUNDS.**

The Comptroller erroneously asserts that Gulf Copper is not entitled to claim the revenue exclusion under Texas Tax Code Section 171.1011(g)(3) because (1) Gulf Copper's subcontractors' activities were not performed in connection with actual or proposed drilling activities, (2) the subcontractor payments were not mandated by contract, and (3) the subcontractor payments did not constitute flow-through funds. Comptroller's Petition at xi, xii, 17. The Comptroller is wrong and his Petition for Review should be denied, just as this Court did in *Titan Transportation, L.P. v. Combs* when the Comptroller made the exact same arguments. 433 S.W.3d 625 (Tex. App.—Austin 2014, pet. denied).

The purpose of the revenue exclusion is to prevent a taxpayer from paying franchise tax on someone else's revenue in industries where use of subcontractors is prevalent. *Id.* at 628, 639. Yet, the Comptroller insists upon imposing extra-statutory requirements and advancing litigating

positions that are incongruent with industry practice and create market distortions both within and across Texas industries.

For example, without the revenue exclusion for subcontracting payments, industries that rely heavily upon subcontractors would bear a much greater margin tax burden than others because subcontractors' revenues would be included in both the contractor's and the subcontractors' tax bases. To remedy this disparity, the Legislature drafted a broad a revenue exclusion relating to real-estate activities. Similarly, under the Comptroller's litigating position, cost-plus agreements satisfy the revenue exclusion's contractual mandate requirement, but fixed-price agreements do not – even though the contractor would pay his subcontractors the same amount under either contract type. As a result, a contractor using fixed-price agreements would have a much higher margin tax bill than a competitor who uses cost-plus agreements because the Comptroller would deny him the benefit of the revenue exclusion.

Therefore, the Court should deny the Comptroller's Petition for Review, thereby leaving in place the revenue exclusion standard articulated by the lower courts and their holdings that Gulf Copper was entitled to exclude qualifying payments to subcontractors from its margin tax calculation (or, alternatively, include them in its COGS subtraction).

**PRAYER**

Counter-Petitioner Gulf Copper and Manufacturing Corporation respectfully prays that this Court deny the Comptroller's Petition for Review and grant Gulf Copper's Petition for Review.

Respectfully submitted,

**MARTENS, TODD, LEONARD & AHLRICH**

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## **CERTIFICATE OF COMPLIANCE**

I hereby certify that this Response to Petition for Review 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 2,858 words, excluding any parts exempted by Tex. R. App. P. 9.4(i)(1).

*/s/James F. Martens*

James F. Martens

## **CERTIFICATE OF SERVICE**

Pursuant to the Texas Rule of Appellate Procedure 9.5, a true and correct copy of the foregoing was served on counsel below via e-mail and e-service on the 21st day of August 2018.

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## **APPENDIX**

1. Report of the Texas Tax Reform Commission (March 29, 2006)
2. Senate Committee on Finance, Bill Analysis, Tex. H.B. 3, 79th Leg., 3rd C.S. (Tex. 2006)
3. Josh Haney & Bruce Wright, *The History of the Texas Franchise Tax*, Fiscal Notes Newsletter from the Office of Glenn Hegar, Texas Comptroller of Public Accounts, May 2015
4. Senate Research Center, Bill Analysis, Tex. H.B. 2766, 83rd Leg., R.S. 2013
5. 43 Tex. Reg. 1640 (2018)