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Hope Remains For Texas Drilling Tax Breaks After Court Loss

By **Jess Davis**

Law360, Dallas (June 20, 2016, 10:16 PM ET) -- A Texas Supreme Court ruling denying a tax break for certain oil and gas drilling equipment, which allegedly would have cost the state billions in refunds, wasn't a total loss for the energy industry, with the justices leaving room for such an exemption for more advanced equipment, experts say.

The high court on Friday **rejected arguments** from Southwest Royalties Inc., a subsidiary of Clayton Williams Energy Inc., that it was entitled to a tax exemption for oil and gas drilling equipment like casing and tubing under a state tax law that covers "manufacturing, processing and fabrication." Texas had said it could have lost more than \$4.4 billion in revenue had the court found in favor of Southwest Royalties, given the large number of similar tax refund claims that have been filed.

But while the court found Southwest Royalties' drilling activity didn't constitute processing under the statute, the court didn't wholly adopt a construction of the statute advanced by the comptroller's office: that mineral extraction is categorically excluded from the exemption because the law is restricted to processing and fabrication activities performed during manufacturing.

By agreeing with Southwest Royalties that "processing" of hydrocarbons need not be part of a manufacturing process to come within the exemption provided by Section 151.318 of the Texas Tax Code, the court provided Texas oil and gas companies with some favorable authority for future cases, leaving open the door that oil and gas companies can qualify for tax exemptions on their equipment, Zachary Jones of Gardere Wynne Sewell LLP said.

"This decision did not give the comptroller the statutory reading it wanted," Jones said. "The extraction of oil and gas is not disqualified from being 'processing' if someone can show the facts. This case has given a road map, solidifying what you need to show to be considered a processor, and if a case were built around these terms, it would be a different outcome."

Southwest Royalties had claimed it was entitled to the exemption because its equipment was used to "process" hydrocarbons extracted from an underground reservoir, separating them into component parts like oil and gas to make them ready to sell, and thus falling into a statutory requirement equipment be used to "directly make or cause a chemical or physical change" to the product being sold. It was seeking about a half-million-dollar tax refund, for equipment purchased between 1997 and 2001.

The state argued oil and gas exploration companies are not manufacturers, saying extracting minerals and bringing them to the surface is not manufacturing. The comptroller's office took the position equipment like Southwest Royalties' is instead considered part of transportation.

Ultimately, the court relied on trial findings that though physical changes do occur in hydrocarbons during the drilling process, the changes were directly caused by temperature and pressure changes as the hydrocarbons moved upward toward the surface — not by Southwest Royalties' equipment.

"If someone came back in and was able to show their equipment in fact did do something that met the definition of the comptroller, the exemption would still be available," Joe Hull of Bracewell LLP said.

Hull said given the technological advances in the oil and gas industry since the time period at issue for Southwest Royalties, equipment has surely been developed that does cause the types of physical changes required by statute, and would qualify for the tax exemption.

Future disputes over the tax exemption will come down to factual showdowns over whether a taxpayer can prove a given piece of equipment or a service is considered part of the manufacturing process, instead of being used to transport petroleum or gas products from one point to another, he said. Products used for transportation — moving hydrocarbons from underground to the surface without directly changing them — don't fall under the manufacturing tax exemption.

"It all boils down to whether you can prove the equipment causes a direct, physical change to the product you're planning to sell," Steve Moore of Jackson Walker LLP said.

In other industries, the distinction can be easier to draw, Moore said.

For example, in manufacturing electricity, the turbines that generate and make the electricity are exempt, substations that change the voltage of the electricity are exempt, but transmission line materials like poles and wires are not exempt, because they're used for transporting the electricity. At an automobile manufacturing plant, all the equipment used to build a car — stamping, painting or welding, anything that causes a direct physical change to the steel or plastic — is exempt, while equipment used to move cars around on the floor from one place to the next is considered transportation, he said.

But when it comes to underground drilling, it gets complicated to prove, with engineers typically needed to explain the technology and the physical changes happening to hydrocarbons pulled from reservoirs below the surface, Moore said. Companies that want to claim the exemption need to be prepared to explain their technology in a way that makes clear some processing has happened, he said.

"You're going to have to be able to really document it in a way the comptroller's office respects," Moore said.

The fact-intensive nature of determining whether subsurface, high-tech drilling equipment should be classified as "processing" means other companies pursuing refunds today don't have a clear idea if they'll win, Todd Lowther of Thompson & Knight LLP said. Nor do companies that sell the equipment have a clear picture of whether they're required to collect sales tax on those products, he said.

"Ultimately, the way to make clear how this exemption applies or not comes down to legislative action," Lowther said.

Lowther said the statute is so open to interpretation and argument that courts could face a slew of complicated cases arguing over whether a specific piece of equipment used by a specific company falls under the exemption. Rather than leaving the question to the judiciary to decide piecemeal when the exemption applies, state lawmakers can give the industry clarity quickly by defining state policy for how the exemption applies to the oil and

gas industry, Lowther said.

In the policy debate, the state has a valid concern that it would lose out on billions in revenue if it had to refund or stop collecting sales tax on drilling equipment. On the other hand, oil and gas prices are still depressed, and the legislature may want to provide some incentives to the industry, he said.

Whichever policy argument wins out, clarity and certainty on that question would be better for everyone, Lowther said.

Southwest Royalties is represented by Bryan A. Garner and Karolyne H.C. Garner of LawProse Inc., David E. Keltner of Kelly Hart & Hallman LLP, and Mark W. Eidman and Doug Sigel of Ryan Law Firm LLP.

The comptroller's office is represented by Michael P. Murphy of the Texas Office of the Attorney General.

The case is Southwest Royalties Inc. v. Hegar et al., case number 14-0743, in the Supreme Court of the State of Texas.

--Editing by Katherine Rautenberg and Aaron Pelc.

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