

## INSIGHTS

## Sales Tax Exemption for Manufacturing Held Inapplicable for Oil and Gas Equipment, but Questions Remain

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*Southwest Royalties, Inc. v. Hegar*, No. 14-0743 (Tex. June 17, 2016) (“*Southwest*”), addresses the applicability of a sales tax exemption for property sold for use in manufacturing in the context of oil and gas production. Although the taxpayer, an oil and gas production company, ultimately lost, as it had at the agency, trial court, and appellate court levels, the Court declined to reach a conclusion on several arguments in the case, leaving unresolved questions in the area.

By way of background, Texas, like most states, taxes sales of personal property and certain services. Unless a specific exemption applies, there is a presumption that all sales of tangible personal property and taxable services are subject to tax in the state.<sup>1</sup> Certain sales are exempt, such as sales for resale, sales to certain purchasers (such as educational institutions), particular types of transactions (such as certain sales of entire businesses), or sales of property for particular uses (such as manufacturing of tangible personal property, as was at issue in *Southwest*). Many states provide exemptions from sales tax for sales of property purchased for use in the manufacture of tangible property. These manufacturing exemptions may be based on a principle that equipment purchased for use in manufacturing tangible personal property for ultimate sale is conceptually similar to products purchased for resale, unlike a typical sale at retail. Alternatively, or additionally, these exemptions may be motivated by a desire to incentivize manufacturing activities. Some states exempt entire industries (e.g., Texas generally exempts the newspaper industry and Arkansas generally exempts the oil and gas industry), but the definition of “manufacturing” varies among the states. There is no general rule as to whether oil and gas production activities constitute manufacturing activities, nor is there a general rule as to what types of equipment may be considered used in manufacturing activities.

The litigation in the *Southwest* matter began in 2014 when Southwest Royalties, Inc. sued the State of Texas, claiming that it was entitled to a refund of sales taxes it paid on purchases of certain property used in oil and gas production under the statutory sales tax exemption titled, “Property Used in Manufacturing.”<sup>2</sup> The statute provides an exemption from sales tax for sales to a manufacturer for use of certain items including:

[T]angible personal property directly used . . . during the actual manufacturing, processing, or fabrication of tangible personal property . . . **if the use . . . of the property is necessary or essential to the manufacturing, processing, or fabrication operation and directly makes or causes a chemical or physical change to:**

(A) **the product being manufactured, processed, or fabricated for ultimate sale;** or

(B) any intermediate or preliminary product that will become an ingredient or component part of the product being manufactured, processed, or fabricated for ultimate sale[.]

Tex. Tax Code Ann. § 151.318(a)(emphasis added).

With respect to the above statute, *Southwest* holds, first, that the statutory language is not ambiguous. This conclusion is significant because the Comptroller's interpretation of the statute is not entitled to judicial deference (as unambiguous language is by definition clear and does not need administrative interpretation), and that the "[l]egislature intended 'processing' . . . to mean the application of materials and labor necessary to modify or change characteristics of tangible personal property" for purposes of the sales tax exemption for manufacturing equipment.

In *Southwest*, the opinion addresses the concept of "processing" that may be eligible for the statutory exemption. The particular equipment at issue was "casings, tubing, other well equipment, and associated services," for use in oil and gas production. The opinion describes a "casing" as "a steel pipe that it is inserted into a borehole that keeps the borehole from collapsing" and the "tubing" as "a smaller tube that hangs inside the casing." The opinion further explains that hydrocarbons move through the casing and tubing system where they undergo physical changes when they separate into liquid and gas components during their journey from underground reservoirs to the surface level (with the liquid component in the tubing and the gas component between the tubing and casing).

In its analysis, the opinion focuses on the role of the equipment with respect to the physical changes to the hydrocarbons. Southwest argued that "it proved its equipment was used for 'processing' because it was used in separating the hydrocarbons into their component parts[.]" Texas argued that "even if extraction is processing, the changes the hydrocarbons undergo during their movement to the surface are directly caused by natural pressure and temperature changes, not Southwest's equipment." Ultimately, the court sided with Texas, holding that "Southwest did not prove that the equipment for which it sought a tax exemption was used in 'actual manufacturing, processing, or fabricating' of hydrocarbons." The Supreme Court stated that its conclusion "turns on the fact that the trial court did not find, and there is no evidence that, the equipment was applied to cause changes in their characteristics as the hydrocarbons moved from the reservoir to the surface." As discussed below, the Court did not make a determination as to whether hydrocarbons were tangible personal property or whether oil and gas production was manufacturing.

Additionally, before the opinion reached its ultimately narrow conclusion, it cited Merriam-Webster's Collegiate Dictionary to define the word "used" as "employed in accomplishing something," and the word "actual" as "existing in act and not merely potentially." The opinion then states that although the equipment in question was "used in" the "efficient recovery of hydrocarbons," and that such hydrocarbons underwent physical changes while traveling through the equipment, the company failed to prove that its equipment was the direct cause of physical changes to the hydrocarbons. The opinion does not analyze the significance of the dictionary definition of the word "actual," although the statute does use the word, as in, "actual manufacturing, processing, or fabrication."

Next, the opinion in dicta addresses a distinction between direct and indirect causal connections in the context of "processing," noting that "direct" causation "implies a close link with no intervening causes" and that in a prior case construing the manufacturing sales tax

exemption, another court required that property used in manufacturing must directly be used to modify or change characteristics of tangible personal property in order to qualify as exempt from sales tax. The court observed, in discussing direct causation as a requirement for the exemption in another matter, that “[t]his is similar to the situation here where natural pressure and temperature changes are, as the trial court found, the direct causes of the changes to the hydrocarbons and the equipment was an indirect cause.” In further dicta, the opinion lists examples of property that qualified as equipment used in processing or manufacturing according to agency interpretations of the statute, which it notes are not binding on the Court in any event, including, inter alia, dynamite used to blast rock in the process of reducing large boulders to gravel, explosives used to blast rock in processing gravel and sand, and equipment used to break and shatter limestone and shale into pieces in processing cement.

Also, *Southwest* does not discuss a 1997 amendment to the statute, but the amendment is worth mentioning because it provides further context. The Texas legislature amended Section 151.318(a)(2) by inserting “directly” and “and directly makes or causes a chemical or physical change to” to limit the manufacturing exemption.<sup>3</sup> The State amended the statute after two cases interpreted the exemption more broadly (allowing a sales tax exemption for the purchase of equipment if the equipment was “actually” used in manufacturing rather than requiring a direct causal relationship between the equipment and modifications to the tangible personal property being processed).

Finally, the *Southwest* opinion mentions several of the parties’ arguments (as well as amicus briefs filed on behalf of Southwest Royalties, Inc.) on issues that the case does not resolve. These arguments include whether oil and gas production generally is excluded from the sales tax exemption. The government’s position is that oil and gas producers are not “manufacturers” and oil and gas production is not “processing” for several reasons, including that there is a specific sales tax exemption for certain equipment sold for use in offshore oil and gas exploration (specifically including “drill pipe, casing, tubing, and other pipe”),<sup>4</sup> and that the presence of the specific exemption indicates that the legislature needed to enact such an exemption because this type of equipment generally is not exempt. Also, the opinion notes that the Comptroller’s longstanding position is that mineral extraction alone, meaning, in general, transportation of minerals from a reservoir to the surface, without directly causing any physical or chemical change, is not “processing.” Other unresolved issues include disagreements as to whether minerals, such as hydrocarbons, become tangible personal property when severed from a reservoir or continue to be real property while they are still underground, despite that the minerals have been severed from a reservoir, during the process of extraction. The Texas Supreme Court did not reach a conclusion on the issue of when, exactly, minerals transition from being real property to tangible personal property for sales tax classification purposes.

The case ultimately concludes that the particular equipment in question was not exempt manufacturing equipment. The opinion found that the equipment was not used in “processing” within the meaning of the statute since the company did not prove that the equipment directly caused any physical or chemical changes to the hydrocarbons, and the manufacturing exemption defines “processing” to encompass only equipment that directly makes or causes a chemical change to the property being manufactured or processed. The case did not address the larger questions of oil and gas production in the context of manufacturing generally.

If you would like to discuss the decision and its impact, please contact one of the following members of Bracewell's tax team:

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<sup>1</sup> Tex. Tax Code Ann. §151.051; Tex. Tax Code Ann. §151.010.

<sup>2</sup> Tex. Tax Code Ann. § 151.318

<sup>3</sup> See Fiscal Note, Tex. HB 1855, 75th Leg., RS (1997); *Sharp v. Tyler Pipe Indus., Inc.* 919 S.W.2d 157 (Tex. App.-Austin 1996) (“The Texas statute contains no restriction such as that determined by the Ohio court to be imposed by the term “directly.” . . . [w]e do not construe the term “actual” to prohibit the existence of any intervening medium or agent in the manufacturing process.”); See also *Sharp v. Chevron Chemical Co.*, 924 S.W.2d 429 (Tex. App.-Austin 1996) .

<sup>4</sup> Tex. Tax Code Ann. § 151.324.