



New Texas Case Creates Possible Sales Tax Refund Opportunities for Oil and Gas Exploration and Production Companies

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In a recent ruling from the bench in *Southwest Royalties Inc. vs. Combs*, Cause D-1-GNU-09-004284 (Travis County 250th Dist. Ct.), Judge John Dietz overturned longstanding Texas Comptroller policy and expanded the sale and use tax manufacturing exemption to include certain items used to extract oil and gas from wells. If upheld on appeal, the April 12, 2012, ruling will create significant refund opportunities and prospective tax savings for the oil and gas industry. Taxpayers having potential refunds as a result of this case should consider filing protective refund claims as soon as practical to avoid loss of refunds due to expiration of statute of limitations while the case is being appealed. Of course, any refund will be contingent on the case being upheld on appeal. The case definitely will be appealed, and there is considerable uncertainty about the outcome of the appeals process.

Texas imposes sales tax on all sales of tangible personal property in Texas or for use in Texas unless an exemption applies. One such exemption applies to manufacturing equipment, defined by statute as equipment "used . . . during the actual manufacturing, processing, or fabrication of tangible personal property for ultimate sale if the use or consumption of the property is necessary or essential . . . and directly makes or causes a chemical or physical change to . . . the product being manufactured, processed, or fabricated for ultimate sale" Texas Tax Code section 151.318(a)(2). Historically, in the context of oil and gas drilling and production, the Texas Comptroller has recognized that this exemption applies to certain surface processing equipment such as separators and gun barrels, but has denied the exemption to extraction equipment on the theory that such equipment does not cause the necessary physical or chemical change to oil and gas in order to qualify for exemption.

In *Southwest Royalties Inc.*, the court disagreed with the Comptroller's policy, finding that machinery and equipment used to extract oil and gas from wells was eligible for the sales tax exemption because the extraction processes caused a physical change in the hydrocarbons in the formation and in the wellbore. The specific scope of extraction items qualifying for exemption under the judge's ruling will be clarified when the judge issues a written ruling, which is expected in several weeks. However, the refund claim at issue in the case included casing, tubing, wellhead, and pumping equipment, as well as related supplies—a potentially very broad class of newly exempt items.



The Texas Comptroller has already stated that the application of the judge's ruling could result in a refund liability to the state of \$2 billion and future annual losses of approximately \$500 million in uncollected taxes on the newly exempted equipment. The Comptroller will appeal the ruling. During the trial, the Comptroller not only argued that the "chemical or physical change" requirement had not been satisfied, but also argued strenuously that as a matter of law the manufacturing exemption does not apply to the exploration and production of minerals. We expect the Comptroller to pursue both positions as well as other arguments on appeal. Moreover, in light of the revenue implications, we expect that the Texas legislature in its 2013 session will carefully consider possible legislative changes to address or overturn the judge's ruling.

Oil and gas companies that have purchased and paid Texas sales and use tax on items used to extract oil and gas should consider filing protective refund claims to safeguard their refund opportunities during the period the case makes its way through the appeals process. Texas imposes a four-year statute of limitations on sales tax refund claims, applied on a month-by-month basis. By filing a protective refund claim now, oil and gas companies will avoid the possible loss of refunds for taxes paid on qualifying items purchased four years prior to each month of the period during which the case is being appealed.

For more information on the matters discussed in this *Locke Lord QuickStudy*, please contact the authors:

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