

Texas Ruling Could Expand the Scope of the Manufacturing Exemption from Sales or Use Tax to Equipment Used in Oil and Gas Extraction

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In a recent Texas bench ruling, in the case of *Southwest Royalties, Inc. v. Combs*, Case D-1-GNU-09-004282 (Travis County 250th Dist. Ct.), the court expanded the Texas sales or use tax exemption for manufacturing property to include certain items of tangible personal property such as well casing and certain “down-hole” equipment used to extract oil and gas from wells.

Texas imposes a sales or use tax upon all items of tangible personal property sold or used in Texas unless an exemption applies. One such exemption applies to the purchase of equipment used for manufacturing. The “manufacturing exemption,” applies, in relevant part, to

property used or consumed in or 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 to the manufacturing, processing, or fabrication operation and directly makes or causes a chemical or physical change to the product being manufactured or processed for ultimate sale or to any intermediate or preliminary product that will become an ingredient or component part of the product being manufactured or processed for ultimate sale. (Texas Tax Code section 151.318(a)(2)).

The Texas Comptroller has a long-standing policy of excluding extraction equipment used in the oil and gas drilling and production process from the manufacturing exemption from sales or use tax. The Comptroller determined that such equipment was not used in manufacturing and even if it were, it did not cause a chemical or physical change to the oil and gas extracted from a well. The taxpayer in *Southwest Royalties* challenged the policy and claimed that the well casing and “down-hole” equipment it purchased to extract oil and gas from wells was used to directly cause a physical change to a product or an intermediate or preliminary product. The taxpayer in *Southwest Royalties* claimed that approximately 50 items of tangible personal property that it acquired for use in the extraction process were exempt from Texas sales tax. These items included casing, tubing, wellhead, and pumping equipment.

After trial, the judge in *Southwest Royalties* announced from the bench for the taxpayer that he agreed that the equipment was essential to the oil and gas extraction process and was used to cause a physical change in the hydrocarbons and the wellbore. Until the written opinion of the court is issued, however, it is unclear whether the court's decision applies to each item of equipment listed by the taxpayer. No final judgment has been entered yet, and the court still has plenary power to change its decision in any manner.

The Texas Comptroller has claimed that the application of the *Southwest Royalties* decision could give rise to a \$2 billion refund liability and a significant future loss of sales tax revenue. Thus, it is expected that the Comptroller will appeal the court's decision. Accordingly, until a final judgment is entered by the court and the appeals are exhausted, it is unclear whether oil and gas equipment used in the extraction process will be exempt from Texas sales tax. Oil and gas companies that paid sales tax upon the acquisition of such equipment should nonetheless consider timely filing protective claims for refunds to preserve their claims because Texas provides for a four-year period to claim a refund for sales taxes paid and the appeals process may not be completed in that time.

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