TEXAS COURT OF APPEALS, THIRD DISTRICT, AT AUSTIN

NO. 03-14-00713-CV

Glenn Hegar, Comptroller of Public Accounts of the State of Texas, and Ken Paxton, Attorney General of the State of Texas, Appellants

v.

CGG Veritas Services (U.S.), Inc., Appellee

FROM THE DISTRICT COURT OF TRAVIS COUNTY, 353RD JUDICIAL DISTRICT NO. D-1-GN-12-001316, HONORABLE TIM SULAK, JUDGE PRESIDING

M E M O R A N D U M O P I N I O N

CGG Veritas Services (U.S.), Inc. (CGG) sued Glenn Hegar, Comptroller of Public Accounts of the State of Texas, and Ken Paxton, Attorney General of the State of Texas (collectively, the State), seeking a refund of franchise taxes that CGG paid under protest.[1] *See* Tex. Gov't Code §§ 403.201-.221 (governing protest suit after payment under protest); Tex. Tax Code §§ 112.001-.156 (governing taxpayer suits). CGG asserted that the State erroneously disallowed its "cost of goods sold" (COGS) deduction for the 2008 tax year.[2] The State filed a counterclaim asserting that

[1] This appeal was originally filed in the names of Susan Combs, predecessor to the present Comptroller of Public Accounts of the State of Texas, Glenn Hegar, and Greg Abbott, predecessor to the present Attorney General of the State of Texas, Ken Paxton. Hegar and Paxton have been automatically substituted as appellants pursuant to Texas Rule of Appellate Procedure 7.2(a).

[2] *See* Act of May 19, 2006, 79th Leg., 3d C.S., ch.1, § 5, 2006 Tex. Gen. Laws 1, 8 (amended 2013) (current version at Tex. Tax Code § 171.101(a)) (allowing taxpayer to elect to deduct COGS from total revenue); Act of May 19, 2006, 79th Leg., 3d C.S., ch.1, § 5, 2006 Tex. Gen. Laws 1, 13-16, *as amended by* Act of June 15, 2007, 80th Leg., ch. 1282, §§ 14, 15, 2007 Tex. Gen. Laws 4282,

CGG overstated its Research and Development Credit (R&D Credit) for the relevant tax year, resulting in an underpayment of taxes. After a bench trial, the trial court concluded that CGG was entitled to the COGS deduction. The parties stipulated to an agreed amount for the R&D Credit, and the trial court rendered judgment that CGG's tax due for the 2008 tax year was $1,721,022.23. On appeal, the State asserts that the trial court erroneously interpreted and applied the tax provision governing the COGS deduction and that, as a matter of law, CGG could not take the COGS deduction. The State also maintains that, in the event CGG is entitled to a COGS deduction at all, because CGG failed to segregate its qualifying costs from its nonqualifying costs, it failed to meet its burden to "conclusively establish that a tax was overpaid and the amount of the overpayment." We will affirm the trial court's judgment.

DISCUSSION

This Court has recently provided overviews of the current Texas franchise-tax scheme, originally enacted in 2006, which assesses franchise taxes against a taxable entity's "taxable margin." *See American Multi-Cinema v. Hegar*, No. 03-14-00397-CV, 2015 WL 1967877 (Tex. App.—Austin Apr. 30, 2015, no pet.) (mem. op.); *Titan Transp., LP v. Combs*, 433 S.W.3d 625, 627-29 (Tex. App.—Austin 2014, pet. denied); *Combs v. Newpark Res., Inc.*, 422 S.W.3d 46, 47-48 (Tex. App.—Austin 2013, no pet.). The franchise-tax statute has been substantively amended several times since its enactment, and the provisions applicable to this case are those that were in effect on

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4290-91 (amended 2013) (current version at Tex. Tax Code § 171.1012) (governing calculation of COGS deduction).

January 1, 2008.[3] Under that version of the franchise-tax statute, after calculating total revenue the taxpayer computed its "taxable margin" by first determining its "margin." *See* Tex. Tax Code § 171.101(a)(1) ("The taxable margin of a taxable entity is computed by . . . determining the taxable entity's margin."). The "margin" is the lesser of (1) 70% of the taxable entity's total revenue or (2) the taxable entity's total revenue minus, at the entity's election, either cost of goods sold, as determined under section 171.1012 (the COGS calculation) or compensation, as determined under section 171.1013 (the compensation calculation). *See* Act of May 19, 2006, 79th Leg., 3d C.S., ch. 1, § 5, 2006 Tex. Gen. Laws 1, 8, *as amended by* Act of June 15, 2007, 80th Leg., ch. 1282, § 11, 2007 Tex. Gen. Laws 4282, 4287 (amended 2013) (current version at Tex. Tax Code § 171.101).[4]

CGG is a "fully-integrated geoseismic" company whose clients are companies that explore for and produce oil and gas. CGG's activities include acquiring seismic data for its clients and processing that data to generate images of the subsurface of the earth that aid in the clients' efforts to produce oil and gas from onshore and offshore locations. The underlying tax protest concerns CGG's 2008 franchise-tax report, specifically its inclusion of a $567,600,223 COGS deduction in its margin calculation. When calculating its margin for the 2008 tax year, CGG elected to employ the COGS calculation, that is, to determine its margin by subtracting from its total revenue an amount for cost of goods sold, as determined under section 171.1012. CGG determined that,

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[3] Citations in this opinion will be to the current version of the Tax Code only when intervening amendments are not relevant to the disposition of the issues on appeal.

[4] Not relevant to this case is the option to use the E-Z computation method to determine margin for taxable entities whose total revenue is $10 million or less. *See* Tex. Tax Code § 171.1016 (E-Z computation method and rate for taxpayers with no more than $10 million in total revenue).

under section 171.1012, it was entitled to a COGS deduction in the amount of $567,600,223. *See* Tex. Tax Code § 171.1012 (governing calculation of COGS deduction).

After conducting a "desk audit," the Comptroller determined that CGG "did not qualify for the cost of goods deduction."[5] The Comptroller characterized CGG as a service provider that could not claim a COGS deduction. Accordingly, the Comptroller defaulted to a 30% flat deduction on $1,052,170,534 of total revenue, applied a 51% apportionment factor and a 1% tax rate to the entire sum, and recalculated CGG's franchise-tax obligation to produce a $1,301,568.86 deficiency for the relevant tax year, having credited CGG's prior payment. CGG paid the assessed deficiency, plus interest, under protest. Along with its protest, CGG submitted a letter to the Comptroller explaining its reasons for including the COGS deduction in its margin calculation.

Thereafter, CGG filed the underlying suit, seeking a refund of amounts paid under protest. *See id.* §§ 112.051-.060 (governing tax protest suits). CGG asserted that the costs it included in calculating its COGS deduction were incurred exclusively for the "construction, repair, or industrial maintenance of oil and gas wells, which are real property" and therefore includable in the COGS deduction pursuant to Tax Code subsection 171.1012(i). CGG relied specifically on the third sentence of this subsection, which provides:

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[5] The "desk audit" consisted of the Comptroller's auditor reviewing CGG's 2008 franchise-tax report, information CGG posted on its website about its business activities, and CGG's responses to a questionnaire the auditor had sent to CGG with a letter stating that the review was "not an audit" but "[did] not preclude an audit" on the same time period in the future. The auditor did not speak to anyone at CGG or inspect its facilities, equipment, job locations, or business records. Instead, the decision to deny the COGS deduction was based on the auditor's conclusion, after reviewing CGG's responses to the questionnaire and the company's website, that it "appears that the primary business is a service" and that CGG's business activities "appear[] to be related to the service of licensing seismic data, or processing seismic data for customers."

> A taxable entity furnishing labor or materials to a project for the construction, improvement, remodeling, repair, or industrial maintenance [] of real property is considered to be an owner of that labor or materials *and may include the costs*, as allowed by this section, in the computation of cost of goods sold.

Id. § 171.1012(i) (emphasis added). In the alternative, CGG asserted that the audio and visual recordings it sells qualify as "goods" under section 171.1012(a)(3)(A) because they are sound recordings, images, or sound intended to be mass-distributed by CGG by selling them to as many customers as possible. *See id.* § 171.1012(a)(3)(A) (including in definition of "goods" sound recordings, images, or sounds intended to be mass-distributed by their creator). The State continued to maintain that CGG provides only services to oil and gas exploration and production companies and does not sell anything that meets the statutory definition of "goods."[6]

At trial, the evidence concerning CGG's business operations was essentially uncontrovered. On appeal, the State asserts that the parties are in agreement regarding the work CGG actually performs, but that the State and CGG disagree "as to what statutory label should apply to its business activities." CGG counters that, while its position is that it does produce and sell "goods," that question is ultimately irrelevant because it is entitled to take the COGS deduction by virtue of the fact that it "furnishes labor and materials to a project for the construction of real property."

The State does not dispute that an oil and gas well constitutes "real property" for purposes of section 171.1012(i). Thus, if CGG furnishes "labor and materials" to a project for the

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[6] The term "goods" is defined as "real or tangible personal property sold in the ordinary course of business of a taxable entity." *Id.* § 171.1012(a)(1). "Tangible personal property," however, "does not include (i) intangible property; or (ii) services." *Id.* § 171.1012(a)(3)(B). The State characterizes CGG as a service provider that cannot claim a COGS deduction.

construction of oil and gas wells, it is entitled to include the costs of that labor and materials, as allowed by section 171.1012, in the computation of its cost of goods sold, and deduct that amount from its total revenue to calculate its "margin" for franchise-tax purposes. The parties are in sharp disagreement as to whether CGG does, in fact, furnish labor and materials to projects for the construction of oil and gas wells or, as the State contends, provides only "services" to companies engaged in the exploration and production of oil and gas. The question presented, then, is whether CGG's activities constitute "labor and materials" furnished to a project for the construction of an oil and gas well within the meaning of subsection 171.1012(i).

This Court recently examined the meaning of "labor" as that term is used chapter 171 of the Tax Code. *See Newpark Res.*, 422 S.W.3d at 54-57. In *Newpark Resources* we observed:

> Although we agree that the separate listing of services and labor in section 171.1011(g)(3) indicates that they encompass different concepts, the fact that the terms are listed separately does not mean they are mutually exclusive. Furthermore, the fact that section 171.1011(g)(3) indicates that labor and services have distinct meanings does not provide us with clear guidance as to what that distinction is. Neither term is defined in the statute, and the ordinary definitions of labor and services substantially overlap such that both definitions tend to refer to the words interchangeably.

Id. at 54 (internal citations omitted). We then considered the meaning of the word "labor" in the context of subsection 171.1012(i), a provision we concluded was intended to allow a taxable entity supplying labor or materials to a project for the construction of real property to deduct its labor or material expenses as if they were a cost of goods sold. *Id.* at 56. We held that the term "labor" as used in subsection 171.1012(i) has the same meaning as in section 171.1012 generally, which permits taxable entities to deduct "all direct costs of acquiring or producing" goods, including "labor costs."

Id. Finally, given the common definition of the term "labor," which encompasses a "wide range of activities, including 'expenditure of physical or mental effort especially when fatiguing, difficult, or compulsory,'" we concluded that the legislature intended section 171.1012 to permit taxable entities to deduct a wide range of labor expenses, including those associated with activities that might also be described as a "service." *Id.* ("We look to the facts of this case to determine whether NES's services, put in the context of Newpark's overall services, qualify as labor for the construction or improvement of real property."). The analytic framework for determining whether a particular "labor cost" is includable as a cost of goods sold under subsection 171.1012(i), therefore, requires determining whether the particular activity is an essential and direct component of the "project for the construction . . . of real property." *Id.* (trial court could reasonably have concluded that removal and disposal of waste material was labor furnished to project for construction of oil and gas well based on trial testimony that this activity was essential to continue drilling of oil and gas well).

The result of this appeal is largely dictated by the following relevant findings of fact of the trial court, which the State does not challenge on appeal:

> FOF 5: CGG's customers are generally oil and gas exploration and production companies.
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> FOF 6: Customers purchase, license, and use CGG's seismic and sound recordings and images to determine where to explore and drill for oil and gas.
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> FOF 7: CGG's seismic services and products are an integral, essential, and direct component of the oil and gas drilling process.
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> FOF 8: In performing seismic work, CGG furnishes labor, including the expenditure of employee effort to acquire seismic data and to create seismic surveys and images.

FOF 9: As a necessary part of the seismic labor furnished by CGG, CGG furnishes materials, such as dynamite, geophones, airguns, marine vessels, and vibroseis trucks.

FOF 10: CGG creates and furnishes seismic sound recordings and images to customers for use in oil and gas drilling projects.

Based on these findings, the trial court concluded that CGG furnished labor and materials to projects for the construction, improvement, remodeling or repair of oil and gas wells within the meaning of subsection 171.1012(i).[7] Unchallenged findings of fact are binding on an appellate court unless the contrary is established as a matter of law or there is no evidence to support the finding. *McGalliard v. Kuhlmann*, 722 S.W.2d 694, 696-97 (Tex. 1986). The trial court's finding that CGG's seismic services and products are an "integral, essential, and direct component" of the drilling process is amply supported by record evidence. For example, there was evidence that seismic data provides a "roadmap" or "blueprint for the project," which CGG's customers use "as a guide [for] where to drill the wells, [and] how deep to drill the wells." There was also evidence that an oil and gas exploration and production company cannot reasonably go out and drill a well without the information CGG provides. Thus, as we did in *Newpark Resources*, we hold that the trial court in the present case could reasonably have concluded that the seismic data acquisition and processing CGG performs for its oil and gas exploration and production company customers is "labor furnished to a project for the construction of real property."

On appeal, the State argues that the trial court erred in concluding that CGG was entitled to a COGS deduction because, even if CGG's activities qualify as "labor and materials"

[7] The trial court also concluded that oil and gas wells constitute real property for purposes of subsection 171.1012(i), a conclusion of law that the State does not challenge.

within the meaning of subsection 171.1012(i), they are too far removed from the construction of an oil and gas well to qualify for that deduction. *See Newpark Resources*, 422 S.W.3d at 57 ("Admittedly, other cases may present a close issue as to when labor is too far removed from the construction, improvement, remodeling, repair, or industrial maintenance of real property to qualify for the cost-of-goods-sold deduction under section 171.1012(i)."). Relatedly, the State argues that subsection 171.1012(i) is self-limiting, permitting only the deduction of the costs associated with actually furnishing the labor and materials to a project, and does not, as CGG argues, create an alternate pathway for a taxable entity to be treated as producing "goods" and therefore entitled to every type of deduction available under section 171.1012.

Implicit in the statutory scheme is that some of a taxable entity's activities in a given case may be of a type that would not qualify as deductible under subsection 171.1012(i); that is, they might not constitute an actual *cost of* the labor or materials furnished to a project for the construction of real property. Similarly, there is also a point at which the relationship of a taxable entity's activities to a particular project is so attenuated that the expenses related to those activities may not constitute the costs of furnishing labor and materials *to* that project. However, in this case the State made no attempt in the trial court to make any such distinction regarding CGG's activities. Rather, the State took the position that, as a matter of law, CGG was not entitled to take a COGS deduction *at all*.[8] Thus, the State failed to preserve the argument that while CGG may have been permitted to include some of its expenses in a COGS deduction, it was not entitled to include the

[8] At trial the State stated that "we're not fighting them on [CGG's costs], except as to whether they're eligible for them." The Comptroller's auditor agreed that he "did not challenge any of the categories or the amounts" reflected on CGG's COGS calculation spreadsheet.

entire $567,600,233. The State insists that it need not have attempted to present evidence of which of CGG's expenses were too attenuated to qualify for a COGS deduction because they were all associated only with a "potential project." The State argues that, at the time CGG provides seismic data and processing to its customers, no well construction has actually occurred and there is no existing project to which CGG could furnish any labor or materials. Thus, according to the State, none of CGG's costs were associated with furnishing labor *to* a project. This argument ignores evidence in the record that CGG's surveying can take place before or after a well is drilled and that CGG often engages in what it describes as "4D" projects in which it processes seismic data related to mature, producing fields to identify the location of additional hydrocarbons.

The evidence does not conclusively establish that CGG's seismic data acquisition and processing activities were not, as the trial court found, integral to the drilling process, which the parties do not dispute is a "project for the construction of real property." Consequently, CGG was entitled to elect to take a COGS deduction. On this record, there is sufficient evidence to support the trial court's judgment that CGG was entitled to claim a COGS deduction in the amount of $567,600,223.

CONCLUSION

Because, on this record, we cannot conclude that the trial court reversibly erred by rendering judgment that CGG could claim a COGS deduction of $567,600,233, we affirm the trial court's judgment.

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Scott K. Field, Justice

Before Chief Justice Rose, Justices Pemberton and Field

Affirmed

Filed: March 9, 2016