TEXAS COURT OF APPEALS, THIRD DISTRICT, AT AUSTIN

NO. 03-16-00771-CV

NTS Communications, Inc., Appellant

v.

Glenn Hegar, Comptroller of Public Accounts of The State of Texas; and Ken Paxton, Attorney General of The State of Texas, Appellees

FROM THE DISTRICT COURT OF TRAVIS COUNTY, 250TH JUDICIAL DISTRICT NO. D-1-GN-13-000168, HONORABLE GISELA D. TRIANA, JUDGE PRESIDING

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

This is a suit for tax refund filed pursuant to section 112.151 of the Texas Tax Code. The trial court rendered a take-nothing judgment against the taxpayer after disposing of cross-motions for summary judgment and obtaining an agreed stipulation as to remaining issues of fact. We will affirm the judgment of the trial court.

BACKGROUND

This dispute arises from an attempted amendment to the 2008 franchise tax report filed with the Comptroller of Public Accounts by NTS Communications, Inc. The parties characterize the relevant facts as undisputed but join issue on the extent to which NTS can deduct certain expenses as costs of goods sold under the Texas franchise tax statutes.

NTS is a telecommunications provider based in Lubbock, Texas, and offers its customers Internet access, landline telephone service, and online video streams. The parties refer to these collectively as the "telecom products" and individually as, respectively, the "Internet product," the "telephone product," and the "video product."[1] NTS also sells landline phones and accessories.

In its motion for summary judgment, NTS described the telecom products as follows:

> Plaintiff's telephone product enabled its customers to make both local and long distance calls. Plaintiff's Internet product provided its customers with either dial-up or digital subscriber lines broadband access to the Internet. Plaintiff's video product enabled its customers to receive streaming video and audio on their televisions via Internet connections.

NTS incorporated this description into its briefs on appeal, and we accept the description as accurate. *See* Tex. R. App. P. 38.1(g). NTS delivers these telecom products via electrical signals transmitted by fiber-optic, copper, and cable networks.

The State of Texas levies franchise taxes against a taxable entity's "taxable margin," a portion of its total margin.[2] The Tax Code allows NTS to calculate its total margin as the lesser of 70% of NTS's total revenue, which the parties refer to as "the 70% method," or its total revenue minus the cost of goods sold, which the parties refer to as "the COGS method."[3] "The cost of goods

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[1] We will use the parties' language without endorsing any connotation of the word "product" as it might pertain to a distinction between goods and services.

[2] Tex. Tax Code § 171.002(a) (2008). Where not otherwise indicated, all citations to the Texas Tax Code refer to the statutes on January 1, 2008, which govern the disputed tax report.

[3] *See, respectively*, Tex. Tax Code § 171.101(a)(1)(A), (a)(1)(B)(ii)(a). A third method, deduction of certain compensation expenses, is not at issue here. *See id*. § 171.101(a)(1)(B)(ii)(b).

sold includes all direct costs of acquiring or producing the goods." Tex. Tax Code § 171.1012(c). The cost of goods sold does not include the cost of providing services. *Id*. § 171.101(a)(3)(B)(ii). After the total margin is calculated, NTS's taxable margin is determined based on the total margin and several factors not contested here. *Id*. § 171.101(a). Its franchise tax is then calculated by multiplying the taxable margin by the applicable tax rate. *Id*. § 171.002(a).

NTS originally filed its 2008 report using the 70% method and remitted the resulting franchise tax of $327,937. It later filed an amended report in an attempt to use the COGS method to deduct over $60 million, which NTS claims is the cost of the electricity used to generate and transmit the telecom products. The Comptroller concedes that this deduction, if allowed, would result in a reduced tax obligation and thus a refund due to NTS.

After conducting an assessment audit, the Comptroller rejected NTS's attempt to deduct the electricity costs, concluding that the only "goods" sold by NTS are its landline phones and accessories. The Comptroller determined that deducting the costs of those goods would not result in a lower tax obligation under the COGS method than NTS had already calculated and paid under the 70% method. NTS appealed the decision, and the Comptroller referred the matter to the State Office of Administrative Hearings ("SOAH"). In its proposal for decision, SOAH recommended affirming the Comptroller's original decision, and the Comptroller adopted that proposal as its final decision with only minor, non-substantive revisions.

NTS filed a motion for rehearing, which the Comptroller denied. NTS then sued the Comptroller, seeking refund pursuant to section 112.151 of the Tax Code.[4] NTS later added a claim under the Uniform Declaratory Judgments Act ("UDJA") seeking a declaration that—to the extent section 171.1012 does not allow the proposed deduction—the statute violates the Due Process and Equal Protection clauses of the Fourteenth Amendment of the United States Constitution and the uniform taxation clause of the Texas Constitution. *See* Tex. Civ. Prac. & Rem. Code § 37.004(a) (allowing interested persons to seek declaration regarding validity or construction of statutes).

NTS and the Comptroller filed cross-motions for summary judgment. These motions were, for the most part, mirror images of one another, with each motion characterizing the facts as undisputed and asking the court to dispose of the statutory and constitutional arguments as a matter of law. NTS argued that all three telecom products involve the sale of electricity, which is delineated in section 171.1012(c)(12) as a deductible cost of goods sold. The Comptroller argued that NTS does not sell electricity and, with the exception of certain phones and accessories, only sells services. In support of its UDJA claim and underlying constitutional challenge, NTS denied any rational basis for the statutory and regulatory distinction between NTS and taxpayers entitled to a cost-of-goods-sold deduction. The Comptroller urged the trial court to reject the constitutional challenges as meritless and insufficient to support any claim for declaratory relief.

[4] Section 112.151 requires a taxpayer seeking refund to file suit against the Comptroller and the Attorney General, which NTS has done. We will refer to these Defendants/Appellees together as "the Comptroller."

After a hearing on the cross-motions, the trial court denied NTS's motion in full. The court granted the Comptroller's motion in part, accepting the Comptroller's concession that the sale of the landline phones is the sale of a good, holding:

> [NTS] may not include the costs of its Telecom Products in its cost-of-goods-sold deduction under Tex. Tax Code § 171.1012, except for its costs of acquiring or producing the electricity to power its customers' landline telephones and obtain a dial tone. There is a genuine issue of material fact regarding the amount of these costs. With that exception, Defendants' motion is granted.

After obtaining a stipulation that "limiting [NTS's] cost of goods sold deduction to include solely the costs of acquiring or producing the electricity to power its customers' landline telephones and obtain a dial tone would not result in a refund," the trial court entered a take-nothing judgment against NTS. NTS filed timely appeal.

DISCUSSION

NTS contends the trial court erred by denying its motion for summary judgment and in granting, in part, the Comptroller's motion for summary judgment. We review summary judgment de novo. *Adkisson v. Paxton*, 459 S.W.3d 761, 767 (Tex. App.—Austin 2015, no pet.) (op. on reh'g) (citing *Valence Operating Co. v. Dorsett*, 164 S.W.3d 656, 661 (Tex. 2005)). Summary judgment is proper where the pleadings, evidence, and stipulations of record reveal "there is no genuine issue as to any material fact and the moving party is entitled to judgment as a matter of law." Tex. R. Civ. P. 166a(c). "When both sides move for summary judgment, each side must carry its own burden as the movant, and also as the nonmovant . . . ." *Adkisson*, 459 S.W.3d at 776 (citing *City of Garland v. Dallas Morning News*, 22 S.W.3d 351, 356 (Tex. 2000)). "When the trial court grants one side's

motion and denies the other side's motion, as here, we review the summary-judgment evidence presented by both sides, determine all questions presented, and if we find that the trial court erred, we render the judgment that the trial court should have rendered." *Id.* at 768 (citing *City of Garland*, 22 S.W.3d at 356–57). "A taxpayer who sues for a tax refund after an administrative hearing . . . is like a plaintiff in any other cause of action, and hence carries the burden to establish its eligibility to a refund." *GATX Terminals Corp. v. Rylander*, 78 S.W.3d 630, 634 (Tex. App.—Austin 2002, no pet.) (citing *Key W. Life Ins. Co. v. State Bd. of Ins.*, 350 S.W.2d 839, 846 (Tex. 1961)) (other citations omitted).

I. Summary Judgment on NTS's Claim for Refund

The crux of this dispute is whether NTS's telecom products are properly classified as goods or services under section 171.1012 of the Tax Code. In urging a classification of its telecom products as goods, NTS focuses on the electricity used to generate and transmit these telecom products, arguing it is "entitled to include its costs of acquiring or producing electricity transmitted to and for customers as an inherent and inseparable part of its Telecom Products in its deduction." The Comptroller disagrees, arguing that the telecom products NTS characterizes as "goods" are in fact "services" and thus that any associated costs may not be included in the cost of goods sold. The Comptroller further contends that the trial court, by holding the disputed costs not deductible, must have implicitly concluded the telecom products are not goods under section 171.1012. We review this question of statutory construction de novo. *Titan Transp., LP v. Combs*, 433 S.W.3d 625, 636 (Tex. App.—Austin 2014, pet. denied) (citing *State v. Shumake*, 199 S.W.3d 279, 284 (Tex. 2006)).

A. The Telecom Products Are Excluded from the Definition of Goods in 171.1012(a)(3)(A)(i).

"As the Texas Supreme Court has emphasized many times, our 'primary objective' in statutory construction 'is to determine the Legislature's intent which, when possible, we discern from the plain meaning of the words chosen.'" *Paxton v. Texas Dep't of State Health Servs*., 500 S.W.3d 702, 705–06 (Tex. App.—Austin 2016, no pet.) (quoting *Traxler v. Entergy Gulf States, Inc.*, 376 S.W.3d 742, 747 (Tex. 2012)) (other citations omitted). "We must read words and phrases 'in context' and construe them 'according to the rules of grammar and common usage.'" *Id*. (quoting Tex. Gov't Code § 311.011(a)). "'The import of language, plain or not, must be drawn from the surrounding context, particularly when construing everyday words and phrases that are inordinately context-sensitive.'" *Id*. (quoting *City of Rockwall v. Hughes*, 246 S.W.3d 621, 632 (Tex. 2008) (Willett, J., dissenting)). "[W]hen a statute's words are unambiguous and yield but one interpretation, 'the judge's inquiry is at an end.'" *Id.* (quoting *Combs v. Roark Amusement & Vending, L.P.*, 422 S.W.3d 632, 635 (Tex. 2013)).

The legislature restructured the state's franchise tax in 2006. Since then, this Court has been called on to construe the statutory scheme several times.[5] "For purposes of the cost-of-goods-sold deduction, a 'good' is 'real or tangible personal property sold in the ordinary course of business of a taxable entity.'" *Combs v. Newpark Res., Inc*., 422 S.W.3d 46, 53 (Tex.

[5] *See generally Hegar v. Gulf Copper & Mfg. Corp*., 535 S.W.3d 1 (Tex. App.—Austin 2017, pet. filed); *Hegar v. Autohaus LP*, 514 S.W.3d 897 (Tex. App.—Austin 2017, pet. filed); *American Multi-Cinema, Inc. v. Hegar*, No. 03-14-00397-CV, 2017 WL 74416 (Tex. App.—Austin Jan. 6, 2017, pet. filed) (mem. op. on reh'g); *Hegar v. CGG Veritas Servs. (U.S.), Inc*., No. 03-14-00713-CV, 2016 WL 1039054 (Tex. App.—Austin Mar. 9, 2016, no pet.) (mem. op); *Combs v. Newpark Res., Inc*., 422 S.W.3d 46 (Tex. App.—Austin 2013, no pet.).

App.—Austin 2013, no pet.) (quoting Tex. Tax Code § 171.1012(a)(1)). "'Tangible personal property' is further defined as 'personal property that can be seen, weighed, measured, felt, or touched or that is perceptible to the senses in any other manner' . . . ." *Id.* (quoting Tex. Tax Code § 171.1012(a)(3)(A)(i)). Tangible personal property is also defined, in some circumstances, to include "films, sound recordings, videotapes, live and prerecorded television and radio programs." Tex. Tax Code § 171.1012(a)(3)(A)(ii). "'Tangible personal property' does not include . . . services." *Id.* § 171.1012(a)(3)(B)(ii).

We agree with the Comptroller that the statute classifies the telecom products as services. "Services" is not defined in the statute, so we look to "common usage" to interpret the term. Tex. Gov't Code § 311.011. To determine common usage, we consult dictionaries to identify the most "pertinent" definitions. *Newpark Res.*, 422 S.W.3d at 54. Merriam-Webster defines service as "the performance of work commanded or paid by another." *Webster's Third New International Dictionary Unabridged* 2075 (Phillip Gove ed. 2002); *see also Newpark Res.*, 422 S.W.3d at 54 (quoting *id.*). It also defines service as "the provision, organization, or apparatus for conducting a public utility or meeting a general demand," and illustrates this definition with the example of "telephone service." *See Webster's*, *supra*, at 2075. Similarly, Oxford defines service generally as the "supply of the needs of (persons)," and more specifically as "[t]he supply or laying-on of gas, water, etc." *The Compact Oxford English Dictionary* 1719 (2d ed. 1994). It further explains that the term is "[a]lso applied to other facilities, such as electricity, waste disposal, etc., especially provided for domestic use." *Id.* Thus, the most pertinent definitions support the Comptroller's argument that NTS's telecom products, by supplying Internet access, telephone connectivity, and

video streams to private consumers through a network of cables and wires, are considered services as that term is commonly used.

The classification of NTS's telecom products as services is also consistent with this Court's previous explanation that "railroads, telephone companies, and physicians perform services although they produce no goods." *Newpark Res.*, 422 S.W.3d at 54 (interpreting services as it appears in Tax Code section 171.1012 and quoting *Webster's*, *supra*, at 2075). We note, in addition, that NTS's corporate representatives repeatedly referred to its telecom products as "services" at deposition,[6] and that NTS registered with the Comptroller under classification 4813, "establishments furnishing point-to-point communications services,"[7] further underscoring the common understanding that these telecom products are services. Because the telecom products at issue are properly classified as services, NTS may not include the costs of providing those services in its calculation of the cost of goods sold under section 171.1012.

B. NTS Has Not Shown Its Video Product Is a Good under Subsection 171.1012(a)(3)(A)(ii).[8]

NTS argues that even if the telecom products do not satisfy the broad definition of

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[6] *E.g.*, Nissenson Dep. 30:25–31:2, Oct. 1, 2014 ("I'm selling you phone, Internet[,] and video products. I'm using electrical signals to provide you that service."). NTS submitted this and other deposition transcripts in support of its motion for summary judgment.

[7] State Office of Admin. Hearings, *Re: NTS Commc'ns, Inc.*, Docket No. 304-12-6201.13 (Aug. 10, 2012) (proposal for decision).

[8] NTS's motion for summary judgment only raised this argument with respect to the video product, so we limit our analysis to that product. Tex. R. App. P. 33.1; Tex. R. Civ. P. 166a(c).

tangible personal property in subsection (a)(3)(A)(i), its video product satisfies the narrower definition set forth in subsection (a)(3)(A)(ii),which defines tangible personal property to include:

> films, sound recordings, videotapes, live and prerecorded television and radio programs, books, and other similar property embodying words, ideas, concepts, images, or sound, without regard to the means or methods of distribution or the medium in which the property is embodied, for which, as costs are incurred in producing the property, it is intended or is reasonably likely that any medium in which the property is embodied will be mass-distributed by the creator or any one or more third parties in a form that is not substantially altered.

Tex. Tax Code § 171.1012(a)(3)(A)(ii).

The Comptroller contends this subsection is inapplicable because NTS does not sell the films or television programming its customers watch through the video product. NTS disagrees, likening the disputed transactions to those at issue in *American Multi-Cinema, Inc. v. Hegar*. *See generally* No. 03-14-00397-CV, 2017 WL 74416 (Tex. App.—Austin Jan. 6, 2017, pet. filed) (mem. op. on reh'g). *American Multi-Cinema* required us to determine whether a district court had erred in holding, following a bench trial, that a movie theater could include certain costs of showing its films in the calculation of cost of goods sold under section 171.1012. *Id.* at *4. The Comptroller argued there, much as it does here, that the sale of movie tickets in exchange for an opportunity to view a film is not the sale of the film itself. *Id.* at *5. In resolving this question, we relied exclusively on subsection (a)(3)(A)(ii). *Id.* After finding the taxpayer's argument and evidence consistent with the statutory language, we turned to an amendment clarifying the deductions available to movie theaters and confirming the permissibility of the proposed deduction. *Id.* at *7 (citing Act of June 14, 2013, 83d Leg., R.S., ch. 1232, § 10(a), 2013 Tex. Gen. Laws 3104, 3108,

codified at Tex. Tax Code § 171.1012(t) (2014)). In light of the record and the unambiguous language of the amendment, we found no error in the trial court's conclusion. *Id.*

Our narrow *American Multi-Cinema* holding does not reach the present case, as the amendment dispositive of the issue in that context does not apply here. The amendment provides:

> If a taxable entity that is a movie theater elects to subtract cost of goods sold, the cost of goods sold for the taxable entity shall be the costs described by this section in relation to the acquisition, production, exhibition, or use of a film or motion picture, including expenses for the right to use the film or motion picture.

See Tex. Tax Code 171.1012(t) (2014). By its own terms, the amendment only impacts movie theaters.

Moreover, the *American Multi-Cinema* record revealed that the taxpayer's witnesses had demonstrated how the disputed transactions satisfied subsection (a)(3)(A)(ii). We summarized extensive evidence regarding the taxpayer's purchase of the films, its "method[] of distribution," the "medium in which the property [was] embodied," and the taxpayer's role in "producing the property," in addition to evidence regarding mass distribution and substantial alteration. *See* 2017 WL 74416, at *5–6 (applying statutory language to evidence). Here, in its motion for summary judgment and in response to the Comptroller's cross-motion, NTS pointed the trial court to just four pages of testimony to support its argument that the video product should be classified as a good under subsection 171.1012(a)(3)(A)(ii). That testimony includes references to CNN and ESPN, but does not explain how the subsection's definition of "tangible personal property" includes the films and television programming its customers might view through NTS's video product. Nor has NTS pointed the trial court to any evidence it owns those films or television programming. Yet the cost of goods sold may be included in an entity's section 171.1012 calculation "only if that entity owns

the goods." Tex. Tax Code § 171.1012(i). Without evidence supporting its argument, NTS cannot show that its video product is a "good" and therefore cannot generate a genuine issue of material fact regarding its right to the proposed deduction and resulting refund. *Id*. § 112.151(f); *see also Rogers v. Ricane Enters., Inc*., 772 S.W.2d 76, 81 (Tex. 1989) (requiring plaintiff to point trial court to evidence to support arguments at summary judgment); *GATX Terminals*, 78 S.W.3d at 634 (describing taxpayer's burden to establish right to refund).

C. The Mixed-Transaction Rule Does Not Allow the Proposed Deduction.

NTS contends the sale of telecom products has elements of a good and a service and thus that the Comptroller's mixed-transaction rule, 34 Tex. Admin. Code § 3.588(c)(7), allows it to deduct the cost of the electricity used to transmit those products. The Comptroller concluded the rule does not allow such a deduction, and the trial court rendered its order and final judgment without reference to the rule. We review the interpretation of an administrative rule de novo. *Hegar v. Autohaus LP*, 514 S.W.3d 897, 902 (Tex. App.—Austin 2017, pet. filed) (construing administrative rules in same manner as statutes because they have the "same force and effect" as statutes) (citing *Rodriguez v. Service Lloyds Ins. Co.*, 997 S.W.2d 248, 254 (Tex. 1999)).

The mixed-transaction rule provides, "If a transaction contains elements of both a sale of tangible personal property and a service, a taxable entity may only subtract as cost of goods sold the costs otherwise allowed by this section in relation to the tangible personal property sold." 34 Tex. Admin. Code § 3.588. It is undisputed the mixed-transaction rule applies to some of NTS's sales: the parties stipulate that the landline phones and accessories are tangible personal property, and thus that transactions involving a telecommunications service and the sale of phones or

accessories would implicate the mixed-use transaction rule. But the rule only allows the deduction of costs incurred "in relation to the tangible personal property sold." *Id.* The parties agree that, even after deducting every cost associated with those sales, including the electricity necessary for customers to use the phones, NTS would not be entitled to a refund. NTS has not identified any other transactions to which the mixed-transaction rule applies[9] and therefore cannot generate an issue of material fact sufficient to withstand the Comptroller's motion for summary judgment. Tex. R. Civ. P. 166a.

II. Summary Judgment on NTS's Claim for Declaratory Relief

NTS contends the disputed Tax Code provisions and associated regulations, by allowing deductions for the cost of selling goods but not the cost of selling services, violate the Equal and Uniform clause of the Texas Constitution and the Equal Protection and Due Process clauses of the United States Constitution. *See, respectively*, Tex. Const. art. I, § 3; U.S. Const. amend. XIV, § 1. NTS argues the trial court erred by rejecting this challenge and dismissing the associated claim for declaratory relief. We review constitutional questions de novo, subject to the limits of our jurisdiction over the subject matter. *See Alobaidi v. University of Tex. Health Sci. Ctr.*,

[9] NTS contends all its transactions implicate the mixed-transaction rule, arguing electricity is the tangible personal property that, when paired with a service, results in a mixed transaction. We cannot agree with the proposed construction. As already explained, NTS concedes the disputed electricity is "an inherent part" of the telecom products, and we conclude those telecom products are services under the statutory language. *See Texas Orthopaedic Ass'n v. Texas State Bd. of Podiatric Med. Exam'rs*, 254 S.W.3d 714, 719 (Tex. App.—Austin 2008, pet. denied) (acknowledging our obligation to construe rules "in harmony with" underlying statute (citing *Southern Ins. Co. v. Brewster*, 249 S.W.3d 6, 15 (Tex. App.—Houston [1st Dist.] 2007, pet. denied))).

243 S.W.3d 741, 744 (Tex. App.—Houston [14th Dist.] 2007, pet. denied) (determining jurisdiction over constitutional arguments before proceeding to analysis).

We have no jurisdiction over challenges to the constitutionality of the state's franchise tax, as the legislature divested the district court and this Court of jurisdiction over the subject matter through the statute enacting the franchise tax. The statute provides, "The supreme court has exclusive and original jurisdiction over a challenge to the constitutionality of this Act or any part of this Act and may issue injunctive or declaratory relief in connection with the challenge." Act of May 2, 2006, 79th Leg., 3d C.S., ch. 1, § 24, 2006 Tex. Gen. Laws 1, 40; *see also In re Nestle USA, Inc.*, 387 S.W.3d 610, 616 & n.66 (Tex. 2012) (acknowledging exclusive original jurisdiction over constitutional challenges to the state's franchise tax). And NTS's claim for declaratory relief cannot establish jurisdiction where none exists. *See Texas Dep't of Transp. v. Sefzik*, 355 S.W.3d 618, 621–22 (Tex. 2011) ("[T]he UDJA does not enlarge the trial court's jurisdiction but is 'merely a procedural device for deciding cases already within a court's jurisdiction.'" (quoting *Texas Parks & Wildlife Dep't v. Sawyer Trust*, 354 S.W.3d 384, 388 (Tex. 2011)) (other citations omitted)).

CONCLUSION

Having rejected NTS's arguments, we affirm the trial court's judgment.

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Jeff Rose, Chief Justice

Before Chief Justice Rose, Justices Field and Bourland

Affirmed

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