TEXAS COURT OF APPEALS, THIRD DISTRICT, AT AUSTIN

NO. 03-17-00284-CV

Appellant, Nabors Drilling Technologies USA, Inc., Successor by Merger to Ryan Directional Services, Inc.// Cross-Appellants, Glenn Hegar, Comptroller of Public Accounts of The State of Texas, and Ken Paxton, Attorney General of The State of Texas

v.

Appellees, Glenn Hegar, Comptroller of Public Accounts of The State of Texas, and Ken Paxton, Attorney General of The State of Texas// Cross-Appellee, Nabors Drilling Technologies USA, Inc., Successor by Merger to Ryan Directional Services, Inc.

FROM THE DISTRICT COURT OF TRAVIS COUNTY, 53RD JUDICIAL DISTRICT NO. D-1-GN-15-003250, HONORABLE AMY CLARK MEACHUM, JUDGE PRESIDING

MEMORANDUM OPINION

On cross-appeals, the parties dispute portions of the trial court's final judgment rendered in this suit brought by Nabors Drilling Technologies USA, Inc., against the Comptroller and the Attorney General for a refund of sales and use taxes allegedly overpaid. The judgment ordered that Nabors is entitled to a refund of $105,171.75, about $40,000 less than the amount to which Nabors claimed it was entitled. Nabors contends on appeal that the trial court erred in denying the full requested refund for purchases that it claims qualified for an exemption from sales and use taxes under tax code section 151.324(b). *See* Tex. Tax Code § 151.324(b) (exempting from sales and use taxes "drilling equipment" that is built for exclusive use outside Texas). In its appeal, the Comptroller contends that the trial court erred in granting Nabors any refund because it did not prove its entitlement to an exemption from use taxes provided in tax code section 151.330(b).

See id. § 151.330(b) (exempting from use taxes tangible personal property that is moved into Texas, temporarily stored here, and used solely outside Texas). For the following reasons, we will affirm the portion of the trial court's judgment denying Nabors a refund under section 151.324(b), reverse the portion of the judgment awarding Nabors a refund under section 151.330(b), and render judgment that Nabors is not entitled to any refund and shall take nothing on its refund claims.

BACKGROUND

Nabors provides directional-drilling services[1] to customers at their oil- and gas-well drilling sites both in and outside of Texas by building custom "mud motors" and "MWD [measurement while drilling] tools" at its Houston facility that meet individual job specifications. To build the mud motors and MWD tools (collectively, tools), Nabors purchases from vendors both within and outside of Texas various component parts—e.g., rotors, stators, transmissions, batteries, and bearing assemblies. Except for rare, unplanned losses during customer jobs, Nabors does not generally sell the tools to its customers but, rather, deploys them to job sites along with four employees to operate them. The tools are attached to the "drill string" at the customers' drilling sites and, when a job is complete, returned to Nabors's Houston facility where they are disassembled and the resulting component parts are cleaned and stored indefinitely until Nabors needs them for another job. Nabors does not always match the same component parts that were used together in a prior tool when building a later tool.

After the Comptroller audited Nabors for sales- and use-tax compliance for the period of July 1, 2002, through June 30, 2006, and determined that Nabors owed over $3 million in

[1] As found by the trial court, "[d]irectional drilling is drilling non-vertically."

taxes, penalties, and interest, Nabors paid the taxes under protest, sought refunds at the administrative level, and ultimately filed a tax-refund suit under chapter 112 of the tax code seeking "to recover $134,775.67 in sales and use tax overpayments, including audit penalty and interest, $198,786.68 in audit reductions, and statutory interest." *See id.* § 112.151(a), (f) (providing that person may sue Comptroller to recover amount of tax, penalty, or interest that is subject of tax-refund claim and must produce "contemporaneous records and supporting documentation appropriate to the tax or fee for the transactions in question to substantiate and enable verification" of amount of refund claimed). Nabors claimed in its suit that it owed no use taxes for components that were "temporarily stored" in Texas, *see id.* § 151.330(b), and no sales taxes for "drilling equipment" that was used exclusively out-of-state, *see id.* § 151.324(b).

After a bench trial, the trial court concluded that Nabors's in-state purchases are not tax-exempt under section 151.324(b) and that, therefore, Nabors was not entitled to a refund for any of the sales taxes it paid under that section. However, the trial court also concluded that Nabors's out-of-state purchases of items that were used only on out-of-state jobs are tax-exempt under section 151.330(b) and awarded Nabors a refund of use taxes under that exemption. In cross-appeals, Nabors takes issue with the former conclusion, and the Comptroller takes issue with the latter.

DISCUSSION

Burden of proof and standards of review

Tax exemptions are narrowly construed, and the taxpayer has the burden to "clearly show" that an exemption applies. *Southwest Royalties, Inc. v. Hegar*, 500 S.W.3d 400, 404 (Tex. 2016). When a tax exemption is claimed, there is a presumption favoring the taxing entity rather than

the taxpayer. *TracFone Wireless, Inc. v. Comm'n on State Emergency Commc'ns*, 397 S.W.3d 173, 183 (Tex. 2013); *see Bullock v. National Bancshares Corp.*, 584 S.W.2d 268, 272 (Tex. 1979) ("An exemption cannot be raised by implication, but must affirmatively appear, and all doubts are resolved in favor of taxing authority and against the claimant."). We review questions of law, such as the proper construction of statutes, de novo. *Southwest Royalties*, 500 S.W.3d at 404.

In a tax-refund suit, a taxpayer has the burden of proof by a preponderance of the evidence. *See Allstate Ins. Co. v. Hegar*, 484 S.W.3d 611, 615 (Tex. App.—Austin 2016, pet. denied); *GATX Terminals Corp. v. Rylander*, 78 S.W.3d 630, 634, 636 (Tex. App.—Austin 2002, no pet.). Findings of fact in a case tried to the court have the same force and effect as a jury verdict. *Catalina v. Blasdel*, 881 S.W.2d 295, 297 (Tex. 1994). Likewise, findings of fact are reviewable for factual and legal sufficiency according to the same standards as jury findings. *Id.* A party who challenges the legal sufficiency of an adverse finding on which it bore the burden of proof must demonstrate on appeal that there is no evidence to support the finding and that the evidence conclusively established all vital facts in support of the contrary finding. *GATX Terminals*, 78 S.W.3d at 641.

Sales and use taxes generally

A sales tax is imposed on each sale of a taxable item in this state. Tex. Tax Code § 151.051(a). For taxable items purchased out-of-state, a tax in the form of a "use tax" is imposed on the storage, use, or other consumption in this state, at the same tax rate as the sales tax. *See id.* §§ 151.101(a), (b) (imposing use tax and establishing rate), .303(a) ("The storage, use, or other consumption of a taxable item the sale of which is subject to the sales tax is exempted from the use tax . . . ."). Tangible personal property that is shipped or brought into this state by a purchaser is

presumed to have been purchased from a retailer for storage, use, or consumption in this state, absent evidence to the contrary. *Id.* § 151.105(a).

Drilling-equipment exemption

Tax code section 151.324(b) (the drilling-equipment exemption) exempts from sales and use taxes any

> [d]rilling equipment that is used for the exploration for or production of oil, gas, sulphur, or other minerals, that is built for exclusive use outside this state, and that is, on completion, removed forthwith from this state.

Id. § 151.324(b). Thus, to be entitled to the exemption, the taxpayer must prove several things: (1) the property for which the exemption is claimed constitutes drilling equipment (a term undefined in the tax code); (2) the equipment is used for the exploration or production of oil, gas, sulphur, or other materials; (3) the equipment was "built" (another undefined term) for exclusive use outside of Texas; and (4) the equipment was removed forthwith from Texas after being built. *See id.* The parties' dispute involves the first and third requirements.

In its first issue, Nabors contends that the trial court's legal conclusion that Nabors's "purchases of the Purchased Items are not tax-exempt under Tex. Tax Code § 151.324(b)" is erroneous because the evidence "conclusively proves" that Nabors met the requirements of the exemption. Nabors seeks a refund quantified by the percentage of Purchased Items that its records show were in fact used exclusively on out-of-state jobs during the audit period. The Comptroller counters that the exemption does not apply to the Purchased Items because they are merely "component parts" that are built by Nabors into drilling equipment (i.e., not "drilling equipment"

themselves) but that, even if the exemption does facially apply to Nabors's "builds" of the tools from component-part purchases, Nabors did not meet its burden of proving that the tools were "built for exclusive use outside" Texas. We agree with the Comptroller on this latter point and, therefore, need not resolve the parties' dispute about whether the Purchased Items constitute "drilling equipment" or merely "components" of drilling equipment. For the purposes of our analysis, we will assume that Nabors's building of tools out of the Purchased Items brings the items under the purview of the exemption—that is, that the first requirement of the exemption has been met. We therefore consider whether Nabors conclusively proved the third requirement: that the "drilling equipment" [i.e., the mud motors and MWD tools] for which it sought tax refunds were "built for exclusive use outside this state." *See id.*

The term "use" is defined broadly in the tax code:

> Except as provided by Subsection (c) of this section,[[2]] "use" means the exercise of a right or power incidental to the ownership of tangible personal property over tangible personal property, including tangible personal property other than printed material that has been processed, fabricated, or manufactured into other property or attached to or incorporated into other property transported into this state, and, except as provided by Section 151.056(b) of this code, includes the incorporation of tangible personal property into real estate or into improvements of real estate whether or not the real estate is subsequently sold.

Id. § 151.011(a). The definition further provides that

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[2] Nabors concedes that subsection (c) is inapplicable to the instant case because it involves the sale by the purchaser of tangible personal property or taxable services, and it is undisputed that Nabors does not sell the mud motors and MWD tools that it builds except in rare circumstances of loss.

> Neither "use" nor "storage" includes the exercise of a right or power over or the keeping or retaining of tangible personal property for the purpose of:
> (1) transporting the property outside the state for use solely outside the state; or
>
> (2) processing, fabricating, or manufacturing the property into other property or attaching the property to or incorporating the property into other property to be transported outside the state for use solely outside the state.

Id. § 151.011(f).

Employing this definition of "use," we consider whether the evidence conclusively established that Nabors built the mud motors and MWD tools out of the Purchased Items at issue "for exclusive use outside the state." The trial court made the following unchallenged findings of fact:[3]

- In order to build mud motors and MWD tools, Nabors purchased items ("the Purchased Items") from vendors both in Texas and outside of Texas.
- After procuring the Purchased Items, Nabors would temporarily move [them] to its facility in Houston. At the facility, Nabors would built [sic] mud motors and MWD tools out of the Purchased Items.
- Nabors purchased more Purchased Items when the inventory levels reached a certain level. The purchases were to replenish stock.
- At the time Nabors purchased a Purchased Item, Nabors did not document the intended place of use of the Purchased Item.
- Mud motors and MWD tools were not built until Nabors needed one for a specific job in a specific location.
- For the time period at issue, Nabors had no evidence concerning how long Purchased Items stayed in inventory before being shipped to a customer drill site as part of a mud motor or MWD tool.

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[3] In its second issue, Nabors does challenge a few of the trial court's other findings, but a review of those findings is not necessary to disposition of this appeal, and we therefore do not address them.

- After Nabors built mud motors and MWD tools, it used them on jobs at customer sites both in Texas and out of Texas. For some, but not all, of the Purchased Items, Nabors tracked the State in which those Purchased Items were used as part of mud motors and MWD tools.

- All of the tracked items were reusable Purchased Items that could potentially be used on more than one job.

- Nabors tracked the State of use for 1,561 reusable Purchased Items. Of those 1,561 reusable Purchased Items, 502 (32.16%) were used only on out of state jobs during the Period. . . . Nabors projected that 32.16% of all reusable Purchased Items were only used on out-of-state jobs and were therefore tax-exempt under Tex. Tax Code §§ 151.324(b) and 151.330(b).

- Nabors did not track the State of use for non-reusable Purchased Items such as batteries and seals.

- Nabors estimates that 53.91% of its purchases of non-reusable Purchased Items were only used on out-of-state jobs.

- The mud motors and MWD tools must be temporarily returned to Nabors'[s] facilities between jobs.

- Nabors does not track any Purchased Items between jobs.

- After arriving back in Houston after a job, the mud motors and MWD tools are disassembled. The reusable Purchased Items are cleaned and stored until they are built into new tools for new jobs.

- The reusable Purchased Items are reassembled in Houston into new mud motors and MWD tools for new jobs. They are not always matched with the reusable Purchased Items that they were matched with when they were part of mud motors and MWD tools used on previous jobs.

These findings conclusively show that from its first incorporation of any particular Purchased Item into a mud motor or MWD tool, Nabors intended that the item would (1) later be returned to its

Houston facility (where it would be disassembled and cleaned or disposed of if non-reusable[4]) and (2) remain in Houston for an indefinite period until it was eventually reassembled into a new tool for a future job at an *unknown* location, possibly *within* the state. In other words, the evidence shows that Nabors did not know the situs of future use of any Purchased Items *at the time* the items were purchased or were first incorporated into a built tool. On this record, Nabors did not prove that any items were incorporated into equipment that was "built for exclusive use" outside Texas because it did not *know* or *intend* that the items would be so exclusively used. To that end, for example, Nabors did not prove that it designated the intended place of use of items upon either their purchase or incorporation into a built tool, thereby ensuring that those specifically designated items would be used only out of state so as to qualify their purchase for the exemption.

Furthermore, Nabors could not meet its burden by relying on the trial court's finding that some of the reusable Purchased Items—502 of them—*happened* to have been used only on out-of-state jobs.[5] The evidence did not show that those particular items were built into motors or tools *for the purpose of being used exclusively outside the state*, which is what the exemption requires. We conclude that, because Nabors's business model anticipates that reusable Purchased Items will be used several times over in different tool configurations, it was incumbent upon Nabors to prove

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[4] Non-reusable Purchased Items are single-use items such as batteries and seals. Because Nabors indisputably did not track where non-reusable Purchased Items were used, as a matter of law it cannot claim a refund for those items under the drilling-equipment exemption because it has no means to prove that *any* of the non-reusable items were built into mud motors or MWD tools *for exclusive use outside of Texas*.

[5] For the purposes of this analysis we assume, without deciding, that the exemption permits multiple iterations of drilling equipment built out of items that are repeatedly removed and returned to the state.

that it intended each of those items for which it seeks the exemption to be used only out of state. The evidence does not conclusively show that Nabors met this burden.

In any event, even if Nabors could meet its burden under the drilling-equipment exemption by proving that certain items turned out to have been used only on out-of-state jobs, Nabors does not cite any evidence in the record, nor have we found any, linking the 502 specific items that it tracked as having been used exclusively outside Texas to the invoices, purchase orders, or other supporting documentation from which a specific calculation of allegedly overpaid taxes could be computed. *See Baker v. Bullock*, 529 S.W.2d 279, 281 (Tex. Civ. App.—Austin 1975, writ ref'd n.r.e.) (noting that in tax-refund suit, taxpayer has burden not only to prove that tax was overpaid but also exact amount of overpayment); *see also* Tex. Tax Code §§ 111.0041(c) ("A taxpayer shall produce contemporaneous records and supporting documentation appropriate to the tax or fee for the transactions in question to substantiate and enable verification of the taxpayer's claim related to the amount of tax, penalty, or interest to be assessed, collected, or refunded in an administrative or judicial proceeding."), 112.151(f) (outlining same burden for refund suits). In other words, Nabors did not prove *which* 502 purchases constituted the exempt ones due to its alleged use of the items exclusively out of state. Rather, it attempted to prove the amount of its refund by claiming that, because 32.16% of the items *that it tracked*[6] were used exclusively outside of Texas, it is entitled to a refund based on the assumption that 32.16% of *all* purchases were used only outside of Texas. However, without supporting documentation demonstrating the exact

[6] Nabors does not identify any evidence in the record indicating what portion of its *total* purchases during the audit period the 502 tracked items constituted.

amount of allegedly overpaid taxes for the 502 items, Nabors failed to meet its burden. *See Baker*, 529 S.W.2d at 281.

Nabors has failed to identify any evidence in the record that conclusively shows its entitlement to a refund, and the exact amount thereof, under the drilling-equipment exemption. Accordingly, the trial court did not err in determining that Nabors is not entitled to a refund under the exemption provided in section 151.324(b).

Temporary-storage exemption

Section 151.330(b) (the temporary-storage exemption) provides:

> The temporary storage of tangible personal property acquired outside this state and then moved into this state is exempted from the use tax imposed by Subchapter D of this chapter if after being moved into this state the property is stored here temporarily and:
>
> (1) is used solely outside this state; or
>
> (2) is physically attached to or incorporated into other tangible personal property that is used solely outside this state.

Tex. Tax Code § 151.330(b). Thus, to be entitled to the temporary-storage use-tax exemption, a taxpayer must prove that the tangible personal property at issue (1) is stored in Texas "temporarily" (a term undefined in the tax code) after being moved into the state and (2) is then used solely outside Texas (either on its own or as attached to or incorporated into other tangible personal property). *See id.* The parties dispute whether Nabors proved both requirements.

In his first issue as cross-appellant, the Comptroller specifically contends that the trial court erred in concluding that Nabors is entitled to a refund under this exemption because the

Purchased Items are not "temporarily" stored in Texas due to the fact that they are repeatedly stored in the state for indefinite periods of time at Nabors's pleasure, citing *ETC Marketing, Ltd. v. Harris County Appraisal District*, 528 S.W.3d 70, 80–81 (Tex. 2017) (considering whether property in form of natural gas stored at taxpayer's facility is located within Texas for "longer than a temporary period" for purpose of determining whether it is subject to state taxation and determining that gas's being held at pleasure of taxpayer discredits taxpayer's "temporary" assertion). In his second issue, the Comptroller contends that the temporary-storage exemption does not apply because Nabors "uses" the Purchased Items in Texas, rather than exclusively outside the state, whenever it brings them to Houston for disassembly, cleaning, and storage in between jobs. In other words, the Comptroller posits that disassembly and cleaning constitute "use." Thirdly, the Comptroller contends that, in any event, Nabors did not meet its evidentiary burden to prove that any *particular* Purchased Item was exempt by virtue of its having been used "solely outside this state" *and* the exact amount of the claimed exemption—for instance, by linking documentation of the purchase of a specific item to documentation showing where that item was used. We conclude that the Comptroller's first and third issues have merit and are dispositive; accordingly, we need not reach his second issue.

In considering whether Nabors met its burden to "clearly show" that the exemption applies, *Southwest Royalties*, 500 S.W.3d at 404, we are mindful that tax exemptions are narrowly construed, *id.*, and there is a presumption in favor of the Comptroller and against the taxpayer, *TracFone Wireless*, 397 S.W.3d at 183. We also note that there is a presumption that property brought into the state by a purchaser was purchased for use, storage, or consumption in this state, and that "storage" is defined in the tax code as "the keeping or retaining for any purpose in this state of

tangible personal property sold by a retailer." *See* Tex. Tax Code §§ 151.011(d), .105(a). There is no question that Nabors "stores" the Purchased Items in Texas, subjecting the purchases to the use tax *absent* Nabors meeting its burden to prove that (a) its storage of the items after bringing them into Texas is only "temporary"[7] and (b) the items are then used solely outside the state. We conclude that Nabors did not meet this burden.

The evidence conclusively showed that Nabors routinely and repeatedly stored the Purchased Items in its Houston warehouse in between jobs. While the plain words of the exemption do not explicitly include or exclude *multiple* episodes of "temporary storage," we find that its substantive phrases contemplate only *one* initial period of temporary storage before an item is permanently removed from the state. Specifically, the exemption provides that "*after* being moved into this state" the property is "stored here temporarily" and then "used solely outside the state," *see id.* § 151.330(b) (emphasis added), implying that the property is not returned to Texas for more storage.

Furthermore, Nabors's repeated storage periods of indeterminate duration[8] are more akin to ordinary, generic storage (i.e., "retaining for any purpose," *see* Tex. Tax Code § 151.011(d)) than the type of storage implied by the modifier "temporary" (i.e., "lasting for a time only," *see* Webster's 3rd New Int'l Dictionary 2353 (2002)). The trial court found that "Nabors purchased more Purchased Items when the inventory levels reached a certain level. The purchases were to

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[7] The word "temporary," although not defined in the tax code, ordinarily refers to a limited duration. *Allstate Ins. Co. v. Hegar*, 484 S.W.3d 611, 625 (Tex. App.—Austin 2016, pet. denied); *see* Webster's 3rd New Int'l Dictionary 2353 (2002) (defining "temporary" as "lasting for a time only : existing or continuing for a limited time : IMPERMANENT, TRANSITORY").

[8] In an unchallenged finding, the trial court found that "[f]or the time period at issue, Nabors had no evidence concerning how long Purchased Items stayed in inventory before being shipped to a customer drill site as part of a mud motor or MWD tool."

replenish stock." Such behavior supports our determination that Nabors's storage of the items is ordinary taxable storage rather than tax-exempt temporary storage—essentially, Nabors's storage constitutes perpetual retention of purchased inventory, punctuated by intermittent periods of use of the inventory in built tools. In any event, at best the exemption is ambiguous as to whether it contemplates multiple periods of temporary storage. Because of our mandate to strictly construe exemptions and resolve all doubts in favor of the Comptroller, *National Bancshares*, 584 S.W.2d at 272, we reject Nabors's interpretation and hold that it did not prove its entitlement to the exemption.

Moreover, even if the statute contemplated repeated periods of "temporary storage," Nabors nonetheless did not prove its entitlement to the exemption because—as we have previously concluded with respect to the drilling-equipment exemption—while Nabors proved that a certain number of the Purchased Items were ultimately used only on out-of-state jobs, it did not link those items with supporting documentation of their purchase from which a specific calculation of its alleged tax-overpayment could be computed. *See Baker*, 529 S.W.2d at 281.

Nabors did not prove that the Purchased Items for which it sought an exemption were "temporarily stored" in Texas. Thus, it is not entitled to an exemption from paying use taxes on their purchase.

CONCLUSION

Because Nabors did not prove its entitlement to a refund under either of the claimed exemptions, the trial court properly denied it a refund under section 151.324(b) of the tax code, and we affirm that portion of its judgment. However, the trial court erred in awarding Nabors a refund

under section 151.330(b). Accordingly, we reverse the remainder of the trial court's judgment and render judgment that Nabors shall take nothing on its refund claims.

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David Puryear, Justice

Before Justices Puryear, Pemberton, and Bourland

Affirmed in Part; Reversed and Rendered in Part

Filed: June 6, 2018