

Judge Reverses Own Decision to Extend the Texas Sales Tax Manufacturing Exemption to Include Oil and Gas Extraction Equipment

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On April 11, 2012, Judge John Dietz issued a ruling from the bench in *Southwest Royalties, Inc. v. Combs*, Case D-1-GNU-09-004282 (Travis County 250th Dist. Ct.) to extend the Texas sales tax exemption for manufacturing property to include certain items of property, such as well casing and “down-hole” equipment, used to extract oil and gas. (For more information about this ruling, see Bracewell’s previous client alert [here](#).) On Monday, Judge Dietz reversed his decision and held that such equipment is not eligible for the Texas sales tax manufacturing exemption.

Under Texas law, to qualify for the manufacturing exemption from sales tax, property purchased generally must be necessary for the manufacturing or processing of, and directly cause a physical change to, the product produced for sale. At trial, Southwest claimed that the equipment was used during the extraction process and directly caused a physical change to the extracted oil and gas. The Comptroller contested both of Southwest’s positions and specifically stated that the physical change that occurred to the hydrocarbons in the wellbore was a mere consequence of the extraction process and the equipment did not directly cause a physical change to the extracted oil and gas.

Upon the conclusion of the trial, Judge Dietz initially ruled that the well equipment was essential to the oil and gas extraction process and was used to cause a direct physical change to the hydrocarbons in the wellbore. Judge Dietz later reheard the case and expressed concern that the physical change that occurred in the well was incidental to the process of bringing the oil and gas to the surface and was not directly caused by such equipment.

In his final signed judgment, Judge Dietz agreed with the Comptroller and reversed his prior ruling. Judge Dietz found that Southwest had not satisfied its burden of proof that the equipment used to extract oil and gas directly caused a physical change in the oil and gas extracted. Thus, the equipment that Southwest purchased for use in the extraction process was not exempt from Texas sales tax. At this time, it is unclear whether Southwest will appeal this decision.

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