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Texas Court Rules Natural Gas Destined For Interstate Commerce Properly Subject To Local Property Tax.

The Texas First Court of Appeals has ruled that the owner of natural gas stored in a Texas reservoir was properly assessed local property tax, regardless of whether the gas was sold in interstate commerce.1 Rejecting the taxpayer's contention that the "dormant" U.S. Constitution Commerce Clause rendered the assessment unconstitutional, the Court concluded that the tax did not fail any of the four prongs of the substantial nexus test established in Complete Auto.2

Background

ETC Marketing, Ltd. (ETC) is a marketer of natural gas with offices and employees in Texas. ETC buys, sells, and markets natural gas to customers located outside Texas, but is not in any way restricted from selling to Texas customers. Its affiliate, Houston Pipeline Company (Houston Pipeline), operates an intrastate natural gas pipeline and a reservoir for the storage of natural gas in Texas.

ETC buys natural gas destined for sale to interstate purchasers from multiple sellers, and "immediately entrusts" the product to Houston Pipeline for storage. ETC's storage agreement with Houston Pipeline allows it to purchase gas and "time the market" by holding the gas for delivery at a later date in order to maximize the sale price.3 Because natural gas is considered to be fungible, the points of transfer from ETC to Houston Pipeline and ultimately to ETC's customers do not necessarily relate to a physical location associated with the seller's gas, as gas owned by various marketers is physically commingled in the pipeline system which includes both intrastate and interstate pipeline. Distinct volumes of gas are segregated by paper allocation, but due to the fungible nature of the product, cannot be separately identified and tracked by the owners.

Since the reservoir where ETC stores its natural gas is located in Harris County, Texas, the Harris County Appraisal District (HCAD) appraised the value of approximately 33 billion cubic feet of natural gas owned by ETC and stored in the reservoir for calendar year 2010, and assessed related ad valorem taxes. While ETC conceded that it was the owner of the natural gas, it contended that all of the gas stored in the reservoir was exempt from property tax under the Commerce Clause of the U.S. Constitution because the gas was destined to be sold in interstate commerce. HCAD countered that the sale of gas was not in interstate commerce, but even if the sale were considered to be in interstate commerce, it would still be subject to tax under the Complete Auto test. The 127th District Court rejected ETC's summary judgment motion and rendered final judgment for HCAD, holding that the stored gas was subject to ad valorem taxation as the gas was not in interstate commerce.4 ETC appealed the decision to the Court of Appeals.

Application of Complete Auto to Ad Valorem Tax

Texas law provides that all tangible personal property is subject to property tax if it is located in a taxing unit for longer than a temporary period, unless forbidden by law.5 In addition, property exempt from ad valorem taxation by federal law is exempt from taxation.6 Noting that the federal

exemption applies only to activities related to interstate commerce, the Court accepted that the natural gas at issue was in the stream of interstate commerce. To decide whether an applicable exemption was available under federal law, the Court focused its attention on whether the application of property tax to the natural gas failed any of the prongs of the dormant Commerce Clause test established in Complete Auto. The Court considered each of the four factors necessary to allow a local government to tax goods in interstate commerce: (i) substantial nexus to the taxing state; (ii) fair apportionment; (iii) no discrimination against interstate commerce; and (iv) a fair relation to state-provided services.7 Importantly, the Court noted that the burden of proof is on the taxpayer to show that the tax fails to meet at least one of the prongs.8

Substantial Nexus

First, to survive constitutional scrutiny, a tax must apply to an activity that has a substantial nexus with the taxing state. ETC argued that physical presence alone does not satisfy the substantial nexus prong in ad valorem cases. The Court disagreed, referencing both federal and Texas cases in which physical presence was found to be sufficient to meet this part of the test.9 The Court focused on ETC's physical presence in Harris County and other parts of Texas, including its offices, employees and stored natural gas, in finding a substantial nexus between the activity being taxed and Texas.

Fair Apportionment

The second prong of the Complete Auto test is whether the tax is fairly apportioned (i.e., each state taxes only its fair share of an interstate transaction). In order for the requirements of this prong to be met, a tax must be both internally and externally consistent.10

A tax is considered to be internally consistent when it is structured so that if every state were to impose an identical tax, multiple taxation would not result.11 The Court quickly dismissed this requirement, noting that because ETC was not attempting to store gas in two states at the same time, there was no risk of multiple taxation.

The external consistency test examines whether the state has taxed only the portion of revenue from the interstate activity which reasonably reflects the in-state component of the activity being taxed.12 ETC argued that the ad valorem tax at issue was externally inconsistent because it would be impossible to determine, at any given time, the actual physical location of each molecule of its owned natural gas. However, because ETC had conceded its ownership of 33 billion cubic feet of natural gas stored in the reservoir located in Harris County, the Court rejected this contention. Accordingly, the Court found the ad valorem tax to be fairly apportioned.

Discrimination Against Interstate Commerce

The Court subsequently considered whether the ad valorem tax discriminated against interstate commerce. Noting that the U.S. Supreme Court had previously determined that "ad valorem tax of general application … is of necessity non-discriminatory,"13 the Court concluded that this particular tax was valid.

Fair Relation to State-Provided Services

The final prong of the Complete Auto test considers whether the tax is fairly related to services provided by the state. The Court noted that no detailed accounting of the services provided to a taxpayer was necessary to prove this fact, but instead "police and fair protection, along with the usual and usually forgotten advantages conferred by the State's maintenance of a civilized society, are justifications enough."14

ETC argued that this prong was not satisfied because the gas was entrusted to Houston Pipeline, which pays property taxes on the reservoir and related equipment. Also, ETC argued that Houston Pipeline had complete and exclusive control over the activity being taxed, which was storage of gas in the reservoir. Finding that ETC had not met its burden of proof on this issue, the Court noted that ETC retained control over the disposition of the gas in the reservoir, as indicated in the evidence provided during the district court's decision. While the gas is stored in the reservoir, the Court found that ETC "enjoys the benefit of public services which facilitate gas storage, which in turn allows it to accomplish its business objective of buying natural gas and holding it for sale at some later point in time." Thus, the Court concluded that the ad valorem tax was fairly related to the services provided by Texas.

In ruling against ETC, the Court reiterated that it was not necessary to resolve the dispute between ETC and the HCAD regarding whether the natural gas was sold in interstate commerce to evaluate the validity of the tax. The ad valorem tax was properly imposed because ETC stored the gas in Texas for the business purpose of selling the gas at a higher price at a later time.

Commentary

The interstate commerce exemption is especially significant for taxpayers engaged in the oil and gas industry in Texas because it is one of the few exemptions potentially applicable to ad valorem taxes on oil and natural gas. Three general exemptions from Texas ad valorem taxes are available for tangible personal property: (i) the freeport exemption; (ii) the goods-in-transit exemption; and (iii) the interstate commerce exemption. The freeport exemption applies when certain types of property are transported outside Texas within 175 days,15 but is not available for oil, natural gas or other petroleum products. Similarly, the goods-in-transit exemption does not apply to oil, natural gas, or petroleum products.16 Thus, businesses in the oil and gas industry generally must rely solely on the interstate commerce exemption for relief from Texas property taxation.

This decision is distinguishable from two recent Texas appellate court decisions that were favorable to the taxpayer and addressed the same constitutional concerns.17 Both cases involved petroleum products being stored in Texas that were later to be transported out of state. In Peoples Gas, the Sixth District Court of Appeals, which sits in Texarkana, held that the natural gas could not be taxed locally because there was insufficient nexus.18 In BP America, the Eleventh District Court of Appeals, which sits in Eastland, held that an ad valorem tax could not be imposed on crude oil stored in a tank farm that is an integral part of an interstate pipeline system.19 The Texas Supreme Court has yet to rule in either of these cases. It is interesting to note that the dissenting opinion in ETC cited Peoples Gas as indistinguishable on the substantial nexus issue.20

The issue of whether property tax properly applies to stored oil and natural gas has been highly litigated in recent years, both in Texas and in other states. For example, both the Oklahoma and Kansas State Supreme Courts found against taxpayers in recent decisions, finding that property tax was validly assessed.21 The United States Supreme Court has refused to hear both the Oklahoma and the Kansas cases,22 despite the fact that the Solicitor General of the United States was requested to file a brief expressing the views of the federal government on this issue.23

The Court's insightful analysis reflects the far-reaching effect of the Complete Auto precedent.24 In practice, Complete Auto's four-prong test continues to lessen the practical effect of the Dormant Commerce Clause, and defenses based upon the concept, with respect to interstate commerce (in contrast to foreign commerce).

Finally, it is important to note that ETC is an appellate court decision that is binding in the area of the court's jurisdiction,25 but is not binding in other parts of Texas. The taxpayer will still have an

opportunity to appeal to the Texas Supreme Court.26

Footnotes

1 ETC Marketing, Ltd. v. Harris County Appraisal District, Texas Court of Appeals, First District, No. 01-12-00264-CV, Oct. 2, 2014.

2 Complete Auto Transit, Inc. v. Brady, 430 U.S. 274 (1977). The test addresses whether the entity has substantial nexus under the Commerce Clause, thereby allowing a state to impose a tax.

3 ETC has historically stored gas in the reservoir for several months at a time, buying it during warmer months and selling it to northern markets in the winter months. The length of time the gas is stored depends on the volume, time of year, and demand for natural gas.

4 Harris County Appraisal District v. ETC Marketing, Ltd., 127th District Court, No. 2010-71360.

5 TEX. TAX CODE ANN. § 11.01.

6 TEX. TAX CODE ANN. § 11.12.

7 Barclays Bank PLC v. Franchise Tax Board, 512 U.S. 298, 310-11 (1994).

8 Vinmar, Inc. v. Harris County Appraisal District, 947 S.W.2d 554, 555 (Tex. 1997).

9 Relying upon Quill Corp. v. North Dakota, 50 U.S. 298 (1992), which reaffirmed that physical presence satisfies the first prong of the Complete Auto test for sales and use tax purposes. Several Texas cases reached the same conclusion with respect to ad valorem taxes. See, for example, Rylander v. 3 Beall Bros. 3, Inc., 2 S.W.3d 562, 570 (Tex. Ct. App. 1999), cert. denied, 538 U.S. 1013 (2003) and Peoples Gas, Light, and Coke Co. v. Harrison Central Appraisal District, 270 S.W.3d 208 (Tex. Ct. App. 2008), cert. denied, 131 S. Ct. 2097 (2011).

10 Goldberg v. Sweet, 488 U.S. 252 (1989).

11 Id.

12 Id.

13 Japan Line, Ltd. v. Los Angeles County, 441 U.S. 434, 445 (1979).

14 Okla. Tax Comm'n v. Jefferson Lines, Inc., 514 U.S. 175, 200 (1995).

15 TEX. CONST. art. VIII, §1-j.

16 TEX. TAX CODE ANN. §11.253(a)(2)(D).

17 See Peoples Gas, Light & Coke v. Harrison Central Appraisal District, 270 S.W.3d 208 (Tex. Ct. App. 2008), in which the Court held that a tax assessment on stored natural gas was invalid because of a lack of substantial nexus; Midland Central Appraisal District v. BP America Production Co., 282 S.W.3d 215 (Tex. Ct. App. 2009), in which ad valorem tax was found to be improperly assessed on oil passing in interstate commerce through an interstate pipeline, but temporarily held in Texas.

18 The majority in ETC distinguishes Peoples Gas by saying the natural gas marketer's "only connection to Texas was through the 'structure and location' of the separately owned pipeline which made the decision about where to store the gas and paid its own ad valorem taxes on the facility and

equipment used for storage of natural gas in Texas. In contrast, ETC Marketing had a physical presence in Harris County including employees, offices, and – most significantly – natural gas that it had specifically contracted to store with Houston Pipeline. Unlike the pipeline at issue in Peoples Gas, Houston Pipeline's facilities are located entirely within Texas, including the Bammel reservoir in Harris County. There was no evidence that the gas was already bound for another state when it was committed to Houston Pipeline."

19 The majority distinguishes BP from ETC because the oil in the BP case "was not held in the tank farm for storage purposes or for any business purpose of the owner other than its transmission through the pipeline."

20 ETC Marketing, No. 01-12-00264-CV (Keyes – dissenting) pg. 9.

21 In re Assessment of Personal Property Taxes, 234 P.3d 938 (Okla. 2008); In the Matter of the Appeals of Various Applicants from a Decision of the Division of Property Valuation of the State of Kansas for Tax Year 2009 Pursuant to K.S.A. 74-2438, 313 P.3d 789 (Kan. 2013).

22 Certiorari was denied for the Kansas case on Oct. 6, 2014, while certiorari in the Oklahoma case was denied on Mar. 1, 2010.

23 In her brief to the Court, the Solicitor General argued that the Oklahoma Supreme Court had correctly rejected the dormant Commerce Clause challenge.

24 In comparison, this is the precedential effect some commentators thought, and some tax practitioners wished, the U.S. Supreme Court decision in the Quill case (Quill Corp. v. North Dakota, 504 U.S. 298, 309 (1992)) had. The precedential effect of Quill has, however, been relied upon sparingly by the courts.

25 Counties served by the First Court of Appeals are Austin, Brazoria, Chambers, Colorado, Fort Bend, Galveston, Grimes, Harris, Waller and Washington.

26 The taxpayer filed a motion for rehearing with the Court of Appeals on October 20. If the Court refuses to rehear the case, the taxpayer will have 45 days from that refusal to file a petition for review with the Texas Supreme Court. Indeed, there might be increased incentive for the Texas Supreme Court to take this case (if appealed) to resolve a perceived split in the Courts of Appeals between ETC on one side, and BP America and Peoples Gas on the other.

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