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Multistate Tax
EXTERNAL ALERT

Texas Court of Appeals Overturns Trial Court Decision – Transporter of Aggregate Allowed Franchise Tax Revenue Exclusion

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Overview

On March 14, 2014, the Texas Court of Appeals reversed a trial court decision and held that Titan Transportation, LP ("Titan") was entitled to the franchise tax revenue exclusion under former Texas Tax Code ("TTC") § 171.1011(g)(3). The Court of Appeals also remanded the case back to the trial court to determine the appropriate tax amount to be refunded to Titan.[1] In this Tax Alert we summarize the proceedings, the arguments presented by the parties, and the Court of Appeal's analysis and holding; and we briefly describe some recent amendments to TTC § 171.1011.

Background

Titan is in the business of hauling, delivering, and depositing "aggregate" at real-property construction sites, where the aggregate is used as an ingredient in concrete or as a foundation for the construction of roads, buildings, and parking lots. Titan provides this service primarily through the use of subcontractors, to whom it is contractually obligated to share a portion of the gross receipts from the provision of those services. In its 2008 franchise tax return, Titan claimed a revenue exclusion under former TTC § 171.1011(g)(3) for certain "flow-through" payments made to its subcontractors during the 2008 tax year. For the tax year at issue, TTC § 171.1011(g)(3) provided in relevant part as follows:

> A taxable entity shall exclude from its total revenue, to the extent [reported to the IRS as income], only the following flow-through funds that are mandated by contract to be distributed to other entities: . . .
>
>> (3) subcontracting payments handled by the taxable entity to provide services, labor, or materials in connection with the actual or proposed design, construction, remodeling, or repair of improvements on real property or the location of the boundaries of real property.

Through a desk audit, the Texas Comptroller of Public Accounts ("Comptroller") disallowed Titan's exclusion from total revenue, finding that Titan was a trucking company rather than a construction company and thus was not engaged in a type of business that qualified for the (g)(3) revenue exclusion.

Titan brought suit in the District Court of Travis County (trial court), seeking a refund of franchise taxes paid under protest along with a refund or credit for an overpayment of taxes. Titan's primary assertion was that the Comptroller had erroneously denied the revenue exclusion. Following a bench trial, the trial court rendered a judgment that Titan was not entitled to the exclusion.

Appellate Court Ruling

In its appeal to the Texas Court of Appeals, Titan contended that the trial court "misinterpreted and misapplied the applicable tax provisions and that, as a matter of law, it qualified for the revenue exclusion . . . ."[2] In contrast, the Comptroller's primary argument was that to qualify for the (g)(3) exclusion, a taxpayer must provide "design, construction, remodeling, or repair" services and, accordingly, "Titan cannot claim the . . . exclusion because it is not a construction company."[3]

The court's review of the conflicting positions of the parties centered on a plain-meaning analysis of former TTC § 171.1011(g)(3). The court began with a brief summary of the rules of statutory construction, requiring that the court:

> [G]ive effect to the legislature's intent[, recognizing that] ordinarily "'the truest manifestation' of what lawmakers intend is what they enacted . . ." [and] give an unambiguous statute its plain meaning without resorting to rules of construction or extrinsic aids.[4]

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[1] *Titan Transportation, LP v. Susan Combs*, *Comptroller*, Texas Court of Appeals, (3rd Dist.) Cause no. 03-13-00034-CV, (Mar. 14, 2014).
[2] *Titan Transportation, LP*, slip op. at 2.
[3] *Id.*, slip op. at 21.
[4] *Id.*, slip op. at 19 (citations omitted).

Applying this standard of review, the court stated: "The fundamental flaw in the State's analysis is that the limitations it advances are extra-textual and alter the statute's plain meaning."[5] As explained by the court, the Comptroller's contention that Titan could not claim the (g)(3) exclusion because it was not a construction company is based on the Comptroller's reading of the statutory phrase "services, labor, or materials" as modified by the terms "design, construction, remodeling, or repair[,]" such that only "entities that are design, construction, remodeling, or repair companies can claim the exclusion when they are subcontracting for services, labor or materials."[6]

In rejecting this interpretation, the court focused on the Comptroller's act of ignoring the statute's "in connection with" language. As noted previously, subsection (g)(3) permits the exclusion of subcontracting payments made "to provide services labor or materials *in connection with* the . . . design, construction, remodeling , or repair . . ." of real property improvements (emphasis added). The court explained that the "in connection with" language is a "phrase of intentional breadth[,]"[7] thus conveying the legislature's intent to permit the exclusion where there is "a reasonable – i.e., more than tangential or incidental – relationship between the activities delineated in the statue[, namely, design, construction, remodeling, or repair] and the services, labor, or materials for which the subcontractors receive payment."[8] On this basis, the court ruled: "Given the breadth of the statute's language, there is no textual support for the State's position that the statute is limited to construction companies and excludes transportation companies."[9] The court then addressed whether, under the facts before it, there was a "reasonable relationship" between the construction of improvements on real property and Titan's services. The court concluded that: "the required nexus is established by evidence that Titan provided services that were logically and reasonably connected with the construction of improvements on real property and, indeed, were directly related to the construction of such improvements."[10]

Based on the foregoing, the Court of Appeals: (1) ruled that under the plain language of TTC § 171.1011(g)(3), Titan was entitled to the revenue exclusion with respect to the applicable subcontractor payments; and (2) remanded the case to the trial court to determine the appropriate refund amount.[11]

The Comptroller has 45 days (from the date the Court of Appeals issued its opinion) to appeal the *Titan* decision to the Supreme Court of Texas.

Amendments to TTC § 171.1011

Effective January 1, 2014, TTC § 171.1011(g)(3) was amended to require the exclusion of:

> flow-through funds that are mandated by contract *or subcontract* to be distributed to other entities [and that are] subcontracting payments *made under a contract or subcontract* entered into by the taxable entity to provide services, labor, or materials in connection with the actual or proposed design, construction, remodeling, *remediation,* or repair of improvements on real property or the location of the boundaries of real property.[12]

The Legislature also added a specific exclusion applicable to taxable entities "primarily engaged in the business of transporting aggregates," which allows such entities to exclude from total revenue "subcontracting payments made by the taxable entity to independent contractors for the performance of delivery services on behalf of the taxable entity."[13]

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[5] *Id.*, slip op. at 21, citing the Supreme Court of Texas in *Combs v. Roark Amusement & Vending, L.P.*, ____ S.W.3d ____,No. 11-0261, 2013 WL 855737, at *2 (Tex. Mar. 8, 2013).
[6] *Titan Transportation, LP*, slip op. at 21-22.
[7] *Id.*, slip op. at 22.
[8] *Id.*, slip op. at 22-23.
[9] *Id.*, slip op. at 24.
[10] *Id.*
[11] *Id.*, slip op. at 30-31.
[12] TTC § 171.1011(g)(3) (emphases added), as amended by Acts 2013, 83rd Leg., R.S., Ch. 1034 (H.B. 2766), Section 1. The bill analysis indicates that the amendment was proposed in response to the Comptroller's interpretation of section 171.1011(g)(3) as "allowing an entity to exclude subcontracting payments only when the entity has a contract in place that states that a specific portion of the work will be subcontracted." The Comptroller's interpretation was apparently viewed as inconsonant with industry practices. *See*, Senate Research Ctr., Bill Analysis, Tex. H.B. 2766, 83d Leg., R.S. 2013. The amendment was said to be necessary to clarify that the (g)(3) revenue exclusion applies even in the absence of a prime contract explicitly requiring a contractor to use subcontractors.
[13] TTC § 171.1011(g-8), as added by Acts 2013, 83rd Leg., R.S., Ch. 1232 (H.B. 500), Sec. 7. The bill analysis states that the amendment was proposed in response to concern, on behalf of companies that transport aggregates, that the Comptroller has determined that the transporting companies are required to pay franchise tax on 100 percent of the money collected from their customers, even though the companies give a significant percentage of that money to subcontractors as payment for subcontractor services. *See,* House Ways & Means Comm., Bill Analysis, Tex. H.B. 500, 83d Leg., R.S. 2013.

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