

Texas Third Court of Appeals Affirms Certain Real Property Service Costs Are Deductible For Texas Franchise (“Margin”) Tax Purposes

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Overview

Affirming a Travis County District Court (“District Court”) decision, the Texas Third Court of Appeals (“Court of Appeals”) held on December 31, 2013, that for purposes of calculating the Texas Franchise Tax (commonly referred to as the Texas Margin Tax) a taxpayer may deduct as Costs of Goods Sold (“COGS”)¹ certain costs related to real property services.² On January 16, 2014, The Texas Comptroller (“Comptroller”) filed a motion for rehearing in the Court of Appeals. In its motion the Comptroller stated that it “accepts the Court’s opinion and reasoning, but moves for rehearing to request . . . [clarification of] two areas of the opinion”³

Although the Court of Appeals’ decision is not yet final, taxpayers with entities providing real property services may wish to consider whether the court’s analysis may provide a basis for deducting as COGS various labor or materials furnished to a project for the construction or maintenance of real property, including activities involving oil and gas wells. Such services might potentially include the transportation and disposal of waste material as well as remediation. Additionally, taxpayers that have excluded costs otherwise eligible for the COGS deduction on the basis that the costs were incurred by an affiliate that only provided services may wish to reconsider such treatment and whether a refund claim may be appropriate. The statute of limitations for refunds involving Franchise Tax reports filed in 2010 may expire as early as May 15, 2014.

In this Tax Alert, we summarize the Court of Appeals’ decision and the Comptroller’s motion for rehearing.

Background

Newpark Resources, Inc. (“Newpark”) is a fully-integrated oilfield services business that provides products and services to companies in the oil and gas industry. Newpark’s business lines include fluid systems and engineering, materials and integrated services, and environmental disposal and reclamation services.

The costs at issue in the case primarily related to labor and materials of Newpark’s wholly-owned subsidiary, Newpark Environmental Services, LLC (“NES”), provided as part of Newpark’s comprehensive oilfield services. NES’s services involved environmental disposal and reclamation services related to the drilling or maintenance of oil and gas wells. Upon audit, the Comptroller disallowed NES’s costs as not qualifying for the COGS deduction because the entity provided only services. Newpark paid the resulting additional assessment of tax and filed a protest suit with the District Court. The District Court held in Newpark’s favor, ruling that the taxpayer was entitled to a refund of the protested tax, plus applicable interest.⁴

Texas Third Court of Appeals Decision

On December 31, 2013, the Court of Appeals affirmed the District Court’s ruling.⁵ The first issue before the Court of Appeals was whether, in determining COGS, each member of a combined group is considered part of the group’s business or is treated individually.⁶ Newpark argued that the Comptroller incorrectly viewed NES as an isolated business rather than as part of Newpark.

¹ The Texas Franchise Tax is calculated on a “margin” base (determined by “total revenue” less “COGS” or “compensation,” as applicable). The tax rate is 1% of the taxpayer’s “taxable margin” per period year, reduced to 0.5% for entities primarily engaged in retail or wholesale trade.

² *Combs v. Newpark Res., Inc.*, No. 03-12-00515-CV, 2013 Tex. App. LEXIS 15455 (Tex. App.—Austin Dec. 31, 2013). For additional information on the earlier District Court decision, see our External Tax Alert dated August 16, 2012, accessible at: http://www.deloitte.com/view/en_US/us/Services/tax/Multistate-Tax/2e0f9ef9ac439310VgnVCM1000001a56f00aRCRD.htm.

³ *Combs v. Newpark Res., Inc.*, No. 03-12-00515-CV, Corrected Motion for Rehearing (filed Jan. 16, 2014).

⁴ *Combs v. Newpark Res., Inc.*, No. D-1-GN-11-002205, (250th Dist. Ct., Travis County, Tex. Jul. 2, 2013).

⁵ *Combs v. Newpark Res., Inc.*, 2013 Tex. App. LEXIS 15455 at *33.

⁶ *Id.* at *13.

Agreeing with Newpark, the Court of Appeals concluded that the Texas statute did not require each combined group member's business to be viewed in isolation when determining a member's eligibility for the COGS deduction.⁷ Thus, Newpark was allowed to take a COGS deduction for NES's otherwise eligible costs despite the fact that NES provided only services.

The next issue addressed by the Court of Appeals was whether NES's expenses at issue qualified as COGS. The Comptroller claimed:

NES's removal and disposal of drilling waste material is a "service" within the meaning of section 171.1012 and therefore NES does not sell a good for which the cost-of-goods-sold deduction could apply. See, § 171.1012 (a)(3)(B)(i) (excluding "services" from definition of tangible personal property).⁸

The Comptroller argued further that "NES's removal and disposal of drilling mud is purely a service and does not constitute labor furnished to a project for the construction or improvement of real property" and, therefore, NES was not involved in selling a good for COGS purposes.⁹ In response, Newpark asserted that NES's expenses "are part of the overall labor and materials that Newpark furnishes to the drilling of oil and gas wells, which the Comptroller does not dispute constitutes a project for the construction or improvement of real property."¹⁰

In analyzing the question before it, the Court of Appeals first concluded that a "party that furnishes labor for the improvement of real property . . . [may] deduct . . . [its labor expenses as COGS] as if it sold the property."¹¹ The court then addressed "whether NES's services, put in the context of Newpark's overall services, qualify as labor for the construction and improvement of real property[.]"¹² holding that NES's expenses qualified as COGS because NES's subsequent transport and disposal of the used drilling mud and other waste material was part of the labor involved in the drilling process collectively performed by Newpark and its affiliates.¹³ As determined by the Court of Appeals, NES's disposal of waste material was an "essential and direct component of the drilling process."¹⁴ Consequently, the removal and disposal of waste material was labor furnished to a project for the construction and improvement of real property and, therefore, NES's expenses were properly included within Newpark's overall COGS deduction.¹⁵ Based on the foregoing, the Court of Appeals affirmed the judgment of the District Court.¹⁶

Because the Comptroller has filed a motion for rehearing, the Court of Appeals' decision is not final. Although the Comptroller stated in its motion that it "accepts the Court's opinion and reasoning," it requested clarification of the following two items: 1) that the court clarify its opinion to hold that courts must defer to the Comptroller's definition of the COGS deduction under Section 171.1012(i) and analyze the applicability of the deduction under such definition, and 2) that the court modify its opinion to reflect the Comptroller's actual position on Section 171.1014(e)(1) (namely, that costs associated with the performance of services for third parties outside of the combined group cannot be included in a member's COGS calculation) to avoid confusion in the interpretation of that section.¹⁷

⁷ *Id.* at *15-19.

⁸ *Id.* at *19.

⁹ *Id.* at *23.

¹⁰ *Id.* at *22; See, Texas Comptroller, Franchise Tax Frequently Asked Question 22 accessible at:

http://www.window.state.tx.us/taxinfo/franchise/faq_cogs.html ("The labor and materials used in the construction, improvement, remodeling, repair, or industrial maintenance . . . of real property are allowed as COGS. Oilfield services that constitute construction, improvement, remodeling, repair, or industrial maintenance of oil and gas wells can be included in COGS for allowable costs under TTC 171.1012.").

¹¹ *Combs v. Newpark Res., Inc.*, 2013 Tex. App. LEXIS 15455, at *28-29.

¹² *Id.* at *31.

¹³ *Id.* at *31-32.

¹⁴ *Id.* at *32.

¹⁵ *Id.* at *33.

¹⁶ *Id.* As a separate issue, the Comptroller also argued that NES's payments to its subcontractors did not constitute "flow-through funds" that could be excluded from total revenue because Newpark's contracts with its customers did not require Newpark or NES to use those subcontractors. The majority did not address the "flow-through funds" issue because it found the COGS issue dispositive. However, Chief Justice Jones provided a concurring opinion explaining the necessity of calculating total revenue, including whether Newpark's flow-through payments to subcontractors should be excluded from the total revenue amount. In his concurring opinion the Chief Justice highlighted that although the approach of the majority opinion of ignoring the revenue exclusion issue to focus on the COGS deduction ultimately had no impact on the result in this particular case, such a fact would not be true in all instances.

¹⁷ *Combs v. Newpark Res., Inc.*, No. 03-12-00515-CV, Corrected Motion for Rehearing (filed Jan. 16, 2014).

Considerations

Although the case is not yet final, taxpayers providing real property services may wish to consider whether, under the Court of Appeals' analysis, labor or materials provided as part of real property construction or maintenance (including activities involving oil and gas wells) may qualify for the COGS deduction. Such services might include the transportation and disposal of waste material as well as remediation. This may be particularly appropriate given the Comptroller's June 2012 guidance, allowing taxpayers to amend Franchise Tax reports in order to change (or make) an election using COGS or compensation.¹⁸

Additionally, taxpayers that have excluded costs otherwise eligible for the COGS deduction on the basis that the costs were incurred by an affiliate that only provided services may wish to reconsider such treatment and whether a refund claim should be filed in light of the Court of Appeals' analysis. Taxpayers considering filing a refund claim should keep in mind that the statute of limitations for Franchise Tax reports filed in 2010 could potentially expire as early as May 15, 2014.

Contacts

If you have questions regarding this court decision or pertaining to other Texas tax matters, please contact any of the following Deloitte Tax professionals:

Russell Brown
Partner
Deloitte Tax LLP, Dallas
rubrown@deloitte.com
(214) 840-7533

Pamela Downs
Partner
Deloitte Tax LLP, Dallas
pdowns@deloitte.com
(214) 840-7572

Brad Brookner
Director
Deloitte Tax LLP, Houston
bbrookner@deloitte.com
(713) 982-4897

Robert Topp
Director
Deloitte Tax LLP, Houston
rtopp@deloitte.com
(713) 982-3185

Jacob Aguero
Senior Manager
Deloitte Tax LLP, Houston
jaguero@deloitte.com
(713) 982-4246

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¹⁸ See, Texas Comptroller, Ann. (Jun. 6, 2012), accessible at: http://www.window.state.tx.us/taxinfo/franchise/cog_compensation.html.