

# Texas Comptroller Issues Revised Policy for Exclusions and Deduction for Cost of Goods Sold

## Overview

On June 30, 2016, the Texas Comptroller of Public Accounts (Comptroller) released a memorandum announcing a revised franchise tax policy on exclusions and the cost of goods sold (COGS) deduction.<sup>1</sup> The revised policy allows for the exclusion of certain subcontracting payments that qualify as flow-through funds and expands the interpretation of furnished labor or materials for a project for purposes of the COGS deduction.

In this Tax Alert, we summarize the Comptroller's revised franchise tax policy.

## Exclusion for flow-through funds

In *Titan Transportation LP v. Combs*, the Austin Third Court of Appeals held the taxpayer was entitled to exclude from total revenue payments made to its subcontractors that were providing services for its customers under Texas Tax Code (TTC) § 171.1011(g)(3), which provides: "A taxable entity shall exclude from its total revenue...only the following flow-through funds that are mandated by contract to be distributed to other entities..."<sup>2</sup> The Third Court of Appeals explained that the term "other entities" means someone other than the taxpayer and further clarified: "[the] purpose of the (g)(3) exclusion is to prevent double taxation of funds that are not truly gain or income to the taxpayer, and this purpose is satisfied regardless of whether the mandate is contained in a contract with a customer or with a subcontractor."<sup>3</sup>

As a result of the *Titan Transportation* decision, the Comptroller's revised policy provides that a payment is mandated by contract to be distributed to other entities and qualifies as flow-through funds under TTC § 171.1011(g) if the taxable entity either: (1) has a contract with its customers providing that a subcontractor may be used and requiring payments to the subcontractor; or (2) by a written contract between the taxable entity and the subcontractor where the payment is based on the funds paid to the taxable entity by the taxable entity's customers. In addition, the Comptroller's memorandum states that subcontracting payments which qualify as flow-through funds under TTC § 171.1011(g) and have a reasonable nexus to the actual or proposed design, construction, remodeling, or repair of improvements on real property or the location of boundaries of real property, may be excluded from revenue under TTC § 171.1011(g)(3).

## Deduction from COGS

In *Combs v. Newpark Resources Inc.*, the Third Court of Appeals found the taxpayer's activities of removal and disposal of waste materials from oil and gas well drilling sites qualified for a COGS deduction under TTC § 171.1012(i).<sup>4</sup> TTC § 171.1012(i) provides: "A taxable entity furnishing labor or materials to a project for the construction, improvement, remodeling, repair, or industrial maintenance of real property is considered to be an owner of that labor or materials and may include the costs...in the computation of cost of goods sold."

As a result of the *Newpark Resources* decision, the Comptroller's interpretation of what is considered to be furnishing labor or materials to a project for the constructions, improvement, remodeling, repair, or industrial maintenance of real property has been expanded. Specifically, the Comptroller will no longer require an entity to actually physically touch the property or make a change to the property to qualify for the COGS deduction. However, the Comptroller reiterated that the revised policy does not change the treatment of taxable entities renting or leasing equipment to others for purposes of the COGS deduction. Consequently, taxpayers who rent or lease equipment other than heavy construction equipment to others for

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<sup>1</sup> Accession No. 201606856L (June 30, 2016), available [here](#). As stated in the Comptroller's memorandum, this guidance supersedes the June 10, 2014, memo (201406920L) relative to the Comptroller's interpretation of "mandated by contract" as provided in Texas Tax Code § 171.1011(g).

<sup>2</sup> *Titan Transp., LP v. Combs*, 433 S.W.3d 625 (Tex. App.—Austin Mar. 14, 2014, pet. denied), 2015 Tex. LEXIS 416 (Tex., May 1, 2015).

<sup>3</sup> *Id.* at 641. For additional information on the *Titan Transportation* decision, see our External Tax Alert issued on March 20, 2014, available [here](#).

<sup>4</sup> *Combs v. Newpark Res., Inc.*, 422 S.W.3d 46 (Tex. App.—Austin Dec. 31, 2013, no pet.) For additional information on the *Newpark Resources* decision, see our External Tax Alert issued on January 22, 2014, available [here](#).

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use in projects for the construction, improvement, remodeling, repair, or industrial maintenance of real property, are not eligible for the COGS deduction under TTC § 171.1012(k-1).

### Considerations

Taxpayers that have included subcontractor payments within total revenue based on the Comptroller's prior interpretation of "mandated by contract" may wish to consider whether a refund claim should be filed based on the Comptroller's revised policy. In addition, Taxpayers providing real property services may wish to consider whether 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.

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