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Multistate Tax
EXTERNAL ALERT

Texas court holds rent-to-own business classified as a retailer

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Overview

Reversing an earlier trial court decision, the Texas Court of Appeals, Third District, recently held that Rent-A-Center, Inc. (RAC) should be classified as a retailer, and thus allowed to calculate Texas franchise tax using the reduced .5 percent tax rate under Texas Tax Code (TTC) § 171.002(a)-(b).[1] The Court of Appeals also remanded the case to the trial court to adjudicate an unresolved issue that the trial court had not reached in the trial—namely, the amount of the cost of goods sold (COGS) deduction to which RAC was entitled.[2]

On June 25, 2015, RAC filed a motion for rehearing with the Court of Appeals, requesting that the appellate court rule on the COGS deduction rather than remanding the issue back to the trial court. On July 1, 2015, the Court of Appeals requested that the Comptroller file a response to RAC's motion on or before July 13, 2015. On July 1 the Court of Appeals also granted the Comptroller an extension of time to file its own motion for rehearing, thus extending the deadline for such filing until July 10, 2015. Accordingly, this case remains pending.

In this Tax Alert we summarize this Court of Appeals decision and provide some taxpayer considerations.

Background

The issue addressed in this case is whether a "rent-to-own" business, whose majority of revenue is derived from making merchandise available to customers through "rental-purchase" agreements, is "primarily engaged in retail trade," and thus entitled to the .5 percent tax rate for Texas franchise tax purposes. As clarified by the Court of Appeals, recent amendments to TTC § 171.0001(12)(D), effective January 1, 2014, "render this issue moot going forward . . . [as the] definition of 'retail trade' now specifically includes 'rental-purchase agreements activities regulated by Chapter 92, Business & Commerce Code' as well as several other activities involving rental of items . . . ."[3] However, the court noted further that the "statute applicable at the time of the dispute was silent on the subject of rental-purchase agreements."[4]

As summarized by the Court of Appeals, RAC is the largest "rent-to-own" business in the United States. Ninety-seven percent of RAC's merchandise is sold to customers by means of showroom-floor cash purchases, "90-days same as cash," or "early purchase options." In its original franchise tax report for 2008, RAC took the position that it was a retailer, and thus allowed to apply the .5 percent rate under TTC §171.002(b). RAC also claimed a COGS deduction pursuant to TTC §171.1012.

In an audit of RAC's Texas 2008 report, the Texas Comptroller (Comptroller) determined that RAC was a service business under Division I (Services) of the Standard Industrial Classification (SIC) Manual and, accordingly, was not eligible for the .5 percent tax rate, but instead was subject to the 1 percent tax rate for entities not primarily engaged in retail trade.[5] Additionally, the Comptroller disallowed RAC's claimed COGS deduction on the grounds that RAC was providing a service and was not selling goods in the normal course of business. Following the audit's conclusion, RAC paid under protest the assessed additional tax, and, seeking a

[1] *Rent-A-Center, Inc. v. Hegar, Comptroller of Public Accounts, State of Texas*, No. 03-13-00101-CV (Tex. Ct. App. 3rd Dist., Jun. 11, 2015), slip op. at 8-9. A copy of the decision is available **here**.
[2] *Id.*
[3] *Id.* at 1, n.1.
[4] *Id.*
[5] TTC §171.002(a)-(b).

refund, filed suit in Travis County District Court. The trial court found that RAC was not a retailer, thus ruling in favor of the Comptroller.[6] Following this decision, RAC filed an appeal with the Court of Appeals.

RAC's appeal

RAC's position on appeal was that, for the period in question, it qualified as a retailer under former TTC § 171.0001(12) due to the fact that it fundamentally engaged in selling merchandise for personal or household consumption and rendered services incidental to the sale of goods. Further, RAC argued that:

- It maintained places of business or showrooms for the display of merchandise and it was engaged in activities to attract the general public to buy that merchandise.
- Its rental purchase agreements did not signify a lease but served as an alternative method to accommodate the purchase of merchandise by financially limited customers.
- 97 percent of its merchandise, for which it receives 90 percent of its revenue, was sold in an average of 20 months per item.

Comptroller's position on appeal

In seeking to support its contention that RAC was not "primarily engaged in retail trade," the Comptroller focused on RAC's 10-K, which characterized RAC's revenue from rental purchase agreements as "rentals and fees." The Comptroller also deemed relevant to its position that title to the goods did not pass to the customer until the full purchase price was paid.

Appellate court's ruling

The Court of Appeals' analysis centered on whether the trial court had properly ruled that RAC did not qualify as a retailer under former TTC § 171.0001(12). The main question facing the Court of Appeals was whether RAC's rent-to-own activities constituted leasing services or selling goods.

Under TTC § 171.002(c), an entity is primarily engaged in retail or wholesale trade if total revenue from its activities in retail or wholesale trade is greater than the total revenue from its activities in trades other than the retail or wholesale trade. Under the undisputed facts of the case, 90 percent of RAC's revenue was related to goods sold in an average of 20 months. As expressed by the Court of Appeals, given this and other related facts, "the Comptroller's contention that Rent-A-Center is not primarily engaged in 'retail trade' . . . is strained."[7] The court also found the Comptroller's reliance on the 10-K characterization to be unpersuasive, stating that such characterization "is neither dispositive nor, in light of all the facts, accurate."[8] The court was also not persuaded by the Comptroller's claim that RAC's retention of title until full payment is suggestive of other than retail sale activity. As explained by the court, "such fact is not inconsistent with" the facts that title eventually passes to RAC's customers in 97 percent of the transactions and that customers can acquire title to the merchandise by paying the remaining balance due at any time.[9] Based on the foregoing, the court concluded that "Rent-A-Center's offer of merchandise to customers under the rental-purchase agreements is more like selling than leasing and that Rent-A-Center is, therefore, primarily engaged retail trade."[10] Accordingly, RAC qualified for the .5 percent rate under TTC §171.002(b).

The Court of Appeals also ruled that the case be remanded to the trial court for that court to determine the amount of RAC's COGS deduction.[11] On June 25, 2015, RAC filed a motion for rehearing with the Court of Appeals, requesting that the appellate court rule on the COGS deduction rather than remanding the issue back to the trial court. On July 1, 2015, the Court of Appeals requested that the Comptroller file a response to RAC's motion on or before July 13, 2015.

On July 1, 2015, the Court of Appeals granted the Comptroller an extension of time to file a motion for rehearing, thus extending the deadline for such filing until July 10, 2015. As of the date of this Tax Alert, the Comptroller has not yet filed its motion for rehearing.

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[6] *Rent-A-Center, Inc. v. Hegar, Comptroller of Public Accounts, State of Texas*, No. D-1-GN-11-001059 (Tex. 250th Dist. Ct. Dec 11, 2012).
[7] *Rent-A-Center, Inc.*, No. 03-13-00101-CV, slip op. at 7.
[8] *Id*.
[9] *Id*. at 8.
[10] *Id*.
[11] *Id*. at 9.

The Comptroller has 45 days from June 11 to appeal the Court of Appeals' decision to the Texas Supreme Court. As of the date of this Tax Alert, no appeal has been filed, but the appeal period remains open. Accordingly, the case is not yet final.

Considerations

Although this case is currently pending, the Court of Appeals' analysis demonstrates the importance of examining the underlying facts around a taxpayer's revenue stream as opposed to strictly following the 10-K characterization or an SIC code that may not classify a certain line of business as retail or wholesale.

Taxpayers that operate a rent-to-own business but have not filed as a "retailer or wholesaler," and thus have not calculated tax liability based upon the .5 percent franchise tax rate, may wish to consider filing a claim for refund for tax periods open under the statute of limitations. In deciding whether to file a refund claim, taxable entities should also consider that:

1. The Comptroller is not required to hold the claim in abeyance while the case remains pending; thus, a taxpayer may be required to further pursue its claim before an administrative law judge or in a trial court in order to preserve the claim;
2. The filing of a refund claim will extend the regular statute of limitations for assessments[12] and may trigger a general audit of open tax years; and
3. The success or failure of the claim will depend in part on a taxpayer's particular facts and circumstances.

Contacts

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[12] TTC §111.2051.