

# TX Appellate Court Upholds Subcontractor Exclusion While Reversing and Remanding on COGS Methodology

## Overview

On August 11, 2017, the Texas Third Court of Appeals, Austin ("Court of Appeals") upheld an earlier decision by the 201st Travis County District Court ("District Court"), which found that Gulf Copper & Manufacturing Corporation ("Gulf Copper" or "Taxpayer") was entitled to exclude certain subcontractor payments from its revenue under former Texas Tax Code ("TTC") § 171.1011(g)(3) (hereinafter referred to as the "(g)(3) revenue exclusion").<sup>1</sup> However, the Court of Appeals reversed and remanded on the issue of allowable Texas cost of goods sold ("COGS") items based on Gulf Copper's use of federal COGS as the starting point for its Texas franchise tax COGS deduction. Instead, the Court of Appeals found Gulf Copper was required to use a cost-by-cost analysis to determine whether a cost was eligible for inclusion in the Texas COGS deduction.<sup>2</sup>

In this Tax Alert, we summarize the decisions of both the District Court and Court of Appeals as well as offer some taxpayer considerations.

## Background

The *Gulf Copper* case involved a business primarily engaged in the business of surveying, manufacturing, upgrading, and repairing drilling rigs.<sup>3</sup> The facts indicated Gulf Copper used subcontractors to perform these services.<sup>4</sup> Specifically, Gulf Copper utilized two types of subcontractors: (1) "labor" subcontractors, who performed work similar to Gulf Copper's own employees (e.g., welders, fitters); and (2) "outside specialty" subcontractors, who were hired to perform specialized tasks, such as completing rig accommodations or electrical work.<sup>5</sup> On its 2009 franchise tax report, Gulf Copper excluded from its total gross revenues the flow-through payments made to both "labor" and "outside specialty" subcontractors based on the (g)(3) revenue exclusion, which for the report year at issue provided:

A taxable entity shall exclude from its total revenue, to the extent [reported to the federal IRS as income], only the following flow-through funds that are mandated by contract to be distributed to other entities...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.<sup>6</sup>

In addition to excluding its subcontractor payments from total revenue, Gulf Copper also elected to use the COGS deduction to calculate its margin under TTC § 171.1012.<sup>7</sup>

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<sup>1</sup> *Hegar v. Gulf Copper & Mfg. Corp.*, No. 03-16-00250-CV, at \*32 (Tex. App.—Austin, Aug. 11, 2017, no pet. h.), available [here](#).

<sup>2</sup> *Id.*

<sup>3</sup> *Id.* at \*4.

<sup>4</sup> *Id.* at 12.

<sup>5</sup> *Id.* at 13.

<sup>6</sup> In 2013, Texas Tax Code § 171.1011 was amended to add "subcontract" in the introductory language of subsection (g); in addition, subsection (g)(3) was amended to substitute "made under a contract or subcontract entered into" for "handled" and added "remediation." Acts 2013, 83rd Leg., ch. 1034 (H.B. 2766), § 1 (effective Jan. 1, 2014). The current language of the (g)(3) revenue exclusion states: "A taxable entity shall exclude from its total revenue, to the extent [reported to the federal IRS as income], only the following flow-through funds that are mandated by contract or subcontract to be distributed to other entities...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" (amendments emphasized). Tex. Tax Code § 171.1011(g). Thus, the 2013 amendments applicable to the (g)(3) revenue exclusion essentially clarified that payments made pursuant to a subcontract (that otherwise satisfy the requirements under TTC § 171.1011(g)) would qualify as an exclusion from revenue. As a result, the guidance provided under the *Gulf Copper* appellate opinion would have continued applicability under the current version of Texas Tax Code § 171.1011(g).

<sup>7</sup> *Gulf Copper & Mfg. Corp.*, No. 03-16-00250-CV, at \*6.

Following an audit, the Texas Comptroller (“Comptroller”) determined the “labor” subcontractor payments were not eligible for the (g)(3) revenue exclusion and instead should be considered in the calculation of Gulf Copper’s COGS deduction.<sup>8</sup> The Comptroller also audited Gulf Copper’s COGS deduction and significantly reduced the expenses included in Gulf Copper’s COGS calculation.<sup>9</sup> Ultimately, the Comptroller found that only costs either directly or indirectly related to the “fabrication” of goods could properly be included in Gulf Copper’s COGS deduction under TTC § 171.1012.<sup>10</sup> Gulf Copper paid the deficiency assessed under the Comptroller’s revised computation and subsequently filed suit against the Comptroller seeking a refund of all amounts paid under protest.

### Travis County District Court Decision

At trial, Gulf Copper asserted both its “labor” and “outside specialty” subcontractors were engaged in providing services, labor, and materials in the form of manufacturing, constructing, developing, improving, creating, and installing component parts for offshore drilling rigs used to construct, remodel, or repair oil and gas wells, which were improvements on real property.<sup>11</sup> Consequently, Gulf Copper alleged payments to the subcontractors qualified for the (g)(3) revenue exclusion because: (1) the payments were mandated by contract; (2) to be paid to an entity other than Gulf Copper; and (3) the funds paid to the subcontractors were for the provision of “services, labor, or materials in connection with the actual or proposed...construction, remodeling, remediation, or repair of improvements on real property.”<sup>12</sup> Gulf Copper also contended the Comptroller had improperly limited the costs that could be included in the calculation of its COGS deduction.<sup>13</sup>

In response, the Comptroller argued the work the “labor” subcontractors performed did not qualify for the (g)(3) revenue exclusion because: (1) the payments did not satisfy the requirement that they be “mandated by contract” to be distributed to other entities; and (2) the work done in exchange for the subcontractor payments was “two steps away” from actual or proposed construction of improvements on real property, and, therefore, was too “remote or attenuated” from any actual or proposed construction to meet the “in connection with” requirement under the (g)(3) revenue exclusion.<sup>14</sup> In relation to COGS, the Comptroller asserted each of Gulf Copper’s facilities was engaged in both fabrication and non-fabrication activities and only the costs of labor and materials associated with the fabrication activities were “costs of acquiring or producing goods” that could properly be included in calculating the COGS deduction under TTC § 171.1012.<sup>15</sup>

Following a three-day bench trial, the District Court rendered judgment in Gulf Copper’s favor and ordered the Comptroller to refund the entire amount paid under protest. The Comptroller appealed on the following grounds: (1) the District Court erroneously allowed Gulf Copper to exclude from its revenue the subcontractor payments pursuant to the (g)(3) revenue exclusion; and (2) the District Court erred in concluding that Gulf Copper’s COGS calculation was correct, resulting in an overstated COGS deduction, regardless of whether the subcontractor payments were properly considered in the COGS calculation rather than excluded from revenue.<sup>16</sup>

### Texas Court of Appeals’ Ruling

#### Subcontractor Exclusion from Revenue

The Court of Appeals first addressed whether Gulf Copper’s payments to its subcontractors were eligible for the (g)(3) revenue exclusion. On appeal, the Comptroller agreed (as it did at trial), that the amounts paid to the “outside specialty” subcontractors constituted flow-through funds mandated by contract to be distributed to other entities and qualified for the (g)(3) revenue exclusion.<sup>17</sup> However, in regard to the “labor” subcontractors, the Comptroller maintained that because Gulf Copper’s contracts with its customers did not mandate that their payments flow through from Gulf Copper to the subcontractors providing the labor, those payments did not qualify for the (g)(3) revenue exclusion.<sup>18</sup>

In response, the Court of Appeals cited their holding in *Titan Transportation, LP v. Combs*, where it was determined that the “mandate” requirement under the (g)(3) revenue exclusion may be contained in either a contract with a customer or in a

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<sup>8</sup> As discussed in more detail below, the Comptroller agreed that the amounts paid to the “outside specialty” subcontractors constituted flow-through funds mandated by contract to be distributed to other entities, and, therefore, were eligible for the exclusion from revenue under Texas Tax Code § 171.1011(g)(3). See *id.* at 14.

<sup>9</sup> *Id.* at 7.

<sup>10</sup> *Id.*

<sup>11</sup> *Id.* at 8.

<sup>12</sup> *Id.*

<sup>13</sup> *Id.* at 9.

<sup>14</sup> *Id.* at 10.

<sup>15</sup> *Id.*

<sup>16</sup> *Id.* at 12.

<sup>17</sup> *Id.* at 14.

<sup>18</sup> *Id.*

contract with the subcontractor.<sup>19</sup> As explained by the Court of Appeals, the evidence admitted at trial established that Gulf Copper was obligated by its contracts with the “labor” subcontractors to pay such subcontractors for that labor, which satisfied the “mandated” requirement of the (g)(3) revenue exclusion.<sup>20</sup>

The Comptroller reiterated the arguments previously made in District Court. Specifically, that the work done by the “labor” subcontractors was too remote or attenuated to satisfy the statutory requirements of the (g)(3) revenue exclusion.<sup>21</sup> Relying again on the *Titan Transportation* decision, the Court of Appeals determined that the work performed by the subcontractors was an activity reasonably connected to the construction of the oil well.<sup>22</sup> As a result, the Court of Appeals upheld the District Court’s decision that Gulf Copper was entitled to include its payments to both the “labor” and “outside specialty” subcontractors as flow-through funds qualifying under the (g)(3) revenue exclusion.<sup>23</sup>

#### Cost of Goods Sold Deduction

The Court of Appeals next considered whether Gulf Copper’s COGS deduction was supported by factually sufficient evidence. As explained by the Court of Appeals, the Texas COGS deduction is calculated in accordance with TTC § 171.1012. Generally, a COGS deduction is only available to the taxable entity that owns the “goods” in question.<sup>24</sup> However, “an 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 and materials and may include the costs, as allowed by [TTC § 171.1012], in the cost of goods sold.”<sup>25</sup> Nevertheless, “[t]he analytic framework for determining whether a particular ‘labor cost’ is includable as cost of goods sold under subsection 171.1012(i) requires determining whether the particular activity is an essential and direct component of the ‘project for the construction...of real property.’”<sup>26</sup>

Here, Gulf Copper did not engage in a cost-by-cost analysis of each expense to determine whether a cost fit into one of the categories of costs the TTC provides may be included in the calculation of COGS, nor did Gulf Copper adopt the analytic framework described above to determine whether its activities that involved furnishing labor to a project for construction or improvement of real property were “an essential and direct component” of a particular project.<sup>27</sup> Instead, Gulf Copper used as a “starting point” for its COGS calculation the trial balance used to prepare its federal income tax return.<sup>28</sup>

The Court of Appeals explained that TTC § 171.1012(h) does not include a directive to use the amount of a taxable entity’s federal income tax COGS deduction as a starting point for calculating its state franchise tax COGS deduction, and, therefore, avoided considering whether each particular cost corresponds to a COGS deduction permitted by TTC § 171.1012.<sup>29</sup> Subsection (h) of TTC § 171.1012 is prefaced by subsection (b), which provides that “a taxable entity that elects to subtract cost of goods sold for the purpose of computing its taxable margin shall determine the amount of that cost of goods sold as provided by this section.” According to the Court of Appeals, the correct interpretation of TTC § 171.1012 is that subsection (b) addresses how to calculate the amount of the COGS deduction while subsection (h) clarifies that a taxable entity must use the same accounting method—either cash basis or accrual—when determining its COGS deduction.<sup>30</sup> The Court of Appeals also noted that by using its federal income tax COGS deduction as the starting point, “Gulf Copper offered insufficient evidence that the expenses included in that calculation actually correspond to the types and categories of expenses permitted to be included in the calculation of a taxable entity’s state franchise tax COGS

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<sup>19</sup> *Id.* at 14 (citing *Titan Transp., LP v. Combs*, 433 S.W.3d 625, 641 (Tex. App.—Austin 2014, pet. denied)). For additional information on the *Titan Transportation* decision, see Deloitte External Tax Alert, *Texas Comptroller Issues Revised Policy for Exclusions and Deduction for Cost of Goods Sold* (July 19, 2016), available [here](#).

<sup>20</sup> *Id.* at 14-15.

<sup>21</sup> *Id.* at 15.

<sup>22</sup> The Court of Appeals noted that the work performed by the subcontractors related to making a rig compliant with state and federal regulations may not be sufficiently related to the “actual or proposed” construction of an improvement to real property to meet the (g)(3) revenue exclusion requirement. However, the Court of Appeals declined to opine on this portion of the subcontractor payments as the Comptroller failed to make any distinction among the subcontractors’ various activities, but rather, simply argued that Gulf Copper was not entitled to take the (g)(3) revenue exclusion at all. As a result, the Comptroller failed to preserve the argument that Gulf Copper may have been permitted to claim a (g)(3) revenue exclusion for some of its subcontractor payments, while other subcontractor payments may have been for work too attenuated to an actual or proposed project to qualify. *Id.* at 17-18.

<sup>23</sup> *Id.* at 18.

<sup>24</sup> *Id.* at 19 (citing Tex. Tax Code § 171.1012(i)).

<sup>25</sup> *Id.* at 20.

<sup>26</sup> *Id.* (internal citations omitted).

<sup>27</sup> *Id.* at 21.

<sup>28</sup> *Id.*

<sup>29</sup> *Id.* at 23.

<sup>30</sup> *Id.* at 25.

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deduction pursuant to section 171.1012.<sup>31</sup> Consequently, the Court of Appeals held that Gulf Copper had overstated expenses in the calculation of its COGS deduction for Texas franchise tax purposes.<sup>32</sup>

The Court of Appeals also took issue with the Comptroller's method of determining the appropriate COGS deduction, which did not calculate the deduction using a cost-by-cost analysis, but instead, developed percentages that it then applied to disallow and remove certain costs.<sup>33</sup>

Ultimately, the Court of Appeals reversed the District Court's judgment as it pertained to the COGS deduction and remanded the issue to the District Court for further proceedings to determine the exact amount of Gulf Copper's refund.<sup>34</sup>

### Considerations

Taxpayers that have included certain subcontractor payments within total revenue may wish to consider filing a refund claim based on the additional guidance provided by the Court of Appeals on qualifying costs. In addition, taxpayers that have utilized their federal COGS as a starting point for determining their Texas COGS deduction should consult with their tax advisors to analyze potential Texas franchise tax implications.

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<sup>31</sup> *Id.*

<sup>32</sup> *Id.* at 27. Specifically, the Comptroller assigned percentages for each of Gulf Copper's facilities, and then reviewed each type of Gulf Copper's expenses for the facility and, if the expense was one that was generally eligible for inclusion in the COGS calculation (as determined by the Comptroller), it allowed the cost on the percentage basis assigned to the facility where the activity generating the expense occurred. *Id.* at 29. For example, the Comptroller allowed 50% of the labor costs associated with the Port Arthur facility, but based on the Comptroller's determination that 50% of the Port Arthur yard activities were "fabrication," the Comptroller determine that 50% of the labor costs at that facility were a direct cost of producing a good, and, therefore, eligible for the COGS deduction. *Id.*

<sup>33</sup> *Id.* at 31.

<sup>34</sup> *Id.* at 32.