

## TX Appellate Court Disallows Certain Installation Labor Costs in Franchise Tax COGS Deduction

### Overview

On February 24, 2017, the Court of Appeals, 3rd District of Texas ("Court of Appeals"), reversed an earlier decision by the 419th Travis County District Court, and held that Autohaus LP, LLP ("Autohaus" or "Taxpayer") was not entitled to include certain costs associated with installing the automotive parts it sold for purposes of calculating the Texas franchise tax cost of goods sold ("COGS") subtraction.<sup>1</sup>

As of the release date of this Tax Alert, the taxpayer has not filed a motion for rehearing with the appellate court or a petition for review with the Texas Supreme Court; however, the period during which such filings may be made remains open.

In this Tax Alert, we summarize the Court of Appeal's decision and offer some taxpayer considerations.

### Background

The Autohaus case involved a business operating as an automotive dealership.<sup>2</sup> One aspect of the Taxpayer's business included selling new and replacement automobile parts to customers and installing such parts into customer-owned vehicles.<sup>3</sup> On its 2009 Texas Franchise Tax report, Taxpayer claimed a COGS deduction that included labor costs incurred as part of repair work to install automotive parts on customer-owned vehicles.<sup>4</sup>

For purposes of the COGS deduction, Texas Tax Code ("TTC") §171.1012 defines "goods" to mean "real or tangible personal property sold in the ordinary course of business of a taxable entity." Pursuant to TTC § 171.1012(c), the COGS deduction "includes all direct costs of acquiring or producing goods, including . . . labor costs." TTC § 171.1012(a)(2) provides that "production" for purposes of the COGS deduction "includes . . . installation" as well as manufacture, development, and other specified activities. TTC 171.1012(i) provides: "A taxable entity may make a subtraction under this section in relation to cost of goods sold only if that entity owns the goods."

On audit, the Texas Comptroller ("Comptroller") disallowed the repair labor costs as part of COGS. In support of its determination, the Comptroller cited 34 Texas Administrative Code § 3.588(b)(7) (hereinafter, referred to as "Rule 3.588"), which defines "installation" that qualifies as "production" for COGS purposes as only including installation that occurs "during the manufacturing or construction process . . . ."<sup>5</sup> As part of the appellate record, the Comptroller also emphasized Rule 5.3588(c)(7) concerning mixed transactions (*i.e.*, those involving services and goods), which provides: "If a transaction contains elements of both a sale of tangible personal property and a service, a taxable entity may only subtract as cost of goods sold the costs otherwise allowed by this section in relation to the tangible personal property sold."<sup>6</sup> According to the Comptroller, the relevant language in TTC § 171.1012 was ambiguous because it did not detail how "mixed transactions" should be handled or include a definition of "installation."<sup>7</sup> Therefore, Rule 3.588 clarified the ambiguity to allow a business to include in its COGS determination "production costs for installation [labor] only when materials are installed into a product that the business owns and is producing for sale in the ordinary course of business."<sup>8</sup>

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<sup>1</sup> *Hegar v. Autohaus, LP, LLP*, No. 03-15-00427-CV, 2017 Tex. App. LEXIS 1575 (Tex. App.—Austin, Feb. 24, 2017, no pet. h.), available [here](#).

<sup>2</sup> *Id.* at \*3.

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

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

<sup>5</sup> See Plaintiff's Original Petition, *Autohaus LP, LLP v. Combs*, No. D-1-GN-13-000989 (419th Dist. Ct., Travis County, Tex. Mar. 22, 2013) (hereinafter "Plaintiff's Petition").

<sup>6</sup> *Autohaus, LP, LLP*, No. 03-15-00427-CV, 2017 Tex. App. LEXIS 1575, at \*5.

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

<sup>8</sup> *Id.* at \*9.

Taxpayer protested the Comptroller's decision and subsequently brought the matter before the District Court. As part of the court proceedings, Taxpayer filed a motion for summary judgment with the District Court, arguing that it should be allowed to deduct all of its repair labor costs. Taxpayer's primary contention was that the Comptroller had erroneously interpreted the plain, unambiguous language of TTC § 171.1012.<sup>9</sup>

### Travis County District Court Opinion

The District Court granted Taxpayer's summary judgment motion and held that Taxpayer was entitled to include in its COGS deduction all of its labor costs involved in installing the automotive parts that it sold. As part of its ruling, the District Court also held that Rule 3.588(b)(7) "as it applies to the term 'production' is unconstitutional and invalid."<sup>10</sup>

### Texas Court of Appeals' Ruling

On appeal, the Court of Appeals addressed whether the repair labor costs were costs of "producing the goods" (*i.e.*, the automotive parts), and whether TTC § 171.1012 was ambiguous. Ultimately, the Court of Appeals held that, in these particular circumstances, the statutory language was not subject to multiple understandings, and, therefore, was unambiguous. As a result, Rule 3.588 did not apply. However, the Court of Appeals also held that the plain language of the statute did not support the position that Autohaus' repair labor costs associated with customer-owned vehicles were properly included as COGS.<sup>11</sup>

As discussed above, the term "production" in TTC § 171.1012 includes the undefined term "installation." The Court of Appeals noted that within TTC § 171.1012(a)(2), "installation" is listed with other "production" activities, such as "construction" and "manufacture," which all address the direct costs of "producing the goods" versus "acquiring" the goods for resale.<sup>12</sup> Here, the goods Autohaus sold in the ordinary course of its business were automotive parts, and the allowed COGS for Autohaus included the direct costs of "acquiring" the parts for resale to its customers under TTC § 171.1012(c). However, the Court of Appeals held Autohaus did not "produce" the automotive parts by installing them into *customer-owned* vehicles while performing repair work.<sup>13</sup> The Court of Appeals further explained:

"This work did not involve installing anything into or onto the automotive part to "produce" the part...Autohaus did not, in any way, modify, make, or complete the automotive part to "produce" it."<sup>14</sup>

As a result, the repair costs on the customer-owned vehicles were found to be costs of "services," which are excluded from COGS.<sup>15</sup> Because the Court of Appeals rendered its decision based on the plain language of TTC § 171.1012, the Court of Appeals did not address the district court's previous ruling on the validity and constitutionality of Rule 3.588. As a result, Rule 3.588 remains in effect.

Autohaus has the option to file a new motion for rehearing within 15 days of the Court of Appeals' opinion.<sup>16</sup> In addition, Autohaus may file a petition for review with the Texas Supreme Court within 45 days of the last ruling of the Court of Appeals on all timely filed motions for rehearing.<sup>17</sup> Thus, as of the date of this Alert, the case is not yet final.

### Considerations

Although *Autohaus* is not yet final, taxable entities that have deducted installation labor costs associated with customer-owned goods when determining the COGS deduction should consult with their tax advisors to analyze potential Texas franchise tax implications.

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<sup>9</sup> See Plaintiff's Petition at \*4.

<sup>10</sup> Order Granting Plaintiff's Motion for Summary Judgment, *Autohaus LP, LLP v. Combs*, No. D-1-GN-13-000989 (419th Dist. Ct., Travis County, Tex. Jul. 22, 2014).

<sup>11</sup> *Hegar v. Autohaus, LP, LLP*, No. 03-15-00427-CV, 2017 Tex. App. LEXIS 1575 (Tex. App.—Austin, Feb. 24, 2017, no pet. h.), at \*10 (internal quotes omitted).

<sup>12</sup> *Id.* at \*11; see Tex. Tax Code § 171.1012(c) (stating that "cost of goods sold includes all direct costs of acquiring...the goods").

<sup>13</sup> *Autohaus, LP, LLP*, No. 03-15-00427-CV, at \*12.

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

<sup>15</sup> See *id.* (citing Tex. Tax Code § 171.1012(a)(3)(B)(ii)). However, as discussed within a footnote of the appellate opinion, "[w]hen Autohaus was able to show that it was the owner of the vehicle being repaired, the Comptroller allowed the costs to install automotive parts on the vehicle to be included as cost of goods sold because those were "direct costs" of "producing" the goods sold—the vehicle—as compared with the automotive part." *Id.* at \*13, FN 5. Thus, there appears to be an important distinction between installation costs incurred on customer-owned vehicles versus installation costs incurred on taxpayer-owned vehicles.

<sup>16</sup> Tex. R. App. P. 49.5

<sup>17</sup> Tex. R. App. P. 53.7(a).

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