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The Texas Supreme Court Provides Important Guidance in Construing Two Statutory Provisions Dealing with Real Property Work for Texas Franchise Tax Purposes

By David E. Colmenero and Alex J. Pilawski on April 8, 2020

In one of three recent cases addressing the Texas franchise tax, the Texas Supreme Court held that a company engaged in performing work on offshore oil-and-gas drilling rigs could not claim a cost of goods sold deduction with respect to certain costs incurred with that work, but could exclude payments to subcontractors from total revenue. In doing so, the Court examined the relationship between two statutory provisions in the Texas franchise tax statutes specifically addressing real property work, namely Sections 171.1011(g)(3) and 171.1012(i). See Hegar v. Gulf Copper & Mfg Corp. v. Hegar, (Cause No. 17-0894) (Tex. Apr. 3, 2020). Taxpayers and practioners will want to carefully consider existing and future reporting positions in light of this recent decision.

Gulf Copper was engaged in surveying, repairing and upgrading offshore oil-and-gas well drilling rigs. Part of the work was performed by independent contractors who were paid on a hourly basis. Gulf Copper argued it could exclude payments to independent contractors from total revenue under Section 171.1011(g)(3), which permits an exclusion from total revenue for certain payments mandated by contract to be distributed to other entities, including subcontracting payments for 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." Gulf Copper also claimed that other costs could be deducted under Section 171.1012(i), which permits a cost of goods sold deduction to taxable entities "furnishing labor or materials to a project for the construction, improvement, remodeling, repair, or industrial maintenance ... of real property...." Gulf Copper further argued it could deduct these items under the more general provisions of Section 171.1012(c) and (d).

In addressing the applicability of Section 171.1011(g)(3), the Court held that payments to independent contractors could be excluded from total revenue. The Court held that the phrase "in connection with ... requires more than a remote, tangential relationship to the requisite design, remodeling or repair of real-property improvements." The Court determined that payments to the independent contractors satisfied this requirement citing the district court's unchallenged findings of fact which established that the taxpayer's work was a necessary component of enabling the rigs to drill at specified wells.

The Court further held that, because the taxpayer was contractually obligated to pay its subcontractors to perform their work, amounts paid to the subcontractors were "mandated by contract" for purposes of Section 171.1011(g)(3) to flow through the taxable entity to the subcontractor. In rejecting the Comptroller's narrow interpretation of this provision the Court stated, the "mandated by contract" language does not require that funds be earmarked in a contract and "requires only that there be a contract or subcontract in place requiring that the taxable entity's subcontractors be paid."

With respect to the cost of goods sold deduction, the Court stated that, while the phrase "in connection with" in Section 171.1011(g)(3) is an expanding term, the phrase "furnishing to" in subsection (i) reflects restricting language. Under this more limiting language, the Court held that "the requisite labor or materials must be furnished to or incorporated into the real property itself." According to the Court, Gulf Copper did not satisfy this requirement because the labor and materials to survey, repair, and upgrade the rigs were not and did not become part of the wells or well sites.

The Court also rejected Gulf Coppers' broader argument under Section 171.1012(h) that it should be able to include all of its costs in cost of goods sold to the extent deductible for federal tax purposes subject only to the limitations in subsections (e) and (f). Subsection (h) requires a taxable entity to "determine its cost of goods sold, except was otherwise provided by [Section 171.1012], in accordance with the methods used on the federal income tax return on which the report ... is based." The Court construed this subsection to mean that "federal methods are to be used only where there are gaps in the Texas statute." For example, as the Court of Appeals had previously noted, the Tax Code gives no specific instruction as to what accounting method a taxable entity must use in calculating its costs (e.g., cash or accrual). Therefore, a taxable entity must use the same accounting method used on its federal return.

The Court remanded the case back to the district court to determine whether the remaining costs fall within the scope of the non-exhaustive list of costs allowed by subsections (c) and (d). Stated the Court, "whether a particularly cost may be included in the COGS subtraction is not dependent on whether a taxable entity engages in some qualifying activities but rather on whether that cost independently meets the requirements of Section 171.1012."

The Court's holding in Gulf Copper provides important guidance on the applicability of the two key statutory provisions addressing real property work: (Section 171.1011(g)(3) and Section 171.1012(i). These two sections have been the source of controversy between taxpayers and the Texas Comptroller and are likely to continue being so following the Court's holding. Current reporting practices should be examined in the context of this holding, not only with respect to prior reports, but particularly as the 2020 franchise tax reports become due.

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