Dallas Bar Association Tax Section

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Texas in Review: The Twists and Turns of Texas Taxation

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Franchise Tax: Real Property Work

Titan Transportation, LP v. Texas Comptroller, 433 S.W.3d 625 (Tex. App. Austin, March 14, 2014, pet. denied): Exclusion from Total Revenue

- Facts: Titan is in the business of transporting aggregate to construction sites where it is used in construction projects.
- Issue: Titan claimed that it was entitled to exclude from Total Revenue payments made to independent contractors under Section 171.1011(g)(3). Prior to 2013, Section 171.1011(g)(3) permits an exclusion from total revenue for flow-through funds that are mandated by contact to be distributed to other entities including "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." (emphasis added).

Franchise Tax: Real Property Work

Titan Transportation, LP v. Texas Comptroller, 433 S.W.3d 625 (Tex. App. Austin, March 14, 2014, pet. denied): Exclusion from Total Revenue

- The Comptroller argued that (g)(3) requires that the taxable entity: (i) must provide design construction, remodeling or repair services which Titan did not do; (ii) must have a written contract with its customers that essentially requires the subcontract; and (iii) can only meet the flow-through requirement if third-party payments are segregated and paid to the subcontractor only when the Taxpayer has received the money. Titan did not meet any of these requirements.

Franchise Tax: Real Property Work

Titan Transportation, LP v. Texas Comptroller continued…

- Court overruled Texas Comptroller:
  - On the first issue, the Court agreed with Taxpayer arguing that all that is required is a "reasonable nexus" between the service, labor and materials provided by the subcontractor and the real property work. The Court also rejected a related Texas Comptroller argument that a subcontractor must be involved in activities that make a physical change to property to qualify for the exclusion.
  - On the second issue, the Court overruled Comptroller policy relating to the applicability of the exclusion in Section 171.1011(g) only if a contract with a client state that the taxable entity will subcontract out a specified portion of the work. A "tripartite" contractual relationship is not required.

Franchise Tax: Real Property Work

Titan Transportation, LP v. Texas Comptroller continued…

- Court overruled Texas Comptroller:
  - On the third issue, the Court held that the evidence showed that Titan earned and retained only 16% of its customers' gross customer receipts and that the remainder was passed through to the subcontractors, which satisfied the "flow-through" requirements. Failure to treat these payments as flow-through would ignore the "economic realities" of the transactions and could result in double taxation.

Note: Section 171.1011(g)(3) was amended in 2013 to include the word "subcontract."

Franchise Tax: Real Property Work

Combs v. Newpark Resources, Inc., 422 S.W.3d 46 (Tex. App. – Austin, Dec. 31, 2013, no pet.): Cost of Goods Sold/Combined Reporting

- Facts: Taxpayer was a combined group involved in the manufacture, sale, injection, and removal of drilling mud used in oil and gas production. One of the subsidiary entities removed the drilling mud from the well and transported it to waste disposal sites.
- Issue: Taxpayer argued that the subsidiary "furnish[ed] labor or materials to a project for the construction improvement, remodeling, repair or industrial maintenance…of real property…" and its costs were therefore includible in the combined group's cost of goods sold deduction.

Franchise Tax: Real Property Work

Combs v. Newpark Resources, Inc., 422 S.W.3d 46 (Tex. App. – Austin, Dec. 31, 2013, no pet.): Cost of Goods Sold/Combined Reporting

- Held: The court held that, under the plain language of the statute, the subsidiary entity's eligibility to take a cost of goods sold deduction must be viewed within the context of the combined group's overall business rather than in isolation. The court also held that the costs of the entity in question were attributable to labor provided for the construction and improvement of real property and were thus includible in the combined group's cost of goods sold deduction.

Franchise Tax: Real Property Work

Internal Memo (June 30, 2016): Cost of Goods Sold v. Exclusion from Total Revenue

- *Supersedes June 10, 2014 Memo*
  - 171.1011(g)(3): Subcontracting payments that are mandated by contract to be distributed to others and have a reasonable nexus to the actual or proposed design, construction, remodeling, or repair of improvements to real property or the location of boundaries of real property may be excluded.
  - A payment is mandated by contract to be distributed to other entities if the taxable entity has a contract with its customer providing that a subcontractor may be used and requiring payment to the subcontractor, or 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 (e.g., subcontract requires payment based on percentage received from customer). Timing of payment does not determine if payment qualifies as flow-through.

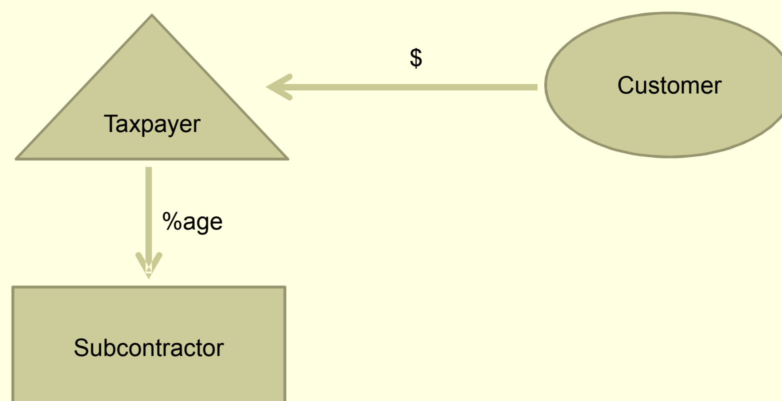
Franchise Tax: Real Property Work

Internal Memo (June 30, 2016): Cost of Goods Sold v. Exclusion from Total Revenue

- Section 171.1011(g)(3): Provides for the exclusion from total revenue of the following: "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."

Franchise Tax: Real Property Work

Illustration:



Franchise Tax: Real Property Work

Internal Memo (June 30, 2016): Cost of Goods Sold v. Exclusion from Total Revenue

- 171.1012(i): No longer required to actually physically touch the property or make a change to the property to qualify for the COGS deduction.
- The policy changes are similar for both Sections 171.1011(g)(3) and 171.1012(i), but with one slight difference. Both permit industries such as transportation companies delivering aggregate and other similar materials to a construction site, waste removal companies, demolition companies, and inspectors, among others, to *claim either a COGS deduction* or an exclusion from revenue – provided the transaction meets the contractual requirement of flow-through funds as described above. The one slight difference is that Section 171.1011(g)(3) uses the term "proposed" – absent from Section 171.1012(i) – which may permit costs for activities performed by architects and engineers to qualify as exclusions from revenue, without regard to whether construction occurs. (emphasis added).

Franchise Tax: Real Property Work

Internal Memo (June 30, 2016): Cost of Goods Sold v. Exclusion from Total Revenue

- Section 171.1012(i) provides in relevant part as follows: "A taxable entity furnishing labor or materials to a project for the construction, improvement, remodeling, repair, or industrial maintenance (as the term "maintenance" is defined in 34 T.A.C. Section 3.357) of real property is considered to be an owner of that labor or materials and may include the costs, as allowed by this section, in the computation of cost of goods sold."

Franchise Tax: Real Property Work

Hegar v. Gulf Copper & Mfg. Corp., 2017 Tex. App. LEXIS 7631, (Ct. App-Austin Aug. 11, 2017, pet. filed)

Facts: Taxpayer is primarily engaged in surveying, manufacturing, upgrading and repairing offshore drilling rigs. A related entity inspects marine vessels, including offshore drilling rigs, and cargo. Taxpayer excluded from total revenue payments made to subcontractors claiming they were excludable under Tex. Tax Code § 171.1011(g)(3). The subcontractor payments at issue were for workers who performed the same types of tasks performed by Taxpayer's employees. They were paid a rate of $35 to $38 per hour. Taxpayer billed its customers $54 per hour per worker.

Issue: Taxpayer argued that payments to its subcontractors could be excluded from total revenue under Section 171.1011(g)(3). Alternatively, it argued that all of its federal cost of goods sold amount, including the subcontractor payments, could be included in cost of goods sold subject to limited exceptions on the basis of Section 171.1012(h), which states, "A taxable entity shall determine its cost of goods sold, except as otherwise provided by this section, in accordance with the methods used on the federal income tax return."

Franchise Tax: Real Property Work

Hegar v. Gulf Copper & Mfg. Corp. continued…

Held: The Court agreed with Taxpayer that it could exclude payments to the subcontractors under Section 171.1011(g)(3) on the basis of Titan. The Court held that doing work on offshore drilling rigs that renders them able to perform the drilling services required to drill a particular well is an activity that is reasonably connected to the construction of that oil well. Performing more general work presented a closer question according to the Court. However, because the State did not raise this latter issue, all of the subcontractor payments could be excluded.

The Court disagreed with Taxpayer's cost of goods sold argument. Section 171.1012(h) does not permit a taxpayer to use the entity's federal income tax COGS sold as a starting point, according to the Court. Rather, it simply clarifies that the taxable entity must use the same accounting method – either cash or accrual – in computing its deduction.

Franchise Tax: Real Property Work

Hegar v. Gulf Copper & Mfg. Corp. continued…

Subsequent History:

- The State filed a Petition for Review on December 20, 2017 related to the COA's ruling on Taxpayer's Exclusion and COGS argument;
- The Taxpayer filed its own Petition for Review on March 22, 2018 related to COA's ruling on its COGS argument.

Franchise Tax: Apportionment

Hallmark Marketing Company, LLC v. Hegar, 2016 LEXIS 314 (Tex. Sup. Ct. April 15, 2016)

- Facts: For 2008, Hallmark generated $4,516,155,458 in gross receipts and $628,243,514 in losses on sales of investments and capital assets. For apportionment purposes, Hallmark excluded the loss amount from the denominator. Following an audit, the Comptroller assessed additional tax claiming that the denominator should be reduced by the loss amount.
- Issue: At issue is Section 171.105(b) which states that, "[i]f a taxable entity sells an investment or capital asset, the taxable entity's gross receipts … includes only the net gain from the sale."

Franchise Tax: Apportionment

Hallmark Marketing Company, LLC, cont'd:

- Court of Appeals: The term "net gain" is ambiguous. It could refer to the particular gain or loss that results from each individual sale or it may instead refer to the taxpayer's cumulative gain or loss on its various investment and capital asset sales. Under the former, losses resulting from individual sales would not be deducted, but under the latter, they would. Citing to the Third Court of Appeals prior holding in *Calver v. Electro-Science Investors, Inc*., 509 S.W.3d 700, 702 (Tex. Civ. App.–Austin, 1974, no writ), the court found that the Texas Comptroller's interpretation was reasonable.

- Note: The statutory language at issue in *Calvert* read, "[A]s to the sale of investments and capital assets, the term 'total gross receipts of the corporation from its entire business' shall include only the net gain from such sales."

Franchise Tax: Apportionment

Hallmark Marketing Company, LLC, cont'd:

- Texas Supreme Court Holding (April 15, 2016): Citing the plain language of Section 171.105(b), the Texas Supreme Court held that Hallmark was not required to reduce the denominator of its apportionment factor by net losses generated from the sale of investments of the Texas Tax Code which states that "only net gain" from the sale of an investment or capital asset is included in the denominator. While noting that it was not bound by the decision in *Electro-Science*, the Court stated that it did not have to relitigate that issue as Hallmark did not generate a net gain under any calculation.

Franchise Tax: Apportionment

Hallmark Marketing Company, LLC, cont'd:

- Texas Supreme Court: "Our goal in interpreting any statute is to ascertain and give effect to the legislature's intent as expressed by the language of the statute…. We presume the legislature chose a statute's language with care, including each word chosen for a purpose while purposely omitting words not chosen….If a statute is unambiguous, we adopt the interpretation supported by its plain language unless such interpretation would lead to absurd results."
- The *Hallmark* decision carries significant implications for any taxpayers that generate losses from the sale of investments and capital assets. Any taxpayer that has generated such losses in the recent past will want to review its Texas franchise tax reports in light of this decision

Franchise Tax: Apportionment

Internal Memo (July 7, 2017), Accession No. 201707002L

- "We have revised the policy regarding the treatment of net losses from the sale of investments and capital assets in calculating gross receipts for apportionment purposes.

  ***

- Although the 'net gain' language only appears in Section 171.105 for gross receipts everywhere, we will also apply the *Hallmark* decision to the calculation of Texas receipts. There must be symmetry between Texas receipts and gross receipts everywhere…"

Query: Is this a correct application of *Hallmark*?

Franchise Tax: Apportionment

Graphic Packaging, Inc. v. Combs, 471 S.W.3d 138 (Tex. App. -- Austin, July 28, 2015, pet. granted): Apportionment/MTC Three-Factor

- Facts: Taxpayer claims that it should be entitled to use the 3-factor apportionment formula provided for under the Multi-State Tax Compact. The trial court denied Graphic's motion for partial summary judgment and granted the Comptroller's cross-motion concluding that Graphic was not entitled to apportion its tax base under the Compact formula.
- Held: On July 28, 2015, the Third Court of Appeal held the three-factor apportionment formula does not apply to the Texas franchise tax because the Texas franchise tax is not an income tax. According to the Court, none of the alternative ways of computing the franchise tax results in taxing net income.

Franchise Tax: Apportionment

- Section 171.106 of Tax Code: "[A] taxable entity's margin is apportioned to this state…by multiplying the margin by a fraction, the numerator of which is the…entity's gross receipts from business done in this state…and the denominator of which is the…entity's gross receipts from its entire business…"
- Section 141.001 of MTC: "The Multistate Tax Compact is adopted and entered into with all jurisdictions…"
  - Article III, Section 1: "Any taxpayer subject to an income tax whose income is subject to apportionment and allocation for tax purposes pursuant to the laws of the party state…may elect to apportion and allocate in accordance with Article IV."
  - Article IV, Section 8: "All business income shall be apportioned to this state by multiplying the income by a fraction, the numerator of which is the property factor plus the payroll factor plus the sales factor, and the denominator of which is three."
  - Article IV, Section 1(a): "'Business income' means income arising from transactions and activity in the regular course of the taxpayer's trade or business and includes income from tangible and intangible property if the acquisition, management, and disposition of the property constitute integral parts of the taxpayer's regular trade or business operations."

Franchise Tax: Apportionment

Graphic Packaging, Inc. v. Combs, 538 S.W.3d 89 (Tex. Dec. 22, 2017):

- The Texas Supreme Court held that Graphic Packaging could not use the three-factor apportionment formula provided for in the Multistate-Tax Compact for apportioning Texas franchise tax, notwithstanding that Texas is a member of the Compact.
- Without deciding if the Texas franchise tax is an income tax, the Texas Supreme Court held that the Texas Legislature made the single-factor apportionment formula provided for in the Texas Tax Code the exclusive formula for apportioning Texas franchise tax.
- In addition, the Court held that the Compact is not a binding regulatory compact for the State of Texas. For this reason, Graphic Packaging could not use the three-factor apportionment formula in the Texas Tax Code for Texas franchise tax.

Franchise Tax: Apportionment

American Airlines, Inc. v. Hegar, Cause No. D-1-GN-16-000621, (pending in Travis County D. Ct.)

- Plaintiff, an airline company, claims that the Texas franchise tax violates the Federal Anti-Head Tax Act, which prohibits a state from assessing "a tax, fee, head charge, or other charge on an individual traveling in air commerce; the transportation of an individual traveling in air commerce; the sale of air transportation; or the gross receipts from that air commerce or transportation." 49 U.S.C. §40116(b).
- Plaintiff cites to *Graphic Packaging* and the Comptroller's arguments for the proposition that the franchise is more akin to a "gross receipts tax." As such, Plaintiff argues that the franchise tax violates the Federal Anti-Head Act.
- Plaintiff filed a motion for summary judgment on August 11, 2016. State filed plea to the jurisdiction on August 16, 2016.

Franchise Tax: Apportionment

Siruis XM Radio, Inc. v. Hegar, Cause No. D-1-GN-16-000739, (pending in Travis County D. Ct.)

- Facts: According to the lawsuit, Sirius XM Radio, Inc. ("SXM") provides a satellite radio service that, among other things, transmits music, sports, talk, entertainment, traffic and weather channels to subscribers throughout the U.S., including subscribers in Texas.
- Issue: The Comptroller claims that the apportionment factor should be based on where the signal is descrambled using a percentage of customers located in Texas applied to against everywhere receipts. SXM argues that all revenues should be sourced outside of Texas because the location of SXM's headquarters, satellite equipment and production facilities are all outside of Texas.
- State filed motions for summary judgment on February 1, 2017 and February 3, 2017.

Franchise Tax: Apportionment

Hearings 111,864-111,869: Prepaid Telephone Cards

- Taxpayer is a seller of prepaid telephone cards. Taxpayer sought a refund of Texas franchise tax on the basis that (i) the sale of prepaid calling cards constitutes the sale of telephone services; (ii) calls made with the prepaid calling cards are international in nature and cannot, therefore, be sourced to Texas; (iii) Taxpayer is entitled to a cost of goods sold deduction for the cost of the prepaid calling cards; and (iv) Taxpayer is entitled to use the reduced rate available to retailers and wholesalers
- The Comptroller claims that Taxpayer is engaged in selling intangibles and does not, therefore, qualify to use the apportionment sourcing rules applicable to telephone service providers, the cost of goods sold deduction or the .5% rate. The Comptroller also claims that the 2008 refund year is barred by the statute of limitations.

Franchise Tax: Apportionment

Hearings 111,864-111,869: Prepaid Telephone Cards

- **Rule 3.591(e)(30):**
  - (A) Revenues from telephone calls that both originate and terminate in Texas are Texas receipts.
  - (B) Revenues from telephone calls that originate in Texas but terminate outside of Texas or that originate outside of Texas but terminate in Texas are excluded from Texas receipts.
- **Rule 3.591(e)(21)(B):**
  - Sales of intangibles are apportioned based on the location of the payor.

Franchise Tax: Apportionment

Hearings 111,864-111,869: Prepaid Telephone Cards

- In a prior decision (*Hearing No. 108,113* (July 9, 2013)) involving a cost of goods sold issue, the Comptroller held,

  "the Comptroller's policy treating [the sale of] prepaid calling cards as intangible personal property is mandated by the plain language of Texas Tax Code Section 171.1012. ***Petitioner's customers are paying for the telecommunication services embedded in the calling card, and not for the card itself."*** *(emphasis added).*

- ***Query***: For apportionment purposes, should the sale of Prepaid Calling Cards be treated as the sale of telephone services or intangibles?

Franchise Tax: Apportionment

Hearings 111,864-111,869: Prepaid Telephone Cards

- The Comptroller also claims that the 2008 refund year is barred by the statute of limitations. Taxpayer filed its refund claim later than 4 years from when the report for 2008 was due, but within 4 years from when the Comptroller's assessment became final.
- Generally, a refund claim must be filed within 4 years from when tax was due and payable or 6 months after determination becomes final.
- Tax on an assessment is due and payable 10 days after it becomes final under Tex. Tax Code Sec. 111.0081. Tax on original report is due by due date of report.
- ***Query***: When is tax "due and payable" for purposes of triggering 4-year SOL?

Franchise Tax: Apportionment

Hearings 111,864-111,869: Prepaid Telephone Cards

- On June 27, 2016, the ALJ issued a final Proposal for Decision ruling in favor of taxpayer for all years other than the 2008 report year. The 2008 year was denied on SOL grounds.
- The Comptroller issued a final decision adopting the PFD on October 13, 2016.
- Taxpayer has filed a lawsuit in Travis County district court on the 2008 statute of limitations issue.

Franchise Tax: Cost of Goods Sold

American Multi-Cinema, Inc. v. Combs, 2015 Tex. App. LEXIS 4388 (Tex. App. – Austin, Texas April 30, 2015, opinion withdrawn and substituted): Movie Theaters

- Facts: Taxpayer is engaged in the movie theater business. It claims that it is entitled to include the cost of exhibiting movies and other content to its customers. Taxpayer also claims that it is engaged in producing TPP and therefore costs of the entire auditorium are costs that may be included in cost of goods sold.
- Held: On April 30, 2015, the Third Court of Appeals agreed with Taxpayer. The court held that the exhibition of movies by Taxpayer constitutes the production of personal property for which a cost of goods sold deduction could be claimed. The cost of exhibiting movies and other content to paying customers could be included in cost of goods sold. In addition, costs associated with the square footage of its auditoriums were also direct costs of production.

Franchise Tax: Cost of Goods Sold

American Multi-Cinema, Inc. v. Combs, 2017 Tex. App. LEXIS 85 (Tex. App. – Austin, Texas Jan. 6, 2017, pet. filed): Movie Theaters

- On Motion for Rehearing, the Court withdrew its decision and substituted another decision that arrived at the same conclusion but on different grounds.
- The Court concluded that AMC qualified for a COGS deduction under Section 171.1012(a)(3)(A)(i) stating "Because it is dispositive, we limit our review of the evidence to AMC's theory under section 171.1012(a)(3)(A)(ii) and expressly do not resolve whether the evidence also supports the trial court's finding that AMC's product falls within the definition of "tangible personal property" in section 171.1012(a)(3)(A)(i).

Franchise Tax: Cost of Goods Sold

American Multi-Cinema, Inc. v. Combs, 2017 Tex. App. LEXIS 85 (Tex. App. – Austin, Texas Jan. 6, 2017, pet. filed): Movie Theaters

- The court again rejected the Comptroller's argument that the sale of a movie ticket constitutes the sale of a service or an intangible, noting that the definition of TPP does not have a take home requirement.
- The court also affirmed its prior holding that AMC was engaged in production activities in exhibiting its films for purposes of the COGS deduction.

Franchise Tax: Cost of Goods Sold

NTS Communications v. Combs: Do telephone, cable and Internet access services qualify for the cost of goods sold deduction?

- "Goods" means real or tangible personal property sold in the ordinary course of business of a taxable entity.
- "Tangible personal property" includes personal property that can be seen, weighed, measured, felt, or touched or that is perceptible to the senses in any other manner.
- Mixed Transaction Rule: 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.

Franchise Tax: Cost of Goods Sold

NTS Communications v. Combs: Do telephone, cable and Internet access services qualify for the cost of goods sold deduction?

- Travis County District Court Ruled in Favor of Texas Comptroller on August 24, 2016.
- Notice of Appeal Filed November 18, 2016 by Petitioner.
- Submitted for consideration on the briefs, March 23, 2018.

Franchise Tax: Cost of Goods Sold

Autohaus LP, LLP v. Combs (Tex. Dist. Ct. April 29, 2015): Installation Activities

- Facts: Taxpayer is an automobile dealer in the business of selling and repairing automobiles. At issue were labor costs associated with the installation of automobile parts in the repair business.
- Issue: Taxpayer claimed these labor costs were includable in cost of goods sold under the plain language of Tex. Tax. Code 171.1012 as the definition of "production" in 171.1012(a)(2) included "installation." Comptroller argued that "production" was defined by Texas Admin. Code. 3.588(b)(7) and thus only included "installation during the manufacturing or construction process."

Franchise Tax: Cost of Goods Sold

Autohaus LP, LLP v. Combs (Tex. Dist. Ct. April 29, 2015): Installation Activities

- The District Court granted Plaintiff's Motion for Summary Judgment in its entirety, granting the deduction and associated refund, along with declaring that Tex. Admin. Code 3.588(b)(7) is invalid because it conflicts with Tex. Tax. Code 171.1012(a)(2). Final Judgment entered April 29, 2015.
- The District Court also awarded taxpayer attorneys' fees.

Franchise Tax: Cost of Goods Sold

Definition of Production:

- Section 171.1012(c): Cost of goods sold includes all direct costs of acquiring or producing goods.
- Section 171.1012(a)(2): "'Production' includes construction, *installation*, manufacture, development, mining, extraction, improvement, creation, raising, or growth."
- Comptroller Rule 3.588(a)(7): "Production – Construction, manufacture, *installation occurring during the manufacturing or construction process*, development, mining, extraction, improvement, creation, raising, or growth."
- ***Query***: Should installation labor be included in cost of goods sold regardless of whether related to manufacturing or construction?

Franchise Tax: Cost of Goods Sold

Hegar v. Autohaus LP, LLP, 514 S.W.3d 897 (Tex. App. – Austin Feb. 24, 2017, pet. filed): Installation Activities

- Held (on appeal): "[W]e cannot agree with Autohaus' interpretation of the statute that it also 'produced' the automotive parts by subsequently installing them on customer-owned vehicles while performing repair work. This work did not involve installing anything into or onto the automotive part to 'produce' the part – the automotive part had already been 'produced' prior to Autohaus's 'acquiring' it for resale. In other words, Autohaus did not, in any way, modify, make, or complete the automotive part to 'produce' it." The court also overruled the district court's award of attorneys fees.

Petition for review filed with Texas Supreme Court on May 24, 2017.

2017 Franchise Tax Bill Enacted into Law

HB 4002 (Rep. Dennis Bonnen): Cost of Goods Sold

Amends the definition of "production" as follows:

- "Production" means ~~*[includes]*~~ construction, ~~*[installation]*~~, manufacture, development, mining, extraction, improvement, creation, raising, or growth."
- Effective: September 1, 2017.

Franchise Tax: Cost of Goods Sold

Hegar v. Sunstate Equipment Co., LLC, 2017 Tex. App. LEXIS 481 (Tex. App. – Austin, January 20, 2017, pet. filed): Heavy Duty Equipment Leasing Costs

- Facts: Sunstate Equipment Co, LLC rents heavy machinery to contactors charging delivery and pick-up fees as part of its contracts. It included costs associated with the delivery and pick-up services in cost of goods sold which the Comptroller disallowed following an audit.
- Issues: Sunstate argued that its costs could be included in COGS under Section 171.1012(k-1) and Section 171.1012(i). The Comptroller argued that the costs were not deductible under Section 171.1012(e) which excludes from COGS "distribution costs, including outbound transportation costs …"

Franchise Tax: Cost of Goods Sold

Hegar v. Sunstate Equipment Co., LLC, 2017 Tex. App. LEXIS 481 (Tex. App. – Austin, January 20, 2017, pet. filed): Heavy Duty Equipment Leasing Costs

- Section 171.1012(k-1) permits certain heavy construction equipment rental or leasing companies to include in COGS "costs otherwise allowed by this section in relation to TPP that the entity rents or leases in the ordinary course of business."
- Section 171.1012(i) states that an "entity furnishing labor or materials to a project for the construction, improvement, remodeling, repair or industrial maintenance … of real property" is considered the owner of the labor or materials and "may include the costs, as allowed by this section, in the computation of cost of goods sold."

Franchise Tax: Cost of Goods Sold

Hegar v. Sunstate Equipment Co., LLC, 2017 Tex. App. LEXIS 481 (Tex. App. – Austin, January 20, 2017, pet. filed): Heavy Duty Equipment Leasing Costs

- Held: The court agreed with the Comptroller holding in part that Section 171.1012(k-1) was intended to extend the COGS deduction to allow qualifying rental companies to deduct costs of obtaining the equipment they rent out. The delivery and pick up costs were not direct costs of acquiring or producing the equipment rented. The costs were more akin to the distribution and outbound transportation costs that are specifically excluded from COGS.
- The Court also disagreed that Sunstate could deduct its delivery and pick-up costs under Section 171.1012(i). The Court noted that Sunstate rented equipment to subcontractors involved in construction work. According to the Court, the subcontractors might be able to rely on subsection (i), but not Sunstate.

Franchise Tax: Cost of Goods Sold

Corning v. Hegar, 534 S.W.3d 28 (Tex. App.—San Antonio, April 5, 2017, pet. denied): Product Liability Costs

- Facts: Owens Corning made a one-time payment of $2.2 billion into an asbestos trust fund to cover personal injury claims it had previously sold containing asbestos. Owens Corning stopped selling the products in 1973 but many of its products containing asbestos continued to be sold after then. Owens Corning filed a franchise tax report for the 2008 report year including the payment in its cost of goods sold deduction claiming it was deductible as a cost of quality control. The Comptroller disagreed and this lawsuit ensued.
- Held: After reviewing the examples provided in the Tax Code for costs includable in cost of goods sold as a quality control cost, the Court concluded that only costs incurred to improve the quality of products sold qualify as quality control costs. In this case, the costs were not made to improve the quality of the asbestos-related products or goods. Thus, the payment made to the asbestos trust fund to pay personal-injury claims in pending and future asbestos-product-liability lawsuits was not a cost of quality control under Section 171.1012.

Sales Tax

Fitness International, LLC v. Hegar, 2016 Tex. App. LEXIS 6337 (Third Ct. App. – Austin, June 16, 2016, pet. denied): Sales for Resale Exemption

- Fitness International, LLC (Fitness) owns and operates health clubs in Texas that sell memberships granting access to the facilities. Fitness argued that the purchase of items such as personal sanitation consumables (e.g., body wash, shampoo and hand sanitizer), towels, basketballs and work out equipment, including cardio machines, abdominal machines, stretch machines, arm/shoulder equipment, leg equipment, weight racks, scales and promotional flyers qualified for the resale exemption.
- The trial court held in favor of Fitness on all items except the equipment and promotional flyers. On appeal, the Comptroller did not challenge the trial court's holding in favor of Taxpayer but continued to argue that the work-out equipment did not qualify for the resale exemption.

Sales Tax

Fitness International, LLC v. Hegar, 2016 Tex. App. LEXIS 6337 (Third Ct. App. – Austin, June 16, 2016, pet. denied): Sales for Resale Exemption

- At issue was Section 151.006(a)(3) which states that a sale for resale includes a sale of "tangible personal property to a purchaser who acquires the property for the purpose of transferring it … as an integral part of a taxable service."
- Citing the dictionary meaning of the terms "transfer" and "resell", the Court concluded that Fitness did not purchase the equipment and other items at issue for the purpose of (i) reselling them, (ii) transferring (i.e. legally conveying) them; (iii) transferring legal possession of them (so as to make members' property rights equal to or superior to Fitness's rights) or (iv) offering them for lease or rental. Fitness therefore could not purchase these items tax free under the sale for resale exemption.

Sales Tax

Hegar v. CheckFree Services v. Corp., 2016 Tex. App. LEXIS 4039 (Tex. Civ. App.—Houston, April 19, 2016, no pet.): Data Processing

- Facts: Taxpayer contracted with several banks to provide bill pay services through the banks' online banking services to bank customers. The Comptroller claimed that these services were taxable data processing services. The trial court help that the services at issue were "bill pay services" and not data processing services and therefore not taxable. Specifically, the Trial Court held, "CheckFree has thousands of skilled and/or certified professionals who collaborate in the performance of these professional services centered around bill payment."
- Held: The Houston Court of Appeals agreed with the Trial Court that the services were not taxable. "[T]o the extent that CheckFree provided [data processing services], they were ancillary to the professional bill pay services provided by CheckFree for the bank's customers-the electronic commerce services that the bank purchased from CheckFree."

Sales Tax

Allstate Inc. Co. v. Hegar, 484 S.W.3d 611 (Tex. App. – Austin, Feb. 19, 2016, pet. denied.): Temporary Personnel

- **Facts**:
  - Taxpayer, ("Allstate"), an insurance carrier, subcontracted with another entity, Pilot Catastrophe Services, Inc. ("Pilot") to provide insurance claims adjusters as needed to supplement Allstate's existing staff of claims adjusters.
  - Allstate argued that the adjusters provided by Pilot were excluded from Texas sales tax under Section 151.057(2) of the Texas Tax Code as temporary employees.
  - The Texas Comptroller argued that the adjusters provided by Pilot did not qualify as temporary employees because they were provided by Pilot on a continuous and ongoing basis and were therefore not temporary in nature. In support of its argument, the Texas Comptroller noted that, on any given date throughout the tax years in question, there was at least one Pilot employee, and typically more, providing adjusting services to Allstate.

Sales Tax

Allstate Inc. Co. v. Hegar, 484 S.W.3d 611 (Tex. App. – Austin, Feb. 19, 2016, pet. denied.): Temporary Personnel

- Section 151.057 states that "a service performed by an employee of a temporary employment service as defined by Section 93.001, Labor Code, for an employer to supplement the employer's existing work force on a temporary basis, when the service is normally performed by the employer's own employees, the employer provides all supplies and equipment necessary, and the help is under the direct or general supervision of the employer to whom the help is furnished."
- **Held:**
  - The Court disagreed with the Texas Comptroller's "holistic" view of the services provided by Pilot, holding that the temporary services exclusion must be applied on an individual employee basis. When viewed in this manner, the Court had no trouble concluding that the individual adjusters were provided by Pilot to Allstate on a temporary basis

Sales Tax

Legislative Change Regarding Temporary Employment Services: SB 745 (Sen. Kolkhorst) and HB 4052 (Rep. Murphy)

- Changes the exclusion for temporary employment service to an exemption;
- Precludes the employer from renting, leasing, purchasing or otherwise acquiring for use supplies and equipment necessary to perform the service from the temporary employment service or entity or from any member of its affiliated group;
- Requires that the employer have the sole right to supervise, direct, and control the work of the temporary employee.
- Effective Date: September 1, 2017.

Sales Tax

The Geo Group, Inc. v. Hegar, 2017 Tex. App. LEXIS 7559 (Tex. App.—Austin 10, 2017, pet. filed): Exemption for "Residential Use" of Gas and Electricity

- Tex. Tax Code 151.371 exempts "residential use" of gas and electricity
- Taxpayer operates prisons
- Query: do prisons qualify for the exemption because the inmate reside there?

Sales Tax

Exemption for "Residential Use" of Gas and Electricity, Continuing….

- Two elements of exemption:
  - 1. Use must be in a structure occupied as a home or residence
  - 2. Use of gas/electricity must have been by the owner of the occupied structure
- Court disagreed the prisons qualified for the exemption
  - Prisons not occupied as a home or residence – detention is primary and house is a component of the confinement
  - Taxpayer used gas/electricity as part of a commercial venture and as part of a service provided to the government pursuant to contract
- Petition for Review filed by Taxpayer
  - TXSC has ordered briefing on the merits

Successor Liability

Agri-Plex Heating and Cooling, LLC v. Hegar, 2017 Tex. App. LEXIS 386 (Tex. App.—Austin, Jan. 19, 2017, no pet.)

- Facts: Taxpayer purchased a business on August 24, 2006 for a total price of $53,800.00: $34,200 was consideration for the assets and $19,600.00 was consideration for a non-compete agreement. After the purchase, the Comptroller audited and assessed tax against the seller in the amount of $64,097.34 for the audit period April 1, 2003 to December 31, 2006. The Comptroller asserted successor liability against the buyer for the full amount of the sales price $53,800.00. Taxpayer did not withhold any amount from the sales price nor did it obtain a certificate of no tax due from the Comptroller
- Issue: Taxpayer argued it could not be held liable as a successor for any part of the tax assessed against buyer because the amount of tax due was not fixed or ascertainable at the time of closing – presumably because no assessment had been made as of that date. The taxpayer cited to use of the word “amount” which appears several times in section 11.020. Taxpayer argued alternatively that it could only be held liable up to the $34,200 it paid for the assets, not the $19,600 paid for the non-compete agreement.

Successor Liability

Agri-Plex Heating and Cooling, LLC v. Hegar, 2017 Tex. App. LEXIS 386 (Tex. App.—Austin, Jan. 19, 2017, no pet.)

- Holding No. 1: Taxpayer could be held liable as a successor under Tex. Tax Code sec. 111.020. The word “amount” “does not refer to an amount ascertainable at the time of purchase, but to the amount of tax liability, which can be determined through the Comptroller’s audit after the purchase for taxes due up to four years before the purchase.” Thus, the Court agreed with the Comptroller that the word “amount” in Section 111.020 refers to the amount of tax ultimately determined to be due, not to the amount of tax known or specified to be due at the time of purchase.
- ***Query***:
  - Can a taxpayer also be held liable for amounts not originally due until after the date of the purchase price under Section 111.020?

Successor Liability

Agri-Plex Heating and Cooling, LLC v. Hegar, 2017 Tex. App. LEXIS 386 (Tex. App.—Austin, Jan. 19, 2017, no pet.)

- Holding No 2: The Court also held that Taxpayer could be held liable for the full amount of the purchase price including the amount paid for the non-compete in part because the purchase agreement stated that the amount paid for the non-compete was part of the "cash consideration paid for the sale of all the assets." The Court noted that the non-compete agreement was attached as an Exhibit to the purchase agreement and included a statement that the $19,600 paid for the non-compete agreement "shall be deemed to be a part of the purchase price consideration."
- ***Query***:
  - Would it make a difference if the purchase agreement either made no reference to the amount paid for the non-compete or specifically stated that the amount paid for the non-compete was not consideration for the sale of assets?

District Court Litigation

OGCI Training, Inc. v. Hegar, 2017 Tex. App. LEXIS 10096 (Tex. App.—Austin, Oct. 27, 2017, no pet.): Sufficiency of Protest Letter

  - Based in Oklahoma City, OK
  - Provides comprehensive educational development services to large petroleum companies.

- Section 112.053: Issues in protest-payment suit limited to those arising from the reasons expressed in the written protest as originally filed.
- OCGI challenged Comptroller's position that revenues from training sessions performed in Texas should be fully apportioned to Texas

District Court Litigation

OGCI Training, Inc. v. Hegar, 2017 Tex. App. LEXIS 10096 (Tex. App.—Austin, Oct. 27, 2017, no pet.): Sufficiency of Protest Letter

- In Protest Letter, taxpayer argued receipt-producing activities occurred in both Texas and Oklahoma for seminars performed in Texas
- In amended petition, Taxpayer included allegation that training sessions performed by third-party instructors
- Comptroller filed Plea to the Jurisdiction as this was not raised in Protest Letter
- Court construed OCGI's claim that its income arrangements w/ third-party instructors impact calculation of gross receipts and apportionments did "arise" from reasons presented in protest letter

District Court Litigation

Hegar v. EBS Solutions, Inc. 2018 Tex. App. LEXIS 2816 (Tex. App. – Austin 2018, no pet. h.): Filing a Lawsuit Without Prepayment of Tax Assessed

- Facts: Taxpayer received a franchise tax assessment from the Texas Comptroller following an audit in the amount of $298,520.00. Taxpayer made two payments of $75,000 each and thereafter filed a lawsuit in district court under Chapter 112 of the Texas Tax Code which permits a lawsuit to be filed but requires payment of the assessed amount under protest.. The Comptroller filed a plea to the jurisdiction seeking to dismiss the lawsuit for failure to pay the full amount of the assessment as required under Chapter 112, which the district court rejected. The Comptroller appealed.

District Court Litigation

Hegar v. EBS Solutions, Inc. 2018 Tex. App. LEXIS 2816 (Tex. App. – Austin 2018, no pet. h.): Filing a Lawsuit Without Prepayment of Tax Assessed

- Held: After an extensive review of the relevant case law, the Court concluded that the prepayment requirement violates the Open Courts guarantee of the Texas Constitution. Accordingly, the Court held that, based on prior case law, Section 112.108 of the Tax Code which precludes declaratory and injunctive relief was invalid. The Taxpayer could seek declaratory relief instead of filing a lawsuit under Chapter 112, provided the lawsuit did not otherwise violate the State's sovereign immunity.

Query: Following *EBS Solutions, Inc*., to what extent can a taxpayer file a lawsuit challenging an assessment of tax without prepaying the full amount at issue?

Constitutional Issues

Hegar v. Tex. Small Tobacco Coal. & Global Tobacco, Inc., 2017 Tex. App. LEXIS 2547 (Tex. App.—Austin, March 24, 2017, no pet.): Federal Equal Protection Clause and Due Process Clause

- Background:
  - In 1990s Texas settled w/ Big Tobacco companies
  - Other smaller manufacturers ("Subsequent Participating Manufacturers") settled w/ States as part of "Master Settlement Agreements"
- Taxpayer has not entered into any settlement agreement with Texas
- In 2013, Legislature passed tax on tobacco products manufactured by non-settling manufacturers
  - Also taxed SPM's products but at much lower rate

Constitutional Issues

Hegar v. Tex. Small Tobacco Coal. & Global Tobacco, Inc., 2017 Tex. App. LEXIS 2547 (Tex. App.—Austin, March 24, 2017, no pet.): Federal Equal Protection Clause and Due Process Clause

- Taxpayer challenged tax under Equal and Uniform Clause of Texas Constitution.
- Texas Supreme Court ruled in favor of State in 2016.
- On remand, Taxpayer challenged tax under federal equal protection clause and federal due process clause.

Constitutional Issues

Hegar v. Tex. Small Tobacco Coal. & Global Tobacco, Inc., 2017 Tex. App. LEXIS 2547 (Tex. App.—Austin, March 24, 2017, no pet.): Federal Equal Protection Clause and Due Process Clause

- Equal Protection Clause
  - “simply keeps governmental decision makers from treating differently persons who are in all relevant respects alike.”
  - Because TXSC found tax did not violate the more stringent Equal and Uniform Clause, tax can’t violate Equal Protection Clause
  - Sufficient differences b/t business operations of settling and non-settling manufacturers

Constitutional Issues

Hegar v. Tex. Small Tobacco Coal. & Global Tobacco, Inc., 2017 Tex. App. LEXIS 2547 (Tex. App.—Austin, March 24, 2017, no pet.): Federal Equal Protection Clause and Due Process Clause

- Due Process Clause
  - When considering a tax levied against in-state activities, the DPC is applicable only when the tax is so arbitrary as to compel the conclusion that it does not involve an exertion of the taxing power, but constitutes, in substance and in effect, the direct exertion of a different and forbidden power, as, for example, the confiscation of property
  - Purpose of tax was to recover future healthcare costs and reduce underage smoking which is reasonably related to the tax

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Mr. Colmenero practices in the areas of Federal Tax Litigation, State Tax Litigation and Wealth Transfer Tax Litigation. He represents individuals, closely held businesses, and large corporations in IRS audits, appeals, and litigation in the United States Tax Court, Federal District Courts and the United States Court of Federal Claims, U.S. Courts of Appeals and the United States Supreme Court. He also represents taxpayers in disputes with the Texas Comptroller of Public Accounts, the Texas Workforce Commission and has helped taxpayers resolve tax related controversies with several other states as well.

With respect to state tax, Mr. Colmenero was previously a tax auditor for the State of Texas and, as a lawyer, has successfully represented many taxpayers in contested proceedings involving sales and use tax, franchise tax, motor fuels tax, mixed beverage tax, employment tax and others. Mr. Colmenero has expertise in representing taxpayers through contested Texas tax proceedings including audits, Independent Audit Review Conferences, administrative hearings before the State Office of Administrative Hearings and in State court litigation. With the enactment of the revised franchise tax and a corresponding increase in audits and assessments by the State of Texas, Mr. Colmenero has assisted numerous taxpayers in challenging various aspects of the Texas Comptroller franchise tax policies and assessments and in planning business structures and business transactions to mitigate exposure to the revised franchise tax.

Mr. Colmenero is a Certified Public Accountant and maintains active involvement in various professional legal and accounting organizations. He is the past chair of the Dallas CPA Society and past chair of both the State and Local Tax Committee the Tax Controversy Committee of the Tax Section of the State Bar of Texas. He is a past chair of the Tax Section as well as the former Program Director of the Leadership Development Academy of the Tax Section of the State Bar of Texas. He also served on the Executive Board of Directors (2014-15) and was a member of the Board of Directors (2015-2017) for the Texas Society of CPAs. Mr. Colmenero frequently speaks on substantive and procedural tax issues involving both federal and state tax matters.

Mr. Colmenero was admitted to practice in Texas in 1997.

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Mr. Pilawski's State Tax Controversy and Litigation practice focuses on representing taxpayers in disputes with the Texas Comptroller of Public Accounts involving sales and use tax, mixed beverage tax, and franchise tax, among others. He has extensive experience working with taxpayers to successfully resolve disputes in contested proceedings through administrative hearings and in Texas state court. He also assist taxpayers in remedying noncompliance with Texas taxes, including guiding them through the Texas Comptroller's Voluntary Disclosure program.

His State Tax Planning practice involves assisting taxpayers in structuring their business and transactions to minimize exposure to franchise tax.

His Commercial Litigation practice involves representing individuals and entities in both state and federal court in a variety of controversies including complex business disputes, securities, and health care, among others.

Mr. Pilawski is also active in the Tax section of the State Bar of Texas. He recently completed the State Bar of Texas Tax Section Leadership Academy and was the co-chair of the planning committee for the Advance Tax Law Course.

Mr. Pilawski was admitted to practice in Texas in 2010.

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The information included in these slides is for discussion purposes only and should not be relied on without seeking individual legal advice.