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DATE: June 30, 2016

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SUBJECT: Policy change based on TITAN and NEWPARK

Note: This memo supersedes the June 10, 2014 memo (201406920L) on the interpretation of "mandated by contract" as provided in Tax Code Section 171.1011(g). The policy was overturned in Titan Transp., LP v. Combs, 433 S.W.3d 625 (Tex.App.—Austin 2014, pet. denied).

ISSUE

Based on the courts' language and analysis in TITAN and NEWPARK, we are revising the policy with regard to payments eligible for exclusion under Section 171.1011(g) and qualifying activities for the COGS deduction under Section 171.1012(i).

BACKGROUND

The court in TITAN found that Titan Transportation, L.P. (Titan), which is in the business of hauling, delivering, and depositing aggregate at real property construction sites, was entitled to exclude from revenue, pursuant to Section 171.1011(g)(3), payments the taxpayer made to its subcontractors providing this service for its customers.

Newpark Resources, Inc. (Newpark), an oil field service business, was the reporting entity for a combined group which included its subsidiary, Newpark Environmental Services, L.L.C. (NES). The court in NEWPARK found that Newpark was entitled to take a COGS deduction under Section 171.1012(i) for NES's activities of removal and disposal of waste materials from oil and gas well drilling sites.

REVISED POLICY

This change has immediate effect and a taxable entity may file an amended franchise tax report for years that are open within the statute of limitations.

Section 171.1011(g) states, "A taxable entity shall exclude from its total revenue…only the following flow-through funds that are mandated by contract to be distributed to other entities:…"

According to the Third Court of Appeals, the term "other entities," as used in Section 171.1011(g), merely means someone other than the taxable entity. The court explained the "purpose of the (g)(3) revenue exclusion is to prevent double taxation of funds that are not truly gain or income to the taxpayer, and this purpose is satisfied regardless of whether the mandate is contained in a contract with a customer or with a subcontractor." Titan Transp., LP v. Combs, 433 S.W.3d 625, 641 (Tex. App. Austin 2014, pet. denied).

Under the revised policy, a payment is mandated by contract to be distributed to other entities and qualifies as flow-through funds under Section 171.1011(g) 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. For example, the contract between the taxable entity and the subcontractor require payment based on a percentage of the funds the taxable entity receives from its customer. The timing of the payments does not determine if a payment qualifies as a flow-through fund.

Further, payments which qualify as flow-through funds under Section 171.1011(g) and have a reasonable nexus to the actual or proposed design, construction, remodeling, or repair of improvements on real property or the location of boundaries of real property, may be excluded from revenue pursuant to Section 171.1011(g)(3).

With regard to COGS, Section 171.1012(i) states, "A taxable 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 or materials and may include the costs, as allowed by this section, in the computation of costs of goods sold."

Under the revised policy, we are expanding the interpretation of what is considered to be furnishing labor or materials to a project for the construction, improvement, remodeling, repair, or industrial maintenance of real property and will no longer require an entity 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. The policy for both Sections will 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.

Costs considered too far removed from the construction, improvement, remodeling, repair, or industrial maintenance of real property do not qualify for either an exclusion from revenue or a COGS deduction. For example, entities providing services that are defined as "service costs" under Rule 3.588(b)(9), such as legal services and accounting services, are too far removed and do not qualify for either an exclusion from revenue or a COGS deduction.

Further, the revised policy does not change the treatment of taxable entities renting or leasing equipment to others for use in or during such projects. Section 171.1012(k-1) still limits the COGS deduction to taxpayers renting or leasing certain items to others. Taxpayers who rent or lease equipment other than heavy construction equipment, such as fencing or port-a-potties, to others for use in projects for the construction, improvement, remodeling, repair or industrial maintenance of real property, are not eligible for the COGS deduction under Section 171.1012.

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