The Texas Supreme Court Denies a Cost of Goods Sold Deduction for Costs Associated with Picking up and Delivering Heavy Construction Rental Equipment

By David E. Colmenero and Alex J. Pilawski on April 21, 2020

 

In one of three recent decisions issued by the Texas Supreme Court involving the Texas franchise tax, the Court held that certain costs associated with the rental of heavy construction equipment could not be included in the cost of goods sold deduction. *See Sunstate Equipment* Co., LLC v. Hegar, Cause No. 17-044 (Tex. Apr. 3, 2020). The Court held these costs were not includable in cost of goods sold under the provisions dealing with either the rental of equipment or real property work. In doing so, the Court set some general parameters for the applicability of these provisions.

The taxpayer, Sunstate Equipment Co., LLC ("Sunstate") was engaged in the business of renting heavy construction equipment used at real property construction sites. Sunstate sought to include certain costs associated with picking up and delivering this equipment to job sites in its cost of goods sold ("COGS") deduction. Sunstate relied in part on subsection (k-1) of Section 171.1012 which reads: "Notwithstanding any other provision of this section, the following taxable entities may subtract as cost of goods sold the costs otherwise allowed by this section in relation to tangible personal property that the entity rents or leases in the ordinary course of business ... (2) heavy construction equipment rental or leasing company." Because the equipment was used at construction sites, Sunstate also argued that its costs were includable in cost of goods sold under subsection (i) of Section 171.1012, which reads in part, "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 [Tex. Admin. Code] 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."

As an initial matter, the Court rejected the Comptroller's argument that the COGS deduction is tantamount to an exemption and should therefore be strictly construed against the taxpayer. The Court held that the franchise tax is a tax on an entity's "taxable margin" and not on revenue, and therefore the COGS deduction does not amount to an exemption. Rather, it is a subtraction to determine the amount subject to tax in the first place.

The Court also held that subsection (k-1) extends the COGS subtraction available under Section 171.1012 to heavy construction equipment rental or leasing companies but does not expand the types of costs this type of taxpayer can subtract as part of its taxable margin. The Court declined to construe the phrase "in relation to" expansively, holding that it should be construed as specifying only the types of entities that are entitled to the COGS subtraction rather than the types of costs that can be deducted. The Court also found the "notwithstanding" language at the beginning of subsection (k-1) to be consistent with this reading because, according to the Court, it creates an exception to the statute whereby a heavy construction equipment rental or leasing company can subtract COGS despite not actually selling equipment.

The Court then considered whether the costs at issue fell within the general provisions of Section 171.1012, including subsection (c), (d), (f) and concluded they did not. The costs were not deductible under any of these provisions, according to the Court, because the costs were not directly or indirectly related to acquiring or producing goods.

With respect to subsection (c), which permits a deduction for direct costs of acquiring or producing goods, the Court held the term "acquire" refers to direct costs associated with the initial receipt of goods that will ultimately be sold. The Court noted in particular that rehandling costs are excluded from COGS pursuant to subsection (e)(6) in support of this conclusion. Because the costs of picking up and delivering equipment were not derived from the initial acquisition of equipment, the Court held these costs could not be subtracted as direct costs for acquiring goods. Likewise, the Court held the costs did not fall within the definition of "production," because the statutory definition for that word did not include "delivery". Stated the Court, "[I]t seems the Legislature contemplated COGS subtractions for both the costs of acquiring goods ready to sell, as well as costs contributing directly to making goods sellable, while excluding costs associated with transporting goods for sale or goods sold (or, in the context of rental companies, goods rented out)."

Because the Court concluded that Sunstate was not engaged in "production," the insurance costs for pick-ups and deliveries were also not deductible under Section 171.1012(d)(6) as Sunstate alternatively argued. That subsection permits a cost of goods sold deduction for "the cost of insurance on a plant or a facility, machinery, equipment, or materials directly used in the production of goods." Likewise, none of the costs at issue could be deducted as administrative or overhead costs under subsection (f) because that provision requires a taxpayer to demonstrate the costs are "allocable to the acquisition or production of goods."

Turning to subsection (i), the Court held that to qualify for a deduction under this provision, "the labor or materials at issue must be furnished to a project that is of the specific type identified in the statute ... [*viz*] construction projects, improvement projects, remodeling projects, repair projects, and industrial maintenance projects." In other words, stated the Court, the question is whether the labor at issue was "furnished to the real property owner's construction project?" In this case, because the labor was furnished to move equipment from one project to another, it was furnished to meet Sunstate's own project of fulfilling its contractual obligations, rather than to a project for the construction or improvement of real property.

As with other recent franchise tax decisions issued by the Texas Supreme Court, the *Sunstate* decision carries significant implications for many taxpayers, particularly those involved in renting or leasing equipment. The decision is also important in evaluating the scope of the deduction available to taxpayers for real property work under Section 171.1012(i). The applicability of this decision to any given set of facts will of course depend on the particular circumstances. But prior and current reporting positions, particularly those within the statute of limitations, may need to at apilawski@meadowscollier.com. You can also reach both attorneys at (214)744-3700.

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