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Texas State Tax Update

Danielle V. Ahlrich

Author Contact Information:
Danielle V. Ahlrich
Martens, Todd, Leonard & Ahlrich
Austin, Texas
dahlrich@textaxlaw.com
512.542.9898

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FRANCHISE TAX

COST OF GOODS SOLD

The cost of goods sold ("COGS") subtraction has been the most difficult and most litigated aspect of the Texas margin tax. The standard COGS provision allows a producer or reseller of goods to subtract direct and indirect costs incurred to produce or acquire the goods sold. *See* Tex. Tax Code § 171.1012(c), (i). However, given the Texas economy's reliance upon the oil and gas and construction industries, the margin tax also extends COGS to taxpayers who furnish labor or materials to projects for certain types of real estate activities (*e.g.*, construction, remodeling, and repair of real property). *See* Tex. Tax Code § 171.1012(i), third sentence. Without this industry-specific COGS grant, taxpayers in the construction and oilfield services industries would not be able to claim COGS because they do not produce or sell "goods," as defined by the statute. Over the years, the legislature has enacted a proliferation of additional industry-specific COGS provisions in an attempt to resolve taxpayer complaints about either the unavailability of the subtraction or the Texas Comptroller's narrow interpretation of existing provisions. *See, e.g.,* Tex. Tax Code §§ 171.1012(k-1)(2) (heavy construction leasing companies), (k-2) (pipeline companies), (t) (movie theaters).

In the margin tax's early years, COGS litigation focused on a taxpayer's ability to claim the COGS subtraction, at all. For example, in *Newpark Resources* and *CGG Veritas,* the Comptroller took the position that these oilfield service providers were not entitled to claim COGS under the real estate COGS provision (discussed above) because their activities were too far removed from the drilling construction projects. *Comb v. Newpark Res., Inc.*, 422 S.W.3d 46 (Tex. App.—Austin 2013, no pet.); *Hegar v. CGG Veritas Servs., Inc.*, No. 03-14-00713-CV, 2016 Tex. App. LEXIS 2439 (Tex. App.—Austin 2016, no pet.). The Comptroller simply reduced these taxpayers' COGS subtractions to zero and issued assessments for allegedly underpaid tax, which the taxpayers successfully challenged in district court and the court of appeals.

However, as taxpayers began to win the cases where the Comptroller tried to deny COGS altogether and the courts began to broadly construe the COGS statute, litigation moved towards disputes about the scope of the subtraction. In other words, the Comptroller would agree that a taxpayer was entitled to subtract COGS, but not at an amount sufficient to generate a tax on margin – *i.e.*, gross profits. Several taxpayers are currently petitioning the Texas Supreme Court for review of this type of COGS issue. *See, e.g.*, *Hegar v. Gulf Copper & Manuf. Corp.*, 535 S.W.3d 1 (Tex. App.—Austin 2017, pet. filed, No. 17-0894), reh'g denied (Sept. 21, 2017); *Hegar v. Autohaus LP, LLP*, 514 S.W.3d 897 (Tex. App.—Austin 2017, pet. filed, No. 17-0253); *Hegar v. Sunstate Equip. Co.*, No. 03-15-00738-CV, 2017 WL 279602 (Tex. App.—Austin Jan. 20, 2017, pet. filed, No. 17-0444); *American Multi-Cinema, Inc. v. Hegar*, No. 03-14-00397-CV, 2017 WL 74416 (Tex. App.—Austin Jan. 6, 2017, pet. filed, No. 17-0464). Thus, we seem to be on a countdown to high-court clarification of COGS.

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