# Texas Supreme Court Issues Opinions on TX COGS Deduction & Revenue Exclusion

## Overview

On April 3, 2020, the Texas Supreme Court (Supreme Court) issued two opinions related to the Texas franchise tax cost of goods sold (COGS) deduction in the context of companies claiming to furnish labor or materials to projects related to real property under Texas Tax Code (TTC) § 171.1012(i).[1] As part of its recent holdings, the Supreme Court also opinioned on several other key issues related to calculating the Texas franchise tax, as further discussed below.

In *Sunstate Equipment Co., LLC v. Hegar*, the Supreme Court upheld the decision by the Texas Third Court of Appeals, Austin ("Court of Appeals"), which found that Sunstate Equipment Co., LLC (Sunstate), a heavy equipment rental company, was ineligible to subtract as COGS any costs associated with the delivery and pick-up of its rental equipment, finding the costs were not labor or materials furnished to a project for the improvement of real property under TTC § 171.1012(k-1) or TTC § 171.1012(i).[2]

In *Hegar v. Gulf Copper & Mfg. Corp.*, the Supreme Court partially affirmed the previous decision by the Court of Appeals, which found that Gulf Copper & Manufacturing Corporation (Gulf Copper) was entitled to exclude certain subcontractor payments from its revenue under former TTC § 171.1011(g)(3); however, the Supreme Court reversed the Court of Appeals' holding related to COGS and ultimately found Gulf Copper was not entitled to a COGS subtraction under TTC § 171.1012(i) and would only be eligible to include costs shown to be eligible through a cost-by-cost analysis.[3]

In this Tax Alert, we summarize the decisions made by the Supreme Court in both the *Sunstate* and *Gulf Copper* opinions as well as offer some taxpayer considerations.

***Sunstate Equipment Co., LLC v. Hegar***

## Background

For the years at issue, Sunstate's operations primarily consisted of renting out heavy construction and industrial equipment to customers in various locations including Texas.[4] Sunstate typically delivered its rental equipment to a customer's construction site and picked up such equipment at the end of the rental term; Sunstate charged for its delivery and pick-up services separately.[5] The parties stipulated "the delivery and pick-up component of Sunstate's business activity was an integral part of its operations."[6]

On its 2009 and 2010 Texas franchise tax reports, Sunstate elected to use the COGS deduction when computing its franchise tax liability and included its delivery and pick-up costs.[7] Sunstate was audited by the Texas Comptroller of Public Accounts (Comptroller) for report years 2009 and 2010, and assessed tax, penalties, and interest for both periods.[8] Sunstate paid the amounts under protest and brought suit for a refund seeking adjustments to include the labor, fuel, depreciation, maintenance, and property tax costs related to its delivery and pick-up of equipment in its COGS deduction.[9] Both parties filed a motion for summary judgment, and the 53rd Texas District Court of Travis County granted Sunstate's motion, ordering a full refund in the amount paid.[10] The Court of Appeals reversed and rendered judgement in favor of the Comptroller, concluding the costs related to pick-up and delivery could not be included in the COGS deduction.[11]

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[1] *Sunstate Equip. Co., LLC v. Hegar*, 63 Tex. Sup. J. 707, 2020 Tex. LEXIS 268, No. 17-0444 (Tex. Apr. 3, 2020), available here; *see also Hegar v. Gulf Copper & Mfg. Corp.*, 63 Tex. Sup. J. 732, 2020 Tex. LEXIS 270, No. 17-0894 (Tex. Apr. 3, 2020), available here.
[2] *Sunstate Equip. Co., LLC*, 63 Tex. Sup. J. 707 (Tex. Apr. 3, 2020).
[3] *Gulf Copper & Mfg. Corp.*, 63 Tex. Sup. J. 732 (Tex. Apr. 3, 2020).
[4] *Sunstate Equip. Co., LLC*, , 63 Tex. Sup. J. 707, at *6.
[5] *Id*. at *6.
[6] *Id*. at *7.
[7] *Id*. at *7-8.
[8] *Id*. at *8.
[9] *Id*. at *8.
[10] *See Sunstate Equip. Co., LLC v. Hegar*, Cause No. D-1-GN-14-000281 (53rd Dist. Ct., Travis County, Tex. Oct. 28, 2015).
[11] *See Sunstate Equip. Co., LLC v. Hegar*, 578 S.W.3d 533 (Tex. App.—Austin 2017, pet. granted) (mem. op.).

## Texas Supreme Court Opinion

On appeal to the Texas Supreme Court, Sunstate argued it was entitled to subtract costs under TTC § 171.1012(k-1) (hereinafter referred to as "subsection (k-1)") and that its costs fell within those specified by TTC §§ 171.1012(c) and (d). Alternatively, Sunstate argued TTC § 171.1012(i) (hereinafter referred to as "subsection (i)") independently authorized including the costs within its COGS deduction because the expenses were part of the costs associated with "furnishing labor or materials to a project for the construction…of real property."[12]

Overview of Relevant Texas Provisions

- TTC § 171.1012 addresses the costs permitted to be subtracted from taxable revenue as COGS, as well as the taxable entities entitled to subtract COGS in calculating taxable margin for Texas franchise tax purposes (e.g., "all direct costs of acquiring or producing the goods," but excluding "services" under TTC § 171.1012(c)).[13]
- Subsection (k-1) addresses COGS in the context of companies that would not otherwise be eligible to utilize the COGS deduction and specifically allows "a heavy construction equipment rental or leasing company" to "subtract as cost of goods sold the costs otherwise allowed by this section in relation to the tangible personal property that the entity rents or leases in the ordinary course of the business entity."[14]
- Generally, a taxable entity may only utilize the COGS deduction if the entity owns the goods.[15] However, under subsection (i), "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 cost of goods sold."[16]

The parties stipulated that Sunstate constituted the type of entity eligible for the COGS deduction under subsection (k-1).[17] Under subsection (k-1), Sunstate's "goods" were determined to be the heavy construction and industrial equipment it rents as part of its business operations.[18] In reliance on this provision, Sunstate categorized the labor, fuel, depreciation, maintenance, and property tax costs related to its delivery and pick-up of equipment as direct costs eligible to be subtracted as COGS under TTC § 171.1012(c).[19] Sunstate argued subsection (k-1)'s use of the term "in relation to" is a "phrase of intentional breadth" and therefore entitled Sunstate to "subtract any costs incurred that have some reasonable nexus to the goods."[20] Specifically, Sunstate claimed the delivery and pick-up costs at issue were an "integral part" of renting out heavy equipment, furthered the purpose of providing equipment to its customers, and the equipment could not typically have been rented without Sunstate incurring such costs.[21]

In finding Sunstate's delivery and pick-up costs were not deductible as COGS, the Supreme Court emphasized that subsection (k-1) only permits a taxable entity qualifying for the COGS subtraction to "subtract as cost of goods sold the costs otherwise allowable by this section," thereby narrowing the eligible costs to those allowed under other parts of TTC § 171.1012.[22] As a result, Sunstate was restricted to including costs that those of a retailer selling the same equipment would be eligible to deduct.[23] Under TTC § 171.1012(c), a taxable entity is permitted to subtract "all direct costs of acquiring or producing the goods." According to the Supreme Court, "the COGS scheme in section 171.1012 distinguishes between costs to *acquire or produce* goods that will ultimately be sold—included in COGS—from costs incurred in the *distribution or selling* of goods—excluded from costs of goods sold."[24]

The Supreme Court first focused on TTC § 171.1012(c)'s use of the term "acquire" as compared to the specific exclusions from COGS under TTC § 171.1012(e), focusing on the disallowance of "rehandling costs" from eligible COGS.[25] Relying on the dictionary definition of the term "rehandling" (defined as "handling again"), the Supreme Court explained by excluding "rehandling" costs, the Texas Legislature "removed the possibility that an entity could subtract costs for acquiring the same goods repeatedly…and narrowed the potentially broad definition of "acquire" to refer to direct costs associated with the

[12] *Sunstate Equip. Co., LLC*, 63 Tex. Sup. J. 707, at *1 (internal citations omitted).
[13] *See id*. at *9.
[14] See *id*. at *10; *see also* Tex. Tax Code § 171.1012(k-1) (emphasis added).
[15] Tex. Tax Code § 171.1012(i); *see also Sunstate Equip. Co., LLC*, 63 Tex. Sup. J. 707, at *10-11.
[16] Tex. Tax Code § 171.1012(i) (emphasis added).
[17] *Sunstate Equip. Co., LLC*, 63 Tex. Sup. J. 707, at *6.
[18] *Id*. at *13.
[19] *Id*. at *12.
[20] *Id*. at *15 (internal citations omitted).
[21] *Id*. at *14.
[22] *Id*. at *14, 18-19.
[23] *Id*. at *19.
[24] *Id*. at *22 (emphasis added). As an example, the Supreme Court noted the Texas Tax Code distinguishes between inbound transportation costs—included in Texas COGS—from outbound transportation costs—excluded from Texas COGS. *Compare* Tex. Tax Code § 171.1012(c)(4) with Tex. Tax Code § 171.1012(e)(3). *See Sunstate Equip. Co., LLC*, 63 Tex. Sup. J. 707, at *22-23.
[25] *Id*. at *24-25.

initial receipt of goods that will ultimately be sold."[26] Because Sunstate did not derive the delivery and pick-up costs as a result of the initial acquisition of its equipment, the Supreme Court held the costs were not eligible to be included within the COGS deduction as an acquisition cost.[27]

The Supreme Court then addressed whether the costs were otherwise eligible as a direct cost of "producing" the goods under TTC § 171.1012(c).[28] Sunstate relied on subsection (k-1) in conjunction with subsection (i) in claiming the costs associated with the delivery and pick-up of equipment were for production because they were arguably essential to the construction, improvement, and development of real property.[29] In rejecting this argument, the Supreme Court explained the costs Sunstate incurred moving equipment from one location to another was to fulfill Sunstate's own contractual obligations to provide equipment to its customers and were not furnished to a project for the construction or improvement of real property under subsection (i).[30] Further, TTC § 171.1012(e) excludes "distribution costs, including outbound transportation costs," as well as "rehandling costs" from COGS; as a result, the Supreme Court presumed the Texas Legislature intentionally omitted "delivery" from the definition of "production" as well.[31] Because Sunstate did not derive its delivery and pick-up costs from the initial acquisition of its equipment or from the production of its equipment, the Supreme Court held the costs were not properly subtracted as COGS under TTC § 171.1012(c).[32]

According to the Supreme Court, regardless of subsection (i) or subsection (k-1), a taxable entity's costs must otherwise qualify under other parts of TTC § 171.1012(c).[33] As explained by the Supreme Court, "[i]n other words, the costs that can be subtracted as COGS under section 171.1012 do not change simply because an entity qualifies for a subtraction under subsection (k-1)."[34]

***Hegar v. Gulf Copper & Manufacturing Corp.***

**Background**

*Gulf Copper* involved a business primarily engaged in the business of surveying, manufacturing, upgrading, and repairing drilling rigs.[35] In certain instances, Gulf Copper used subcontractors to perform these services.[36] On its 2009 franchise tax report, Gulf Copper excluded from its total gross revenues flow-through payments made to subcontractors under former TTC § 171.1011(g)(3) (hereinafter referred to as the "(g)(3) exclusion").[37] Additionally, Gulf Copper elected to use the COGS deduction for purposes of calculating its Texas franchise tax in reliance on TTC § 171.1012(i).[38]

Following an audit, the Comptroller determined a portion of the subcontractor payments were not eligible for the (g)(3) exclusion and also found certain costs could not be included in Gulf Copper's COGS deduction.[39] Gulf Copper paid the assessed amount under protest and filed suit to recover the disputed amount.[40] The 201st Travis County District Court rendered judgement for Gulf Copper on both issues.[41] The Court of Appeals thereafter affirmed with respect to the revenue exclusion for subcontractor payments and reversed and remanded with respect to the COGS deduction.[42] The Comptroller petitioned the Supreme Court for review arguing: the (g)(3) exclusion did not apply to Gulf Copper's disputed payments to subcontractors; and TTC § 171.1012(i) did not allow Gulf Copper to subtract its rig, survey, repair, and upgrade work as a direct cost for purposes of computing the COGS deduction.[43] Gulf Copper filed a counter-petition arguing the method it used to calculate its COGS deduction was proper.[44]

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[26] *Id*. at *25-26.
[27] *Id*. at *26.
[28] *Id*. at *26.
[29] *Id*. at *26, *32.
[30] *Id*. at *38-39.
[31] *Id*. at *27.
[32] *Id*. at *29.
[33] *Id*. at *28-29.
[34] *Id*. at *29.
[35] *Hegar v. Gulf Copper & Mfg. Corp.*, 63 Tex. Sup. J. 732, 2020 Tex. LEXIS 270, No. 17-0894 (Tex. Apr. 3, 2020), at *3.
[36] *Id*. at *4.
[37] *Id*. at *4.
[38] *Id*. at *4-5.
[39] *Id*. at *4-5.
[40] *Id*. at *5.
[41] *See Hegar v. Gulf Copper & Mfg. Corp.*, Cause No. D-1-GN-14-004620 (53rd Dist. Ct., Travis County, Tex. Feb. 22, 2016).
[42] *See Hegar v. Gulf Copper & Mfg. Corp.*, 535 S.W.3d 1 (Tex. App.—Austin 2017, pet. granted); *see further* Deloitte External Alert, *TX Appellate Court Upholds Subcontractor Exclusion While Reversing and Remanding on COGS Methodology* (Aug. 28, 2017), available here.
[43] *Hegar v. Gulf Copper & Mfg.* Corp, 63 Tex. Sup. J. 732, at *6-7.
[44] *Id*. at *7.

## Texas Supreme Court Opinion

Subcontractor Exclusion from Revenue

Under TTC § 171.1011, a taxable entity may exclude certain flow-through funds when calculating total revenue, including certain payments to subcontractors as described in TTC § 171.1011(g)(3). For the year at issue, the (g)(3) exclusion provided:

> A taxable entity shall exclude from its total revenue, to the extent [reported to the federal IRS as income], only the following flow-through funds that are mandated by contract to be distributed to other entities…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.[45]

The parties agreed the rig survey, repair, and upgrade work Gulf Copper's subcontractors performed qualified as "services, labor, or materials" and agreed that drilling an oil well qualified as the "construction…of improvement on real property."[46] However, the parties disagreed as to whether the work was "in connection with" the drilling of the oil wells as Gulf Copper's subcontractors did not survey, repair, or upgrade oil wells; instead, the subcontractor's work was done on rigs that were subsequently used to construct oil wells.[47] The Comptroller conceded the "in connection with" language under the (g)(3) exclusion broadened the scope of work to which the exclusion applied beyond the actual "design, construction, remodeling, or repair of improvements on real property."[48] However, the Comptroller argued Gulf Copper's work was still too remote: temporarily remote because it occurred before drilling; physically remote because it occurred away from the drilling site; and contractually remote because Gulf Copper's contracts were not with the well owners.[49]

The Supreme Court concluded the "in connection with" language under the (g)(3) exclusion requires more than remote, tangential relationship.[50] However, Gulf Copper's rig survey, repair, and upgrade work provided by its subcontractors was found to be "in connection with" the drilling of the oil wells because Gulf Copper's work was a "necessary component of enabling the rigs to drill specific wells."[51]

The Supreme Court also found Gulf Copper's subcontractor payments satisfied the additional requirements under TTC § 171.1011(g) (hereinafter referred to as "subsection (g)") that "only flow-through funds that are mandated by contact or subcontract" are eligible for exclusion from revenue.[52] The Supreme Court held "mandated by contract" simply requires a contractual relationship.[53] Contrary to the Comptroller's assertions, subsection (g) does not distinguish between a taxable entity's contract with a subcontractor versus a contract with a customer (i.e., either will suffice for purposes of subsection (g)), and subsection (g) does not require a contract to contain language earmarking funds to be passed through to a subcontractor.[54] As a result, Gulf Copper's contracts with its subcontractors, which required payments to subcontractors, satisfied the "contract" requirement under subsection (g).[55]

Cost of Goods Sold Deduction

As part of its operations, Gulf Copper manufactured steel plates that it installed on the hulls of oil rigs to replace parts of the corroded hulls.[56] The Comptroller agreed the steel plates were "goods" under TTC § 171.1012, and that Gulf Copper

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[45] Tex. Tax Code § 171.1011(g)(3) (emphasis added). In 2013, Texas Tax Code § 171.1011 was amended to add "subcontract" in the introductory language of subsection (g); in addition, subsection (g)(3) was amended to substitute "made under a contract or subcontract entered into" for "handled" and added "remediation." Acts 2013, 83rd Leg., ch. 1034 (H.B. 2766), § 1 (effective Jan. 1, 2014). The current language of the (g)(3) revenue exclusion states: "A taxable entity shall exclude from its total revenue, to the extent [reported to the federal IRS as income], only the following flow-through funds that are mandated by contract or subcontract to be distributed to other entities…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" (amendments emphasized). Tex. Tax Code § 171.1011(g). Thus, the 2013 amendments applicable to the (g)(3) revenue exclusion essentially clarified that payments made pursuant to a subcontract (that otherwise satisfy the requirements under TTC § 171.1011(g)) would qualify as an exclusion from revenue. As a result, the guidance provided under the *Gulf Copper* opinion would have continued applicability under the current version of TTC § 171.1011(g).
[46] *Hegar v. Gulf Copper & Mfg. Corp.*, 63 Tex. Sup. J. 732, at *9.
[47] *Id*. at *9.
[48] *Id*. at *11.
[49] *Id*. at *11.
[50] *Id*. at *14.
[51] *Id*. at *14.
[52] *Id*. at *16.
[53] *Id*. at *20.
[54] *Id*. at *18-19, 21.
[55] *Id*. at *23.
[56] *Id*. at *24-25.

was eligible to subtract the costs of manufacturing and installing such plates.[57] However, the parties disagreed as to whether Gulf Copper was also eligible to include other labor costs under TTC § 171.1012(i) or subsection (i), along with whether Gulf Copper's method of calculating its COGS deduction was proper.[58]

As mentioned above, a taxable entity may generally only utilize the COGS deduction if the entity owns the goods.[59] However, under subsection (i):

> 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 cost of goods sold.[60]

The parties agreed that drilling an oil well is "a project for the improvement of real property," but disputed whether Gulf Copper's work involved "labor or materials" and whether Gulf Copper's work, which occurred in locations separate from the drilling sites, constituted "furnishing labor or materials to " such well-drilling projects.[61] The Supreme Court began its discussion by noting despite similarities, the language governing the (g)(3) exclusion—which allows a taxable entity to exclude certain subcontracting payments to provide services, labor, or materials in connection with the actual or proposed design, construction, remodeling, or repair of improvements on real property—differs significantly from the language under subsection (i) governing COGS—which applies to a taxable entity furnishing labor or materials to a project for the construction, improvement, remodeling, repair, or industrial maintenance of real property.[62] Thus, the Supreme Court's holding that Gulf Copper was entitled to the (g)(3) exclusion was not determinative of whether Gulf Copper was eligible to take a COGS deduction under subsection (i).[63] Instead, the Supreme Court found the language under subsection (i) narrower than the language under the (g)(3) exclusion.[64]

According to the Supreme Court: "Gulf Copper's labor and materials were not directed toward real property, but toward preparing equipment for later use on real property."[65] Citing the *Sunstate* opinion, the Supreme Court held Gulf Copper's labor and materials were more properly characterized as "furnished to its own project of fulfilling its contracts to repair and upgrade equipment and not to a project for the construction or improvement of real property."[66] Consequently, the Supreme Court held that under subsection (i), the required labor or materials must be furnished to or incorporated into the real property itself to qualify for the COGS deduction.[67]

When calculating its COGS deduction, Gulf Copper used the amount it had reported under the Internal Revenue Code § 263A as its starting point then subtracted those costs expressly disallowed by TTC § 171.1012(e) and limited by TTC § 171.1012(f).[68] In rejecting this methodology, the Supreme Court adopted the position of the Court of Appeals and held Gulf Copper was required to show that each of its costs independently qualified under TTC § 171.1012 as "federal methods do not govern the substance of the [Texas] COGS calculation."[69]

### Considerations

Taxpayers that have utilized federal COGS as a starting point for determining their Texas COGS deduction along with taxpayers that have relied on TTC § 171.1012(k-1) or TTC § 171.1012(i) as a basis for claiming the COGS deduction should consult with their tax advisors to analyze potential Texas franchise tax implications. Taxpayers that have included certain subcontractor payments within total revenue may wish to consider filing a refund claim based on the additional guidance provided by the Supreme Court on qualifying costs.

## Contacts:

If you have questions regarding the Supreme Court's decisions or other Texas tax matters, please contact any of the following Deloitte professionals:

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[57] *Id*. at *24-25.
[58] *Id*. at *25.
[59] Tex. Tax Code § 171.1012(i).
[60] Tex. Tax Code § 171.1012(i).
[61] *Hegar v. Gulf Copper & Mfg. Corp.*, 63 Tex. Sup. J. 732, at *25-26.
[62] *Id*. at *27.
[63] *Id*. at *27.
[64] *Id*. at *28.
[65] *Id*. at *29.
[66] *Id*. at *29-30 (internal citations omitted).
[67] *Id*. at *30-31.
[68] *Id*. at *34-35.
[69] *Id*. at *32, *35.

**Robert Topp**
**Managing Director**
Deloitte Tax LLP, Houston
+1 713 982 3185
rtopp@deloitte.com

**Jacob Aguero**
**Partner**
Deloitte Tax LLP, Houston
+1 713 982 4246
jaguero@deloitte.com

**Lauren Rothman**
**Senior Manager**
Deloitte Tax LLP, Houston
+1 713 982 2462
lrothman@deloitte.com

**Scott Bedunah**
**Senior Manager**
Deloitte Tax LLP, Dallas
+1 214 840 1722
scbedunah@deloitte.com

**Grace Taylor**
**Manager**
Deloitte Tax LLP, Houston
+1 713 982 3809
grtaylor@deloitte.com

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