

Texas Appellate Court – Certain subcontracting expenses excluded from Franchise Tax

March 18, 2014

In brief

On March 14, 2014, the Texas Third Court of Appeals ruled that the franchise tax flow-through funds exclusion applied to subcontracted services that have a reasonable connection to real property construction, remodeling, design, or repair work. The court rejected the Comptroller of Public Account's argument that only taxpayers engaged in construction services qualify for the exclusion.

Taxpayers subcontracting transportation and other services should review whether their services have a reasonable connection to real property construction, remodeling, design, or repair work to satisfy the requirements of Texas' flow-through funds exclusion. [[*Titan Transportation, LP v. Comptroller of Public Accounts*](#), Tax. App. Ct., No. 03-13-00034-CV (3/14/14)]

In detail

Exclusion for flow-through funds

For the report year at issue, the formula for calculating taxable margin under the Texas franchise tax allowed taxpayers an exclusion from total revenue for the following flow-through funds 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.”

Exclusion claimed for subcontractor payments

During the report year at issue, Titan Transportation LP (Titan) was engaged in the business of hauling, delivering, and depositing aggregate (a material used to make concrete) at real property construction sites. Titan provided this service primarily through subcontractors, to whom Titan was contractually obligated to share its gross receipts received from such services.

A standard contract obligated Titan's subcontractors to provide a 'complete transportation service' including

the delivery of products 'in accordance with customer delivery instruction.' Titan's subcontractors generally delivered aggregate to a specified area of a construction site at the direction of Titan customers. The service was more efficient for Titan customers and saved them from having to use additional labor to put the aggregate to a useful purpose.

On its franchise tax report, Titan claimed its subcontractor payments qualified for the flow-through fund exclusion in Texas Tax Code § 171.1011(g)(3). On audit, the Comptroller denied the exclusion. Titan paid the assessment and filed suit in a

Texas trial court, which ruled in favor of the Comptroller. Titan appealed to the Texas Third Court of Appeals.

Activities with a ‘reasonable nexus’ to real property construction qualify for the exclusion

The Comptroller argued before the court that a subcontractor must be engaged in construction services to qualify for the exclusion. In other words, the subcontractor’s activities must involve an actual change to the physical character of real property to qualify for the revenue exclusion.

The court disagreed, holding that the exclusion extends to services, labor, or materials that ‘have a reasonable connection to construction, remodeling, design, or repair work on real property.’ The court found that such a ‘nexus’ was established by the following facts:

- Aggregate was indispensable to the types of construction projects for which Titan claimed the exclusion.
- The service of picking up and transporting aggregate to construction sites was necessary and integral to the construction of improvements on real property.
- Aggregate had to be placed in a particular location on a construction site to be useful.
- Aggregate was deposited in a manner that saved Titan customers time, labor, and money.

Accordingly, the court found that Titan’s activities, performed through subcontractors, were sufficiently related to real property construction such that payments made to subcontractors qualified for the flow-through funds exclusion.

Comptroller-asserted requirements not necessary to qualify for exclusion

The court’s dismissal of several Comptroller arguments, including those asserted at lower levels, clarifies the following regarding the flow-through fund exclusion:

- The exclusion is not strictly limited to construction companies. The Comptroller read the statute as requiring that only taxpayers engaged in construction services (and not transportation companies) could qualify for the exclusion. The court found this interpretation to be too restrictive. As noted above, services that have a *reasonable connection* to construction may qualify for the exclusion. Subcontractors do not need to cause a material or physical change to property.
- A taxpayer does not need to have a direct contract with customers requiring the subcontracting of certain services. In this case, Titan had written contracts with only its subcontractors. A direct contract with customers is not required by statute.
- Payments do not need to flow directly from customer to taxpayer to subcontractor. The Comptroller asserted a ‘segregate, wait, and trace’ position such that, to qualify as *flow through funds*, Titan would have to receive payment first and then pay its subcontractors only when it has the money in hand. In this case, Titan’s accrual method of accounting resulted in Titan paying subcontractors before it received payments from its customers. The statute does not require subcontractors to be paid only the actual dollars taxpayers receive.

One argument advanced by the Comptroller involved analogizing Titan to a ‘mere courier’ making deliveries to a construction site. The court found that this analogy failed because couriers rarely know the contents of packages nor would they be able to establish the nexus required between their delivery service and the actual/proposed design or construction of real property.

Subsequent law change

Effective January 1, 2014, statutory modifications provide that the flow-through exclusion extends to qualified contracts and *subcontracts*. The court recognized that the law was enacted to clarify that the revenue exclusion applies even in the absence of a prime contract explicitly requiring a contractor to use subcontractors. Legislative history provides that the law change was proposed because the Comptroller’s interpretation was inconsistent with the practices of the industry.

Also effective January 1, 2014, the exclusion is extended to taxable entities ‘primarily engaged in the business of transporting aggregates.’ This exclusion allows such entities to exclude certain subcontracting payments. The court noted that the law was enacted so that aggregate transporters were not paying franchise taxes based on artificially inflated revenue amounts.

The court addressed these law changes in a footnote and does not directly comment on their impact to the court’s decision. The opinion suggests that the concepts in the law changes were indeed ‘clarifications’ that may be applied in years prior to the law’s January 1, 2014 effective date.

Cost of goods sold argument not reached by the court

Titan advanced an alternative argument that its subcontractor payments qualified as deductible costs of goods sold because they were costs relating to labor and materials furnished to real property construction and improvement projects. Because the court ruled in Titan's favor regarding the flow-through funds exclusion, the court did not address the merits of the cost of goods sold argument.

The takeaway

The court's decision strikes a decisive blow to the Comptroller's general

principle that the revenue exclusion was limited solely to taxpayers engaged directly in construction activities. The Comptroller has historically asserted a narrow application of the flow-through funds exclusion, which was not consistent with the statute's plain meaning. The court went to great lengths to analyze the code construction and legislative intent underlying the revenue exclusion. The court was also guided (several times) in its opinion by the principle that the 'manifest purpose' of the flow-through funds exclusion is to except from taxation 'gross receipts that do not constitute actual gain or income to the taxpayer.'

Taxpayers engaged in subcontracted activities may not be categorically excluded from the flow-through exclusion simply because they are not engaged in construction. Taxpayers subcontracting services similar to those provided by Titan should review whether their services have a reasonable connection to construction, remodeling, design, or repair work on real property consistent with the *Titan* opinion such that they may qualify for the flow-through funds exclusion.

Let's talk

If you have any questions regarding how the *Titan* decision impacts your business, please contact:

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