

Texas Appellate Court - Combined group COGS may include expenses from a member engaged in providing services

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In brief

Under Texas Margin Tax provisions, a combined group's cost of goods sold (COGS) deduction may include expenses from a member that cannot independently claim a COGS deduction. The Comptroller has taken the narrow view that each unitary group member is viewed in isolation when determining COGS expenses that may be included in the combined group's COGS deduction. Texas taxpayers that have determined certain subsidiaries in a unitary group did not qualify for a COGS deduction should review their COGS computation to determine whether refund claims may be filed consistent with the reasoning in this opinion. [*Combs v. Newpark Resources, Inc.*, Texas App. Ct, 3rd Dist. No. 03-12-00515-CV (12/31/13)]

We expect the Texas Comptroller to appeal to the Texas Supreme Court. Review by the Texas Supreme Court is discretionary and is initiated by filing a Petition for Review.

In detail

Facts

For the 2008 and 2009 report years at issue, Newpark Resources, Inc. was an integrated oilfield services company. Newpark's primary business activity was the manufacture, sale, injection, and removal of 'drilling mud,' which is a product injected into a well hole as it is being drilled to facilitate the removal of waste material from the hole. Newpark used several subsidiaries for its various drilling mud operations. One of

Newpark's subsidiaries, NES, removed and disposed of the waste material. Newpark's customers generally purchased an integrated package from Newpark, which may have included NES's removal and disposal services, rather than separately contract with each subsidiary.

For the report years at issue, Newpark filed as a member of a combined group that included NES. Newpark elected to take the COGS deduction on such reports and included in its deduction NES's expenses. On

audit, the Comptroller denied the reporting group's deduction of NES's expenses, finding that NES was a service company not entitled to a COGS deduction. A trial court ruled in favor of Newpark and the Comptroller appealed to the appellate court.

Each member's COGS deduction must be determined by considering its expenses in the context of the group's overall business

The Comptroller argued that NES's expenses could not be included in Newpark's overall COGS deduction because a

company may only take a COGS deduction if it sells goods and NES provided only services – it did not sell any goods for which it could independently claim a COGS deduction.

The appellate court disagreed, determining that NES's expenses should be considered in the context of Newpark's overall sales and not in isolation. The court provided three main reasons for its conclusion:

- Texas law provides that a group calculates its COGS by “determining the cost of goods sold for each of its members . . . as if the member were an individual taxable entity.” The court viewed this provision as a ‘procedural tool’ and not a substantive limitation requiring each member’s business activity to be viewed in isolation from the combined group.
- Another provision of the Margin Tax states that a “member of a combined group may claim as cost of goods sold those costs . . . owned by another member of the combined group.” The court found that this allows a member that does not sell goods itself to deduct expenses it incurs to sell goods owned by another group member. The court reasoned that it would be inconsistent to treat individual members as isolated entities, but nevertheless allow them to deduct costs for selling another member’s goods.
- Texas law provides that “a combined group is a single taxable entity for purposes of the application of the [franchise tax].” Affiliated entities engaged in a unitary business file a single tax report for the combined group. All members of the group must take

the same general deduction. The court determined the requirement that a combined group choose a general deduction “for all its members” supports the conclusion that the Margin Tax is intended to apply to all members of the group as if they were a single taxpayer.

In this case, NES’s operations were not isolated; rather, they were part of the overall business provided by Newpark. Therefore, NES’s COGS expenses, as determined in the context of the combined group’s overall business operations, could be included in the group’s COGS calculation.

Drilling site waste removal and disposal expenses qualify as COGS

The Comptroller argued that NES could not claim a COGS deduction because qualified COGS expenses related to real property improvements must derive from ‘labor.’ The Comptroller asserted that NES provided ‘services’ rather than ‘labor.’

The court disagreed, concluding first that a party that supplies labor to the construction, improvement, remodeling, repair, or maintenance of real property can deduct qualified labor expenses as COGS. As applied to NES, the court found that ‘labor’ is to be interpreted broadly and that NES’s transport and disposal of used drilling mud and other waste material is part of the ‘labor’ involved in the drilling process. Accordingly, NES’s disposal of waste material was an essential and direct component of the drilling process and therefore its related expenses should be deductible as COGS for the improvement of real property.

Flow through exclusion not resolved

The Margin Tax allows taxpayers to exclude from total revenue all “flow-through funds that are mandated by contract to be distributed to” subcontractors that “provide services, labor, or materials in connection with” various improvements to real property.

At the trial court, Newpark advanced an alternative argument that it was entitled to exclude NES’s payments made to subcontractors for hauling waste material. Because the appellate court affirmed the trial court’s decision on the COGS matter, Newpark’s alternative argument was not resolved by the appellate court.

The takeaway

The Comptroller has taken the narrow view that each unitary group member is viewed in isolation when determining whether a member’s COGS expenses may be included in the overall group’s COGS deduction. This appellate court decision is a taxpayer victory. Texas taxpayers filing as a unitary group that takes the COGS deduction should review their COGS computation to determine whether refund claims may be filed consistent with the reasoning in this opinion, pending the result of the Comptroller’s likely appeal to the Texas Supreme Court. Taxpayers taking the compensation or 30% deduction should also consider the potential for similar refund claims reflecting the COGS deduction.

The court’s refusal to address the flow-through exclusion is disappointing for taxpayers expecting resolution in this area. Since the court resolved NES’s matter on the COGS issue, taxpayers are left operating under continuing ambiguities regarding similar flow-through funds.

Let's talk

For a deeper discussion of how this issue might affect your business, please contact:

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